

TEXAS DEPARTMENT OF HOUSING AND COMMUNITY AFFAIRS
An Internal Audit of the Loan Servicing Division
Audit Report # 19-001

Executive Summary

The Office of Internal Audit (OIA) reviewed TDHCA's Loan Servicing division and its policies, procedures, and controls that are currently in place. Based on our reviews and testing the Loan Servicing division provides good service to TDHCA. Various procedures and controls should be strengthened, as described in the detailed report.

Findings and Recommendations

- The division should consider establishing task specific Standard Operating Procedures (SOPs) to improve efficiency and consistency within the division
- Loan Servicing should establish processes, procedures, and guidelines to collect all required monthly reports, and to ensure that appropriate actions are taken based on the results of the reports.
- Loan Servicing should establish and enforce a deadline for all Habitats to have the new 2018 LSAs signed and returned to TDHCA
- Loan Servicing should ensure that all loans are being serviced by Habitats that are under a valid LSA with TDHCA
- The division should establish processes that would ensure completed annual verification of Primary Residency on forgivable loans and proper documentation of the outcome of the review.
- The division should consider establishing specific methods, such as "Random Sample Generators", to select loan samples for testing and verification.
- The OIA recommends that division consider establishing processes that could provide verification on Primary Residency for repayable loans as well as forgivable loans.
- TDHCA should establish policies and procedures to ensure coverage for un-insured properties to protect its financial interest in the property.

Response:

Management agreed with our recommendations, and detailed responses are included in the body of the audit report.

Responsible Area:

Director of Program Controls and Oversight, and Loan Servicing Manager

Objective, Scope and Methodology

Our scope included a review of the Texas Government Code, applicable rules and regulations for each loan and grant type, as well as the division's policies, processes, and procedures. Based upon our preliminary understanding of the Loan Servicing division we identified critical points and risk, to develop audit objectives and an audit program including methodology. The Texas Internal Auditing Act, Tex. Gov't Code §2102.005 requires testing of the controls of a state agency's major programs and systems, and the controls related to them.



Mark Scott, CPA, CIA, CISA, CFE, MBA
Director, Internal Audit

11/28/2018
Date Signed



TEXAS DEPARTMENT OF HOUSING AND COMMUNITY AFFAIRS

www.tdhca.state.tx.us

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October 28, 2018

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Board Members of the Texas Department of Housing and Community Affairs ("TDHCA")

RE: REVIEW OF THE LOAN SERVICING DIVISION

Dear Board Members:

This report presents the results of the Office of Internal Audit ("OIA") "*Review of the Loan Servicing Division*". This audit was conducted in accordance with applicable audit standards. It included the objectives to evaluate and explain the *Loan Servicing Division* and to evaluate the administrative and internal control procedures related to the program.

The Loan Servicing division audit was identified during the 2018 Fiscal Year risk assessment and was included in the FY 2018 Annual Audit Plan. Loan Servicing division rated high on the risk assessment due to the complexity of transactions for various loan programs and various grant requirements.

This report includes the following sections:

- A. Background
- B. Scope and Methodology
- C. Standard Operating Procedures (SOPs)
- D. Submission of monthly reports by Habitats for Humanities
- E. Loan Servicing Agreement
- F. Primary Residency
- G. Escrow Accounts



A) BACKGROUND

The Loan Servicing's primary mission is to provide support to the Texas Department of Housing and Community Affairs (TDHCA) and its mission by providing customer service to moderate and low income Texans who are served through affordable single family homeownership and affordable rental housing. Loan Servicing provides quality customer service to the TDHCA's borrowers and performs the day to day servicing of all loans in accordance with applicable state and federal laws and regulations

The Loan Servicing division provides support and servicing functions for multifamily loans, single family new construction and rehabilitation loans, and junior lien down payment and closing cost assistance loans through partnering with Habitat for Humanity (Habitats). Habitats are nonprofit housing organizations that provide a variety of housing assistance and services throughout many communities.

B) Scope and Methodology

Our scope included a review of the Texas Government Code, applicable rules and regulations for each loan and grant type, as well as the division's policies, processes, and procedures. Based upon our preliminary understanding of the Loan Servicing we identified critical points and risk, to develop audit objectives and an audit program including methodology.

We reviewed the Loan Servicing division's goals, processes, and roles and responsibilities. We reviewed the controls related to the program and tested certain transactions and controls. The Texas Internal Auditing Act, TGC Sec. 2102.005 requires testing of the controls of a state agency's major programs and systems, and the controls related to them.

C) Standard Operating Procedures (SOP)

An SOP is a procedure specific to the operation of a division that describes the activities necessary to complete tasks in accordance with applicable rules and regulation. It defines expected practices in a process where quality standards exist. SOPs play an important role in any organization and division as they're policies, procedures and standards needed to operate in a successful way. They can create efficiencies, consistency and reliability, fewer errors, and value added to the division.

As of the beginning date of this review the Loan Servicing did not have formal SOPs for different aspects and responsibilities of the division. The staff appears to be relying on instructional materials instead which in some cases are outdated and inaccurate.

Finding Item Number	Status Pertaining to the Recommendations and Action to be Taken	Target Completion Date	Responsible Party
19-001.01	The division should consider establishing task specific Standard Operating Procedure to improve efficiency and consistency within the division	02/28/19	S. D'Couto G. Garcia

Management Response:

Management agrees to formalize all SOPs identifying roles and responsibilities, and, while many SOPs are regularly updated, management also agrees to implement a schedule and tracking system to ensure that all SOPs are reviewed at least annually to maintain accuracy and consistency with the process.

D) Submission of monthly reports from Habitats

The Loan Servicing Agreement between TDHCA and the Habitats require the Habitats to submit the following reports on monthly basis:

SECTION 2,

(f) Servicer shall furnish the Department with monthly reports in the format provided by the Department, showing collections, prepayments and reconciliation's of all Loans subject to the Agreements;

(g) Servicer shall furnish the Department with monthly reports in a form satisfactory to the Department showing delinquencies and collection and workout efforts of all Loans subject to this Agreement;

Loan Servicing receives a reconciliation report from each Habitat along with payment (s) for all the loans that they're servicing. This is a monthly report and is due by 5th of each month. The staff then performs reconciliation between the report and payment amount received from the Habitat, and the TDHCA record. Our review found that in several cases the reconciliation report received from the Habitat did not match the record at TDHCA. Current procedure is for staff to communicate the discrepancy to the Habitat through emails. Loan Servicing does not have SOPs in place for further tracking and resolving of issues that are identified in the report. Loan Servicing division also does not require Habitats to submit a separate monthly report showing delinquencies and collection and workout efforts. The staff relies on the information that is included within other report.

Finding Item Number	Status Pertaining to the Recommendations and Action to be Taken	Target Completion Date	Responsible Party
19-001.02	Loan Servicing should establish processes, procedures, and guidelines to collect all required monthly reports, and to ensure that appropriate actions are taken based on the results of the reports.	01/31/19	S. D' Couto G. Garcia

Management Response:

The Habitats service approximately 1300 loans at no charge. Of the loans serviced, 10 loans are 30 days delinquent; 6 are 60 days delinquent and 4 are 90 days delinquent equaling a delinquency rate of approximately 1.54%. Generally, reporting would not be required for 30 days delinquent loans, leaving 10 loans requiring reporting. In an effort to achieve consistent and easy reporting, Loan Servicing staff implemented a single report method to assist the Habitat Servicer with monthly reporting of balances, payment remittance detail and provide a space for reporting delinquency workout efforts. Management agrees to implement follow-up procedures to ensure that any variances between the TDHCA and Servicer balances are properly communicated and resolved timely, and that the Servicers provide delinquency workout updates until the loan is brought current.

E) Loan Servicing Agreements

Loan Servicing Agreement (LSA) is a written legal document stating the expectations of both parties, and how different situations will be resolved in case of non-compliance with the stated terms and conditions. Apart from making the agreement between two parties legally binding, it can also serve for future references and serve as proof in the event of misunderstandings, complaints or disputes.

In reviewing Loan Servicing Agreements between TDHCA and Habitats who serve as the servicer for agency's outstanding loans, we noted that the division has updated and revised its LSA in 2018. The division has provided the new LSA to all active Habitats to sign and return to TDHCA. As of start of this review only nine Habitats had returned a signed LSA to TDHCA. The remaining Habitats are operating under the old LSA which are mainly dated 2013. Two of the Habitats are operating under old LSAs dated 2001 and 2007, and in one instant the Habitat doesn't have an LSA on file with TDHCA.

Finding Item Number	Status Pertaining to the Recommendations and Action to be Taken	Target Completion Date	Responsible Party
19-001.03a	Loan Servicing should establish and enforce a deadline for all Habitats to have the new 2018 LSAs signed and returned to TDHCA	01/31/19	S. D'Couto
19-001.03b	Loan Servicing should ensure that all loans are being serviced by Habitats that are under a valid LSA with TDHCA	01/31/19	S. D'Couto

Management Response:

Loan Servicing Agreements do not have an expiration date; the term of the LSA remains in effect until all loans under the servicing agreement are satisfied. The updated LSA was sent to 27 Servicers at the end of July and 16 LSAs have since been returned and, management is in communication with 2 Servicers with questions. Loan Servicing staff continues to conduct follow-up communications with Servicers to ensure the return of all LSAs unless the Servicer submits formal communication to terminate the servicing relationship. Management will ensure that a deadline is communicated if/when the LSA is updated in the future.

F) Primary Residency

Texas Administrative Code (TAC) Chapter 20, Rule§20.13 (m) states:

Loans are only permitted for potential borrowers who will occupy the property as their Principal Residence. The property must be occupied by the potential borrower within the later of 60 days after closing or completion of the final draw of Department funds for rehabilitation or reconstruction and remain their Principal Residence as defined in the Mortgage Loan documents or in the case of Forgivable Loans, until the forgiveness period has concluded in accordance with the Mortgage documents.

The Loan Servicing division selects a sample of 10% of the total Forgivable loans each year to perform verification of borrower's Primary Residency. The Forgivable loans are HOME HBA (Homebuyers Assistance loans), HOME OCC (Owner Occupied loans), and HOME CFD (Contract for Deed loans). The 10% sample is proportionally divided among the three types of Forgivable loans. The review utilizes

various County Appraisal District (CAD) records and comparing them to borrowers' information on record at TDHCA. When available, searches of owner information of online CAD records will be conducted. Otherwise, requests will be made to the appraisal district for owner information.

It appears that the Loan Servicing division did not perform an annual verification of Primary Residency in 2015 and 2016. A review of 83 loans (10% of total loans) was performed by the staff in 2017. However, it doesn't appear that the review was completed and the appropriate actions were taken as the result of the review. The staff was also unable to provide the method that was used in selecting the sampled loans.

Finding Item Number	Status Pertaining to the Recommendations and Action to be Taken	Target Completion Date	Responsible Party
19-001.04 a	The division should establish processes that would ensure completed annual verification of Primary Residency on forgivable loans and proper documentations of the outcome of the review.	01/31/19	S. D'Couto
19-001.04 b	The division should consider establishing specific methods, such as "Random Sample Generators", to select loan samples for testing and verification.	01/31/19	S. D'Couto
19-001.04c	The OIA recommends that division consider establishing processes that could provide verification on Primary Residency for repayable loans as well as Forgivable loans.	02/28/19	S. D'Couto H. Cabello

Management Response:

Management will update the Primary Residency procedure to include confirmation to management by the responsible Loan Servicing staff that the process has been completed and noted instances of non-compliance have been documented and communicated to the borrower. Previous loan samples were randomly selected by staff from the list of loans produced by the query. Management further agrees to update the procedure to include a "Random Sample Generator" tool.

Management will meet with internal division stakeholders and evaluate extending the primary residency review to include repayable loans.

G) Escrow Account

Texas Administrative Code (TAC) Chapter 20, Rule§20.13 (k) requires an escrow account to be established if TDHCA holds a first lien Mortgage Loan which is due and payable on a monthly basis to TDHCA. If an escrow account held by TDHCA is required then the borrower must contribute monthly payments to cover the anticipated costs of real estate taxes, hazard and flood insurance premiums, and other related costs as applicable calculated by TDHCA.

Rule§20.13(k)(2)(G);

The Department will establish and administer the escrow account in accordance with the Real Estate Settlement and Procedures Act of 1974 (RESPA) under 12 U.S.C.§2601 and its implementing regulations at 12 CFR §1024 (Regulation X), as applicable

TDHCA maintains an escrow account for the payments of real estate taxes and homeowners' insurance premiums. The account is set up as a general pool for all Bootstrap program loans, and not for each individual borrower separately. All of the escrow payments that are received from borrowers are deposited in to the account, and individual real estate taxes and insurance premiums are paid from this account.

It appears that in some situations borrower's real estate taxes and homeowners insurance premiums are paid despite borrower's delinquency on payments and lack of sufficient escrow balance on individual level. If the funds in the general escrow account for the program is depleted the program will continue payments of taxes and insurance premiums through general funds. The payments are generally processed as temporary transfers from Bond Program Administration (BP Admin) account. The general administrative account is from residual funds and is considered unrestricted. Once the portfolio regenerates its cash balance the funds are transferred back to BP Admin account. The average time between the two transfers is approximately 6 months. This is considered a tool in protecting agency's position as first lien holder of the property.

The borrower has the right to cancel and discontinue their homeowner's insurance, or in some cases can become ineligible for insurance coverage of their property. If a property is not covered under homeowner's insurance due to ineligibility or borrower's choice, the Loan Servicing Division contacts the borrower in an attempt to re-establish homeowner insurance coverage for the property. However, TDHCA does not have any policy in place to mandate insurance coverage for the property, such as lender-placed insurance. We've noted that since 2017 there are nine loans that are not protected under homeowner's insurance.

Finding Item Number	Status Pertaining to the Recommendations and Action to be Taken	Target Completion Date	Responsible Party
19-001.05	TDHCA should establish policies and procedures to ensure coverage for un-insured properties to protect its financial interest in the property.	2/28/19	S. D'Couto H. Cabello

Management Response:

Record of individual escrow account balances are maintained at the loan level in the MITAS software. Although less frequent than in past years, when a loan becomes delinquent the escrow account balance may fall short of the amount to be disbursed and the Department covers the shortage until the shortage is reimbursed when the borrower's delinquency is cured.

Approximately 500 property insurance policies are tracked and maintained on 438 loan accounts. Loan Servicing became aware of 4 of the 9 un-insured properties through its insurance renewal process in 2018. In relation to the number of loan accounts, the rate of uninsured loans is approximately 2% of the population. In addition to other detractors, Lender force-placed insurance is generally expensive and a cost that is passed on to the borrower that tends to already have very limited financial means. Management recognizes the risk and will review the procedures in place to ensure that remedies within the control of Loan Servicing staff are fully employed to get insurance coverage replaced, as well as, conduct outreach to State Office of Risk Management for input on uninsured property coverage options and vendors offering lender force-placed insurance coverage to determine possible option(s) available to mitigate risk.

OIA extends our sincere appreciation to management and staff of the Loan Servicing division for their cooperation and assistance during the course of this audit.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark Scott". The signature is fluid and cursive, with the first name "Mark" being more prominent than the last name "Scott".

Mark Scott, CPA, CIA, CISA, CFE, MBA
Internal Audit Director

MS/NS