AUDIT REPORT

FIRST FUNDING, INCORPORATED

A NON-SUPERVISED LOAN CORRESPONDENT

LARGO, MD

2004-PH-1009

JUNE 29, 2004

OFFICE OF AUDIT, MID-ATLANTIC
PHILADELPHIA, PA

Issue Date June 29, 2004	
Audit Case Number 2004-PH-1009	

audit report

TO: John C. Weicher, Assistant Secretary for Housing - Federal Housing Commissioner, H

Daniel G. Temme

FROM: Daniel G. Temme, Regional Inspector General for Audit, Mid-Atlantic, 3AGA

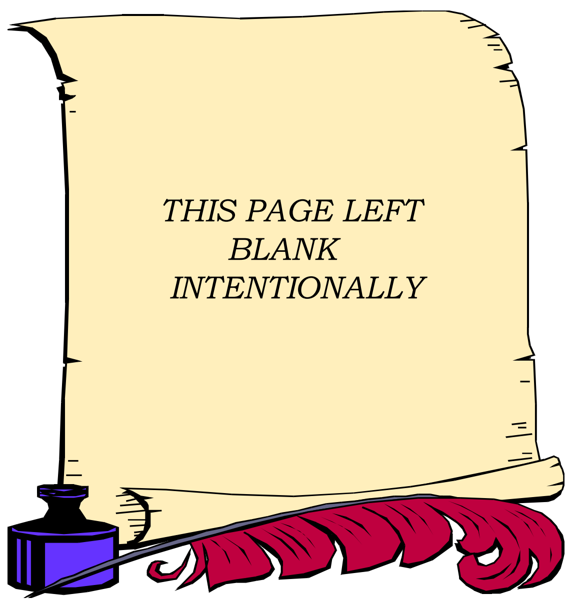
SUBJECT: First Funding, Incorporated, a Non-Supervised Loan Correspondent
Largo, Maryland

We completed an audit of First Funding, Incorporated. We selected First Funding, Incorporated for review because of their high default rates. The objectives of our audit were to determine whether First Funding, Incorporated: 1) implemented its quality control plan according to HUD regulations; and 2) complied with HUD regulations, procedures, and instructions in the origination of FHA-insured loans selected for review.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide us, for each recommendation without a management decision, a status report on: the corrective action taken; the proposed corrective action and the date to be completed; or why action is considered unnecessary. Additional status reports are required at 90 days and 110 days after report issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

We appreciate the courtesies and assistance extended by the management and staff of First Funding, Incorporated and the HUD Philadelphia Homeownership Center.

Should you or your staff have any questions, please contact Ms. Christine Begola, Assistant Regional Inspector General for Audit, at (410) 962-2520.


THIS PAGE LEFT
BLANK
INTENTIONALLY

Executive Summary

We completed an audit of First Funding, Incorporated (First Funding), an FHA-approved, non-supervised loan correspondent whose office is located in Largo, Maryland. The objectives of our audit were to determine whether First Funding developed and implemented its quality control plan according to HUD regulations; and complied with HUD regulations, procedures, and instructions in the origination of FHA-insured loans selected for review. This included determining whether First Funding exercised due diligence in originating its loans.

First Funding had not adequately developed and implemented a quality control plan that meets HUD regulations. Furthermore, First Funding's office operations did not comply with HUD-FHA approval requirements. In addition, First Funding did not exercise due diligence in their loan origination process. The results of our audit are summarized below and detailed in the Findings Section of this report.

First Funding's Quality Control Process Was Not Adequate

First Funding did not adequately develop and implement a quality control plan that fully meets HUD requirements as outlined in HUD Handbook 4060.1 REV-1, Chapter 6. First Funding also did not conduct required quality control reviews. Specifically, First Funding did not meet its 10 percent sample requirement for quality control reviews for three months, review loans defaulting within the first six months, or review 10 percent of the rejected loans. Consequently, First Funding's quality control reports were incomplete and of marginal value in improving loan origination performance. Furthermore, the staff assigned to quality control was not knowledgeable of HUD requirements.

Office Operations Did Not Comply With HUD-FHA Requirements

First Funding did not administer its loan correspondent office operations in conformity with HUD-FHA approval requirements. Specifically, First Funding did not: exercise control and responsible management supervision over their employees; require exclusivity of their employees; and maintain office space that is apart from any other entity. Because of these compliance deficiencies, First Funding's eligibility as a HUD-FHA approved mortgagee is questionable. The operational deficiencies stem from First Funding's disregard and/or lack of knowledge of HUD-FHA approval requirements.

First Funding Did Not Exercise Due Diligence In Originating Its Loans

Our audit of loan origination activities disclosed that First Funding did not always originate FHA-insured loans in accordance with HUD requirements. For example, First Funding did not exercise due diligence in the review of the borrower's liabilities and credit characteristics or verify a borrowers source of funds. In addition, they charged the borrower fees that were unjustified. Consequently, mortgage loans of questionable eligibility were approved for FHA insurance, and borrowers may have incurred unwarranted costs. These deficiencies contributed to an increased risk to the FHA insurance fund.

Recommendations

We recommend that HUD take appropriate steps to ensure First Funding takes immediate action to implement a quality control plan that meets all HUD requirements. We also recommend that HUD require First Funding to take immediate action to correct its ongoing operational deficiencies that do not comply with HUD-FHA loan correspondent approval requirements. Further, HUD should consider taking appropriate administrative action against First Funding for its continual failure to comply with HUD requirements.

Auditee Comments

We provided our initial draft of this report to First Funding on April 20, 2004. We discussed the findings and recommendations with First Funding at an exit conference on May 6, 2004. First Funding provided written comments to the draft on May 18, 2004. First Funding's response consisted of a five page letter and a copy of the Quality Control Plan.

Generally, First Funding concurred with our findings and recommendations. However, they disagreed with our findings concerning FHA Case Binder 249-4485090 and the use of child support payments in calculating the debt to income ratio. The complete text of the letter is included in Appendix E. The Quality Control Plan is not included and is available upon request.

Table of Contents

Introduction

HUD insures mortgages made by private lending institutions under Section 203 of the National Housing Act. HUD designates these institutions as supervised mortgagees, non-supervised mortgagees, loan correspondents, investing mortgagees, and government institutions. Depending upon their designation, the institutions have the authority to originate, purchase, hold, service, or sell FHA-insured mortgages. Specifically, a loan correspondent can only originate loans for an approved sponsor.

First Funding, Incorporated was incorporated on August 13, 1997 under the laws of the state of Maryland. First Funding received approval from HUD as a Title II non-supervised loan correspondent on February 11, 1998. First Funding's office is located at 1101 Mercantile Lane, Suite 201, Largo, Maryland 20774.

As a non-supervised loan correspondent, First Funding's principal activity is the origination of mortgages for sale or transfer to an approved FHA sponsor under the HUD Single Family Direct Endorsement Program. The sponsor is responsible to HUD for the actions of its loan correspondent in originating insured mortgages. The sponsor underwrites the loans originated by the loan correspondent and is required to supervise and perform quality control reviews of its loan correspondents. The sponsor must be an approved mortgagee that is also authorized to participate in the HUD Single Family Direct Endorsement Program.

From August 1, 2001 through July 31, 2003, First Funding originated 228 loans with a total mortgage amount of $35,421,841. As of September 11, 2003, 15 of these loans (7 percent) have gone into default status at least once. As of January 30, 2004, mortgagees initiated foreclosure action on 10 of the 15 defaulting loans at least once during the life of the loan (see Appendix D). HUD paid loss mitigation claims on three of the ten loans in foreclosure status with net losses to HUD of $2,050, and paid a partial claim of $11,308 in loss mitigation costs on an additional loan in which foreclosure had not been initiated.

HUD's Quality Assurance Division performed a Title II monitoring review of First Funding in February 2000 and July 2001. The results of the Quality Assurance Division's reviews detailed in the findings letters to First Funding and its sponsors are briefly discussed below.

The February 2000 findings letter, prepared by the Quality Assurance Division, disclosed that First Funding failed to implement a quality control plan, failed to have office space that is separate and apart from any other entity, and had deficiencies in their loan origination files such as false documentation and inadequate sources of funds. The findings letter from the July 2001 review disclosed that loan files originated by two particular loan officers contained falsified documentation as well as instances of inadequacy of the source of funds. First Funding terminated the previously mentioned loan officers' employment subsequent to the Quality Assurance Division's review.

Audit Objectives

The audit objectives were to determine whether First Funding complied with HUD regulations, procedures, and instructions in the origination of FHA-insured loans selected for review; and to determine whether First Funding's quality control plan was developed and implemented according to HUD regulations.

Audit Scope And Methodology

To accomplish the audit objectives, we:

- Reviewed 100 percent of the FHA-insured loans (15 case files) originated by First Funding that had gone into default at least once as of September 11, 2003. The 15 loans reviewed were from the universe of 228 loans originated by First Funding with beginning amortization dates for the two-year period from August 1, 2001 to July 31, 2003. The results of the detailed testing apply only to the 15 FHA-insured loans selected and cannot be projected to the universe of 228 FHA-insured loans.

- Examined records and related documents of First Funding.

- Reviewed applicable HUD records relating to First Funding's non-supervised loan correspondent activities.

- Conducted interviews with officials and employees of First Funding and the HUD Quality Assurance Division.

In addition, we relied in part on data maintained by HUD in the Single Family Data Warehouse and Neighborhood Watch. We did not perform a detailed analysis of the reliability of HUD's Single Family Data Warehouse or Neighborhood Watch data.

The audit generally covered the period of August 1, 2001 through July 31, 2003. This period was expanded to include the most current data while performing our audit. Therefore, where applicable, the audit period was expanded to include current data through January 30, 2004. We conducted our fieldwork from October 2003 through March 2004.

Our audit was conducted in accordance with Generally Accepted Government Auditing Standards.

First Funding, Incorporated's Quality Control Process Continues to Be Inadequate

First Funding, Incorporated's quality control process over its origination of insured mortgages was deficient in a number of activities. Specifically, First Funding's quality control plan did not contain all of the specific elements as outlined in HUD Handbook 4060.1 REV-1, Chapter 6. In implementing its plan First Funding did not meet its 10 percent sample requirement for quality control reviews for three months, review loans defaulting within the first six months, or review 10 percent of rejected loans. Further, the quality control reports they prepared were incomplete because they did not contain all of the required elements. The individual who performed the quality control reviews was not knowledgeable of the requirements that should take place during the quality control review. The deficiencies associated with First Funding's quality control plan and procedures stem from their lack of knowledge of HUD's and their own quality control requirements. Therefore, First Funding is unable to guarantee the accuracy, validity, and completeness of its loan origination operations.

First Funding's Quality Control Plan Did Not Meet HUD Requirements

As a condition of the HUD-FHA approval process, loan correspondents must have and maintain a quality control plan for the origination and servicing of insured mortgages. HUD Handbook 4060.1 REV-1, Chapter 6, provides the general requirements along with mortgagee type specific requirements for quality control plans. The primary objective of a quality control plan is to assure compliance with HUD-FHA requirements.

During a review conducted by the Philadelphia Homeownership Center in 2000, First Funding was informed that their quality control plan did not contain all of the specific elements as outlined in HUD Handbook 4060.1 REV-1, Chapter 6. HUD instructed First Funding to make sure it updated its plan to include all the required elements that pertain to loan correspondents.

Although we found that First Funding completed some of the necessary changes, their quality control plan continues not to meet HUD requirements. Specifically, First Funding's quality control plan did not include:

- Procedures to identify and review all loans that go into default within six months of closing.

- Written notification to senior management if deficiencies were noted.

- Documentation of actions taken by management, including identifying the cause of the deficiencies and initiating prompt action to notify employees and correct the deficiencies.

- Expansion of the scope of quality control reviews if fraudulent activity or patterns of deficiencies were identified.

- Procedures to keep its personnel informed of the changes; and assure that employees are held accountable for performance failures or errors.

- Procedures to ensure that employees are knowledgeable of and adhere to HUD-FHA requirements and the mortgagee's policies and standards.

The lack of an adequate quality control plan prevented First Funding from evaluating the accuracy, validity, and completeness of its loan origination operations. Therefore, First Funding did not identify and correct potential deficiencies in the loan origination process.

Ten Percent Sampling Requirement Was Not Met

HUD Handbook 4060.1 REV-1, paragraphs 6-1, General, and 6-3, General Quality Control Plan Requirements for Loan Origination, state that quality control reviews are to be performed within 90 days of the loan closing. The mortgagee is required to review either: the lesser of 10 percent of all loans closed on a monthly basis, or a random sample that provides a 95 percent confidence level with 2 percent precision.

We found First Funding did not follow their own requirements for performing quality control reviews of 10 percent of monthly loans for August 2001, April 2002, and November 2002. All other monthly loans were reviewed as required. However, one of the loans that closed in August 2002 was not reviewed until September 2003, which is more than a year after the loan closing date and therefore is outside of the HUD required 90-day review period.

The failure to meet the sampling requirements in reviewing the loans prevents First Funding from evaluating the accuracy, validity, and completeness of its loan origination operations.

Required Reviews Were Not Completed On Defaulted And Rejected Loans

Paragraphs 6-1, General, and 6-3, General Quality Control Plan Requirements for Loan Origination, of HUD Handbook 4060.1 REV-1, also require the mortgagee to review all loans which go into default within the first six months and review 10 percent of rejected loans. First Funding did not perform quality control reviews on loans that went into default within six or fewer payments as required, nor did they review rejected loans. We identified via Neighborhood Watch that from August 1, 2001 through July 31, 2003, 11 loans went into default with less than six months of payments being made. First Funding performed quality control reviews on two borrowers a month after the closing date, not after the loan went into default. The other nine loans did not have any quality control reviews performed on them.

First Funding was unaware of the requirement to review all loans defaulting within the first six months. They were also unaware that 10 percent of rejected loans also needed to be reviewed. The failure to complete the review of loans defaulting within the first six months and rejected loans, prevents First Funding from evaluating the accuracy, validity, and completeness of its loan origination operations.

Quality Control Reviews Were Missing Pertinent Information

From August 2001 through July 2003, First Funding performed 27 quality control reviews. We found none of the 27 reviews contained a written re-verification of the borrower's employment or deposit institution, and a new credit report was not obtained as required. Instead, First Funding re-verified the borrower's information by telephone. However, we found inconsistencies in the recorded contact dates. For example, the date the quality control reviewer contacted the borrower’s employer and deposit institution did not match the date the quality control review was performed. For some dates a significant amount of time elapsed between the contact date and the date of the quality control review.

We also noted that 15 quality control reports were missing pertinent information such as the FHA loan numbers and closing dates. In three cases, the loan numbers were incorrect. We obtained the missing information by reviewing other documents such as the Home Mortgage Disclosure Act forms, and a listing of loans originated by First Funding. We also found 8 did not have a desk review of the property appraisal done as required.

Quality Control Reviewer Was Not Adequately Trained To Perform The Reviews

Per paragraph 6-1, General, of HUD Handbook 4060.1 REV-1, the quality control plan is to provide for the independent evaluation of the significant information gathered for use in the mortgage credit decision making and loan servicing process for all loans originated or serviced. The quality control reviews are to be performed by mortgagee management/supervisory personnel who are knowledgeable and have no direct loan processing, underwriting, or servicing responsibilities.

At the time of our audit, the office manager of First Funding was performing the quality control reviews. However, the office manager was not adequately trained to carry out the quality control activities. This individual was not aware of the requirement that a written re-verification of the borrower's employment and deposit institution must be obtained, and that quality control reviews must be performed on loans that go into default in less than six months after closing, as well as loans that were rejected. The individual also explained that she did not believe that First Funding was responsible for obtaining a new credit report as part of the quality control process.

In summary, as shown by the discussions above, First Funding's quality control process did not meet HUD's requirements or its own requirements for approved non-supervised loan correspondents under the HUD Single Family Direct Endorsement Program. The HUD Quality Assurance Division identified similar deficiencies, as discussed in the finding, in First Funding's quality control process during their Title II monitoring review of First Funding in 2000.

Under HUD's Single Family Direct Endorsement Program, the mortgage loan is underwritten and closed without prior HUD review or approval. Therefore, it is imperative that First Funding implement its quality control policies and procedures in accordance with HUD's and its own requirements. Without the establishment of a proper quality control plan and procedures, First Funding is unable to ensure the accuracy, validity, and completeness of its loan origination operations.

Auditee Comments

First Funding agreed with our findings. After our audit, First Funding reviewed HUD Handbook 4060.1 REV-1, Chapter 6 to obtain a better understanding of their responsibilities. Further, First Funding hired an outside contractor to assist them in implementing a Quality Control Plan and to provide quality control reviews on a monthly basis.

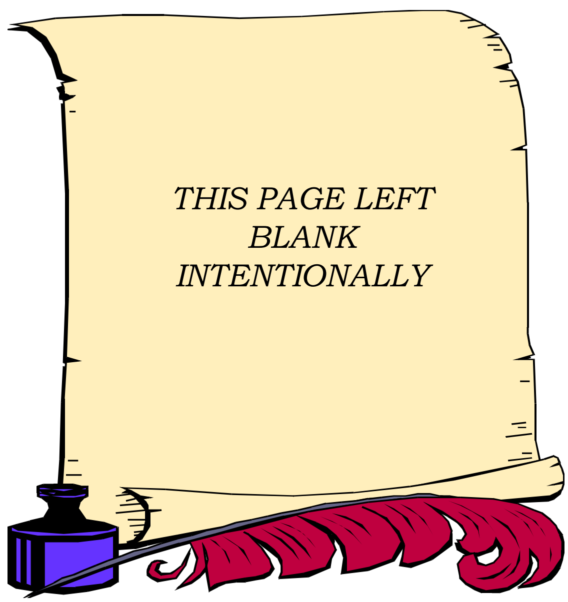
Recommendations

We recommend the Assistant Secretary for Housing-Federal Housing Commissioner:

1A. Take appropriate monitoring measures to ensure that First Funding, Incorporated makes changes to its current quality control process, which includes implementing requirements established by HUD in their existing quality control plan and conducting reviews according to HUD requirements.

1B. Require First Funding, Incorporated's senior management to fully implement the quality control plan. The controls should ensure First Funding identify and correct deficiencies in the loan origination process before it submits the loan packages to the direct endorsement sponsor.

1C. Consider taking administrative action(s) due to the continual deficiencies and noncompliance found in the quality control activities.


THIS PAGE LEFT
BLANK
INTENTIONALLY

First Funding, Incorporated's Office Operations Did Not Comply With HUD-FHA Approval Requirements

First Funding, Incorporated did not administer its non-supervised loan correspondent activities in conformity with HUD-FHA approval requirements as discussed in HUD Handbook 4060.1 REV-1. Specifically, First Funding did not exercise control and responsible management supervision over their employees or require exclusivity of their employees. Furthermore, they failed to have office space that is separate and apart from any other entity. The deficiencies associated with First Funding's responsibilities stem from their lack of knowledge of HUD-FHA mortgagee approval requirements. Therefore, First Funding's eligibility as a HUD-FHA approved mortgagee in the origination of FHA-insured loans is questionable.

Senior Management Did Not Adequately Control And Supervise Its Employees

Paragraph 2-13, Control and Supervision of Staff, of HUD Handbook 4060.1 REV-1, requires a mortgagee to exercise control and responsible management supervision over their employees. The requirement regarding control and supervision must include, at a minimum, regular and ongoing reviews of employee performance and of work performed.

First Funding's senior management did not exercise control and responsible management supervision over its employees and actively participate in the loan origination process performed by its loan officers and loan processors. Management stated the only review of a loan officer's work that takes place prior to submission to the sponsor is when the loan officer is "known to do sloppy work". In addition, senior management told us that they do quarterly verbal performance reviews of their employees but they do not document these reviews. Therefore, we were unable to support any evidence of ongoing reviews of employee performance.

Employees Of The Mortgagee Were Not Employed Exclusively

Paragraph 2-14, Conducting Mortgagee Business, of HUD Handbook 4060.1 REV-1, requires employees of the mortgagee, excluding the receptionist, whether full or part time, to be employed exclusively by the mortgagee at all times, and conduct only the business affairs of the mortgagee during normal business hours. First Funding did not require exclusivity of its employees as required by

HUD. A loan officer was allowed to originate FHA-insured loans while employed by a real estate agency as a realtor. In addition, this same loan officer was the realtor on one of the loans that we reviewed, which went into default within 6 months of closing. Furthermore, an individual that formally worked as First Funding's bookkeeper and quality control reviewer was also the settlement agent at Maryland Title and Escrow, the settlement company which shares space with them. This individual was the settlement agent on two of the loan files we selected for review. The individual was still on the payroll of First Funding when both of these loans went to settlement.

Mortgagee Shared Office Space With Another Entity

Paragraph 2-16, Office Facilities, of HUD Handbook 4060.1 REV-1, requires that a mortgagee be located in a space that is separate and apart from any other entity. However, a mortgagee may share general reception-type entrances or lobbies with another business. We found First Funding shares office space with Maryland Title and Escrow (MT&E) (Appendix B). Employees of First Funding and MT&E worked in each other's assigned area and shared the area in which the office equipment was located. Furthermore, while on site, we observed that on numerous occasions, employees of First Funding would answer the phone lines of MT&E and employees of MT&E answered the phone lines of First Funding.

Auditee Comments

Overall First Funding agreed with our finding and recommendations. First Funding acknowledged that they did not know about the various HUD rules concerning the documentation of staff supervision, exclusivity of employees, and the use of the office space. Since our audit, First Funding has attempted to implement new policies and procedures that they hope will alleviate the issues noted.

OIG Evaluation of Auditee Comments

We are encouraged by the fact that First Funding has started to implement various policies and procedures that will respond to the issues noted in this report. However, HUD will need to determine if the proposed actions are acceptable to correct the problems.

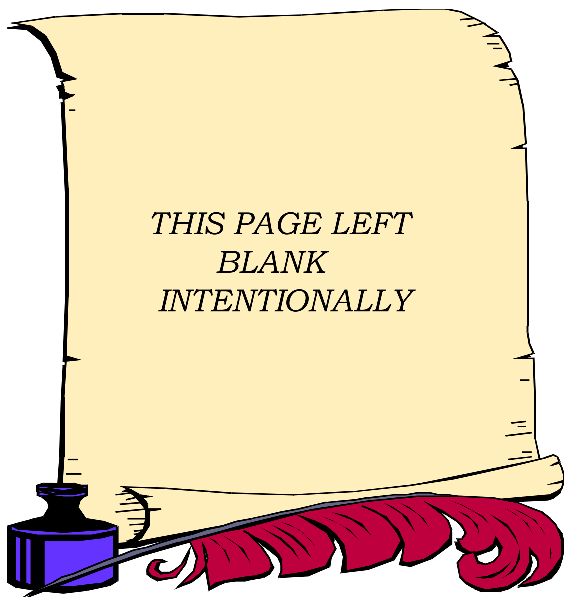
Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner:

2A. Require First Funding, Incorporated to take immediate action to correct the operational deficiencies not in compliance with HUD-FHA loan correspondent approval requirements. This would include the following:

- Exercise control and responsible management supervision by senior management over its employees,
- Require employees to be exclusive, and
- Have office space that is separate and apart from another entity.

2B. Review First Funding, Incorporated's implementation of recommendation 2A and ensure their operations comply with FHA approval requirements.


THIS PAGE LEFT
BLANK
INTENTIONALLY

First Funding, Incorporated Did Not Exercise Due Diligence Over Its Loan Origination Process

First Funding, Incorporated did not always originate FHA-insured loans in accordance with HUD requirements. For the 15 FHA-insured loans we selected for review, First Funding did not maintain complete loan origination files for any of the loans. We also found they did not exercise due diligence in the review of the borrower's liabilities and credit characteristics for two loans; charged one borrower for fees which were unjustified, and did not verify a borrower's source of funds. The deficiencies associated with First Funding's loan origination activities stem from: their lack of knowledge of HUD requirements; failure to implement their quality control process; and senior management's lack of control and responsible supervision over First Funding's employees. These deficiencies contributed to an increased risk to the FHA insurance fund.

We selected and reviewed a sample of 15 FHA-insured loans originated by First Funding[1]. Since First Funding is a loan correspondent and uses HUD-approved sponsor mortgagees to underwrite its FHA loans, we did not specifically focus on the adequacy of the loan underwriting. However, we did note a number of deficiencies related to the sponsor's underwriting that directly related to First Funding's role in the loan origination process. The deficiencies we identified in the FHA case binders and First Funding's loan origination files are discussed below.

Incomplete Loan Files

HUD Handbook 4000.2 REV-2, requires the origination mortgagee to retain the entire case file pertaining to loan origination, either in hard copy or microfilm form, for at least two years from the date of insurance endorsement for auditing purposes. Upon request, mortgagees must make legible hard copies of the material available to HUD staff.

First Funding did not maintain complete case files as required. For the 15 case files reviewed, copies of documents were missing signatures. In addition, two case files were missing bank statements, and one file did not include a gift letter.

[1] Loans with a beginning amortization date between August 1, 2001 and July 31, 2003

The absence of documentation in the case files prohibits First Funding from ensuring it documented the loan origination process properly. In addition, missing and/or incomplete documentation may impede the performance of quality control reviews.

FHA Case Binder 249-4485090

Child Support Payments Were Excluded In Calculating Debt Ratio

Per HUD Handbook 4155.1 REV-4, CHG-1, child support payments must be included as a part of the debt ratios' calculations. Further, the HUD Handbook states the mortgage payment and fixed payment to income ratios should not exceed 29 and 41 percent respectively, unless the mortgagee identifies compensating factors that could justify exceeding these ratios. However, we found the mortgagee did not include the child support payments totaling $476 when it calculated the debt ratios. The mortgagee calculated the mortgage payment to income ratio at 31 percent and the fixed payment to income ratio at 43 percent; both exceeded HUD's requirements. The mortgagee identified as a compensating factor the fact that the borrower was only going to increase rent payments by $24. Per the loan file, the borrower was currently paying rent of $1400 to his wife (with whom he lived) and the estimated mortgage payment was going to be $1424.

According to HUD Handbook 4155.1 REV-4, CHG-1, paragraphs 2-3A, the lender must determine the borrower's payment history of the housing obligations through cancelled checks covering the most recent 12-month period; thus the lender should have obtained cancelled rent checks that were made payable to the borrower's wife. We did not find any evidence of the payments in the loan file. Therefore, using the current rent payments of $1400 as a compensating factor was not justifiable.

Consequently, we recalculated the debt ratios to include the child support payments. Had the child support been appropriately included, the ratios would have been 31 percent and 53 percent respectively. We did not identify any other valid compensating factors to justify exceeding the ratios.

Mortgagee Shopped For A Lender To Obtain Loan Approval

We also noted that for this case, First Funding submitted the loan to various lenders until the loan was approved. The first lender noted that there were numerous conditions of the loan that needed to be satisfied before they could approve the loan. Specifically, the lender noted that First Funding did not include the child support payments in the calculation of the ratios. Documentation contained in the First Funding's loan origination file disclosed that once they realized this, they withdrew the loan from the first lender and submitted the loan to a second lender. The President of First Funding explained that one reason they withdrew the loan from the lender was because First Funding did not agree with all of the conditions noted by the lender.

The second lender approved the loan without including the child support payments in the calculation of the ratios. The President and a loan officer of First Funding explained that this was not of great concern to them, because it is totally upon the discretion of the lender whether or not to include the payments. Also, representatives of First Funding explained that the child support payments were going to end in less than ten months of the closing of the loan. However, according to HUD Handbook 4155.1 REV-4, CHG-1, paragraphs 2-11A, child support payments lasting less than ten months must be included in the calculation of debt to income ratios if the amount of debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing.

Based upon the facts presented above, First Funding disregarded HUD loan origination requirements in order to ensure that the loan was approved. Therefore we recommend the sponsor indemnify HUD on the original loan balance of $161,740.

FHA Case Binder 249-4328425

Borrower's Payment History Was Not Properly Verified

HUD Handbook 4155.1 REV-4, CHG-1, Previous Rental or Mortgage Payment History, states that the payment history of the borrower's housing obligation is of significant importance in evaluating credit. Thus, the lender must determine the borrower's payment history of their housing obligations, prior to the issuance of the loan. Documentation in First Funding's loan file indicated the borrower owed

$1,800 in back rent payments. The borrower was to pay this debt prior to loan settlement. However, we found no documentation from First Funding's files that showed the borrower actually satisfied the debt prior to the mortgagee issuing the loan.

FHA Case Binder 249-4110156

Justification Was Not Provided For Overages

The Tiered Pricing Rule as described in 24 CFR 202.12, and HUD Mortgagee Letters 94-16 and 94-43, allows the lender to charge overages (discount fees) and retain them; however, a lender's customary lending practices may not provide for a variation in "mortgage charge rates" (discount point, origination fee, and other such fees) exceeding two percentage points on its FHA-insured Single Family mortgages within a geographical area. Any variation within two percentage points must be based on actual variations in fees or costs to the lender to make a loan. Whenever a lender makes a variation in pricing within the two percent, the lender must provide a justification. A record of the justification must be maintained for a period of at least two years and must be made available to the secretary upon demand.

First Funding charged the borrower an overage of $6,058 in the form of a loan "discount". We also found that the sponsor paid First Funding $5,653.80 for a Yield Spread Premium. According to the Real Estate Settlement Procedures Act, a Yield Spread Premium is an indirect compensation from the lender, which may reduce the up-front costs for a borrower, but consequently increases the interest rate of the loan in order to compensate the broker. When we questioned the President of First Funding about being paid for both a discount and a Yield Spread Premium, the President informed us that the $6,058 was not an actual loan discount to reduce the interest rate. The fee was actually charged to the borrower because the President considered the loan "risky", and because there was no other place on the HUD-1 to note these fees. The President also provided us with a copy of their policy, which states that First Funding will charge two to four points above their normal fees if the loan is determined to be risky, so that it will cover their cost if a repurchase is necessary due to an early default on the loan.

We did not perform an analysis to determine if the variation in the "discount" exceeded two percentage points on First Funding's FHA-insured Single Family mortgages within the geographical area. However, even if the variation was within the required two percentage points, there was no justification in the loan file that showed the variation charged was based on actual variations in fees and costs incurred by First Funding to originate the loan. The overage charged by First Funding as a "discount" was not properly justified. Therefore, we consider it to be a violation of HUD-FHA regulations.

FHA Case Binder 249-4411035

Debt To Income Ratios Exceeded HUD Requirements

Per Handbook 4155.1 REV-4, CHG-1, the borrower's mortgage payment to effective income ratio and total fixed payment to income ratio should not exceed 29 and 41 percent, respectively, unless the mortgagee identifies compensating factors that could justify exceeding these ratios. The effective income ratio and total fixed payment to income ratios for the above mentioned loan were calculated to be 29.59 and 47.16 percent respectively.

In calculating the monthly income, the co-borrower's social security payments were "grossed-up" by the Everbank Wholesale Lending (Formerly First Alliance Bank) underwriter. Handbook 4155.1 REV-4, CHG-1, Non-taxable Income, states that if a source of regular income is not subject to federal taxes, the amount of continuing tax savings attributable to the non-taxable income source may be added to the borrower's gross income. The percentage of income that may be added may not exceed the appropriate tax rate for that income amount. We determined that the underwriter used an incorrect percentage rate to gross-up the co-borrower's income. The co-borrower received social security benefits for 2000 totaling $8,807. The tax rate for $8,807 ($733 per month) in 2000 was 15 percent, however, 25 percent was used to gross-up the income, thereby overstating the co-borrower's monthly income by $73. Using the correct income tax rate, we determined the correct income and used that amount to recalculate the ratios. When we recalculated the mortgage to income ratio it was 29.93 percent (an increase of .34 percent) and the fixed payment to income ratio became 47.72 percent (an increase of .56 percent), which exceeded HUD ratio limits.

Since the original ratios exceeded HUD requirements, the underwriter approved compensating factors. The compensating factors included the fact that the borrower had an overall good credit rating and had the ability to save. The underwriter also noted that the borrower would be receiving a four percent raise two months after settlement. However, if in fact the borrower's four percent raise was included in the calculation, the total fixed payment to income ratio would still be 46.19 percent, which is 5.19 percent above HUD requirements. Based upon our analysis, we do not believe that either the compensating factors nor the grossed-up non-taxable income justified the excessive ratios. HUD has already paid a partial claim of $11,307.68 on this loan. Furthermore, the borrower was in default as of January 30, 2004. Therefore, we recommend that the sponsor indemnify HUD for the original insured loan balance of $210,003.

In summary, the above cases illustrate that HUD assumed unnecessarily high risk when insuring the loans originated by First Funding. The deficiencies associated with First Funding's loan origination activities stem from their lack of knowledge of HUD requirements as demonstrated in the origination of loans associated with the case illustrations above. Further, as we discussed under the two previous findings, First Funding's failure to properly implement its quality control process and exercise control and supervision over its employees contributed to the problems we identified in its loan origination process.

Since First Funding did not carry out its loan origination activities in accordance with HUD requirements we recommend the sponsor indemnify HUD on FHA Case Numbers 249-4485090 and 249-4411035. We also recommend that the eligibility of the "discount" charged on FHA Case Number 249-4110156 be determined and reimbursed if found unsupported. Additionally, HUD should consider taking other administrative action(s) as deemed appropriate for the deficiencies noted in the report.

Auditee Comments

First Funding agreed with our finding concerning the need to properly document and maintain the loan files. However, First Funding disagreed with our assessment of FHA Case Binder 249-4485090. Specifically First

Funding disagreed with our use of child support payments in the debt to income ratio and the compensating factor of rent and payments. First Funding believes that it was the underwriter/sponsor's responsibility to make an assessment to include the child support payment in the debt to income ratio and not First Funding's. In addition, the underwriter/sponsor accepted the compensating factor once it was verified on the credit report.

First Funding also disagreed with our assessment that it did not properly justify the overage charge. First Funding stated that it charged the fee for the seven months of work that was put in on this loan and believes it is justified.

OIG Evaluation of Auditee Comments

In the case of the FHA Case Binder 249-448090, we reviewed First Funding's concern that the underwriter/ sponsor was aware of the child support payments not included in the debt to income ratio and have adjusted our recommendation to request indemnification from the sponsor instead of First Funding. As for the overage charge, First Funding was unable to provide proper support to show that it based the variation charged on actual variations in fees and costs incurred by First Funding to originate the loan. The overage charged by First Funding as a "discount" was not properly justified; therefore, we consider it to be a violation of HUD-FHA regulations.

Recommendations

We recommend the Assistant Secretary for Housing-Federal Housing Commissioner:

3A. Determine whether First Funding, Incorporated's deficiencies in the loan origination process warrant administrative action(s).

3B. Request Indemnification from the sponsor on FHA Case Number 249-4485090, whose original loan balance was $161,740.

3C. Determine the eligibility of the $6,058 overage charged by First Funding on FHA Case Number 249-4110156. If it is determined that these fees remain unsupported, require First Funding to reimburse the fees charged as follows:

i. If the loan is current, make a refund to the borrowers,
ii. If the loan is delinquent, apply a refund to the delinquency,
iii. If a claim has been paid, pay a refund to HUD and sent to the HUD Single Family Claims Center.

3D. Request Indemnification from the sponsor on FHA Case Number 249-4411035, whose original insured loan balance was $210,003.

Management Controls

In planning and performing our audit, we considered the management controls of First Funding, Incorporated to determine the audit procedures, not to provide assurance on their management controls. Management controls include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Management Controls

We determined the following management controls were relevant to our audit objectives:

- Loan Origination Process - Policies and procedures that management has in place to reasonably ensure that the loan origination process complies with the HUD-FHA program requirements.

- Quality Control Plan - Policies and procedures that management has in place to reasonably ensure implementation of HUD-FHA quality control requirements.

The following audit procedures were used to evaluate the management controls:

- Review of established procedures formulated by First Funding in originating FHA-insured loans,

- Interviews with officials and employees of First Funding,

- Examination of records and related documents for FHA-insured loans originated between August 1, 2001 and July 31, 2003,

- Review of records and files maintained by HUD's Quality Assurance Division in connection with the oversight of First Funding, and

- Interviews with applicable officials and employees of HUD's Quality Assurance Division relating to activities associated with First Funding.

Significant Weaknesses

A significant weakness exists if management controls do not give reasonable assurance that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained and maintained, and fairly disclosed in reports.

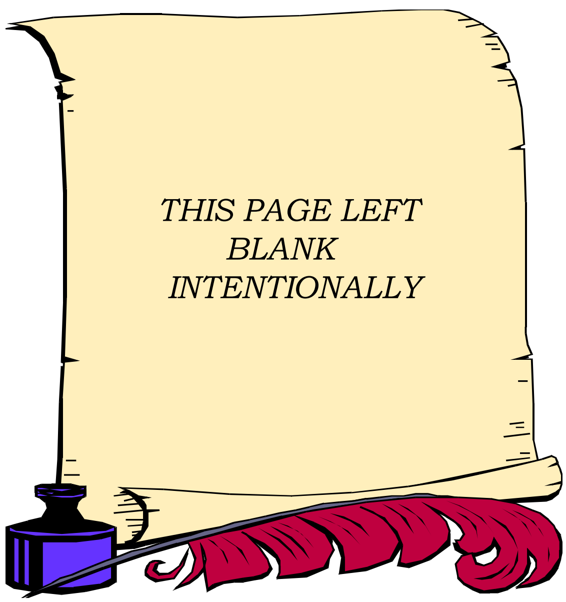
Our review of First Funding's management controls over its loan origination and quality control procedures for the origination of FHA-insured loans showed First Funding as not complying with HUD requirements. Our audit disclosed the following significant weaknesses with First Funding's Single Family loan program:

- Quality control process,
- Operating in accordance with HUD-FHA approval requirements, and
- The loan origination process.

The deficiencies are discussed in detail in the Findings in this report.

Follow Up On Prior Audits

This is the first audit of First Funding, Incorporated conducted by HUD's Office of the Inspector General. The mortgagee's last independent audit report for the year ending September 30, 2002 did not contain any findings.


THIS PAGE LEFT
BLANK
INTENTIONALLY

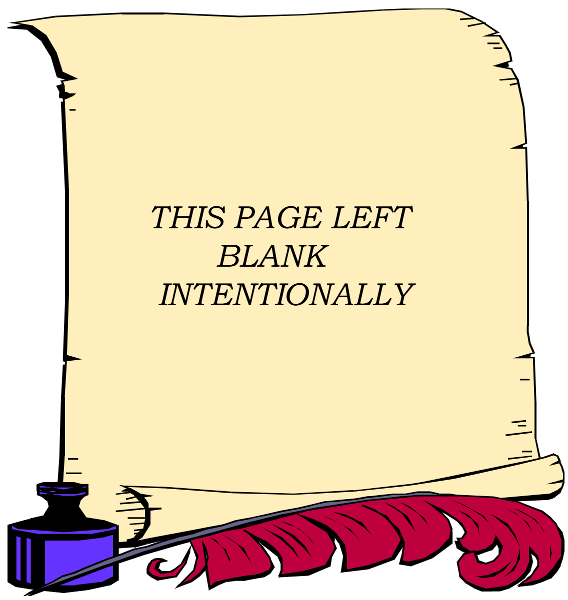
Schedule of Questioned Costs and Funds Put to Better Use

Recommendation Number	Type of Questioned Cost		Funds Put to Better Use 3/
	Ineligible 1/	Unsupported 2/	
3B			$161,740
3C		$6,058	
3D			$210,003
TOTALS		$6,058	$371,743

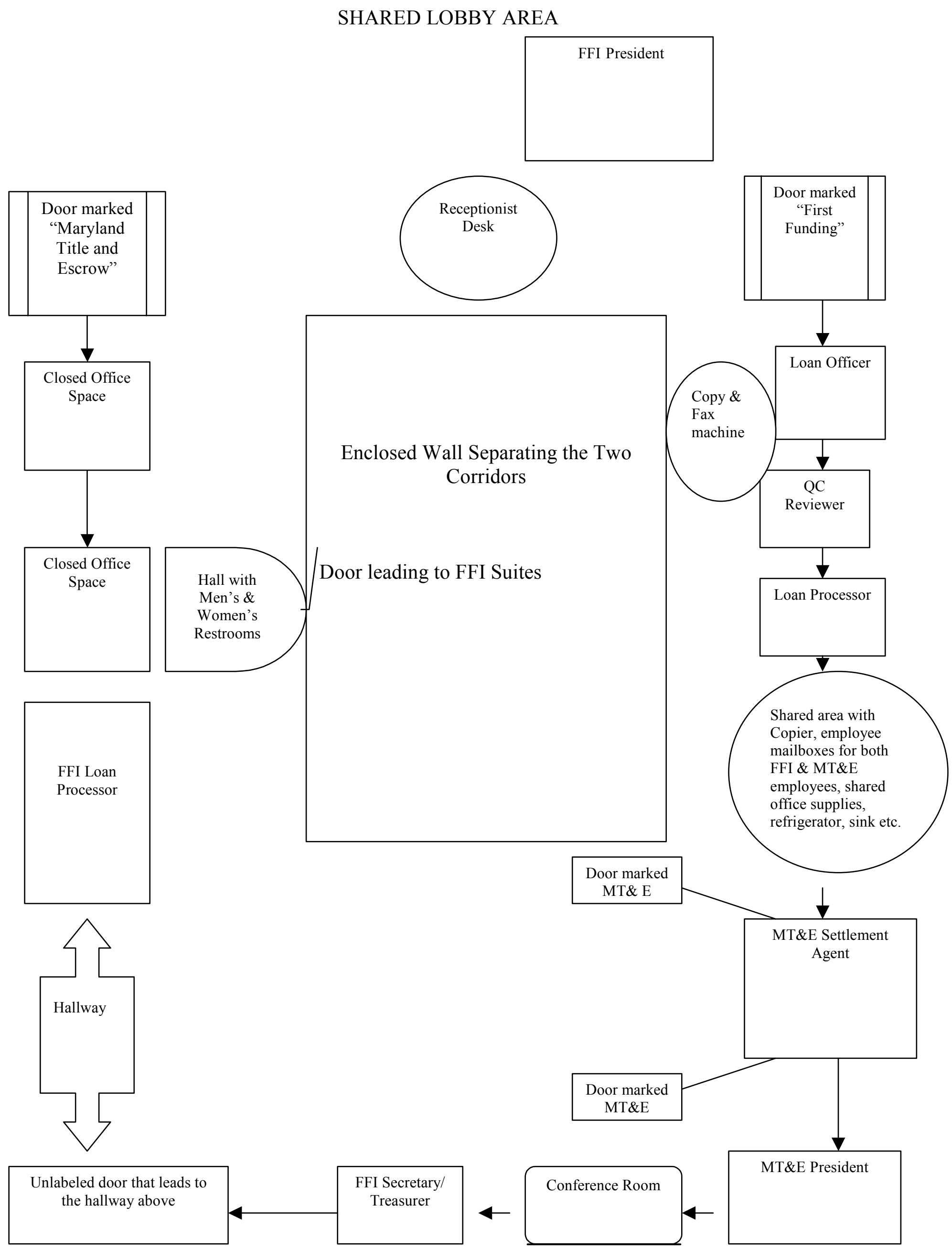
1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law, contract or federal, state, or local policies or regulations.

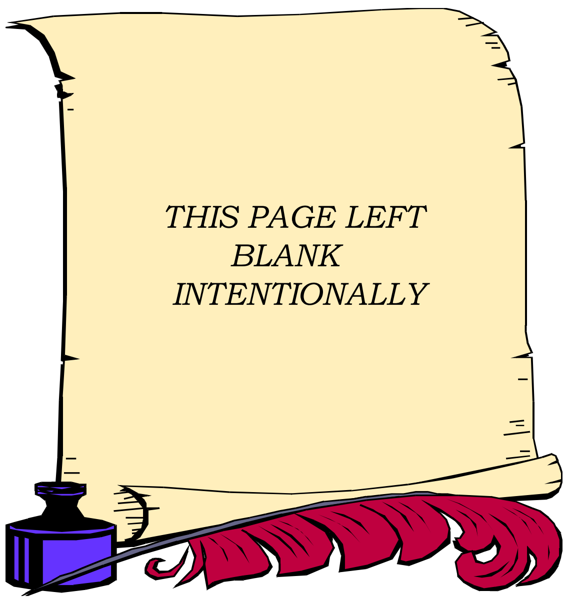
2/ Unsupported costs are costs charged to a HUD-financed or HUD-insured program or activity and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the costs. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

3/ Funds Put to Better Use are costs that will not be expended in the future if our recommendations are implemented.


THIS PAGE LEFT
BLANK
INTENTIONALLY

First Funding, Incorporated (FFI) and Maryland Title and Escrow (MT&E) Office Space Diagram

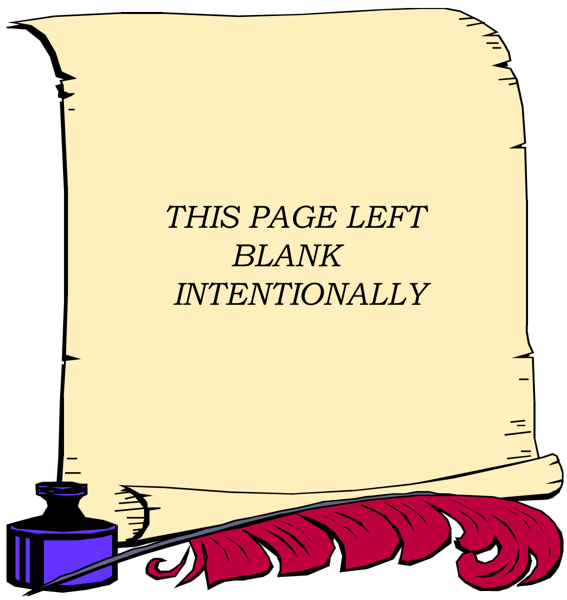



THIS PAGE LEFT
BLANK
INTENTIONALLY

First Funding, Incorporated (FFI) and Maryland Title and Escrow (MT&E) Office Space Diagram

Case Number	Mortgage Amount	Current Default as of 9/11/03	Defaul t Status	Payment s Before First Default Reported	Sponsor Name
249-4279983	$ 108,300	Y	68	11	American Mortgage Express Corp.
249-4110156	$ 161,537	Y	12	0	American Mortgage Express Corp.
249-4256188	$ 51,507		20	3	Alliance Mortgage Company
249-4430488	$ 165,597		20	5	Chase Manhattan
249-4485090	$ 161,740	Y	68	0	First Alliance Bank
249-4498672	$ 174,224	Y	45	0	Cardinal Financial Company
249-4411035	$ 210,003	Y	10	6	First Alliance Bank
249-4414961	$ 165,901		13	4	Chase Manhattan
241-6094911	$ 127,839		20	11	Cardinal Financial Company
249-4328425	$ 101,310	Y	68	4	American Mortgage Express Corp.
241-6329571	$ 147,682	Y	68	5	American Mortgage Express Corp.
249-4348725	$ 128,790	Y	42	10	Aegis Mortgage Corporation
249-4419634	$ 137,910		19	6	International Mortgage Corporation
249-4388219	$ 125,012		19	3	International Mortgage Corporation
249-4388697	$ 190,566		19	9	First Alliance Bank
TOTAL	**$2,157,918**				

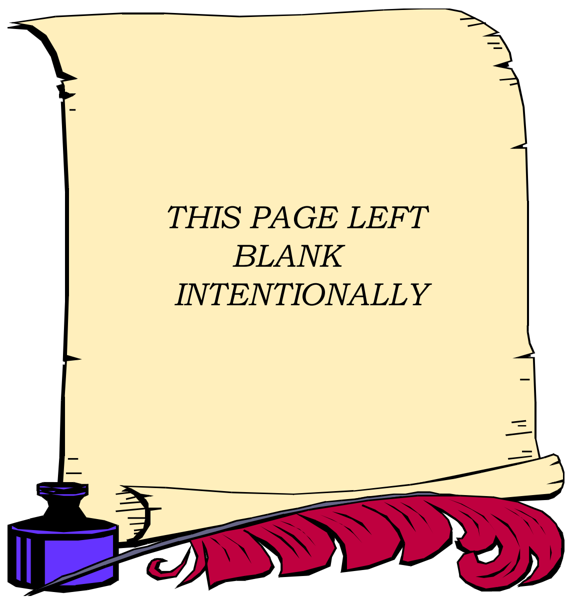
Default Status Codes	**Default Status Descriptions**
10	Eligible for Partial Claim
12	Repayment
13	Paid in Full
19	Partial Reinstatement
20	Reinstated by Mortgagor
42	Delinquent 90 Days or More
45	Foreclosure Completed
68	First Legal Action to Foreclose


THIS PAGE LEFT
BLANK
INTENTIONALLY

Status of FHA-Insured Loans Selected for Review as of January 30, 2004

Case Number	Mortgage Amount	Current Default as of 1/30/04	Default Status	Loss Mitigation Claim Paid
249-4279983	$ 108,300.00	Y	68	
249-4110156	$ 161,537.00	Y	12	
249-4256188	$ 51,507.00	N	20	
249-4430488	$ 165,597.00	N	20	$ 625.00
249-4485090	$ 161,740.00	Y	68	
249-4498672	$ 174,224.00	Y	43	
249-4411035	$ 210,003.00	Y	12	$11,307.68
249-4414961	$ 165,901.00	N	13	
241-6094911	$ 127,839.00	N	20	$ 750.00
249-4328425	$ 101,310.00	Y	68	
241-6329571	$ 147,682.00	Y	68	
249-4348725	$ 128,790.00	N	19	
249-4419634	$ 137,910.00	N	19	
249-4388219	$ 125,012.00	N	19	$ 675.00
249-4388697	$ 190,566.00	N	19	
TOTAL	**$2,157,918.00**			**$13,357.68**

Default Status Codes	Default Status Descriptions
12	Repayment
13	Paid in Full
19	Partial Reinstatement
20	Reinstated by Mortgagor
43	Foreclosure Started
68	First Legal Action to Foreclose


THIS PAGE LEFT
BLANK
INTENTIONALLY

Auditee Comments

FIRST FUNDING, INC.

1101 MERCANTILE LANE • SUITE 201 • LARGO, MD 20774 • 1-800-293-9991 • OFFICE 301-322-5250 • FAX 301-322-5696

To: U.S. Department of Housing & Urban Development

Fr: First Funding, Inc.
Edward Heck

RE: Response to H.U.D. Audit

Date: May 18, 2004

To Whom It May Concern,

Please accept the following for our written response to the findings from the audit.

<u>Finding #1</u> – First Funding, Inc. Quality Control Process Continues to Be Inadequate

First Funding, Inc. agrees with the auditor's findings after pulling the HUD Handbook 4060.1 Rev. 1 Chapter 6 we realize that First Funding, Inc. Quality Control Plan was inadequate. Upon reviewing all of the information in the Handbook 4060.1 Rev. 1 Chapter 6 First Funding, Inc. decided that it would be best to hire an outside firm to handle the Quality Control. The firm, which was hired, is Quality Control Management Assurance Corporation. This company has implemented a Quality Control Plan which meets H.U.D. guidelines (see enclosed Quality Control Plan). This company is also going to be performing First Funding, Inc. monthly Quality Control. (See enclosed contract). First Funding, Inc. knows that this will correct having a Quality Control Plan that meets H.U.D.'s guidelines, making sure that we meet our 10% closed loan requirement per month. This will also ensure that defaulted loans get Quality Controlled within the first 6 months from default, and 10% of rejected loans get reviewed.

Finding #2 – First Funding, Inc. Office Operations Did Not Comply With HUD-FHA Approval Requirements

Control & Supervision Not Exercised

First Funding, Inc. Senior Management does exercise control and responsible management supervision over its employees and we do actively participate in the loan origination process performed by its Loan Officers and Loan Processors. After reviewing Paragraph 2-13, Control and Supervision of Staff, of HUD Handbook 4060.1 Rev-1. First Funding, Inc. realized that the current way of participating in the loan origination process performed by its loan officers and loan processors was being done incorrectly. First Funding, Inc. senior management meets several times per month to review loan officers and loan processors work performance. The evaluations were discussed verbally between the two operating managers and the employees. This is because First Funding, Inc. is a small company and we opted to do everything verbally. First Funding, Inc. now realizes that all reviews have to be documented in writing. We have implemented this change.

Exclusivity of Employees Not Require

First Funding, Inc. did not know of the rule in Paragraph 2-14, Conducting Mortgagee Business, of HUD Handbook 4060.1, Rev-1. First Funding, Inc. is aware of this rule now. As far as the loan officer that was allowed to originated FHA insured loans while being employed by the real estate agency. He is no longer doing real estate (as of July 2003 he has received his letter showing that he was inactive which was given to the HUD auditors) and is a full-time loan officer with First Funding, Inc. As far as First Funding, Inc. bookkeeper and Quality Control Reviewer who was also the settlement agent at Maryland Title and Escrow. First Funding, Inc. (as of January 1, 2003) no longer employs her. First Funding, Inc. realizes excluding the receptionist that the mortgagee must exclusively employ all employees.

Office Space Is Not Separate and Apart From Another Entity

First Funding, Inc. did not know the rule in Paragraph 2-16, Office Facilities, of HUD Handbook 4060.1 REV-1, requires that a mortgagee be located in a space that is separate and apart from any other entity. At the exit conference Edward Heck showed the HUD auditors that Maryland Title and Escrow was in the process of moving to a separate location. Maryland Title will have their own phone lines, fax machines and copiers. The only thing that First Funding, Inc. and Maryland Title & Escrow will share is a main entrance/lobby.

Finding #3 - First Funding, Inc. Did Not Exercise Due Diligence Over Its Loan Origination Processes

Incomplete Loan Files

First Funding, Inc. realizes that these files had missing information when the HUD auditors did their review. The information was present when the loan was submitted to the sponsor for underwriting. First Funding, Inc. has read HUD Handbook 4000.2 Rev-2 and realized that we are required to retain the entire case file pertaining to loan origination for at least two years from the date of endorsement. First Funding, Inc. will ensure that we will do a more thorough job of keeping the proper documentation.

Due Diligence Not Exercised in Reviewing Liabilities and Credit Characteristics

In regards to FHA Case Binder 249-4485090 – the child support payments were disclosed to the underwriter/sponsor (First Alliance Bank) at the time this loan file was submitted. At the discretion of the underwriter/sponsor they were the ones that decided that the child support did not have to be counted because there was less than 10 payments left. First Funding, Inc. has read HUD Handbook 4155.1 Rev-4, CHG 1. First Funding, Inc. realizes that per the guideline if the monthly payment impacts the borrower ability to pay the loan back then it must be counted regardless of how many payments are left. At the instruction of the underwriter/sponsor we were told that they were not going to count it in the debt to income ratio. As far as the compensating factor of rent and payments increasing by only $24. The rent was being paid to his wife whom he lived with. The payments were verified by the credit agency (Mortgage Credit Reports of America). The guidelines did not specify that it had to be canceled checks. The underwriter/sponsor said that it was acceptable that the rent was verified on the credit report. The underwriter/sponsor is the one that used the $1,400 rent payment as a compensating factor. As far as the home in which the borrower lived with the wife being a HUD foreclosure with a claim on it. First Funding, Inc. would not know this information. We do not have access to this information. As far as First Funding, Inc. submitting the loan to various lenders. This loan was submitted to one other lender, International Mortgage. The reason that the loan was taken from International was due to the time it was taking them to underwrite the loan file, not because of the conditions that they were requiring. As far as the president of First Funding, Inc. stating, " the reason we withdrew the loan from the first lender was because we did not agree with all the conditions noted by the lender especially the note to include the child support payments totaling $476 in the calculation of ratios". The president of First Funding, Inc did not say this statement.

Also, the president never stated that "this was not of great concern to them, as far as submitting the loan from the first lender to the second lender. First Funding, Inc. disagrees with the auditor's findings on this above referenced case. We did not disregard HUD's loan origination requirements. All the documentation in this file was submitted accurately and truthfully. It was the underwriter/sponsor sole discretion how they underwrote and approved this loan. First Funding, Inc. feels that if HUD is requesting indemnification on this loan it should come from the sponsor not from First Funding, Inc.

Discount Points Did Not Reduce Borrower's Interest Rate

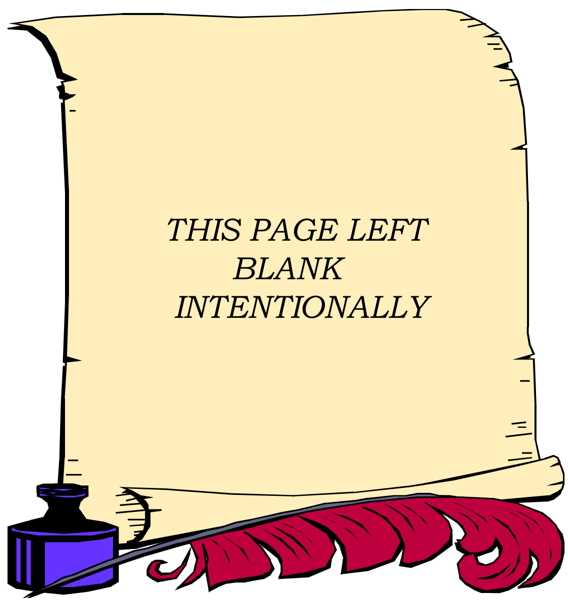
The $6,057.64 for "loan discount" and $5,653.80 for yield spread premium was charged to the borrower. This was charged to the borrower because First Funding, Inc. worked with this borrower for over seven months. This is an average of $1,674 per month. There was a lot of time and hard work put into this loan to get to the approval stage. This is the reason why the above fees were charged. The reason that the $6,057.64 was charged as a loan discount was because HUD does not allow the mortgagee to put it under mortgage broker fee. If HUD guidelines would allow this. These fees would have been put under mortgage broker fee. HUD's rules require this to be put under loan discount. It truly was a mortgage broker fee or loan origination fee. But, HUD does not allow the loan origination fee to be more that one percent. First Funding, Inc. did provide the auditors with a copy of their policy that states that we will charge 2-4 points above normal fees if determined that the loan is risky. This policy was not implemented on this loan. The only reason that this policy was implemented to cover the cost of repurchase due to early default. Several of our sponsors on their wholesale rate sheets have a similar policy charging additional points for borrowers with low FICO scores. We assumed that it was okay for the lenders to charge this then it was okay for First Funding, Inc. to have the same rule. We have since done away with this policy (see enclosed letter) In regards to Section 8 of RESPA the rule prohibits a person from giving or accepting any part of a charge for services that are not performed "unearned fee". First Funding, Inc. does not understand how this rule applies to the above referenced case. When we earned these fees over the seven months of hard work that was put into this case. First Funding, Inc. does not practice "predatory lending". First Funding, Inc. disagrees with the auditors request for First Funding, Inc. to reimburse the borrower $6,057.64 for unearned/unallowable fees charged when these fees were earned.

In conclusion, First Funding, Inc. realizes that when we were selected to be audited due to high default rate. We would like to point out as of May 18, 2004 our default rate has dropped well below HUD's requirement. We have worked very hard over the last few years to continuously bring our default rate down. As you can see, by looking on FHA Connections/Neighborhood Watch our default rate has consistently dropped over the last few years. First Funding, Inc. believes by implementing the above guidelines our default rate will continue to stay below HUD guidelines and we will strive to be a mortgagee that meets all of HUD's guidelines and requirements.

If you have any questions please feel free to contact me at (301) 322-5250 Ext. 105

Sincerely,

Edward Heck
President


THIS PAGE LEFT
BLANK
INTENTIONALLY