audit report

Issue Date June 1, 2005
Audit Report Number 2005-FW-1011

TO: Frank L. Davis
General Deputy Assistant Secretary for Housing, H

FROM: Frank E. Baca
Regional Inspector General for Audit, 6AGA

SUBJECT: Harry Mortgage Company Generally Complied with HUD Loan Origination Requirements but Did Not Perform Quality Control Reviews of All Early Defaults.

HIGHLIGHTS

What We Audited and Why

We surveyed Harry Mortgage Company (lender), Oklahoma City, Oklahoma, because of its high default and claim rate. According to the U.S. Department of Housing and Urban Development's (HUD) Neighborhood Watch system, 6.01 percent of the loan originations by the lender resulted in defaults or claims during the two-year period ending September 30, 2004. For the same period, the Oklahoma City Metropolitan Statistical Area had a 2.67-percent default and claim rate, less than one-half of the lender's rate.

The survey objective was to determine whether the lender acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of Federal Housing Administration single family mortgages. An additional objective was to decide whether deficiencies warrant an in-depth audit.

What We Found

For 14 of the 15 loans reviewed, we found that the lender acted in a prudent manner and complied with HUD regulations, procedures, and instructions in originating Federal Housing Administration single family mortgages. However, one loan exhibited poor underwriting and warrants indemnification. In addition, the lender did not make required reviews of early defaults. HUD reported the deficiency in December 2002. The deficiencies do not warrant further audit work.

What We Recommend

We recommend that the General Deputy Assistant Secretary for Housing require the lender to indemnify HUD for the deficient loan, ensure that the lender has procedures to monitor defaults, and take appropriate administrative action against the lender for not reviewing early payment defaults, a recurrence of a HUD finding.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

The lender provided a response to the report at our exit conference on May 10, 2005. The lender generally disagreed with our recommendation regarding the deficient loan. It also indicated it has implemented new procedures for quality control.

The complete text of the auditee's response, along with our evaluation of that response, can be found in Appendix B of this report.

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BACKGROUND AND OBJECTIVES

Harry Mortgage Company's (lender) main office is in Oklahoma City, Oklahoma, and it has a branch office in Tulsa, Oklahoma. The lender is a nonsupervised direct endorsement lender. The U.S. Department of Housing and Urban Development (HUD)/Federal Housing Administration approved the main office on October 18, 1963, and the branch office on September 12, 1977, to originate single family loans under section 203(b)(1) of the National Housing Act. On May 28, 2004, the lender engaged a private firm to provide quality control services. HUD terminated the lender as an approved Federal Housing Administration lender on November 17, 2004, because of a high default and claim rate.

RESULTS OF AUDIT

Finding 1: Lender Generally Complied with HUD Requirements but Approved One Loan That It Should Have Rejected

Of the 15 loans reviewed, we found one that the lender's underwriter should have rejected, Federal Housing Administration number 421-3978468. The lender's staff disregarded HUD requirements when originating the loan. They did not obtain a reasonable explanation for negative bank balances, a large deposit three days before closing, and the source of funds for two money orders. As a result, the lender subjected HUD to unnecessary risk by approving the HUD-insured loan of $138,061. The borrower defaulted without making a loan payment.

The borrower did not provide a reasonable explanation for his negative bank balances. He submitted to the lender three months of bank statements, which had negative balances. In a letter of explanation, the borrower stated the reason for the negative bank account balances was that his employer had not deposited his payroll checks in a timely manner. However, the deposit date identified on the pay statement is consistent with the deposit date on the bank statement. Therefore, the borrower's explanation is questionable and not sufficient to resolve the issue. HUD Handbook 4155.1, REV 4, paragraph 2-3, states that the borrower's explanation for derogatory credit must make sense and be consistent with other credit information in the file.

The borrower had an unexplained deposit of $460 three days before closing. This deposit ensured the borrower had enough funds to close. HUD Handbook 4155.1, REV 4, states the lender should verify large unexplained deposits. Based on the borrower's negative bank balances, $460 is a large deposit. The lender should have verified the source of the unexplained deposit.

The borrower had unexplained money orders purchased with funds that did not come out of his bank account. The borrower paid $400 in earnest money with two $200 money orders on the same day. The borrower's bank statements do not show that he withdrew the earnest money payment from his bank account. HUD Handbook 4155.1, REV 4, states if the earnest money appears excessive based on the borrower's history of accumulated savings, the lender must verify the source of funds. The lender's underwriter disregarded HUD requirements to obtain required verifications. Without the required verifications, the underwriter should have rejected the loan.

Recommendation

We recommend that the General Deputy Assistant Secretary for Housing:

1A. Require the lender to indemnify HUD for loss on Federal Housing Administration loan number 421-3978468.

Finding 2: Lender Did Not Review Loans Going into Default within the First Six Payments

Neither the lender's staff nor its quality control contractor reviewed all early payment default loans as required by HUD. Although the lender's quality control plan included such reviews, the lender had not implemented adequate controls to ensure its staff or contractor conducted the reviews. As a result, the lender had no way to identify patterns or correctable causes of early payment defaults.

We examined the lender's quality control reports for evidence that the lender had reviewed 12 loans. For the remaining three loans in our sample, HUD no longer required the lender to keep quality control reports, nor did the lender still have the reports.

Neither the lender's staff nor its quality control contractor had reviewed any of the 12 loans in our sample that defaulted after the borrowers made one or fewer payments. HUD requires the lender to review all loans going into default within the first six payments (Handbook 4060.1, REV-1, CHG-1, Chapter 6, part B, paragraph 6-6D). In December 2002, the HUD Quality Assurance Division reported, "Harry Mortgage failed to perform quality control reviews of all early payment default loans as required. Specifically, on those loans that went into default within the first six months, no quality control reviews were being performed as required."

HUD also requires lenders to take steps to identify the patterns of early defaults by location, program, or loan characteristic (Handbook 4060.1, REV-1, CHG-1, Chapter 6, part B, paragraph 6-5C). The lender's quality control plan requires a review of all early payment default loans. However, the lender had not implemented management controls or procedures to monitor for defaults and to ensure its staff or contractor conducts the reviews. As a result, the lender did not identify patterns or causes of early payment defaults.

Recommendations

We recommend that the General Deputy Assistant Secretary for Housing:

2A. Ensure that the lender has procedures to monitor defaults and ensure its staff or contractor conducts the required quality control reviews on early payment defaults before reinstating the lender as a direct endorsement lender for HUD.

2B. Take the appropriate administrative action, to include imposing civil monetary penalties, against the lender for not reviewing early payment default loans, a recurrence of a finding that HUD reported in December 2002.

SCOPE AND METHODOLOGY

We divided the survey objective into mortgage credit analysis areas to determine whether the borrower had available assets to close the loan, was creditworthy, and had adequate and stable effective income. To accomplish the objective, we selected 15 loans for review from a list of 155 of the lender's defaulted loans in HUD's Neighborhood Watch system[1] from January 1, 2001, through September 30, 2004. We selected all loans with one or fewer payments before first default was reported. We reviewed relevant federal regulations, HUD handbooks, title company closing files, and Federal Housing Administration and lender loan origination files. Our review of the loan origination files included:

1. Determining whether a pattern of defaults existed;
2. Examining loan documents for inconsistent and derogatory information;
3. Comparing the final application with the preliminary application, verifications of deposit and employment, credit reports, and any other relevant documentation available to establish consistency; and
4. Examining the appraisal and comparing the subject and details with comparable properties for value consistency. This included a review of information maintained by the offices of the Oklahoma and Cleveland County tax assessors.

We interviewed HUD Quality Assurance Division staff and held an entrance conference with the lender's executives on November 16, 2004. We conducted our fieldwork through March 16, 2005. We performed our fieldwork at the lender's office and reviewed Federal Housing Administration case binders in our office in Oklahoma City, Oklahoma. We conducted our audit survey in accordance with generally accepted government auditing standards.

1 We did not perform procedures to assess the data contained in HUD's Neighborhood Watch system. The survey did not include other computer-generated data.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal controls were relevant to our survey objectives:

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

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

Significant Weakness

Based on our survey, we believe the following item is a significant weakness:

- The lender had not implemented adequate controls to ensure its staff or contractor conducted the reviews of early defaults as discussed in Finding 2.

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation Number	Funds to be Put to Better Use[1]
1A	$138,061

1 "Funds to be put to better use" are quantifiable savings that are anticipated to occur if an Office of Inspector General (OIG) recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

Harry Mortgage Co.

3048 N. Grand Blvd.• Oklahoma City, OK 73107
Phone (405) 606-2501 Fax (405) 606-2947

May 10, 2005

Mr. Frank E. Baca, Regional Inspector General
c/o US Dept. of HUD Office of Inspector General
319 Taylor Street, #13A09
Fort Worth TX 76102

Re: FHA Case #421-3978468[redacted]
HMC Loan #2101230

Mr. Baca:

Comment 1

The following is in response to your preliminary draft dated April 27, 2005 wherein you recommend Harry Mortgage Co. (HMC) indemnify the above referenced FHA loan. More specifically, this correspondence addresses each item with which the OIG's office took issue, listed on page 2 of your report entitled "What We Recommend." First, (recommendation numbered 1A. page 2) we believe the finding starting on page 5 are not on point as to the HUD guidelines when used on the above referenced loan.

<u>"Negative bank balances" - 1st paragraph of the results (2nd paragraph on the page):</u>

Comment 2

The borrower's August 2003 bank printout reflects one insufficient funds charge. The borrower's July 2003 bank statement does not reflect any insufficient charges. The June 2003 statement contained three insufficient charges. By looking at all of the bank statements on the whole, it does not appear that the borrower made a habit of overdrawing his bank account. It is perfectly logical to expect that not receiving previous payroll in a timely manner would have caused a domino effect that would have caused a fair amount of financial burden on the borrower and his ability to maintain a positive bank balance for several months to come. One could argue that the borrower's employer had indeed been late in depositing his payroll in previous months. For this reason, the explanation given by the borrower for the negative bank balances was not questioned. Given the circumstances, we believe the borrower's explanation makes sense and resolves this issue.

<u>"Unexplained large deposit"- 2nd paragraph of the results (3rd paragraph on the page):</u>

Comment 3

Per the August 2003 bank printout in the file, the borrower was paid on August 8th via ACH. Also on August 8th, check number 793 in the amount of $450 was negotiated. On August 11th, check number 794 in the amount of $250 was negotiated and there was a $60 withdrawal. Our position is that the 2 checks more than likely were for cash, given their "exact" dollar amounts.

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Comment 3

The total of these withdrawals totaled $760. It is practical and logical to conclude that the borrower re-deposited $460 of these funds upon realizing that he did not have sufficient funds to close on his home loan. The closing companies in our location require buyers to come to closing with certified funds. This appears to be a realistic explanation for the $460 deposit considering the amounts of the recent withdrawals and considering that the deposit in question was made a mere 3 days after the initial withdrawal was made.

"Unexplained money orders" - last paragraph of the results (4th paragraph on the page):

Comment 1

Based on the following information, the guidelines set forth in HUD Handbook 4155.1, REV 4 (09/95), Chapter 2. Section 3 (Borrowers Cash Investment in the Property). 2-10(A.) do not appear to be specifically applicable to this case as indicated in your report.

Comment 3

Per the Mortgage Credit Analysis Worksheet (Section 12. Line h), the underwriter used only the initial earnest money deposit of $100 (per the original contract) for qualifying purposes ($325 appraisal fee + $100 Earnest Money = $425 entered on line h). The $400 mentioned in your report was excluded from the underwriting decision and was not counted toward funds available nor as funds received.

The borrower was given credit for the full $500 at closing. However, as long as the seller proves that the earnest money has been received, the closing company is required to give credit for the deposit on the settlement statement. Because the funds were excluded from the underwriting of the file, we were not required to verify them. Also, the amount of the earnest money deposit in this case was $500, which is less than .4 (four-tenths) of one percent of the sales price on the subject property and is minimal relative to the sales price.

Comment 1

The cited requirements did not pertain to this case; therefore, no HUD requirements were disregarded or otherwise ignored by the underwriter with respect to the earnest money.

Comment 4

Rejecting this loan on the basis of excessive, unverified earnest money would not have been justifiable since the underwriter excluded the $400 of additional earnest money in the underwriting of the file. This loan was underwritten in accordance with FHA guidelines.

For these reasons, we are requesting that HUD OIG reconsider its recommendation for Harry Mortgage Co to indemnify HUD on this loan as neither Harry Mortgage Co. nor its employees subjected HUD to any unnecessary risk by approving this loan for HUD insuring.

Comment 5

Second, (recommendation 2A. page 2) HMC has implemented new procedures to ensure Quality Control reviews are ordered in a more timely manner. One of our underwriters now monitors the Neighborhood Watch on a monthly basis and complies reports for the owners and management to review. The underwriter also contacts our in-house counsel with this information to ensure our outside quality control company performs the required audit of these files.

We also require an internal review of early defaults (monthly) by one of our underwriters, who was not the original underwriter, to compile information that might give management a quick first look of any tends that may be occurring.

HMC has enclosed copies for your review that are actual samples of the charting and reports

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HMC now uses to better monitor the HUD activities. These reports are being generated either monthly or Quarterly and have helped management better supervise various HUD insured lending. Some of these reports have been created only in the last few months but we have tracked the data back the last two years.

Harry Mortgage Co. has been an approved FHA/HUD lender since 1963. We are an independent full service mortgage banker. FHA loans are very important to our company and to our State. We will continue to modify our procedures to comply with any and all HUD regulations. We do not believe the underwriting used in the above referenced case merits any indemnification on our part and respectfully request your reply.

Sincerely,

Steve H

Harry Mortgage Co.
Steve Harry, Senior Vice President

CC: Mr. Lon Keister, Senior Auditor

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OIG Evaluation of Auditee Comments

Comment 1 The lender stated HUD Handbook 4155.1 REV 4 Chapter 2-10 A does not appear to be specifically applicable to this case. We stated in the report that if the earnest money appears excessive based on the borrower's history of accumulated savings, the lender must verify the source of funds. This statement is from HUD Handbook 4155.1 REV 4 Chapter 2-10 A. We believe this is applicable based on the borrower's history of negative bank balances. The lender should have verified the source of the earnest money to ensure the borrower used his funds.

Comment 2 Negative Bank Balances – The lender assumed the borrower's explanation of the negative bank balances was acceptable although documents contained in the file do not support the explanation. The pay and bank statements in file show the employer deposited the borrower's paycheck without delays. The borrower's explanation remains questionable and insufficient to explain three months of negative balances.

Comment 3 Unexplained Large Deposit and Money Orders - The lender assumes that the $460 deposit came from a re-deposit of borrower's funds. The borrower's bank statement shows the borrower issued two checks that totaled $760. The lender stated it is "more than likely" the two checks were cash withdrawals, and that the borrower probably later realized he did not have sufficient funds to cover closing costs and re-deposited $460 of the $760 into the bank account. The lender has no documentation to support these assumptions. In addition, even if the lender's assumptions were correct, the transactions still do not explain where the borrower came up with $460 to re-deposit into his account since he paid $735 in money orders (a $325 money order for the application fee and two money orders totaling $400 for earnest money), leaving only $35 of the $760. The lender should make proper verifications instead of unsupported assumptions.

Comment 4 The lender indicates rejecting the loan on the basis of excessive and unverified earnest money would not have been justifiable since the underwriter excluded the $400 of additional earnest money in the underwriting of the file. However, as stated in the finding, we believe the loan should not have been approved because of three things: (1) no reasonable explanation for negative bank balances; (2) unexplained deposit three days before closing; and (3) unexplained money orders for funds not withdrawn from the bank account. HUD requires the explanations to make sense and be consistent with other credit information in the file. By approving the loan without adequate explanations as required, the lender subjected HUD to unnecessary risk. According to HUD's Neighborhood Watch System, foreclosure is completed and the borrower never made a payment.

Comment 5 The lender indicates it has implemented new procedures in connection with its quality control plan. HUD will need to review and ensure the plan's adequacy.

Appendix C

CRITERIA

HUD Handbook 4060.1, REV-1, "Mortgagee Approval Handbook"

Paragraph 6-5C. Identify Patterns. Lenders must identify patterns of early defaults by location, program, loan characteristic, loan correspondent, or sponsor. Lenders may use HUD's Neighborhood Watch - Early Warning system to identify patterns. Lenders must identify commonalities among participants in the mortgage origination process to learn the extent of their involvement in problem cases. Loans involving appraisers, loan officers, processors, underwriters, etc., who have been associated with problems, must be included in the review sample.

Paragraph 6-6D. Early Payment Defaults. In addition to the loans selected for routine quality control reviews, lenders must review all loans going into default within the first six payments. As defined here, early payment defaults are loans that become 60 days past due.

HUD Handbook 4155.1, REV-4, "Mortgage Credit Analysis for Mortgage Insurance"

An excerpt from paragraph 2-3. The borrower's explanation must make sense and be consistent with other credit information in the file.

Paragraph 2-10A. Earnest Money Deposit. If the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds. Satisfactory documentation includes a copy of the borrower's cancelled check. A certification from the deposit holder acknowledging receipt of funds and separate evidence of the source of funds is also acceptable. Evidence of source of funds includes a verification of deposit or bank statement showing that at the time the deposit was made, the average balance was sufficient to cover the amount of the earnest money deposit.

Paragraph 2-10B. Savings and Checking Accounts. A verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account or the account was opened recently, the lender must obtain a credible explanation of the source of those funds.