audit report

Issue Date December 20, 2005	
Audit Report Number 2006-DE-1001	

TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing Commissioner, H

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FROM: Ronald J. Hosking, Regional Inspector General for Audit, 8AGA

SUBJECT: First Magnus's Denver Branch Did Not Follow HUD Requirements in Underwriting 31 Insured Loans

HIGHLIGHTS

What We Audited and Why

We audited the Denver, Colorado, branch of First Magnus Financial Corporation (First Magnus) because of its high default rate. Our objective was to determine whether the First Magnus Denver branch followed the Department of Housing and Urban Development (HUD) requirements in underwriting Federal Housing Administration-insured mortgages.

What We Found

The branch did not follow HUD requirements in underwriting 31 Federal Housing Administration-insured loans. We reviewed 51 loans. Thirty-two of the loans required full underwriting, and 19 were streamline refinances. We found significant underwriting deficiencies for 12 of the 32 loans that required full underwriting. These deficiencies affect the insurability of the loans. We also identified overinsured mortgages and unallowable fees in 19 of the loans reviewed. The branch office lacked supervision and formal policies to ensure compliance with HUD requirements. As a result, First Magnus placed HUD's insurance fund at risk for $1,643,617, overinsured mortgages totaling $10,004, and charged unallowable fees totaling $1,611.

What We Recommend

We recommend that the assistant secretary for housing – federal housing commissioner require First Magnus to

- Indemnify and/or reimburse HUD for the potential and actual losses on 11 loans with significant deficiencies,

- Reimburse the appropriate parties for the overinsured and unallowable charges, and

- Develop policies and procedures to ensure adequate supervision over its underwriting process.

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

We provided the draft audit report to First Magnus on November 23, 2005, and requested their comments by December 16, 2005. First Magnus provided their written response on December 15, 2005. First Magnus agreed with the finding and recommendations.

The complete text of the auditee's response is in appendix B of this report.

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BACKGROUND AND OBJECTIVES

First Magnus Financial Corporation's (First Magnus) home office is located in Tucson, Arizona. The U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration approved First Magnus as a direct endorsement lender in 1996. HUD authorized the wholesale branch located in Denver, Colorado, to sponsor Federal Housing Administration loans in December 1999. The branch office only performs underwriting. It does not originate Federal Housing Administration-insured loans.

The Denver branch underwrote 2,962 Federal Housing Administration-insured loans with beginning amortization dates between April 01, 2003, and March 31, 2005. The original mortgage amount of these loans totaled $503,444,719. Two hundred fifty-nine of these loans (8.74 percent) defaulted within the first two years of closing. The original mortgage amount of the defaulted loans totaled $44,970,184.

The objective of the audit was to determine whether the Denver branch followed HUD regulations, procedures, and instructions in the underwriting of Federal Housing Administration-insured single-family mortgages.

RESULTS OF AUDIT

Finding 1: Denver Branch Did Not Follow HUD Requirements in Underwriting 31 Insured Loans

The Denver branch of First Magnus did not follow HUD requirements in underwriting 31 Federal Housing Administration-insured loans. The branch office lacked supervision and formal policies to ensure compliance with HUD requirements. As a result, First Magnus placed HUD's single-family insurance fund at risk for $1,643,617, overinsured mortgages totaling $10,004, and charged unallowable fees totaling $1,611.

HUD Requirements Not Followed

The Denver branch did not follow HUD requirements in underwriting Federal Housing Administration-insured loans. We reviewed 51 loans. Thirty-two of these loans required full underwriting, and 19 were streamline refinances. We found significant underwriting deficiencies for 12 of the 32 loans that required full underwriting. Appendix C lists these major deficiencies. Due to the seriousness of the deficiencies, HUD should not have insured the loans.

These deficiencies include

- Excessive ratios without sufficient compensating factors (ten loans)
- Questionable credit history (seven loans)
- Underreported liabilities (four loans)
- Insufficient employment documentation (four loans)
- Outstanding judgments (four loans)
- Overstated income (four loans)
- Unsupported assets (two loans)
- Documents passed through interested third party (two loans)
- Buydown agreement not assessing borrowers' future ability to pay (two loans)
- Overinsured mortgages and unallowable fees (two loans)

We also identified overinsured mortgages and unallowable fees in 19 of the loans reviewed. Including the two loans identified above, 21 loans contained these charges (see appendix C). First Magnus needs to reimburse the appropriate parties for the overinsured and unallowable charges.

Deficient Loan Examples

First Magnus approved case number 052-2747876 based on unacceptable credit history, understated liabilities, overstated income, insufficient employment documentation, unsupported assets, inaccurate and excessive debt-to-income ratios, and prohibited involvement by an interested third party. The net loss to HUD on the resale was $68,090.

Unacceptable Credit History and Understated Liabilities
The borrower's credit history was unsatisfactory. The documentation for some of the borrower's outstanding debt passed through the real estate agent, an interested third party. The underwriter did not adequately verify that the borrower paid all of the outstanding debt before closing, including outstanding derogatory debt of $2,000.

Overstated Income and Insufficient Employment Documentation
The underwriter did not adequately establish the anticipated amount of income and the likelihood it would continue. The borrower did not provide Internal Revenue Service W-2 forms. The only documentation provided was an incomplete pay stub (no year-to-date earnings, deductions, etc.) by an interested third party, the realtor. The tax information ordered by First Magnus was for only one year, and it showed much less income than was reported on the verification of employment.

Our reverification of employment did not support the income reported in the file, and the borrower was not employed after loan closing. The lender did not properly verify the borrower's income and whether that income was to continue; therefore, the lender should not have included it in calculating borrower's income ratios. The documentation did not sufficiently support the borrower's ability to repay the mortgage debt.

Unsupported Assets
The underwriter did not verify all funds for the borrower's cash investment. The file contained an incomplete and unsigned budget letter.

Inaccurate and Excessive Debt-to-Income Ratios
First Magnus approved the loan with high and inaccurate qualifying ratios. The underwriter approved the loan at the buydown rate without adequate compensating factors. Using the actual note rate, the mortgage payment expense ratio was 35 percent, and total fixed payment ratio was 48 percent. As discussed above, the file documentation does not support these ratios. Due to these factors, it is unlikely the borrower has the ability to repay the mortgage debt.

Prohibited Involvement by Interested Third Party
The underwriter relied on documentation passed through the real estate agent, as an interested third party, to support the borrower's income, employment,

and payoff of debts. Underwriters must verify that verification documents pass directly between the lender and provider without any third-party handling.

For case number 052-3146518, First Magnus approved the mortgage based on an unacceptable credit history, overstated income, understated liabilities, and inaccurate and excessive debt-to-income ratios. The net loss to HUD on the resale was $51,314.

Unacceptable Credit History
The borrower's credit history was unsatisfactory. There were no letters of explanation in the file for an open collection account of $104 and for a recently paid off derogatory account with a high balance of $14,224. The lender did not document its analysis of past derogatory accounts, such as the borrower's disregard for financial obligations, an inability to manage debt, or factors beyond the borrower's control.

Overstated Income
The underwriter included the borrower's commissions for effective income; however, the underwriter did not obtain a current pay stub to ensure the commissions were likely to continue. The underwriter did not properly verify the commission income to ensure it was stable and that the borrower had the capacity to repay the mortgage debt. Without the commission income, this borrower does not qualify for the mortgage.

Understated Liabilities
The underwriter understated the recurring expenses by $138 per month. The underwriter did not use the most current credit report in the file. The analysis did not take into account the new loan taken out by the borrower for the cash investment in the property.

Inaccurate and Excessive Debt-to-Income Ratios
We recalculated the ratios using the correct gross monthly effective income and correct recurring expenses discussed above. The total fixed payment-to-income ratio would be 64.28 percent, which exceeds HUD requirements by 23 percent.

Appendix D lists the case details for the 11 loans (excludes one loan already resolved with HUD) with significant deficiencies.

Lack of Supervision

The branch manager did not supervise employees to ensure prudent underwriting and compliance with HUD requirements. HUD requires lenders to exercise control and responsible supervision over their employees. The requirement for control and supervision must include regular and ongoing reviews of employee performance and of work performed. The branch manager was not involved in the day-to-day supervision of employees and did not perform ongoing reviews of employee performance.

When the corporate office identified deficiencies, the branch did not have formal procedures to correct them and prevent the problems from reoccurring. The branch manager received various deficiency reports from the corporate office. The branch manager primarily passed the deficiency information to the responsible employee through e-mail correspondence. The employees either e-mailed their response directly to the corporate office or indirectly through the branch manager. Several of First Magnus's six-month early payment default reports stated the same problems.

Undue Risk to HUD's Insurance Fund

First Magnus placed HUD's insurance fund at unnecessary risk by not following HUD underwriting requirements. The insurance fund is at risk for the potential and actual losses to HUD totaling $1,643,617. The 11 loans with material deficiencies had original insured mortgage amounts totaling $2,012,717. Four loans are currently active with original insured amounts of $781,777. Three loans had claims paid totaling $638,618. Four loans caused losses to HUD on the property sales totaling $223,222. Due to the seriousness of the deficiencies identified, HUD should not have insured the loans.

Because the underwriters did not follow proper underwriting guidelines, borrowers' mortgages were overinsured and borrowers were charged unallowable fees. The overinsured mortgages totaled $10,004, and the unallowable charges totaled $1,611. First Magnus needs to reimburse the appropriate parties for these amounts.

Conclusion

The branch did not follow HUD requirements in underwriting the insured loans. At the branch level, there is a lack of supervision and formal policies to ensure compliance with HUD requirements. The insurance fund is at risk for the potential and actual losses to HUD.

Recommendations

We recommend that the assistant secretary for housing – federal housing commissioner require First Magnus to

1a. Indemnify four actively insured loans originated at $781,777, which it issued contrary to HUD's requirements.

1b. Indemnify HUD for future losses on three loans with claims paid totaling $ 638,618, which it issued contrary to HUD's requirements.

1c. Reimburse HUD for claims paid and losses incurred on four loans totaling $ 223,222, which it issued contrary to HUD's requirements.

1d. Pay down the principal balance of the 10 overinsured loans totaling $10,004. For loans with claims already paid, remit the payment to HUD.

1e. Reimburse the appropriate parties for the unallowable fees totaling $1,611. For loans with claims already paid, remit the payment to HUD.

1f. Develop and implement policies/procedures to supervise its underwriting process.

SCOPE AND METHODOLOGY

The Denver branch underwrote 2,962 Federal Housing Administration-insured loans with beginning amortization dates between April 01, 2003, and March 31, 2005. Two hundred fifty-nine of these loans defaulted within the first two years of closing. We reviewed 51 of these defaulted loans. We selected the loans that posed the highest risk to the insurance fund. The risk factors we considered were the number of payments before default and claims paid. The results of our review only apply to the loans we reviewed.

To accomplish the audit objective, we

- Reviewed regulations and reference materials related to single-family requirements.
- Reviewed Federal Housing Administration case binders for compliance with regulations.
- Reviewed First Magnus's electronically scanned loan case files.
- Interviewed Denver branch officials and staff.
- Obtained the Denver branch's policies and procedures.
- Reviewed the Denver branch's quality control plan and quality control reviews, including the early payment default reports. We did not evaluate First Magnus's organizationwide implementation of the quality control process. Its corporate office performs this function. Another region is performing an audit of First Magnus's quality control process at the corporate level. We only reviewed the quality control procedures as they relate to the underwriting function at the branch level.
- Interviewed and discussed findings with the Denver HUD Quality Assurance Division office.

We used data maintained by HUD in the Single Family Data Warehouse and Neighborhood Watch systems for background information and in selecting our sample of loans. We did not rely on the data to base our conclusions. Therefore, we did not assess the reliability of the data.

We performed the audit work from May to October 2005 and conducted the audit in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that it meets the following objectives:

- 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 audit objectives:

- Underwriting policies and procedures – Policies and procedures established by management to ensure Federal Housing Administration-insured loans are underwritten in accordance with HUD requirements and

- Quality control process – Policies and procedures established by management to ensure implementation of the quality control plan and performance of related reviews in accordance with HUD requirements.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

Based on our review, we believe the following items are significant weaknesses:

- First Magnus does not have an adequate underwriting process to ensure compliance with HUD requirements.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1a			$ 781,777
1b		$ 638,618	
1c	$ 223,222		
1d	$ 10,004		
1e	$ 1,611		

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 polices or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a 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 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

FIRST MAGNUS
FINANCIAL CORPORATION

December 15, 2005

Ronald J. Hosking
Regional Inspector General for Audit
U.S. Department of HUD
Region 8 Office of Audit
UMB Plaza Building
1670 Broadway, 24th Floor
Denver, CO 80202-4801

Re: Draft Audit Report
First Magnus Financial Corporation
Denver, CO Branch Office
Tucson, AZ Corporate Office

Dear Mr. Hosking:

We are in receipt of a discussion draft dated November 23, 2005 that reports on the Office of Inspector General audit findings pertaining to the First Magnus Financial Corporation branch office located in Denver, CO. In addition, certain First Magnus corporate and branch personnel participated in an exit conference directly related to this audit on December 6, 2005 that was conducted by OIG Auditor Sarah Pon. At this conference, First Magnus was granted an extension until December 16, 2005 to provide its written comments for this report.

The discussion draft offers recommendations that the Assistant Secretary for Housing – Federal Housing Commissioner should take against First Magnus. The First Magnus response to these recommendations is as follows:

1a. Indemnify seven (7) actively insured loans originated at $1,420,395, which it issued contrary to HUD's requirements.

Risk Management personnel located at the Corporate Office of First Magnus Financial Corporation reviewed each of these seven (7) loans for underwriting deficiencies in direct correlation with HUD/FHA underwriting guidelines. We concur that First Magnus should be required to indemnify HUD against the possibility of future loss on each of these seven (7) loans.

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1b. Reimburse HUD for claims paid and losses incurred on four (4) loans totaling $223,222, which it issued contrary to HUD's requirements.

Risk Management personnel located at the Corporate Office of First Magnus Financial Corporation reviewed each of these four (4) loans for underwriting deficiencies in direct correlation with HUD/FHA underwriting guidelines. We concur that First Magnus should be required to reimburse HUD in the amount of $223,222 with regard to these four (4) loans.

1c. Pay down the principal balance of the ten (10) over-insured loans totaling $10,004. For loans with claims already paid, remit the payment to HUD.

Risk Management personnel located that the Corporate Office of First Magnus Financial Corporation reviewed each of these ten (10) loans in direct correlation with HUD/FHA guidelines. We concur that these ten (10) loans were over-insured; therefore First Magnus should be required to pay down each principal balance by the amount indicated in the discussion draft report or remit to HUD if a claim has already been paid.

1d. Reimburse the appropriate parties for the unallowable fees totaling $1,611. For loans with claims already paid, remit the payment to HUD.

Risk Management personnel located at the Corporate Office of First Magnus Financial Corporation reviewed each of these eighteen (18) loans in direct correlation with HUD/FHA guidelines. We concur that unallowable fees were charged incorrectly to the respective borrowers; therefore, First Magnus should be required to reimburse those fees, in the amounts indicated in the discussion draft report, to those borrowers or remit to HUD if a claim has already been paid.

1e. Develop and implement policies/procedures to supervise its underwriting process.

First Magnus Financial Corporation and its Denver branch office is committed to creating and administering a quality control process that will mitigate future underwriting deficiencies like those that were brought forth in this discussion draft report. Since the cited deficiencies came about primarily due to inadequate training and insufficient monitoring at the branch level, and not because of any intentional disregard for HUD/FHA guidelines, from a corporate perspective we feel confident that the process of underwriting FHA loans can and will be improved at our Denver, CO branch. We also feel confident that the quality of work produced by the Direct Endorsement Underwriters located at this branch can and will be monitored by knowledgeable on-site management personnel, working in tandem with the First Magnus Corporate Quality Control Department.

The actions that First Magnus has already taken or will take to mitigate future underwriting deficiencies at its Denver, CO branch office are as follows:

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- Two Direct Endorsement Underwriters on-site at this branch, which combined accounted for a majority of the FHA loan underwriting in previous years, were relieved of their FHA underwriting responsibilities earlier this year.

- The quality of the FHA loans underwritten by all Direct Endorsement Underwriters at this branch will be monitored by the Branch Manager with assistance from a Regional Underwriting Manager and the First Magnus Corporate Quality Control Department. The Branch Manager will be accountable for taking 'appropriate action' in a timely manner when certain recurring trends, as defined in various corporate audit reports, are evident and detrimental to the HUD/FHA loan program.

- The position of Regional Underwriting Manager located at this branch is being filled with a person who has been a Direct Endorsement Underwriter since 1988. This Regional Underwriting Manager will be responsible for the training and development of all other Direct Endorsement Underwriters located at this branch with major emphasis on originating quality FHA loan products.

- The Operations Manager currently on-site at this branch will become more involved with the underwriting of FHA loans with responsibility to significantly lesson the number of FHA loans closed that are over-insured or that have unallowable fees paid by borrowers.

- This branch is in the process of hiring a previous Operations Manager from another First Magnus branch office. This person, working in tandem with the Operations Manager, will allow for a constant review of the FHA file flow from start to finish. This 'double check' by two experienced people with FHA operational backgrounds will enhance accuracy and will identify the training needs of various branch personnel.

- The Direct Endorsement Underwriters at this branch will immediately begin to adopt a more conservative approach to FHA loan underwriting and will rely more heavily upon the LP and DU automated approval processes, with a corresponding reduction in the number of FHA loans that require a manual underwrite.

- Appropriate branch personnel will attend FHA underwriting training in January 2006 that will be held in the local area and all subsequent FHA training, as needed.

The actions that the Corporate Office of First Magnus will take to assist its Denver, CO branch in mitigating future HUD/FHA underwriting deficiencies are as follows:

- For the next six months an increased percentage of FHA loans originated from this branch will be audited by the First Magnus Corporate Quality Control

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Department for underwriting deficiencies. Results of these audits will be communicated to senior, regional and branch management personnel for training purposes and corrective action. At the end of this six month period, an assessment will be made by appropriate First Magus corporate management personnel with regard to the future of FHA lending at the Denver, CO branch.

- A 'clearinghouse' will be established at the corporate office of First Magnus to monitor the release of FHA loan specific audit information, such as Quality Control Reports, six-month default reports, etc., as well as the return of information [response] from all First Magnus branch offices.

  From this information a system to analyze the data being returned by each branch will be developed to ensure that the information is both accurate and addresses what corrective measures have been taken by the respective branch manager to alleviate the deficiency from recurring.

First Magnus Financial Corporation is committed to originating quality FHA loan products throughout its offices Nationwide. We firmly believe that the actions described herein will dramatically improve the quality of the FHA loan product being originated at our Denver, CO branch office.

Sincerely,

Steve Hartung
Assistant Vice President
Senior Manager
Loss Mitigation

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Appendix C

SCHEDULES OF DEFICIENCIES

SIGNIFICANT DEFICIENCIES

Case number	Questionable credit history	Unsupported assets	Underreported liabilities	Excessive ratios insufficient compensating factors	Overstated income	Insufficient employment documentation	Prohibited involvement by interested third party	Outstanding judgments	Significantly overinsured	Buydown affects pay ability	Original mortgage amount (1)	Claim paid (2)	Loss on sale (3)
052-3146518	X		X	X	X								$ 51,314
052-2747876	X	X	X	X	X	X	X						$ 68,090
052-2817280			X	X	X	X	X						$ 59,218
052-2922722	X			X					X				$ 44,600
052-2844762				X									HUD Resolved.
052-2924979	X							X				$ 209,110	
052-2999800			X	X	X						$ 197,214		
052-3163306				X		X				X	$ 236,572		
052-3426597	X							X				$ 220,809	
052-3427869	X	X		X				X			$ 202,492		
052-3522232				X						X	$ 145,499		
052-3549973	X			X		X		X				$ 208,699	
Count	***7***	***2***	***4***	***10***	***4***	***4***	***2***	***4***	***1***	***2***	***4***	***3***	***4***

Totals	**$ 781,777**	**$ 638,618**	**$ 223,222**

Combined totals = $ 1,643,617

(1) Loans actively insured as of September 30, 2005.

(2) HUD paid a claim for these loans and acquired the property. As of September 30, 2005, HUD has not sold the properties.

(3) HUD incurred a loss after the sale of these properties.

Unallowable Fees and Overinsured Loans

Case number	Type of loan	Unallowable fees (1)	Overinsured loan (2)
052-2890195	Streamline refinance	$ 40.00	
052-2921727	Streamline refinance		$ 1,184.28
052-2922722	Conventional refinance	$ 50.00	See above chart.
052-3147261	Streamline refinance		$ 674.58
052-2693666	Conventional refinance	$ 20.00	
052-3366730	Streamline refinance	$ 40.00	
052-2812701	Streamline refinance	$ 16.00	$ 1,662.96
052-3380210	Purchase	$ 25.00	
052-2822222	Streamline refinance		$ 99.85
052-2826020	Streamline refinance	$ 50.00	$ 1,449.87
052-2830439	Streamline refinance	$ 40.00	
052-2963995	Streamline refinance	$ 40.00	
052-2974532	Streamline refinance	$ 40.00	$ 1,776.70
052-2999800	Purchase	$ 515.00	
052-3138251	Streamline refinance	$ 40.00	
052-3449450	Streamline refinance	$ 45.00	$ 349.00
052-3170619	Cash-out refinance	$ 515.00	
052-3179840	Purchase	$ 15.00	
052-3232401	Streamline refinance	$ 40.00	$ 410.00
052-3291054	Streamline refinance	$ 40.00	$ 1,557.19
052-3327714	Cash-out refinance	$ 40.00	$ 839.75
	Count	***18***	***10***
	Totals	**$1,611.00**	**$10,004.18**

(1) First Magnus charged unallowable administration fees as the lender underwriting these loans. It also charged borrowers unallowable courier fees. Courier fees were unallowable because either the loans were not refinances or the borrowers did not agree to pay for the courier service in writing before loan closing. (HUD Handbook 4000.2, REV-2, paragraph 5-3; HUD Handbook 4000.2, REV-3, paragraph 5-2)

(2) First Magnus did not correctly calculate the allowable mortgage amount for these refinanced loans. (HUD Handbook 4155.1 REV-4, CHG-1, paragraphs 1-11 and 1-12; Mortgagee Letter 2001-12; HUD Handbook 4155.1 REV-5, paragraphs 1-11 and 1-12)

Appendix D

NARRATIVE CASE SUMARIES

(This section contains the narrative case summaries for the loans identified with significant deficiencies.)

HUD case number:	052-3146518	Status:	Net loss to HUD on resale
Loan amount:	$128,504	Loss on resale:	$51,314
Closing date:	September 26, 2003		

First Magnus underwrote and approved the mortgage based on an unacceptable credit history, overstated income, understated liabilities, and inaccurate and excessive debt-to-income ratios. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

<u>Unacceptable Credit History</u>
HUD Handbook 4155.1, REV-4, CHG-1, paragraphs 2-3 and 2-5; 24 CFR [*Code of Federal Regulations*] 203.5(c)
The borrower's credit history was unsatisfactory. There were no letters of explanation in the file for an open collection account of $104 and for a recently paid off derogatory account with a high balance of $14,224. The lender did not document its analysis of past derogatory accounts, such as the borrower's disregard for financial obligations, an inability to manage debt, or factors beyond the borrower's control.

<u>Overstated Income</u>
HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 2
The underwriter included the borrower's commissions for effective income; however, the underwriter did not obtain a current pay stub to ensure the commissions were likely to continue. The underwriter did not properly verify the commission income to ensure the stability of the income and the borrower's capacity to repay the mortgage debt. Without the commission income, this borrower does not qualify for the mortgage.

<u>Understated Liabilities</u>
HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 4
The underwriter understated the recurring expenses by $138 per month. The underwriter did not use the most current credit report in the file. The analysis did not take into account the new loan taken out by the borrower for the cash investment in the property.

<u>Inaccurate and Excessive Debt-to-Income Ratios</u>
HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 5; Mortgagee Letter 97-26
We recalculated the ratios using the correct gross monthly effective income and correct recurring expenses discussed above. The total fixed payment-to-income ratio would be 64.28 percent, which exceeds HUD requirements by 23 percent.

HUD case number:	052-2747876	Status:	Net loss to HUD on resale
Loan amount:	$134,883	Loss on resale:	$68,090
Closing date:	March 31, 2003		

First Magnus underwrote and approved the mortgage based on an unacceptable credit history, understated liabilities, overstated income, insufficient employment documentation, unsupported assets, inaccurate and excessive debt-to-income ratios, and prohibited involvement by an interested third party. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

Unacceptable Credit History and Understated Liabilities

HUD Handbook 4155.1, REV-4, CHG-1, paragraphs 2-3, 2-5, and 2-11; 24 CFR [*Code of Federal Regulations*] 203.5(c)

The borrower's credit history was unsatisfactory. The borrower did not pay an outstanding derogatory debt of $2,000 before closing. The underwriter did not adequately verify that the borrower paid all of the outstanding debt before closing. The documentation for some of the borrower's outstanding debt passed through the real estate agent.

Overstated Income and Insufficient Employment Documentation

HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 2, and chapter 3, paragraph 3-1

The underwriter did not adequately establish the anticipated amount of income and the likelihood of its continuance. The documentation did not sufficiently support the borrower's ability to repay the mortgage debt. The file did not contain the most recent year-to-date pay stub, documenting one full month's earnings. An incomplete pay stub was provided (no year-to-date earnings, deductions, etc.) by an interested third party, the realtor. The borrower did not provide Internal Revenue Service W-2 forms. The tax information ordered by First Magnus was for only one year, and it showed much less income than was reported on the verification of employment.

Our reverification of employment did not support the income reported in the file. The loan closed at the end of March 2003; however, the employer terminated the borrower's employment after March 2003. The lender did not properly verify the borrower's income and whether that income was to continue; therefore, it could not be included in calculating borrower's income ratios.

Unsupported Assets

HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 3

The underwriter did not verify all funds for the borrower's cash investment. The borrower appeared to have completed but did not sign the budget letter noted in the file.

Inaccurate and Excessive Debt-to-Income Ratios

HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 5; Mortgagee Letter 97-26

First Magnus approved the loan with high and inaccurate qualifying ratios. The underwriter approved the loan at the buydown rate without adequate compensating factors. Using the actual note rate, the mortgage payment expense ratio was 35 percent and total fixed payment ratio was 48 percent. As discussed above, the file documentation does not support these ratios. Due to these factors, it is unlikely the borrower has the ability to pay the mortgage.

Prohibited Involvement by Interested Third Party

HUD Handbook 4155.1, REV-4, CHG 1, chapter 3, section 1

The underwriter relied on documentation passed through the real estate agent, as an interested third party, to support the borrower's income, employment, and payoff of debts. Underwriters must verify that verification documents pass directly between the lender and provider without any third-party handling.

HUD case number:	052-2817280	Status:	Net loss to HUD on resale
Loan amount:	$162,450	Loss on resale:	$59,218
Closing date:	April 29, 2003		

First Magnus underwrote and approved the mortgage based on unacceptable overstated income, insufficient employment documentation, understated liabilities, inaccurate and excessive debt-to-income ratios, and prohibited involvement by an interested third party. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

Overstated Income and Insufficient Employment Documentation

HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 2, and chapter 3, paragraph 3-1

The underwriter did not adequately establish the anticipated amount of income and the likelihood of its continuance. The documentation did not sufficiently support the borrower's ability to repay the mortgage debt. The file did not contain the most recent year-to-date pay stub documenting one full month's earnings. An incomplete pay stub was provided (no year-to-date earnings, deductions, etc.) by an interested third party, the realtor. The borrower did not provide Internal Revenue Service W-2 forms.

Our reverification of employment did not support the income reported in the file. The loan closed at the end of April 2003; however, the employer terminated the borrower in March 2003. The lender did not verify the borrower's income and whether it was to continue; therefore, it could not be included in calculating borrower's income ratios.

Understated Liabilities

HUD Handbook 4155.1, REV-4, CHG-1, paragraphs 2-3 and 2-11

There was no verification of rental history as required. The credit report shows one small derogatory item and two liabilities with monthly payments of $47 that were not on the loan application and mortgage credit analysis worksheet. The underwriter should have considered the additional debt in the calculation of recurring expenses.

Inaccurate and Excessive Debt-to-Income Ratios

HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 5; Mortgagee Letter 97-26

First Magnus approved the loan with high and inaccurate qualifying ratios. The underwriter used inaccurate compensating factors. The underwriter did not determine how the borrower would handle the payment shock. The borrower had no verifiable assets or investment in the property. As discussed above, the lack of employment does not support the ratios. It is unlikely the borrower has the ability to repay the mortgage debt.

Prohibited Involvement by Interested Third Party

HUD Handbook 4155.1, REV-4, CHG 1, chapter 3, section 1

The underwriter relied on documentation passed through the real estate agent, as an interested third party, to support the borrower's income and employment. Underwriters must verify that verification documents pass directly between the lender and provider without any third-party handling.

HUD case number:	052-2922722	Status:	Preforeclosure sale completed
Loan amount:	$195,668		
Closing date:	June 12, 2003	Claim Paid:	$44,600

First Magnus underwrote and approved the mortgage based on a questionable credit history and inaccurate and excessive debt-to-income ratios and significantly overinsured loan. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

Unacceptable Credit History
HUD Handbook 4155.1, REV-4, CHG-1, paragraphs 2-3 and 2-5; 24 CFR [*Code of Federal Regulations*] 203.5(c)
The borrower's credit history was unsatisfactory. The borrower had several derogatory credit items shown on the credit report, which shows a poor attitude toward credit obligations. The underwriter did not obtain a written explanation or document compensating factors for approving the loan. The lender did not document its analysis as to whether past derogatory accounts were due to the borrower's disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

Inaccurate and Excessive Debt-to-Income Ratios
HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 5; Mortgagee Letter 97-26
The mortgage payment expense ratio exceeds the guidelines. The underwriter did not list any compensating factors on the mortgage credit analysis worksheet as required. The documentation did not sufficiently support the borrower's ability to repay the mortgage debt.

Significantly Overinsured Loan
HUD Handbook 4155.1, REV-4, CHG-1, chapter 1, section 4
The loan was a cash-out refinance for the purposes of consolidating the first mortgage and a debt. Cash-out refinances are limited to 85 percent of the appraised value. The appraised value is $205,000; therefore, the loan amount should not have exceeded $174,250. The loan amount was actually $195,688, or $21,438 over the allowable insured amount.

HUD case number:	052-2924979	Status:	Property conveyed to insurer
Loan amount:	$193,956	Claims Paid:	$209,110
Closing date:	June 27, 2003		

First Magnus underwrote and approved the mortgage based on questionable credit history and outstanding judgments. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

Questionable Credit History and Outstanding Judgments

HUD Handbook 4155.1, REV-4, CHG-1, paragraphs2-3 and 2-5

The borrower's credit report showed 59 collection accounts and 2 civil judgments. It does not appear the borrower had a good attitude toward credit obligations, although the borrower provided some letters of explanation for the collection accounts. The borrower did not pay two of the judgments totaling $220 before closing. The borrower is required to pay off judgments before loan approval. The underwriter must consider the judgments, as well as the numerous collections, in the analysis of credit worthiness because they indicate the borrower's disregard for credit obligations.

Despite adequate income to support the obligations, the borrower did not have a good attitude toward credit obligations. The borrower did not invest any of his own funds in the property. The borrower deposited $500 as earnest money but received $500 back at closing. The borrower received gift funds as the cash requirement. The borrower only made two payments before defaulting and only made three payments during the approximately one and one-half years of the loan.

HUD case number:	052-2999800	Status:	Reinstated by mortgagor
Loan amount:	$197,214	Indemnification:	$197,214
Closing date:	July 21, 2003		

First Magnus underwrote and approved the mortgage based on overstated income, understated liabilities, and inaccurate and excessive debt-to-income ratios. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

Overstated Income
HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 2
The mortgage credit analysis worksheet overstates the coborrower's monthly income of $497. The underwriter used a 17.8-month average to compute the monthly income for the coborrower. The two pay-stubs and two Internal Revenue Service W-2 forms in the file do not support the higher income amount.

Understated Liabilities
HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 4
The mortgage credit analysis worksheet understated the recurring liabilities by $353. The monthly car payment of $353 was not included in the recurring expenses because there were fewer than 10 monthly payments remaining. However, HUD requirements state that lenders must count debts with fewer than 10 months remaining if the amount of the debt affects the borrower's ability to make the mortgage payment, especially if there are limited cash assets after closing. The borrower's cash reserves are less than one month's reserve. The limited cash reserve, along with the overstated income above, affects the borrower's ability to make the mortgage payment. The car payment should have been included in the recurring expenses.

Inaccurate and Excessive Debt-to-Income Ratios
HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 5; Mortgagee Letter 97-26
The underwriter approved the loan with a high qualifying ratio. The total fixed payment-to-income ratio was 53.70 percent, which exceeds the HUD requirement by 12.7 percent. We recalculated the qualifying ratios using the correct gross monthly income and correct recurring expenses discussed above. The recalculated mortgage payment-to-income ratio of 32.11 percent exceeds the HUD requirement by approximately 3 percent. The total fixed payment-to-income ratio of 68.91 percent exceeds the HUD requirements by almost 28 percent.

HUD case number:	052-3163306	Status:	Delinquent
Loan amount:	$236,572	Indemnification:	$236,572
Closing date:	September 29, 2003		

First Magnus underwrote and approved the mortgage based on insufficient employment documentation, insufficient verification of rent payment history, inaccurate and excessive debt-to-income ratios, and inappropriate use of a buydown to qualify. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

Insufficient Employment Documentation

HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 2, and chapter 3, paragraph 3-1

The underwriter did not adequately verify and document the borrower's income. The underwriter cannot use the income to approve the loan if it is not sufficiently verified and documented. The file did not contain the most recent year-to-date pay stub or Internal Revenue Service W-2 forms to support the income.

Insufficient Verification of Rent Payment History

HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 1, and chapter 3, paragraph 3-1

The underwriter did not verify previous rental payment for the most recent 12 months. The mortgage credit analysis worksheet shows the new total mortgage payment to be $1,582. This is more than a $700 increase in the housing payment. Without verification of the previous rent payment and without considering the buydown interest rate (below), the underwriter did not support that the borrower had the capacity to qualify the loan.

Excessive Debt-to-Income Ratios

HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 5

First Magnus approved the loan with a high mortgage payment-to-income ratio. The mortgage payment-to-income ratio was 35.72, which exceeds the HUD requirement by almost 7 percent. The files did not contain documentation or support for the compensating factors. The underwriter should not have used the buydown to approve the loan. The underwriter should have only used it as a compensating factor.

The mortgage payment-to-income ratio increases to 42.42, and the total fixed payment-to-income ratio increases from 37.98 to 44.68, using the actual note mortgage payment. The file contains no evidence the underwriter considered this increase to determine whether the borrower had the capacity to handle the higher payment. These excessive ratios and the lack of compensating factors do not support approving the loan. It is unlikely the borrower has the ability to repay the mortgage debt.

Inappropriate Use of Buydown to Qualify

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-14; Mortgagee Letter 97-26

First Magnus qualified the borrower using the buydown interest rate but failed to show that the scheduled mortgage payment increase would not adversely affect the borrower and likely lead to default. To use the buydown interest rate to qualify, the underwriter must document the borrower's ability to handle the scheduled mortgage payment increase. It is unlikely the borrower has the ability to repay the mortgage debt.

HUD case number:	052-3426597	Status:	Property conveyed to insurer
Loan amount:	$213,647	Claims Paid:	$220,809
Closing date:	May 28, 2004		

First Magnus underwrote and approved the mortgage based on questionable credit history and outstanding judgments. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

<u>Questionable Credit History and Outstanding Judgments</u>

HUD Handbook 4155.1, REV-5, paragraphs 2-3 and 2-5

The borrower's credit report shows one judgment, two bankruptcies, an account more than 90 days old, 10 seriously delinquent accounts, and 12 closed/paid off accounts. Although the file contained some explanation letters and some of the items were older, it does not appear the borrower had a good attitude toward credit obligations. The borrower did not pay a judgment for $300 before closing, which the borrower is required to pay as a condition of loan approval. The borrower did not explain two derogatory debts. The borrower must explain in writing all collections and judgments. The underwriter must consider the judgments, as well as the overall pattern of credit behavior, in the analysis of credit worthiness because they indicate the borrower's disregard for credit obligations.

The underwriter did not verify rent, and the file did not contain documentation for verification of rental history. The new total mortgage payment is $1,622. Based on the unverified documentation in the file, this is at least a $400 increase in the housing payment. With the borrower's credit history, we question whether the borrower has the capacity to qualify for this high a mortgage amount.

HUD case number:	052-3427869	Status:	Delinquent
Loan amount:	$202,492	Indemnification:	$202,492
Closing date:	May 24, 2004		

First Magnus underwrote and approved the mortgage based on a questionable credit history and outstanding judgment, inadequately supported assets, and inaccurate and excessive debt-to-income ratios. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

<u>Questionable Credit History and Outstanding Judgment</u>
HUD Handbook 4155.1, REV-5, chapter 2, section 1
The borrower's credit report shows 5 judgment and 15 collection accounts. Although the file contained some explanation letters and some of the items were older, it shows a serious disregard for credit obligations, and it does not appear the borrower had a good attitude toward credit obligations. The borrower did not pay a judgment for $700 before closing, which the borrower is required to pay as a condition of loan approval. The borrower must explain in writing all judgments and collections. The borrower paid the collection accounts as a condition for loan approval; however, this decreased the borrower's cash reserves (see below). The underwriter must consider the judgments, as well as the overall pattern of credit behavior, in the analysis of credit worthiness because they indicate the borrower's disregard for credit obligations.

<u>Unsupported Assets</u>
HUD Handbook 4155.1, REV-5, chapter 2, section 3
The underwriter did not adequately verify and document funds for the borrower's cash investment. The file only contained a summary bank statement showing the balance of the bank account. The statement showed a balance of more than $20,000 but did not show the detailed monthly activity. Due to the credit history of the borrower, this is a rather large amount of money and requires the lender to obtain a creditable explanation of the source of funds.

<u>Excessive Debt-to-Income Ratios</u>
HUD Handbook 4155.1, REV-5, chapter 2, section 5
First Magnus approved the loan with excessive qualifying ratios without adequate compensating factors. The mortgage and fixed payment-to-income ratios were 47.89 percent, which exceeds the HUD requirement by almost 19 percent for the mortgage payment ratio and by almost 7 percent for the total fixed payment ratio. There was not support in the files for the compensating factors listed on the mortgage credit analysis worksheet.

The actual cash reserves after closing were almost zero because cash reserves listed in the file paid for collection accounts and the large amount of funds required for closing and should have paid for the outstanding judgments. The underwriter considered that the borrower had a low loan amount compared to the value of the property. However, the loan was for 96 percent of the value of the property, which is not low and is an unsupported compensating factor. The credit history, low cash reserves, and high ratios causes doubt as to whether the borrower can reasonably be expected to meet the expenses involved in homeownership.

HUD case number:	052-3522232	Status:	First legal action to commence foreclosure
Loan amount:	$145,499		
Settlement date:	August 31, 2004	Indemnification:	$145,499

First Magnus underwrote and approved the mortgage based on inaccurate and excessive debt-to-income ratios and inappropriate use of a buydown to qualify. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

Excessive Debt-to-Income Ratios

HUD Handbook 4155.1, REV-5, chapter 2, section 5

First Magnus approved the loan with high qualifying ratios. The total mortgage payment-to-income and the total fixed payment-to-income ratios were 44.80 percent, which exceeds the HUD requirement by almost 16 percent for the mortgage payment ratio and by almost 4 percent for the total fixed payment ratio. The compensating factors were minimal and were not significant factors as required for approving a buydown loan. The underwriter should have used the buydown as a compensating factor, and she should not have used it to approve the loan.

Using the actual note mortgage payment, the mortgage payment expense and total fixed payment ratios were 53.49 percent. We considered an average of the borrower's overtime income and the cash reserves of the borrower, which were compensating factors. The compensating factors were minimal and not significant enough to support the borrower's ability to pay the mortgage. These excessive ratios and the minimal compensating factors do not support approving the loan, and it is unlikely the borrower has the ability to repay the mortgage debt.

Inappropriate Use of Buydown to Qualify

HUD Handbook 4155.1, REV-5, paragraph 2-14

First Magnus qualified the borrower using the buydown interest rate but failed to show that the scheduled mortgage payment increase would not adversely affect the borrower and likely lead to default. To use the buydown interest rate to qualify, the underwriter must document the borrower's ability to handle the scheduled mortgage payment increase. It is unlikely the borrower has the ability to repay the mortgage debt.

HUD case number:	052-3549973	Status:	Accelerated claim disposition
Loan amount:	$201,832	Claims Paid:	$208,699
Closing date:	October 01, 2004		

First Magnus underwrote and approved the mortgage based on an unacceptable credit history, understated liabilities, and inaccurate and excessive debt-to-income ratios. Therefore, HUD insured the loan based on First Magnus's inaccurate representation that the borrower met HUD qualifying guidelines.

Unacceptable Credit History

HUD Handbook 4155.1, REV-5, paragraph 2-3

The borrower's credit history was unsatisfactory. The credit report listed a judgment for $525. HUD requires that court-ordered judgments be paid off before the mortgage loan is eligible for insurance endorsement. The file did not contain documentation that showed the borrower paid off the judgment before closing or endorsement. According to the underwriter, she mistakenly overlooked this judgment.

Understated Liabilities

HUD Handbook 4155.1, REV-5, paragraphs 2-3 and 2-11

The mortgage credit analysis worksheet understates the borrower's recurring liabilities by $602. There is no documentation in the file to show the borrower paid off the five accounts as stated on the application. Four of the five accounts were in collection for bad debts. The balances of these four accounts total $173.

The fifth account not paid off was with Countrywide Home Loans for $92,377 at $602 per month. A condition of the loan approval was the sale of the house mortgaged with Countrywide Home Loans with anticipated sale proceeds expecting to total $9,000. The borrower did not sell the property before loan closing. Since borrower did not pay off the loan before closing, the recurring expenses increased from $469 to $1,071.

Inaccurate/Excessive Debt-to-Income Rratios

HUD Handbook 4155.1, REV-5, chapter 2, section 5

The underwriter approved the loan with high qualifying ratios without adequate compensating factors. The mortgage payment-to-income ratio was 33.70 percent, which exceeds the HUD requirement by almost 5 percent. The total fixed payment-to-income ratio was 44.96 percent, which exceeds the HUD requirement by almost 4 percent. We recalculated the qualifying ratios using the correct recurring expenses discussed above. With the increase of $602 to the recurring expenses, the total fixed payment-to-income ratio increased to 51 percent. This exceeds the HUD requirement by 10 percent.

Compensating factors listed on the mortgage credit analysis worksheet were inadequate, and the file did not contain any support for the exceeding ratios. The file contained no support for the compensating factor of two months' reserves.

The housing expense more than doubled. It increased by more than $800 dollars. This increase, along with the high ratios, causes doubt as to the borrower's ability to meet the expenses involved in homeownership.