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| Issue Date        | October 4, 1999 |
| Audit Case Number | 00-AT-225-1001  |

TO: Charles E. Gardner, Director, Atlanta Homeownership Center, 4AHH

FROM: Nancy H. Cooper  
District Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: Mego Mortgage Corporation  
Title I Approved Lender  
Atlanta, Georgia

Attached is our report on Mego Mortgage Corporation, now known as Altiva Financial, for selected Department of Housing and Urban Development (HUD) insured Title I mortgages originated in the states of Arkansas, California, Florida, Georgia, Louisiana, New York, and Ohio.

The report identifies significant loan origination deficiencies that warrant action by the Atlanta Homeownership Center. Mego did not comply with HUD requirements and prudent lending practices when it originated and/or underwrote 23 of 24 HUD Title I loans. Furthermore, Mego needed to improve its inspection procedures.

Within 60 days, please furnish a status report, for each recommendation, on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued related to this audit.

We are providing a copy of this report to Mego Mortgage Corporation.

Should you or your staff have any questions, please contact James D. McKay, Assistant District Inspector General for Audit, at (404) 331-3369.

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# Executive Summary

We completed a review of Mego Mortgage Corporation (Mego), an approved Title I Lender, generally for the period January 1, 1996, through August 31, 1998. We conducted the review because Mego had a default rate which exceeded the national average for Title I lenders. The audit objective was to determine if Mego originated HUD insured Title I loans according to HUD requirements for borrower income, liabilities, loan amount, and property inspections. We identified noncompliance with requirements for each area.

Mego did not properly process and underwrite Title I loans. Mego consistently approved excessive (\$176,518) and inadequately supported (\$126,930) loan amounts, and in six cases without a proper review of borrowers' income and or liabilities. We also identified instances where Mego approved loans without adequately clarifying differences between work items listed in the application and the detailed cost estimates. The deviations from requirements increased HUD's insurance risk on the loans approved for excessive amounts and whose eligibility Mego did not clearly establish. These matters provided the opportunity for fraud and abuse of the Title I program. We identified several instances where such abuses had occurred.

Mego also needed to improve certain practices and or procedures related to property inspections. We noted (a) two instances where Mego failed to notify HUD about program abuses that came to its attention; (b) one instance where Mego's inspections did not document the borrower's failure to complete repairs; and (c) one instance where Mego did not timely resolve issues raised by a borrower who filed a complaint concerning deficient work by a dealer. These deviations from requirements deprived HUD of information it could have used to protect the integrity of the Title I program. They also reduced assurance that borrowers used their Title I loans for allowable repairs that were reasonably priced and completed with acceptable workmanship.

The forgoing program violations occurred because Mego did not follow or consistently follow HUD requirements and prudent lending practices.

We recommend that the Atlanta Homeownership Center take appropriate administrative action against Mego.

We discussed the issues in this report with Mego representatives during the review and at an exit conference held at Mego's office on August 30, 1999. Mego officials took exception to the report and recommendations. Mego's comments are summarized at the end of each finding, and presented as Attachment B.

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## Abbreviations

|     |   |
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| HUD | Department of Housing and Urban Development |
| CFR | Code of Federal Regulations                 |
| OIG | Office of Inspector General                 |

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# Introduction

## Background

HUD insures property improvement loans made by approved lending institutions under Section 2 of Title I of the National Housing Act. HUD executes a Title I contract with lenders approved by the Secretary to originate, purchase, hold, service, and/or to sell Title I loans. In making Title I loans, the lender may utilize the services of a loan correspondent and/or a dealer. A loan correspondent is a financial institution approved by the Secretary to originate Title I direct loans for sale or transfer to a sponsoring lending institution that holds a valid Title I contract of insurance. A dealer, in the case of property improvement loans, means a seller, contractor or supplier of goods and services. A dealer loan means a loan where a dealer, having a direct interest in the transaction between the borrower and the lender, assists the borrower in preparing the credit application or otherwise assists the borrower in obtaining the loan from the lender.

Mego Mortgage Corporation was incorporated on June 12, 1992, in the State of Delaware. HUD approved Mego as a Title I Lender on March 8, 1993. Effective March 18, 1999, Mego amended its Certificate of Incorporation with the State of Delaware and officially changed its name from Mego Mortgage Corporation to Altiva Financial Corporation. The name change occurred after the period covered by the audit. Throughout the report we use the name Mego to refer to Mego Mortgage Corporation and to Altiva Financial Corporation because that was the name in effect for the period of our tests.

During our audit period, January 1, 1998, through August 31, 1998, Mego funded 13,068 loans of which they had filed 451 claims with HUD. Mego quit processing Title I loans on March 31, 1998.

Mego's office was located on the sixth floor of 1000 Parkwood Circle, Atlanta, Georgia 30339.

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### Audit Objectives, Scope and Methodology

Our audit objective was to determine if Mego complied with HUD Title I requirements related to the analysis of borrower income, borrower liabilities, loan amount and property inspections. The audit generally covered the period January 1, 1996, through August 31, 1998. During that period Mego funded 13,068 Title I loans of which it had filed 451 insurance claims with HUD. To accomplish the audit objectives, we judgmentally selected and reviewed 24 loans with principal amounts that totaled \$470,009. The 24 loans included three for which the borrowers were current on their monthly payments; four where the borrowers were in default; and 16 for which

Mego had filed insurance claims with HUD. The properties were located in the states of Arkansas, California, Florida, Georgia, Louisiana, New York, and Ohio. The sample included 11 loans processed by Mego dealers and 13 loans processed by Mego sponsored loan correspondents. To assess compliance of the loans with requirements, we:

1. Reviewed applicable Federal regulations and HUD guidelines;
2. Interviewed HUD staff, Mego staff, and borrowers;
3. Verified borrower income and liabilities;
4. Obtained and evaluated relevant documents from Mego and HUD; and
5. Inspected properties located in Arkansas, Florida, Georgia, Louisiana, and Ohio to determine if the improvements were properly completed and reasonably priced.

We performed our field work from August 1998 to June 1999. We conducted the audit in accordance with generally accepted government auditing standards.



## Need to Improve Underwriting Practices

Mego personnel did not comply with HUD requirements and prudent lending practices when it originated and/or underwrote 23 of 24 HUD Title I loans. As a result, Mego approved loans for:

- Excessive (\$176,518) and inadequately supported (\$126,930) amounts.
- Six borrowers without a proper credit analysis.
- Six borrowers whose cases involved various other compliance issues.

This occurred because Mego did not comply with requirements when it processed and underwrote the loans. These conditions increased HUD's insurance risk on the loans and the opportunity for fraud and abuse. Mego had filed insurance claims with HUD for 16 of the 24 loans examined. We identified several instances where such abuses had occurred.

We judgmentally selected and performed a limited review of 24 loans to assess whether Mego had complied with certain HUD underwriting requirements. To assist with the analysis, we obtained the services of our construction analyst. The analyst inspected 16 of the properties to analyze the cost of the repairs and to assess the quality and completeness of the work. The analyst also reviewed cost estimates submitted by five of the borrowers to determine if they properly supported the loan amounts.

Excessive and  
inadequately supported  
loan amounts

Title 24 of the Code of Federal Regulations (CFR), Part 201.10(a) states that the total principal obligation for the property improvement loan shall not exceed the actual cost of the project plus applicable fees and charges. Title I loan proceeds shall be used only for eligible purposes cited in the loan application to finance property improvements that substantially protect or improve the basic livability or utility of the property (24 CFR 201.20). To assist in making this determination, lenders are required to obtain a detailed written description of the work to be performed, the materials to be furnished, and their estimated cost (24 CFR 201.26(a)(2)). Lenders are also required to employ trained personnel competent to perform their assigned responsibilities in consumer and mortgage lending activities (24 CFR 202.3(b)).

Mego either did not obtain or did not adequately review borrower cost estimates and contracts to ensure that their loan amounts did not exceed the cost of projects described in the borrowers' Title I loan applications. Specifically, Mego approved:

- **\$176,518 in excessive loan amounts (Appendix A)**
  - Mego approved 18 loans totaling \$355,851 that exceeded what the borrowers needed for work described in their loan applications by \$176,518 or by 50 percent. Some estimates contained information sufficient for Mego to have evaluated the costs, while in other instances more information was needed. However, Mego did not adequately review the detailed information provided nor did it request missing details when needed. Mego simply approved the loan amounts cited in the borrower's applications without adequate consideration of the supporting details and whether the proposed work justified the loan amount.

Our construction analyst reviewed the cost estimates and inspected the properties. During the inspections, the analyst obtained measurements, quantities and other details that should have been but were not included in Mego's file. The analyst used the results to calculate how much the work should have cost.

We were especially concerned about the \$105,032 excessive amounts for dealer processed loans. The dealers were contractors who either knew or should have known they had overvalued the repairs. The dealers helped the borrowers prepare their loan applications that included the repair estimate. The dealers also did the work after Mego approved the borrowers' loan applications. The dealers received the excessive amounts they estimated for the work. The \$71,486 excessive amounts for the loans processed by correspondents, unlike the dealer loans, were the responsibility of the borrowers. However, in both instances, Mego had a responsibility to ensure that the cost estimates justified the loan amounts to reduce the opportunity for fraud and abuse. For instance:

Borrower A received a \$25,000 loan. The borrower said he used \$15,000 to pay bills and about \$8,000 for repairs to the property. The borrower's statements were consistent with our determination that the loan was excessive by \$8,141 and with our determination that the borrower did not perform work valued at \$18,925 in the cost estimate sent to Mego. The borrower said he told the loan correspondent, Real Estate Mortgage Acceptance Co., who processed the loan that he basically wanted the loan to pay bills. Mego made a similar determination as to misuse of funds and incomplete work when it inspected the property. However, Mego did not report this matter to HUD (Finding 2).

The spouse of borrower P said the dealer, City Wide Builder, Inc., completed the work cited in the loan application and then returned \$10,000 of the loan amount to her and her husband. The borrower's statements were consistent with our determination that the dealer overvalued the work by \$15,891. The excessive loan amount was more than enough to offset the \$10,000 allegedly returned to the borrower. This left the dealer with about a \$5,000 windfall as well.

Borrower O received a \$25,000 loan for exterior siding and roof repair to a 408 square foot non-residential structure.



The loan exceeded the indicated repair cost by \$20,949.

- \$126,930 for inadequately supported loan amounts. Mego approved \$126,930 for seven loans without obtaining and or reviewing the details it needed to ensure that the loans did not exceed the cost of projects described in borrower applications. The missing information involved data such as measurements, quantities, and specifications for materials and or supplies. We did not inspect these properties to obtain the missing information as we did for the preceding cases. Instead, we assessed the estimates based on the information contained in Mego's loan file for the respective borrowers.

The frequency of the foregoing deficiencies indicated a systemic problem within Mego's operations. The excessive and inadequately supported loan amounts created the opportunity for fraud and abuse.

Inadequate consideration  
of borrower  
creditworthiness

Lenders are required to verify the borrower's income (24 CFR 201.22(a)(3)). They are also required to include income from all sources that is reasonably expected to be available during the first two years of the loan obligation (24 CFR 201.22(a)(10)). If a credit report is not available or is incomplete, the loan file shall contain other documentation of the lender's diligent investigation of the credit of the borrower (24 FR 201.22(a)(5)). HUD limited approval of Title I loans to borrowers with debt to income ratios at or below 45 percent (Title I Letter TI-412, dated October 18, 1991).

Mego did not properly evaluate income and or liabilities for 6 of the 24 loans examined. For Instance:

- Borrower Q - Mego added 25 percent to the borrower's verified income. The files did not document the basis for the 25 percent increase. In its written response to the finding, Mego stated that it used the 25 percent pursuant to the Equal Credit Opportunity Act to gross-up the borrower's social security income. The HUD Title I regulations don't address this issue. Therefore, we recalculated the borrower's income based on the amount Mego verified with the employer. The results showed a debt to income ratio of 48 percent versus the 39 percent rate Mego calculated.
- Borrower E - The credit report showed the borrower had monthly payments totaling \$1,378 to nine creditors. Mego only used monthly payments totaling \$821 to three of the nine creditors in its analysis of the borrower's creditworthiness. The file did not explain why Mego omitted monthly payments totaling \$557 to the other six creditors. As a result, Mego calculated a 34 percent debt to income ratio when the actual ratio amounted to 58 percent. However, we noticed that Mego obtained an agreement from the loan correspondent, Newport Shores Financial, Inc., to repurchase the loan if the borrower ever becomes 60 days delinquent.

- Borrower W - Based on our independent verification and review, the borrower had an excessive 70 percent debt to income ratio versus the 49 percent ratio Mego calculated and approved.

The files for the other three borrowers did not contain proper support for Mego's decision to approve the loans. The loans involved inadequate verification of overtime for borrower C; inadequate consideration of self employment income for borrower F and, inadequate verification of liabilities for borrower T.

Inadequate verification of  
initial payment

For any loan with a total principal balance in excess of \$5,000, lenders shall obtain written verification of the source of all funds of the borrower required for the borrower's initial payment, if such payment will be in excess of five percent of the loan (24 CFR 201.22(a)(8)).

The settlement statement showed borrower M made a \$1,285 initial payment. The initial payment exceeded five percent of the loan amount. Mego did not obtain the required written verification of the source of funds the borrower used for the initial payment.

Other compliance issue

Title I loan proceeds shall be used only for eligible purposes cited in the loan application (24 CFR 201.20).

The cost estimates for Borrowers A, B, E, and F included repairs that were not mentioned in the list of repairs shown in the loan application. The repairs listed on the application and those listed on the cost estimate should agree.

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Auditee Comments

Excessive or Unsupported Loan Amounts

Mego officials adamantly opposed this finding. Mego contended they obtained and reviewed all information required by the governing regulations. Mego stated federal statutes, regulations, and HUD Title I program guidelines do not define or provide assistance in determining the amount of detail which is required in the written description of improvements or materials to be furnished. Moreover, they knew of no obligation imposed upon a Title I lender, in a statute, regulation, or other written guidance by HUD to price improvements, to engage independent analysts or to

otherwise scrutinize the work to be performed, the materials to be provided, or the actual cost of such materials. Mego agreed they were required by regulation to employ trained personnel to perform their assigned responsibilities in consumer and mortgage lending activities. However, they contended the obligation did not extend to employment of construction analysts or other employees with building, construction or similar training or experience.

Mego said it priced many of the materials which the OIG's estimate listed as excessive and strongly objected to several of the estimates made by the construction analyst retained by HUD. Mego said the construction analyst had the benefit of inspecting the actual improvement after their completion, which information, of course, was not available to Mego at the time it conducted a review of documentation designed to ensure that the loan was eligible for the Title I program. In addition, they said HUD's construction analyst inspected the property years after the improvements were completed which may have contributed to lower estimates of the cost of materials due to deterioration or normal wear and tear. They believed the estimate provided by the borrowers was in the range of the estimate provided by the OIG.

Mego disagreed with the OIG's interpretation of the existing regulations and requested that HUD strictly interpret regulations and enforce them as written. Mego stressed that absent affirmative direction from Congress or HUD, it would not be commercially feasible for Mego to originate Title I loans in accordance with the higher standards the OIG attempts to establish unofficially in the audit report. Nevertheless, Mego said it will revise its manuals addressing Title I in order to incorporate the guidance provided by the draft audit report. Mego urged HUD to formalize such guidance so that all Title I lenders, borrowers, correspondents, and dealers are held to such higher standard. Without such uniformity, Mego said it may determine that it is not commercially feasible for it to conduct its Title I program in accordance with the unofficial guidelines offered in the draft audit report.

Creditworthiness

Mego maintained that it performed a proper underwriting review of the loans for borrowers A, C, E, F, Q, T, V and W and provided supplemental explanations to justify its underwriting decisions.

Inadequate verification of initial payment

Mego agreed with our conclusion.

Missing File

Mego said the file was not missing and provided the file to HUD during its review.

Other Compliance Issues

Mego said the loan applications included attachments describing all improvements when such improvements were not listed in the “body” of the application. These attachments were part of the applications and satisfied 24 CFR 201.20.

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OIG Evaluation of  
Auditee Comments

Excessive or Unsupported Loan Amounts

We welcome Mego’s willingness to modify its operating procedures. However, we disagree with Mego’s position that the statute, regulations or other written guidance by HUD placed no obligation on lenders to price improvements or to otherwise scrutinize the work to be performed to the extent called for by the audit. As mentioned in the report, 24 CFR 201.10(a) states that the total principal obligation for the property improvement loan shall not exceed the actual cost of the project plus applicable fees and charges. Thus, despite Mego’s claim to the contrary, the regulations placed an obligation on lenders to assure that the approved loan did not exceed the amount needed for the repairs. The audit reiterates this requirement and does not attempt to retroactively impose upon Mego obligations not authorized or required by HUD.



Mego questioned the accuracy of OIG's estimates but did not provide any specific examples to support its disagreement. The construction analyst prepared estimates based on RS Means Repair & Remodeling Cost Data (published annually) in effect for the areas where the homes were located at the time of the borrower's loan application.

#### Creditworthiness

Based on Mego's comments and supplemental information we deleted the creditworthiness issues for borrowers A and V. We also revised the presentation for borrower E to reference the indemnification agreement Mego obtained from the loan correspondent. We recognized Mego's explanation for increasing borrower Q and W's social security income by 25 percent based on provisions of the Equal Credit Opportunity Act. We found no reference in HUD's Title I regulations for the 25 percent increase. This issue will require a determination by HUD. We made no other changes based on our assessment of Mego's comments.

#### Missing File

We removed this issue from the report. Mego provided the file following the exit conference. The file contained the information needed to resolve our concerns.

#### Other Compliance Issues

We revised the wording in the report to clarify our position.

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### Recommendations

We recommend that the Atlanta Homeownership Center require Mego to:

- 1A. Reimburse HUD the full or partial claim amounts paid for loans that were not properly underwritten and/or were approved for excessive amounts.
- 1B. Indemnify HUD for any future claims attributed to loans that were not properly underwritten, and/or were approved for excessive amounts.

- 1C. Implement appropriate changes to its underwriting procedures to ensure proper review and analysis of borrower loan amounts and eligibility for Title I loans.

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## Need to Improve Inspection Procedures

Mego needed to improve certain practices and/or procedures related to property inspections. We noted two instances where Mego failed to notify HUD about program abuses that came to its attention and one instance where Mego's inspections did not document the borrower's failure to complete repairs. These matters deprived HUD of information it could use to protect the integrity of the Title I program and reduced assurance that borrowers used the loan for allowable purposes.

We inspected 16 properties that included 7 with loans processed by loan correspondents and nine with loans processed by dealers. We identified the following matters that require action by Mego:

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Program abuses not  
reported to HUD  
(correspondents)

If, after a loan has been made, the lender discovers any material misstatement of fact or that the loan proceeds have been misused by the borrower, dealer or any other party, it shall promptly report this to the Secretary (24 CFR 201.40(a)). Mego did not report the following two program abuses to HUD:

- Mego inspected the work done by Borrower C and noted that the borrower completed only 90 percent of the work and had used \$4,000 of the loan proceeds to pay medical bills. The file contained no evidence that Mego reported this matter to HUD.
- Mego inspected the work done by Borrower A and noted that the borrower completed only 50 percent of the work and used the remaining loan proceeds to pay off credit card debts. The file contained no evidence that Mego reported this matter to HUD.

Mego should have alerted HUD concerning the forgoing abuses. We recognize that these instances may not be representative of Mego's overall compliance with the requirement to inform HUD of program abuses that come to its attention. For instance, we noted two cases where Mego inspected properties and noted evidence of program abuses that it did report to HUD. Mego had an obligation to notify HUD of all program abuses that came to its attention.

Inadequate inspections  
(correspondents)

Lenders are required to conduct on-site inspections of property improvement loans. The purpose of the inspection is to verify the eligibility of the improvements and whether the work has been completed (24 CFR 204.40(c)).

Mego inspected the work done by Borrower D and reported that the work was 100 percent complete. The report cited no violations. However, we inspected the property and determined that the following work (valued at \$15,308 on the borrower's cost estimate) was not done:

|              |                             |
|--------------|-----------------------------|
| Carpet       | \$ 2,500                    |
| Cabinets     | 4,000                       |
| Countertops  | 5,808                       |
| Patio Screen | <u>3,000</u>                |
| Total        | <u>\$15,308<sup>1</sup></u> |

Poor quality workmanship  
not corrected (dealer)

Mego and its dealer, Allstate Industries, Inc., approved a loan for Borrower V for roof repairs which the dealer performed pursuant to a contract dated May 30, 1997. The dealer performed poor quality work leaving the borrower with a roof that leaked. In July 1997 the borrower filed a complaint with Mego concerning the dealer's substandard repairs.

HUD eventually received notice of the complaint and inspected the property in September 1998 (over a year later) along with representatives from Mego and the dealer. HUD recommended repairs using new materials. We inspected the property in April 1999 and determined that the deficient work had not been corrected. The roof still leaked and continued to cause water damage to the home.

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Auditee Comments

Program abuses not reported to HUD (correspondents)

Mego contended any failure by Mego to report program abuses to HUD occurred despite policies and procedures in place to ensure proper notification to HUD.

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<sup>1</sup> This amount is based on the borrower's cost estimate. We determined, as presented in finding 1, that this borrower's overall estimate exceeded the amount needed to do the repairs cited in the loan application.

Inadequate inspections or no inspection (correspondent)

Mego said it relied upon a nationally recognized property inspection company's inspection report stating that the improvements had been completed. Mego said it had no reason to doubt the reliability of this report, and if it had, Mego would have had the property re-inspected. Moreover, the inspection by HUD's construction analyst took place years after the loan date. Therefore, Mego said it is possible that the improvements were made but had deteriorated or been renovated again by the time of HUD's inspection.

No inspection performed

Mego said two loans were made to Ms. Martin, only one of which exceeded the \$7,500 threshold requiring an inspection. Therefore, Mego only required an inspection of the improvements for the loan exceeding \$7,500 as required by the applicable regulation.

Poor quality workmanship not corrected

Mego believed its policy and practice was, and remains, consistent with HUD's regulations and guidelines governing borrower complaints. Despite the factors delaying such correction which were outside of Mego's control, Mego will ensure that the improvements are completed as agreed. The roof problem is for borrower V versus borrower U and the inspection date should be 1998 instead of 1988.

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**OIG response**Inadequate inspections or no inspection (correspondent)

We inspected the work funded by the Title I loan Mego approved.

No inspection performed

Mego's position is correct and we deleted this matter from the report.

Poor quality workmanship not corrected

As cited in the report, Mego's failure to obtain timely corrective action was demonstrated by the complaint, filed in July 1997, being unresolved when we inspected the property in April 1999. We corrected the borrower reference and the inspection date.

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Recommendations

We recommend that the Atlanta Homeownership Center require Mego to:

- 2A. Implement controls to ensure that all Title I property improvements are inspected and that noted violations are reported to HUD.
- 2B. Implement procedures to ensure timelier action by dealers to correct defects in their work noted as a result of borrower complaints.

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# Management Controls

In planning and performing our audit, we obtained an understanding of Mego's management controls. Management is responsible for establishing effective controls. Management controls are the plan of organization, methods and procedures to ensure that management meets its goals. Management controls include the processes for planning, organizing, directing and controlling program operations. They include the systems for measuring, reporting and monitoring program performance.

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## Significant Controls

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

- Management philosophy and operating style
- Loan origination process
- Property inspection process
- Monitoring Dealers and Loan Correspondents

## Significant Weaknesses

A significant weakness exists if the management control does 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 is obtained, maintained and fairly disclosed.

Our review indicated that significant weaknesses existed in the following areas:

- Management did not implement reasonable controls to effectively oversee its loan origination procedures;
- Mego did not properly evaluate loan amounts and did not properly analyze borrowers' credit and income; and
- Mego did not follow HUD's requirements for inspections.

We described these weaknesses in the Findings section of this report.

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## Follow-up on Prior Audits

This is the first OIG audit of Mego Mortgage Corporation. The mortgagee's last independent audit report covered the periods ended August 31, 1997, and 1998. The report did not contain findings. HUD's Quality Assurance Division conducted a comprehensive review of Mego's Title I operations in March 1995. The report dated July 14, 1995, contained five findings related to noncompliance with HUD's underwriting requirements. As of June 30, 1999, Mego had completed action to resolve the findings.

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Mego Mortgage Company  
Atlanta, Georgia

**SUMMARY OF LOANS REVIEWED**

| <u>BORROWERS</u> | <u>CORRESPONDENTS (C)<br/>OR DEALERS (D)</u> | <u>EXCESS<br/>LOAN<br/>AMOUNT</u> | <u>UNSUPPORTED<br/>LOAN AMOUNT</u> | <u>INADEQUATE<br/>CREDIT<br/>REVIEW</u> | <u>OTHER<br/>MATTERS</u> |
|------------------|--|-----------------------------------|------------------------------------|---|--------------------------|
|                  |  | 0                                 | 0                                  |   |                          |
| A                | C-1  | * 8,141                           | -0                                 |   | (e)                      |
| B                | C-1  | * 7,940                           | -0                                 |   | (e)                      |
| C                | C-1  | * 12,173                          | -0                                 | (a)                                     |                          |
| D                | C-2  | * 10,807                          | -0                                 |   |                          |
| E                | C-2  | * 13,214                          | -0                                 | (b)                                     | (e)                      |
| F                | C-2  | * 13,619                          | -0                                 | (a)                                     | (e)                      |
| G                | C-3  | ** 0                              | 19,999                             |   |                          |
| H                | C-3  | ** 0                              | 16,346                             |   |                          |
| I                | C-4  | ** 3,299                          | 9,660                              |   |                          |
| J                | C-5  | ** 0                              | 15,000                             |   | (f)                      |
| K                | C-5  | * 0                               | 0                                  |   |                          |
| L                | C-6  | ** 2,293                          | 17,925                             |   |                          |
| M                | C-7  | 0                                 | 23,000                             |   | (g)                      |
| N                | D-1  | * 18,005                          | -0                                 |   |                          |
| O                | D-1  | * 20,949                          | -0                                 |   |                          |
| P                | D-1  | * 15,891                          | -0                                 |   |                          |
| Q                | D-2  | * 7,086                           | -0                                 | (c), (d)                                |                          |
| R                | D-2  | * 10,184                          | -0                                 |   |                          |
| S                | D-2  | * 8,162                           | -0                                 |   |                          |
| T                | D-3  | * 8,370                           | -0                                 | (d)                                     |                          |
| U                | D-3  | * 7,920                           | 0                                  |   |                          |
| V                | D-4  | * 8,465                           | -0                                 |   |                          |
| W                | D-5  | 0                                 | 25,000                             | (a), (d)                                |                          |
| Totals           |  | <u>\$ 176,518</u>                 | <u>\$126,930</u>                   | 6                                       | 6                        |

**Explanatory Notes:**

- (a) Income not properly verified and or evaluated
- (b) Liabilities understated
- (c) Income overstated
- (d) Liabilities not properly verified
- (e) Discrepancies between the repairs cited in the application and the cost estimate.
- (f) No flood insurance
- (g) Source of initial payment not verified

\* Our construction analyst inspected the property to determine if the work was completed and if it was reasonably priced.

\*\* Our construction analyst reviewed the borrower's cost estimate or the dealer's contract to determine if the work was reasonably priced.

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September 1, 1999

Ms. Nancy H. Cooper  
District Inspector General  
For Audit – Southeast/Caribbean  
U. S. Department of Housing and Urban Development  
District Office of the Inspector General  
Office of Audit  
Richard B. Russell Federal Building  
75 Spring Street, SW, Room 330  
Atlanta, GA 30303-3388

FedEx Number  
811160689362

**Re: MEGO'S RESPONSE TO "EXECUTIVE SUMMARY" AND "FINDINGS" STATED  
IN DRAFT AUDIT REPORT OF THE OFFICE OF INSPECTOR GENERAL FOR  
AUDIT, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, DATED JULY  
27, 1999**

Dear Ms. Cooper:

Enclosed is the above referenced document as discussed with Mr. Narcell Stamps, Senior Auditor during our exit interview of August 30. Also enclosed is an updated Response to Draft Audit Report Dated July 27, 1999, originally sent to you on August 25.

Should you have any questions, please feel free to contact me at 770-952-6700 extension 2508.

Sincerely,

A handwritten signature in cursive script, appearing to read "Samuel P. Schultz".

Samuel P. Schultz  
Vice President  
Regulatory Compliance

Enc.

**MEGO'S RESPONSE TO "EXECUTIVE SUMMARY" AND "FINDINGS"  
STATED IN DRAFT AUDIT REPORT OF THE OFFICE OF INSPECTOR  
GENERAL FOR AUDIT, DEPARTMENT OF HOUSING AND URBAN  
DEVELOPMENT, DATED JULY 27, 1999**

**MEGO'S RESPONSE TO "EXECUTIVE SUMMARY"**

Congress created the Title I loan program to assist those borrowers less attractive to banks and other conforming lenders to obtain credit for needed home improvements. In some cases such improvements are required due to damage by natural causes, but in all cases the loan must be to finance improvements that will "protect or improve the basic livability or utility of the property."<sup>1</sup> The Title I loan program is not modeled after traditional construction lending programs that require escrow accounts, inspections and staged funding. Instead, the program relies to a great extent upon borrowers' promises and representations relative to the use of loan proceeds. Moreover, except in the case of dealer loans, the program permits disbursement of loan proceeds in a lump sum prior to commencement of work. Therefore, absent the protections afforded lenders by the Title I program, many borrowers would be unable to obtain credit. The Title I program enables borrowers to obtain funds to complete home improvements which would not be available to them without the federal government offering insurance to lenders which participate in the Title I program.

The Department of Housing and Urban Development ("HUD") was charged with promulgating regulations in order to implement Congress' stated purpose. Lenders wishing to avail themselves of the protections afforded by the Title I program must comply with these regulations, which usually differ from those guidelines which would be imposed by lenders when originating non-Title I loans. HUD is also limited to

enforcing the regulations as written and is prohibited from imposing obligations upon lenders which are not set forth in the regulations. Any additional duties to be imposed upon parties to a Title I transaction must be promulgated according to federal administrative procedure. Thus, Mego objects to the violations cited in the Audit Report which are not supported by existing statutes and regulations. Although Mego respects the authority of HUD and the Office of the Inspector General ("OIG") to audit its Title I loan program, Mego asserts that many of the specific obligations the OIG attempts to impose retroactively upon Mego are not authorized or required by federal law.

Mego disputes the OIG's finding that it "did not properly process and underwrite Title I loans." Mego prepared a response to each of HUD's narrative case presentations in the Draft Audit Report in support of its compliance with the Title I loan program in all but rare instances where employees did not follow Mego's stated practices and procedures relative to Title I loans. It is Mego's understanding that its comprehensive response, which is only summarized herein, will be provided to the Home Ownership Center along with this abbreviated response. Mego respectfully requests that the Home Ownership Center review and consider Mego's comprehensive response which was delivered to the OIG by letter dated August 25, 1999.

The OIG states in the Draft Audit Report that it "identified instances where Mego approved loans without first resolving discrepancies between various loan documents." It appears that this reference is to cases where the body of the loan application contained statements which were less complete than attachments to the application, which became part of the application by such attachment. In such cases the supplements to the application elaborated on the statements made in the body of the application but were not inconsistent with such statements. Upon additional information from the OIG relative to such alleged discrepancies, Mego would appreciate the opportunity to amend its response.

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<sup>1</sup> 24 CFR 201.20(b)(2).

The above-quoted portion of the Executive Summary goes on to state that Mego approved loans "without obtaining or retaining all relevant supporting documents." Mego responded to each such alleged violation in its response to the OIG's Draft Audit Report dated July 27, 1999. The report indicates that such "deviations from requirements increased HUD's insurance risk on the loans approved for excessive amounts..." and that "these matters provided the opportunity for fraud and abuse of the Title I program." The OIG then concludes that such abuses occurred.

Although Mego acknowledges that HUD's subsequent inquiries revealed that some borrowers failed to use the loan proceeds as promised at the time they applied for the loan and made statements intended to induce Mego to disburse the loan proceeds, this abuse of the Title I program by certain borrowers was not due to any act or omission of Mego. Instead, such abuse was because of the inherent risks in the Title I program which relies upon borrowers' statements as to intended improvements and their cost while failing to impose any specifically articulated obligation upon dealers, correspondents or lenders to substantiate such improvements and their cost. To have placed such obligations upon lenders would have made the Title I program unduly burdensome which would have discouraged or prevented lenders from offering Title I loans to the borrowers Congress intended to assist. Moreover, the Title I program, as evident on its face and corroborated by HUD's verbal guidance over the years via its Washington D.C. office, assumes borrowers' willingness to act honestly, reasonably and prudently when negotiating and entering into contracts for home improvements. When Mego was charged with conducting an additional level of inquiry due to the borrower's failure to perform, Mego's practice was to do so and report to HUD suspected misuses of loan proceeds.

The Executive Summary states that Mego consistently approved excessive and inadequately supported loan amounts. Mego adamantly opposes this finding and refers to

its response to each individual citation in its response to the Draft Audit Report as well as *its response, below, to the OIG's Finding I.*

One of the purposes stated in HUD's summary amending 24 CFR 200, 201 and 202 is to establish "more objective criteria for lenders and loan correspondents to use in approving loans." Still, the statutes, regulations and guidelines instituted by Congress and HUD do not define for lenders the degree of detail that is required to be reviewed relative to property improvements. Mego acknowledges that Title I abuse would be less prevalent if the regulations required lenders to review information of the type and with the degree of detail listed in the Audit Report, but they do not. Furthermore, Mego contends that in some cases, to implement legislation or enact regulations which mandate the standards set forth in the Audit Report, would be impossible. Moreover, forcing lenders to make determinations as to, for instance, the quality of the improvements or materials, would cripple the Title I program and be contrary to the goals of the program.

Because regulations and other written guidelines do not impose upon lenders the *higher standard* and additional obligations stated in the Audit Report, it is improper for HUD to cite Mego for violating these unestablished, unauthorized and retroactive guidelines. Moreover, to require Mego and other Title I lenders to comply with the additional requirements imposed by the Audit Report would undermine Congress' intent in establishing the Title I program.

Mego's practice and procedures complied with the regulations and written *guidelines* imposed by HUD at the time the loans were made. Therefore, Mego objects to the finding that it did not "consistently follow HUD's requirements." Had applicable regulations and written guidelines required Mego to review the type and degree of information and documentation stated in the Audit Report, Mego would have complied with such requirements. For the regional OIG in its first Title I audit to attempt to impose these additional duties upon Mego years subsequent to the origination of the subject loans renders it impossible for Mego to comply with such additional obligations, even if they



had been promulgated properly. Thus, Mego respectfully requests that HUD, operating through the OIG and the Home Ownership Center, (1) review Mego's individual response to each of the cited violations substantiating its compliance with the regulations and guidelines governing such loans, (2) reverse its findings cited in the Audit Report, and (3) seek the degree of detail desired by the OIG via HUD's public promulgation of regulations imposing such additional requirements.

Mego understands HUD's concerns due to relatively high default rates on Title I loans; however, as stated in the exit interview, Mego urges HUD to address such concerns by the proposal and promulgation of additional or revised regulations, or at a minimum, the issuance of a written policy statement regarding the degree of detail required in connection with Title I loans. Mego stresses that absent such affirmative direction from Congress or HUD, it would not be commercially feasible for Mego to originate Title I loans in accordance with the higher standards the OIG attempts to establish unofficially in the Audit Report.

Mego does not disagree in principle with the higher standard of inquiry the OIG desires to impose by means of the Audit Report, but Mego objects with the OIG's doing so on a case-by-case, lender-by-lender basis instead of using the mechanism provided by federal administrative law to address the perceived problems with the Title I program. Moreover, it is unjust to impose a higher standard of review upon certain lenders and not others. Finally, to do so would impact the availability of credit to deserving borrowers for permissible purposes in order to achieve Congress' objectives in establishing the Title I program.

Mego respectfully disagrees with the OIG's interpretation of existing regulations and requests that HUD strictly interpret the regulations and enforce them as written. Mego urges the OIG to consider the impact of its interpretation, without the benefit of formal rulemaking procedure, upon Congress' intent in establishing the Title I program. Mego also urges the OIG to review the standards in the Title I industry relative to the

degree of documentation required by Title I lenders when approving correspondent and dealer loans, which procedures have received the approval by HUD due to its payment of claims on such loans and failure to take corrective action relative to such lenders and loans. Mego encourages the OIG to consider other findings and interpretations made on behalf of HUD relative to the approval of Title I loans to ensure that any interpretation by the OIG is consistent with other findings by the OIG and other divisions of HUD.

It is important to note that representatives of the OIG confirmed that audits of other Title I lenders indicated that such lenders also encountered difficulty in determining the degree of detail required to be obtained relative to Title I improvements. It seems that such lenders' policies and procedures relative to the underwriting and approval of Title I loans were similar to Mego's. Based upon the OIG's discovery that the industry strictly interprets the regulations and such interpretation differs from the OIG's interpretation, it is Mego's position that the OIG should have reported to appropriate authorities at HUD the need for written guidance. Furthermore, the OIG should be charged with reporting such discrepancies to HUD, which is empowered to address any weakness or deficiency in the regulations which govern Title I participants. Moreover, different divisions of HUD interpret the applicable regulations differently than the OIG, which also evidences the need for HUD to clarify its position to the industry.

Mego reminds the OIG, and reiterates the statements Mego's representatives made in the exit interview, that Mego repeatedly sought guidance from HUD representatives regarding the degree of detail required in connection with its Title I program documentation. In response to such inquiries Mego received no guidance other than being advised by HUD to refrain from interfering with borrowers' rights to contract for home improvements unless such contracts were grossly excessive. Moreover, HUD representatives informed Mego that HUD, too, was struggling with the degree of detail required in connection with Title I loans.

Mego appreciates HUD's acknowledgment during its exit interview of the inconsistent guidance and lack of guidance sometimes provided to lenders by its representatives. Mego especially appreciates the direction received from the Home Ownership Center at its exit interview to direct all questions seeking technical guidance relative to Title I loans to the Home Ownership Center and regrets that the availability of this arbiter was not known earlier.

The OIG states in the Audit Report that it conducted the review because of the default rate on Mego's loans; however, of the 16 files which had been submitted for claim, HUD paid claims on 15 of them to date. Mego is awaiting determination of the remaining pending claim. In addition to payment of such claims, over the past five years, HUD paid numerous claims without addressing with Mego any deficiencies regarding the detail in the home improvement descriptions.

As Mego reiterates throughout this response, the regulations are silent as to the degree of detail required in a description of the improvements to be financed with Title I loan proceeds. Had HUD denied claims based upon Mego's failure to follow the applicable regulations and other guidelines, Mego certainly would have changed its practices and procedures if for no other reason than to ensure the payment of future claims. Mego never received any such guidance. To the contrary, HUD paid, without objection or citation, most claims Mego submitted. For the OIG to now claim that Mego did not comply with the applicable regulations, does not allow Mego any opportunity for redress relative to past loans or to protect its interests and the interests of the subsequent purchasers of such loans.

Nevertheless, in response to the Audit Report, and despite HUD's failure to promulgate regulations or issue a policy statement so mandating, Mego will revise its manuals addressing Title I loans in order to incorporate the guidance now provided by the OIG in the Draft Audit Report, dated July 27, 1999. Mego urges the OIG to encourage HUD to formalize such guidance so that all Title I lenders, borrowers, correspondents and

dealers are held to such higher standards. Without such uniformity, Mego may determine that it is not commercially feasible for Mego to conduct its Title I loan program in accordance with the unofficial guidelines offered in the Draft Audit Report.

## **MEGO'S RESPONSE TO the OIG'S FINDINGS**

### **Finding 1 Need to Improve Underwriting Practices**

#### **Excessive and Inadequately supported Loan Amounts**

The OIG's report states that "Mego either did not obtain or did not adequately review borrower cost estimates and contracts to ensure that their loan amounts did not exceed the cost of projects described in the borrowers' Title I loan applications." Mego adamantly opposes this finding.

In every case where this violation is cited, Mego obtained and reviewed all information required by the governing regulation. Such information was in the form of applications, which included supplements detailing the improvements, materials and their estimated or actual costs. In every case where the borrower had retained a contractor to perform services, Mego obtained and reviewed a copy of the contract supporting such improvements. Moreover, for each dealer loan, Mego not only obtained the required certificates of completion prior to disbursing the loan proceeds, but Mego conducted an interview with the borrower to obtain the borrower's verification that the improvements had been completed satisfactorily and that all loan proceeds would be used for the improvements. Mego would be glad to provide to the OIG or the Home Ownership Center documentary and taped evidence of such interviews to evidence its diligence in ensuring its compliance with the Title I program.

The federal statutes, regulations, and HUD Title I program guidelines do not define or provide lenders assistance in determining the amount of detail which is required in the written description of improvements or materials to be furnished. Moreover, HUD has not provided a specific form to document the improvements and materials to be furnished. Therefore, many files contain a "Work Estimate" or similar form created as a tool to assist lenders in ensuring their compliance with the federal regulation. In many

cases the Work Estimate form which was completed by the borrowers and reviewed by Mego to determine the Title I eligibility of the loan is the form which was (and remains) standard in the industry. The Work Estimate form is used by thousands of Title I lenders nationwide and appears to have received the approval of HUD. Such approval is evident from (1) the inclusion of this Work Estimate form in the Title I loan documentation package of a major national form vendor, (2) the use of such form by thousands of lenders without objection by HUD (including some of the largest Title I lenders in the country) and (3) Mego's historical use of this form in files reviewed without objection in previous HUD audits and upon submission of claims.

In every correspondent loan where the borrowers were to complete their own improvements, the Work Estimate, which is a part of the application, complied with 24 CFR 201.20(b)(1) and constituted adequate documentation as required by 24 CFR 201.26(a)(2). The Work Estimates include (1) a detailed description of the work to be performed; (2) the materials to be furnished; and (3) the estimated cost of such materials. For those loans where the borrower is to complete the improvements, the federal statutes and regulations require only an estimated cost of the materials to be furnished, and when work is to be performed by a contractor or dealer, a contract disclosing the estimated or actual cost is all that the regulations require the lender to review. Furthermore, as mentioned elsewhere in this response, Mego was directed by HUD not to "second guess" the work contracted for by the borrower or interfere with the borrower's contractual relationship with a dealer or other contractor.

Moreover, we know of no obligation imposed upon a Title I lender, in a statute, regulation, or other written guidance by HUD, to "price" improvements, to engage independent analysts or to otherwise scrutinize the work to be performed, the materials to be provided, or the actual cost of such materials. Although Mego was required by regulation to employ trained personnel to perform their assigned responsibilities in

**consumer and mortgage lending activities,**<sup>2</sup> this affirmative obligation does not extend to employment of construction analysts or other employees with building, construction or similar training or experience.

Mego complied with its obligation to employ personnel trained in the areas of consumer and mortgage lending. Mego hired only those employees with prior experience in the performance of the duties for which such employees were hired, such as, processing or underwriting. Mego then trained such new hires to ensure their understanding of the Title I lending programs and Mego's procedures. Each new hire received at least one week of one-on-one instruction and direct supervision until the new hire proved competent to handle independently the required job responsibilities. In addition to hiring qualified individuals and providing them with support by existing trained employees, Mego required each employee to follow both HUD's Title I Handbook and Mego's Title I manual.

In the case of several loans cited, the Audit Report states that Mego did not perform a "proper review" or "proper analysis" of the borrower's cost estimate; however, the applicable statutes, regulations and program guidelines do not define or specify what constitutes a "proper review" or "proper analysis." Had the laws or guidelines applicable to Title I loans required Mego to employ construction analysts or employees with building or construction experience, Mego would have done so. Moreover, had such laws or program guidelines required Mego to complete a specific form relative to improvements or invoices for the materials used in such improvements, Mego would have done so. The engagement of independent analysts is not customary at the time of application or loan approval. Furthermore, to require such an analysis at the time of application or as a condition to loan approval could be deemed to be in violation of Congress' stated objective in establishing the Title I program. Even absent such affirmative legal requirements, Mego's employees were directed to notify a supervisor if

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<sup>2</sup> 24 CFR 202.3(b). (Emphasis added.)

any fraudulent or other inappropriate loan purpose or amount was evident from the review of an application or file.

In the case of some loans, the Audit Report cites Mego for failing to obtain measurements, quantities, quality, types, and specifications of materials and supplies. No statute, regulation or written guidance from HUD, other than the Audit Report, imposes such requirements upon Title I lenders, and, as acknowledged by the OIG, there is confusion and a lack of consistency in the industry as to the degree of detail lenders obtain due to HUD's lack of guidance relative to the degree of detail required in the description of improvements. Although Mego does not dispute that it might be prudent for the Title I program to be revised to require some or all of the information listed in the Audit Report, federal law does not permit the OIG to mandate a review of such information by means of an Audit Report, especially retroactively.

Even if the standards stated in the Audit Report were to be imposed upon Title I lenders by a statute or regulation, it would still be difficult for lenders to determine when even the most detailed itemization of improvements is fraudulent or misleading. The price of materials varies widely based upon such factors as the quality of the materials, the style of the materials, the manufacturer of the materials, the negotiating skills of the buyer of the materials, and even the point of purchase of the materials (retail v. wholesale, geographic location of borrower, *etc.*). Moreover, it is difficult, if not impossible, to describe adequately the quality of many building materials. All of these factors contribute to the difficulty in detecting the validity or accuracy of the borrower's estimated costs. Perhaps these are some of the reasons that Congress and HUD did not impose upon Title I lenders the obligations listed by the OIG in the Audit Report.

Due in part to the absence of HUD specific guidelines relative to Mego's obligations and the necessary reliance by lenders upon loan applicants' assertions which is inherent in the Title I program, Mego required the borrowers' repeated written certification of the accuracy of the information provided under 18 U.S.C. Sections



1001, 1010, 1012, and 31 U.S.C. Section 3729 and 3802. Furthermore, all borrowers signed documents describing the Title I program, including the disclosure outlining HUD's role in Title I loans, and describing the remedies available to HUD in case of default, fraud or misrepresentation. In the case of dealer loans, Mego exercised diligence by maintaining in each file a copy of its interview with each borrower affirming the proper use of the loan proceeds. The borrowers also confirmed the completion of the contracted for improvements and their satisfaction with such improvements. Finally, these interviews were taped and the tapes maintained by Mego as evidence of the borrowers' stated compliance with the Title I program.

According to federal regulation, "in the absence of information to the contrary, the lender may rely upon all statements of fact made by the borrower or any co-maker or co-signer in a credit application."<sup>1</sup> As previously stated, the Work Estimate is part of the application, and federal law and program guidelines do not obligate a lender to obtain evidence of the actual cost of materials or employ a construction analyst to ensure the value of the improvements to be completed at any time during the loan process. Mego acted reasonably and in compliance with its obligations when relying upon the certified statements of the borrower relative to the improvements.

The OIG expresses concern about dealer processed loans and states that "dealers were contractors who either know or should have known they had overvalued the repairs." Mego is also concerned about the OIG's finding relative to certain loans where borrowers recently admitted to a misuse of loan proceeds; however, Mego stresses that it obtained a copy of the proposal or contract in compliance with the applicable regulations and written guidelines. Mego's other obligations relative to dealer loans are almost identical to those duties in connection with correspondent loans. Therefore, the assertions stated above regarding the alleged absence of the required detail and a proper review or analysis also apply in the case of dealer loans. Moreover, Mego received verbal direction from HUD that it was not to interfere with the contracts freely entered into by borrowers

and dealers, perhaps because to do so would subject HUD or Mego to potential tort liability or violation of fair lending laws. Finally, in all cases cited by the OIG, the borrowers confirmed the completion and their satisfaction with the improvements. Therefore, Mego, a third party, had no reason to interfere with the contract between these two legally competent parties or to refrain from approving a qualifying loan absent any evidence of fraud or misrepresentation.

Mego stresses that it was not obligated to (1) price the materials to be used in the improvements; (2) obtain receipts or proposals for actual materials; (3) obtain measurements, quantities, quality, types, or specifications of materials and supplies; (4) employ a construction analyst or an expert in building and construction; (5) inspect the materials prior to commencement of the performance of services; or (6) assist borrowers in negotiating contracts; or (7) ensuring that borrowers obtained the lowest possible price for the services to be performed and materials to be purchased or provided. Nevertheless, in response to the Audit Report, Mego has priced many of the materials which the "OIG's Estimate" listed as excessive, and Mego strongly objects to several of the estimates made by the construction analyst retained by the OIG. Moreover, in cases where the OIG inspected the improvements, Mego wishes to remind the OIG that the construction analyst had the benefit of inspecting the actual improvements after their completion, which information, of course, was not available to Mego at the time it conducted a review of documentation designed to ensure that the requested loans were eligible for the Title I program. In addition, in most cases the OIG's construction analyst inspected the property years after the improvements were completed which may have contributed to lower estimates of the cost of materials or improvements due to deterioration or normal wear and tear. Finally, even if Mego were to accept the OIG's findings relative to cost, Mego reiterates that all the law requires is a cost **estimate**, and in most cases, the estimate provided by the borrowers is in the range of the estimate provided by the OIG.

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<sup>3</sup> 24 CFR 201.22(a)(10).

Although Mego's written response to each individual citation by the OIG in the Draft Audit Response is not included herein (based upon the request of the OIG), Mego respectfully requests that the OIG and the Home Ownership Center review and consider its complete response to the OIG's Draft Audit Report which was delivered to the OIG by letter dated August 25, 1999. In each case, Mego obtained and reviewed all information required by applicable statutes, regulations and HUD written guidelines, as is addressed in general terms, above.

### **Inadequate Consideration of Borrower's Creditworthiness**

Again, Mego refers the OIG and Home Ownership to its comprehensive response to the OIG's Draft Audit Report relative to the borrower's creditworthiness. In each case Mego explains and provides evidence to support its determination of the borrower's creditworthiness, by substantiating its verification of income, specifying its credit investigation, or explaining its calculations of income, liabilities and debt to income ratios. In some cases Mego provides evidence of compensating factors as permitted by 24 CFR 201.22(b)(1).

It is Mego's understanding that four loans will be referenced in the OIG's final Audit Report and appreciates the opportunity to address herein its credit determination relative to each such loan.

#### **Borrower Q (Robinson)**

The OIG cites Mego for adding an "unsupported" 25 percent to the borrower's verified income which resulted in an incorrect debt to income ratio. What the OIG fails to recognize is that this "grossing up" of the borrower's social security income is required in order to avoid violating federal law, specifically, Regulation B which implements that Equal Credit Opportunity Act. Moreover, quasi-federal agencies, such as the Federal National Mortgage Association ("Fannie Mae"), require "grossing up."

Regulation B states that, "a creditor shall not discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction."<sup>4</sup> "Discriminate against an applicant means to treat an applicant less favorably than other applicants."<sup>5</sup> "Prohibited

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<sup>4</sup> 12 CFR 202.4.

<sup>5</sup> 12 CFR 202.2(n).

basis" means "... the fact that all or part of the applicant's income derives from any public assistance program...."<sup>6</sup> Public assistance includes social security income.<sup>7</sup>

Therefore, based upon the above regulations, a creditor may not treat an applicant who receives social security income less favorably than an applicant who receives taxable or non-protected income. In order to avoid treating non-taxable income less favorably than taxable income, and in order to ensure equal treatment of all applicants, non-taxable income must be adjusted to an equivalent taxable income. This is customarily referred to as "grossing up" non-taxable income and is required in connection with loans to be sold on the secondary market.

Regulation B also prohibits a creditor from discounting or excluding from consideration the income of an applicant on a prohibited basis.<sup>8</sup> The Commentary to this section of the regulation states that the creditor may not automatically discount any protected income.<sup>9</sup> Protected income is defined to include public assistance, which, as stated above, includes social security income.<sup>10</sup> Thus, a creditor must not discount an applicant's social security income. Because such income is not taxed, in order to treat social security income on a non-discounted basis, it is necessary to adjust it to an equivalent taxable income. Again, the industry recognizes that in order to prevent discounting in violation of federal regulations, non-taxable income must be "grossed up."

As stated above, quasi-federal agencies also require "grossing up" of social security income. Fannie Mae's Selling Guide states that, "the lender should determine the amount of tax savings attributable to the non-taxable income --- the amount of tax that would normally be paid by a wage earner in a similar tax bracket --- and add it to the

<sup>6</sup> 12 CFR 202.2(z).

<sup>7</sup> Regulation B Commentary to 202.2(z) paragraph 3.

<sup>8</sup> 12 CFR 202.6(b)(5).

<sup>9</sup> Regulation B Commentary to 202.2(6)(b)(5) paragraph 3.

<sup>10</sup> Regulation B Commentary 202.6(b)(6) paragraph 1.

borrower's income to develop an 'adjusted gross income.' This adjusted gross income should be used in the calculations for the income and debt ratios."<sup>11</sup>

#### Borrower E (Griffin)

Mego agrees with the OIG's determination; however, Mego employed measures to protect against any risk to Mego or to HUD relative to this loan. There is a letter in the file dated March 22, 1996, written by James L. Belter, Executive Vice President of Mego, to Mr. Jack R. Barnes, President of Newport Shores Financial, Inc. regarding this loan. The purpose of the letter was "to serve as an addendum to the Loan Correspondent Agreement executed on July 17, 1995 among Newport Shores Financial, Inc. and Mego Mortgage Corporation." The letter stated that in the event that the Griffin's loan ever became 60 days contractually delinquent at any time during the term of the loan, Newport Shores Financial, Inc. would repurchase the loan from Mego. Therefore, there was no risk to HUD as there would be no claim filed due to such repurchase by Newport Shores. Mego proactively took steps necessary to protect its and HUD's interest in this loan. Additionally, as stated in the Draft Audit Report, this account is in current payment status.

#### Borrower W (White)

It appears that HUD objects to Mego's approving this loan with a debt to income ratio of 49 percent. As stated below in more detail, the loan was approved due to compensating factors concerning the borrowers' creditworthiness as permitted by 24 CFR 201.22(b)(1).

A review of the file and recalculation of the debt to income ratio revealed that the approved debt to income ratio of 48.5% was correct. Mego's calculation of the

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<sup>11</sup> Fannie Mae Selling Guide Section 201.03.

borrowers' monthly obligations totaled \$1,406, and the borrowers' monthly income totaled \$2,889 as follows:

| <u>Debt</u>      | <u>Payment</u> |
|------------------|----------------|
| Key Bank         | \$318.00       |
| AFSCI            | 131.00         |
| Security Pacific | 582.00         |
| Wards            | 10.00          |
| BJS              | 59.00          |
| Mego             | <u>306.00</u>  |
| Total            | \$1,406.00     |

Income

|            |                        |   |            |
|------------|------------------------|---|------------|
| Borrower   | Pension: monthly gross | = | \$1,722    |
| Borrower   | SS: \$66.50 x 1.25     | = | 83         |
| C/Borrower | SSI: \$513 x 1.25      | = | 641        |
| C/Borrower | Part-time job/5 yrs.   | = | <u>443</u> |
| Total      |                        | = | \$2,889    |

Expenses of \$1,406 divided by income of \$2,889 results in a 48.5% debt to income ratio.

As cited above, this debt to income ratio is acceptable under HUD regulations due to the following compensating factors:

- Credit history in excess of 7 years
- 13 satisfactory credit ratings
- \$1,483 in monthly disposable income
- 23 year residence
- 5+ year part-time employment

Moreover, as discussed above in connection with Borrower Q (Robinson), Mego treated the social security income as required by federal law stated in Regulation B. Therefore, this loan was approved and funded in compliance with HUD regulations.

Borrower C (Armstrong)

The requirement is not: "must verify that overtime is likely to continue for 1" two years of loan". Pursuant to 24 CFR 201.22(B) Income Requirements (2) In determining

whether the borrower's income is adequate, the following definitions are applicable: (i) Effective gross income is defined as continuing income from all sources that is ***reasonably expected*** to be available during the first two years of the loan obligation, without any deduction for income taxes or other items."

Therefore, as borrower's overtime income had been established and properly verified for the previous year and a half, (income verified for the previous 30 months), Mego did consider it ***reasonable to expect*** that the borrower's overtime would continue for the first two years (next 24 months) of the loan obligation. Due to the reasonableness of the expectation that the borrower's overtime income would continue, Mego requests that this citation be deleted from the report.

**NOTE:** Regarding the comment that the file did not contain a VOE to document the verification of overtime pay with borrower's employer, 24 CFR 201.22 "Credit requirements for borrowers. (a) Credit application and review." (3) states in part: "The lender shall conduct a credit investigation based on the credit application, and shall obtain written verification of ***or otherwise document*** the current employment and current income of the borrower and any co-maker or co-signer." Although a fully completed VOE was not obtained, pursuant to regulations, the borrower's current employment and income was documented in the file with a current paystub (7/30/96) (funded 7/29/96), 2 W-2's (1995-1994), and a verbal employment verification with the employer (Hilda) at 305-267-4244, verifying hire dates of "7/23/83 to present."

#### Borrower F (Pigler)

24 CFR 201.22(a)(3) states in part: "If the borrower or any co-maker or co-signer was self-employed during any period of the previous two years, the lender shall obtain documentation of the person's income during such period of self-employment." Mego did obtain a year to date profit and loss statement for 1996, as well as complete tax



returns for 1994 and 1995. Although there were expenses listed on the return for 1995, those expenses did not include a depreciation expense. Depreciation is a non-tangible expense which, when taken, only benefits the borrower in the sense that the borrower will lower his/her tax liability. There is no physical out of pocket expense with depreciation.

HUD regulations require the documentation of the person's income during such period of self-employment (tax returns in this case were provided). However, HUD does not require or instruct lenders to review such returns for specific items to include or delete from income calculations, *i.e.* depreciation. As this file ultimately went to HUD for claim, the tax returns and year to date profit and loss statements for 1996 were submitted, as required, with the claim package. HUD paid the claim which indicates the borrower's self-employment income was verified pursuant to HUD regulations.

Although Mego understands the auditors' reasoning in their comments, due to there being nothing in the regulations regarding what HUD will and will not allow as expense items to consider in tax returns for self-employed borrowers, and HUD's apparent agreement with the income verification/calculation of this loan as evidenced by the payment of this claim, Mego requests that this citation be deleted from the report.

#### Borrower T (Simms)

A review of the loan file indicated that the borrowers listed an automobile loan payment in the amount of \$253. As stated in the finding, this account was not listed on the credit report. There is no indication in the file why a direct credit check was not made with the lender for this automobile. However, the credit report listed three installment accounts, all reported I-1, and the VOM reported an excellent payment history. Therefore, it was considered highly unlikely that the automobile account had not been paid in a satisfactory manner. Additionally, Mego was diligent in its investigation of the borrowers' 90 day credit inquiries which revealed that no additional or new

accounts were opened. Of these inquiries, several were from automobile dealerships. It is considered likely that the automobile account was too new to have a payment history to be reported on the borrowers' credit report. As stated in the finding, Mego did include that payment in the borrowers' debt-to-income ratio of 37%, which is well below HUD's maximum allowed debt-to-income ratio. Additionally, the borrowers' employments were verified at over three years each revealing stability in the community. With a satisfactory credit history, satisfactory debt ratio, and employment stability which exceeded HUD's requirement, this loan met Title I underwriting criteria.

**Discrepancies between the loan application and the cost estimate**

Mego responded to this allegation by the OIG in its individual response to the OIG's citation on specific loan files. Mego respectfully requests that the OIG and the Home Ownership Center refer to Mego's more comprehensive response. In summary, Mego reiterates that the loan applications included attachments describing all improvements when such improvements were not listed in the "body" of the application. These attachments were part of the applications and satisfied 24 CFR 201.20. Therefore, there was no discrepancy as alleged by the OIG in the Audit Report.

**Missing loan files**

The OIG cited Mego for one missing loan file, but this file was not missing. Instead, Mego provided this loan file to the OIG pursuant to the OIG's request in connection with its Audit. The OIG claims that it could not make an adequate determination because Mego did not have the file to produce to the OIG, but the OIG did have the necessary information which was in the file which was in the OIG's possession temporarily.

Mego furnished the file to the auditors upon their first request for the file. The auditors had conversations with the borrowers and even visited their property. During the course of the nine-month audit, the file was reviewed by the auditors and Mego on numerous occasions. Mego affirms that the file was delivered to the auditors and at some time near the end of the audit, the file was again requested by the audit team. At that time, Mego advised the OIG that it was already in possession of the file. Mego located the file with other files returned to Mego by the OIG after the auditors were gone.

Finally, there is no indication in the loan file that the Nahikians' loan was originally denied, as indicated in the Audit Report.

**Inadequate verification of initial payment**

This finding was only made in connection with one file, and Mego concedes that the initial payment was not verified despite practices and procedures in place requiring such verification.

**Recommendation**

Mego's practices and procedures were in compliance with all applicable regulations as is supported by Mego's response to each violation cited in the Audit Report. Although Mego acknowledges rare instances of employees' failure to follow its practices and procedures, such intermittent violations do not warrant action by the Home Ownership Center or any other division of HUD. Moreover, Mego is willing to revise its practices or procedures to incorporate the supplementary guidance offered by the OIG in the Audit Report. As stated above, Mego will revise its manual to address the OIG's position relative to the degree of detail which is required in connection with a description of the home improvements to be financed with the loan proceeds.

Similar to Mego's findings reported to the OIG in connection with certain loans, the OIG subsequently discovered that in some cases, the borrowers did not use the loan proceeds as certified in their loan documentation, and as reiterated in telephone interviews with Mego representatives. It is these lies told by borrowers to which the OIG should attribute any problem with the files cited, because Mego's practices were in compliance with all obligations imposed upon it by the applicable written regulations. Thus, Mego encourages the OIG to pursue each borrower who made a material misrepresentation in order to obtain funds in violation of the Title I program and who perpetrated a fraud against Mego and HUD. Mego will cooperate fully in any effort by HUD to prosecute such borrowers, and will assist in producing evidence that the certified statements inducing Mego to make the loans were later discovered to be lies.

**Finding 2 Need to Improve Inspection Procedures**

**Program abuses not reported to HUD (Correspondents)**

Any failure by Mego to report program abuses to HUD occurred despite policies and procedures in place to ensure proper notification to HUD. In its written finding, the OIG supports Mego's defense, stating, "We recognize that these instances may not be representative of Mego's overall compliance with the requirement to inform HUD of program abuses that come its attention. For instance, we noted two cases where Mego inspected properties and noted evidence of program abuses that it did report to HUD." This position was reiterated by the OIG in its comments during the exit interview.

**Inadequate inspections or no inspection (Correspondent)**

The Audit Report lists only one file where the inspection was inadequate (Bertrand). Mego relied upon a nationally recognized property inspection company's inspection report stating that the improvements had been completed. Mego had no reason to doubt the reliability of this report, and if it had, Mego would have had the property reinspected. Moreover, the inspection by the OIG's construction analyst took place years after the loan date. Therefore, it is possible that the improvements were made but had deteriorated or been renovated again by the time of the OIG's inspection.

**No inspection performed**

Only one file is cited by the Audit Report as not having an inspection performed. As the Audit Report provides, two loans were made to Ms. Martin, only one of which exceeded the \$7,500 threshold requiring an inspection.<sup>12</sup> Therefore, Mego only required an inspection of the improvements for the loan exceeding \$7,500 as required by 24 CFR 201.40. Mego respectfully disagrees with the OIG's finding and seeks clarification from

the OIG as to the authority mandating that an inspection was required in connection with Ms. Martin's loan of less than \$7,500.

**Poor quality workmanship not corrected**

Mego's policy and practice was, and remains, consistent with HUD's regulations and guidelines governing borrower complaints regarding dealer loans. Mego's goal in addressing such complaints is to ensure the customer's satisfaction to the extent possible. Mego acts as a liaison between the borrower and the contractor.

In the case of the Nahikians' loan, which appears to be the loan cited, Mego notified the contractor in writing immediately upon its receipt of Mrs. Nahikian's complaint. Mego telephoned the contractor the day after faxing the written notification of Mrs. Nahikian's complaint. Mego's representative personally visited the property to inspect the improvements, and then advised the contractor of the services which were required. The contractor did not satisfy his obligations promptly, so Mego again traveled to the property, this time joined by HUD's representative and the contractor. The parties agreed to remedial action, but subsequent to this agreement, on several occasions the Nahikians refused to execute documentation evidencing the settlement. The original contractor is no longer in business. Nevertheless, Mego has agreed to correct the improvements now that it has received written authorization from the borrowers. Despite the factors delaying such correction which were outside of Mego's control, Mego will ensure that the improvements are completed as agreed.

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<sup>13</sup> 24 CFR 201.40.

**Recommendation**

Mego's practices and procedures were in compliance with all applicable regulations as is supported by Mego's response above. Although Mego acknowledges rare instances of employees' failure to follow its practices and procedures, such intermittent violations do not warrant action by the Home Ownership Center or any other division of HUD. Moreover, Mego is willing to revise its practices or procedures as may be directed formally by any division of HUD.

**MEGO'S RESPONSE TO MANAGEMENT CONTROL WEAKNESS ALLEGED**

Mego objects to the OIG's finding that "Management did not implement reasonable controls to effectively oversee its loan origination procedures. First, Mego prepared and used manuals to ensure the compliance of its Title I loan program. The most comprehensive of these is entitled "Training and Procedures Manual for the FHA Title I Program." Second, Mego trained all employees involved in the Title I loan program to ensure their understanding of the Title I lending programs and Mego's procedures. Each new hire received at least one week of one-on-one instruction and direct supervision until the employee proved competent to handle independently the required job responsibilities. Third, Mego implemented Quality Assurance Procedures. These procedures are outlined in the "Training and Procedures Manual for the FHA Title I Program." The Quality Assurance Procedures provide specific "Department Responsibilities" and procedures for each type of review mandated by the Procedures. Periodic reports were distributed to and reviewed by senior management which would respond as necessary.

*The Audit Report also alleges that "Mego did not properly evaluate loan amounts and did not properly analyze borrowers credit and income." Mego objects to this alleged weakness and refers the OIG to its response to each file so cited in the Audit Report.*

Finally, the Management Controls portion of the Audit Report alleges that "Mego did not follow HUD's requirements for inspections." Please see Mego's response to Finding 2 of the Audit Report, above.



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