



Issue Date December 16, 2004

Audit Report Number 2005-SE-1002

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

FROM: Frank E. Baca, Regional Inspector General for Audit, Northwest Region, OAGA

SUBJECT: National City Mortgage Company, Federal Way Branch
Federal Way, WA
Nonsupervised Single-Family Mortgagee - Loan Origination

HIGHLIGHTS

What We Audited and Why

We audited National City Mortgage Company's Federal Way Branch Office because there had not been any reviews by the U.S. Department of Housing and Urban Development's (HUD) Quality Assurance Division or Office of Inspector General (OIG), and the branch office had 25 defaults within the previous 2-year period.

Our objectives were to determine whether the Federal Way Branch acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of the Federal Housing Administration-insured single-family mortgages selected for review, and whether the mortgagee's quality control plan, as implemented, met HUD requirements.

What We Found

We found that the lender generally acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of the Federal Housing Administration-insured single-family mortgages selected for review. However, 2 of the 31 loans had a significant underwriting error.

We also found that the lender did not perform quality control reviews for loans that defaulted within the first 6 months from closing. This matter is not addressed in this report, but will be explored in a nationwide audit of National City Mortgage Company to be conducted later this year.

What We Recommend

We recommend that the lender indemnify Loan 561-7688322 in the amount of \$235,660 and repay \$5,506 to the Federal Housing Administration insurance fund for the loss on the sale of property for Loan 561-7561965.

Auditee's Response

The auditee concurred with the finding and recommendations and has taken corrective action. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

The National Housing Act, as amended, established the Federal Housing Administration, an organizational unit within the U.S. Department of Housing and Urban Development (HUD). The Federal Housing Administration provides insurance to private mortgagees against loss on mortgages financing homes. The basic home mortgage insurance program is authorized under Title II, Section 203(b), of the National Housing Act and governed by regulations in Title 24, Code of Federal Regulations, Section 203.

National City Mortgage Company's Federal Way Branch is a traditional branch office located in Federal Way, WA. The branch office was authorized by HUD to originate Federal Housing Administration single-family loans on September 25, 2000.

National City Mortgage Company's corporate office is located in Miamisburg, OH. It is a nonsupervised lender approved under the Direct Endorsement Program to underwrite and close mortgage loans without prior approval from HUD. National City Mortgage has been an approved Federal Housing Administration lender since May 27, 1955, and is a wholly owned subsidiary of National City Corporation, a business unit of National Consumer Finance. The company has about 8,000 employees and operates 330 lending offices in 37 States. It is the country's ninth largest mortgage loan originator, with loan originations in excess of \$105 billion in 2003.

The audit objectives were to determine whether 1) the mortgagee acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of the Federal Housing Administration-insured single-family mortgages selected for review and 2) the mortgagee's quality control plan, as implemented, met HUD requirements.

RESULTS OF AUDIT

Finding 1: National City Mortgage Did Not Always Comply with HUD Underwriting Requirements

For 2 of the 31 loans reviewed, we found the lender's underwriters did not comply with HUD Handbook instructions for qualifying borrowers for HUD-insured mortgages. This occurred because the underwriter (1) did not obtain current income information and (2) mistook an amended petition for divorce as the final decree and excluded the spouse's liabilities from the loan ratio calculations. Because of these underwriter errors, the lender approved two loans for unqualified borrowers, resulting in a claim of \$5,506 and in a \$235,660 unnecessary risk of loss to the HUD-Federal Housing Administration insurance fund.

Two of the 31 Loans Reviewed Had a Significant Underwriting Error

Underwriter Did Not Obtain Current Income Information - Loan 561-7688322

Section 2, Effective Income, of HUD Handbook 4155.1, REV-4, CHG-1, issued September 28, 1995, requires the underwriter to ensure that the anticipated amount of income and likelihood of its continuance must be established to determine the borrower's capacity to repay the mortgage debt.

Part 2-7 D, Commission Income, of the Handbook also requires significant compensating factors for loan approval for individuals whose commission income shows a decrease from one year to the next. Additionally, part 2-9 C, Analyzing Income, states: "Annual earnings that are stable or increasing are acceptable. Conversely, a borrower whose business shows a significant decline in income over the period analyzed may not be acceptable even if current income and debt ratios meet our guidelines."

The borrower's commission income went from \$95,178 in 2000 to \$81,632 in 2001, a decrease of 14.2 percent. Even though the loan did not close until January 21, 2003, the loan file had no documentation of the borrower's 2002 income. We obtained a copy of the borrower's 1099 tax form for 2002, which showed an income of \$51,568. This was a 36.8-percent decline in the borrower's income from 2001 to 2002 and a 45.8-percent overall decline in the borrower's income from 2000 to 2002.

The loan underwriter stated that she followed the instructions provided by the Loan Prospector System and only reviewed the two most recent borrower income tax returns that were available at that time, 2001 and 2000. The underwriter

acknowledged that there had been a decline in the borrower's income from 2000 to 2001 but felt that the decrease was not significant. The underwriter also stated that no additional steps had been taken to determine the borrower's 2002 income.

We recalculated the borrower's debt to income ratios based on the 2002 income of \$51,568. The results showed a mortgage payment expense to effective income ratio of 46 percent and a total fixed payment to effective income ratio of 50 percent. These ratios exceeded HUD guidelines. HUD Handbook 4155.1, REV-4, CHG-1, chapter 2-12, Debt to Income Ratios, paragraph A, Mortgage Payment Expense to Effective Income, states: "If the total mortgage payment does not exceed 29 percent of gross effective income, the relationship of the mortgage payment to income is considered acceptable. A ratio exceeding 29 percent may be acceptable if significant compensating factors are presented." The Handbook also states under paragraph B, Total Fixed Payment to Effective Income: "If the total mortgage payment and all recurring charges does not exceed 41 percent of gross effective income, the relationship of total obligations to income is considered acceptable. A ratio exceeding 41 percent may be acceptable if significant compensating factors are presented."

The underwriter did not comply with HUD Handbook requirements when underwriting this loan. The underwriter noted the decline in the borrower's commission income from 2000 to 2001 but took no action to determine the borrower's 2002 income. A review of the 2002 income would have shown that the borrower's income was continuing to decline, and a recalculation of the borrower's debt to income ratios based on the current 2002 income level would have shown that the borrower did not qualify for a Federal Housing Administration loan.

Spouse's Liabilities Not Included in Loan Ratio Calculations - Loan 561-7561965

We reviewed the HUD loan file and found that the underwriter did not include the nonpurchasing spouse's liabilities in the debt to income ratio calculations.

HUD Handbook 4155.1, REV-4, CHG-1, section 2-2 D, states: "Except for those obligations specifically excluded by state law, the debts of the non-purchasing spouse must be considered in the qualifying ratios if the borrower resides in a community property state or the property to be insured is located in a community property state."

The loan was originated in Washington, a community property State.

The HUD loan file showed that the borrower and the nonpurchasing spouse had signed a petition for dissolution of marriage on July 4, 2002. They had also filed an amended petition for dissolution of marriage on July 16, 2002. These petitions listed the property, debts, and liabilities that would be the responsibility of the petitioner (borrower) and respondent (nonparticipating spouse). However, there was no final divorce decree in either the HUD or the lender loan file. The regional underwriting manager stated that a final decree was necessary to exclude

the nonparticipating spouse's debts from the debt to income ratio calculations. The loan underwriter said that she was aware that a final divorce decree was necessary to exclude the nonpurchasing spouse's debt from the debt to income ratio calculations and that she must have mistaken the amended petition for dissolution of marriage for a final divorce decree.

We contacted the Superior Court County Clerk's Office where the petition was filed. The County Clerk said that the petition for dissolution of marriage had been dismissed and that the couple had reconciled. The borrower and nonpurchasing spouse were legally married when the loan closed on July 23, 2002.

As previously mentioned, HUD Handbook 4155.1, REV-4, CHG-1, chapter 2-12, states that a mortgage payment to income ratio and a total fixed payment to income ratio exceeding 29 percent and 41 percent, respectively, may be acceptable if significant compensating factors are presented.

We combined the borrower's and nonpurchasing spouse's debt and recalculated the debt to income ratios. The recalculation resulted in a mortgage payment to income ratio of 93.7 percent and a total fixed payment to income ratio of 127.7 percent. However, the underwriter did not provide any compensating factors that showed that the ratios were acceptable. If the underwriter had included the nonpurchasing spouse's debt in the debt to income ratio calculations, the borrower would not have qualified for the loan.

This loan went into foreclosure, was conveyed to HUD who sold the property. This resulted in a loss on the sale of property of \$5,506.

Conclusion

The lender's underwriters did not comply with HUD underwriting requirements for 2 of the 31 loans reviewed. These underwriting errors were significant. National City Mortgage Company should indemnify HUD \$235,660 for Loan 561-7688322 and repay the Federal Housing Administration insurance fund \$5,506 for the loss for Loan 561-7561965.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner require National City Mortgage to

- 1A. Indemnify HUD \$235,660 for loan 561-7688322.
- 1B. Repay the Federal Housing Administration insurance fund \$5,506 for the loss to HUD on Loan 561-7561965.

National City Mortgage Company has entered into an agreement with HUD to indemnify loan 561-7688322. They have also repaid \$5,506 to HUD for the loss to the Federal Housing Administration insurance fund for loan 561-7561965. The recommendations are therefore closed. No further action is required.

SCOPE AND METHODOLOGY

Our review covered the period from May 1, 2002, through April 30, 2004, and was modified as needed to achieve our objectives.

To accomplish our objectives we reviewed (1) relevant statutory, regulatory, and HUD Handbook requirements; (2) 31 HUD loan files and 19 lender loan files; and (3) the lender's internal controls relating to loan origination. In addition, we interviewed lender branch and corporate staff, as well as HUD personnel.

To determine our sample of loans for review we

- Downloaded from HUD's Neighborhood Watch system a list of all defaulted loans for the period May 1, 2002, through April 30, 2004, originated by the Federal Way Branch of National City Mortgage Company.
- Selected all new loans that had not been paid in full.
- Selected refinanced loans not paid in full for which National City Mortgage Company was the original lender and the closing date of the original loan was May 1, 2001, or later (no more than 3 years from the ending date of our review period).
- Included in the sample the original loan and any refinanced loans relating to the original loan.

The sample selection method resulted in 31 loans for 21 borrowers, originated by the Federal Way Branch of National City Mortgage Company.

We performed our review 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 the following objectives are being achieved:

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

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

Relevant Internal Controls

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

- Loan Origination Process - Policies and procedures that management has in place to reasonably ensure that the loan origination process complies with HUD program requirements.
- Quality Control Plan - Policies and procedures that management has in place to reasonably ensure implementation of HUD quality control requirements pertaining to loan origination.

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

Our review found that the lender had not performed required reviews of loans defaulting within the first 6 months from closing. However, we did not expand the scope of the assignment and perform additional audit work to determine the extent and significance of the lender's noncompliance with HUD requirements. The Office of Inspector General (OIG) will address this issue later in a nationwide audit of National City Mortgage Company.

APPENDIXES

Appendix A

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

Recommendation Number	Ineligible 1/	Funds To Be Put to Better Use 2/
1A		\$235,660
1B	\$5,506	

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

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

National City® Mortgage

3232 Newmark Drive
Miamisburg, OH 45342

December 7, 2004

Mr. Frank E. Baca
Regional Inspector General for Audit
Northwest Region Office of the Inspector General
US Department of Housing and Urban Development
909 1st Avenue, Suite 126
Seattle, WA 98104

Re: Draft Audit Report for Audit of NCM Federal Way, WA Branch
Finding Number 1(a) FHA Case Number 561-7688322 – NCM Number 1876592
Finding Number 1(b) FHA Case Number 561-7561965 – NCM Number 0812000

Dear Mr. Baca:

We have carefully reviewed your findings, and we would like to take this opportunity to address the issues presented in your audit, as follows:

HUD Finding:

We also found that the lender did not perform quality control reviews for loans that defaulted within the first 6 months from closing. This matter is not addressed in this report, but will be explored in a nationwide audit of National City Mortgage Co. to be conducted later this year.

NCM Response to Finding:

National City Mortgage is aware of HUD's requirements to audit loans that go delinquent 60 days in the first 6 months of the loan. To further mitigate risk, National City Mortgage has taken a more conservative stance to audit loans that go delinquent 30 days in the first 6 months of the loan.

During the time period of the review, May 1, 2002 through April 30, 2004 the OIG noted 25 loans were in default. The NCM audit group reviewed the following:

- 7 loans were fully audited with no trends noted
- A limited review was performed on 10 loans (servicing and origination system data was reviewed noting no trends as the reason for default).
- An additional seven loans were reviewed, but due to poor data collection (manual spreadsheets) the audits reports could not be retrieved

The exceptionally high volume levels in 2002 and 2003 created a backlog within the First and Early Payment Default (FEPD) area facilitating the use of a limited review audit to search for trends that would initiate an expanded review. NCM is aware that a limited audit review is not

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within HUD's guidelines. We believed the limited review was the most effective way to identify risk during the high volume time period. In March 2003, the limited review process was discontinued. The staffing was doubled, back logged audits were outsourced, and a database was implemented to collect loan level data to bring us into compliance with HUD guidelines. Reports have been refined over the past couple of years to enhance the reporting of the audit data from characteristics to loan level detail and trend reports.

National City Mortgage appreciates the opportunity to address the issues identified by the Auditor during their audit of the branch office located in Federal Way, Washington. We will use this data to insure our processes concur with HUD standards.

We have carefully reviewed your findings on the two mortgage loans (referenced above) which were identified as having significant underwriting errors. National City Mortgage (NCM) has also reviewed the documentation included in our mortgage loan files and we would like to take this opportunity to address the issues presented in your audit, as follows:

HUD Finding Number 1: National City did not always comply with HUD Underwriting Requirements.

HUD Finding Number 1(a): Underwriter did not obtain current income information on FHA Case Number 561-7688322

NCM Response to Finding Number 1(a):

Based upon our review of the income documentation included in our mortgage loan file, NCM has determined that our underwriter should have requested documentation showing the borrower's income for the year 2002. The additional documentation would have provided a more accurate estimate of the borrower's capacity to repay the mortgage debt.

NCM concurs with the OIG's finding regarding the significant underwriting error on this Loan which was streamlined refinanced (original case number 561-7688322 to the new Case Number, 561-7813536).

HUD Finding Number 1(b): Spouse's liabilities not included in loan ratio calculations on FHA Case Number 561-7561965

NCM concurs with the OIG's finding that the non-purchasing spouse's liabilities were not included in the debt-to-income ratio for qualification purposes.

The NCM underwriter did not realize that the document provided for her review by the branch personnel was an amended petition for divorce and not the actual divorce decree as had been required as a prior-to-closing condition of the approval.

Based upon our review of the file and the findings noted by the OIG, we are attaching a copy of the check in the amount of \$5,506.00 to repay the Federal Housing

Mr. Frank Baca
Office of the Inspector General

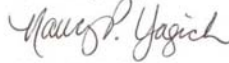
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Administration insurance fund for the loss to HUD on FHA Case number 561-7561965.
Please advise us as to where we should send the check.

National City Mortgage appreciates the opportunity to address the issues identified by the Auditor during their audit of our Branch Office located in Federal Way, Washington. We intend to use the data provided by the OIG to improve on the training and proficiency of our underwriting and processing staff.

Yours very truly,



Nancy P. Yagich
Vice President
National City Mortgage

Enclosure

cc: B. Bibb
T. Otto
S. Hansford
A. Payne
V. Allen
M. Burckhardt

202 477 8943

OIG Evaluation of Auditee Comments

National City Mortgage Company concurred with the audit finding and recommendations.