Issue Date August 3, 2005	
Audit Report Number 2005-FW-1013	

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

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

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

HIGHLIGHTS

What We Audited and Why

We surveyed First Mortgage Company (lender), in Oklahoma City, Oklahoma. We selected the lender because of its high number of defaults and claims. The lender is the largest originator of FHA loans in the state. The lender originated 2,021 FHA loans during the two-year period ending January 31, 2005. According to the U.S. Department of Housing and Urban Development's (HUD) Neighborhood Watch, the lender had 71 defaults and claims in the State of Oklahoma, the most retail defaults and claims in the state during the two-year period. The lender's default and claim rate was 106 percent of the rate for the State of Oklahoma.

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

What We Found

For eleven of the thirteen loans reviewed, we found that the lender acted in a prudent manner and complied with HUD regulations, procedures, and instructions in originating Federal Housing Administration single-family mortgages. However, two loans exhibited poor underwriting. One loan warrants reimbursement of HUD for the loss on foreclosure. The other loan warrants indemnification of HUD. In addition, the lender did not make the required review of each early payment default. HUD reported in February 2003 that the lender was not reviewing early payment defaults as required. We concluded the deficiencies do not warrant further audit work by us.

What We Recommend

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner require the lender to reimburse HUD for the loss incurred on one deficient loan, indemnify HUD for the other deficient loan, and take appropriate administrative action against the lender for not reviewing early payment defaults, which is a recurrence of a HUD quality assurance review finding. We also recommend that the lender improve its procedures for reviewing early payment defaults.

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

Auditee's Response

We provided a copy of our draft report to the lender on June 29, 2005, and had an exit conference on July 15, 2005. We received written responses from the lender on July 11 and 20, 2005. The lender agreed it should indemnify HUD for one loan, but did not agree that deficiencies in originating the other loan rendered it unacceptable. In addition, the lender indicated it did not get information timely enough to ensure timely review of all early payment defaults. The lender indicated it will conduct the required reviews of early payment defaults when it gets the information timely. The lender's complete response is attached as Appendix B.

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BACKGROUND AND OBJECTIVES

First Mortgage Company (lender), an Oklahoma limited liability company, is a lender that provides financing for the purchase of a home. The operations of the lender consist primarily of originating, selling, and servicing residential mortgage loans. The lender has its corporate office in Oklahoma City, Oklahoma, and seven branch offices in three states: Colorado, Nebraska, and Oklahoma. The lender serves as a nonsupervised direct endorsement lender for the U.S. Department of Housing and Urban Development (HUD)/Federal Housing Administration. HUD approved the Oklahoma City branch office on August 22, 2001, to originate single-family loans under Section 203(b) of the National Housing Act. On November 14, 2002, the lender engaged a private firm to provide quality control services.

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

RESULTS OF AUDIT

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

Of the thirteen Federal Housing Administration loans reviewed, we found two that the lender should have rejected. For one loan, the lender's procedures did not ensure its staff followed HUD requirements when calculating self-employment income. For another loan, the lender did not have procedures to ensure they included a borrower's costs paid outside of closing when verifying the borrower's funds to close. As a result, the lender subjected HUD to unnecessary risk by approving the HUD-insured loans for $125,781.

Lender Did Not Correctly Calculate the Borrower's Income

For case number 421-3979299, we found that the lender overstated the self-employed borrower's income, thereby also overstating the borrower's ability to repay the loan. As a result, the lender subjected HUD to unnecessary risk when it approved the HUD-insured loan of $62,902.

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-9C1, requires the lender to either increase or decrease the self-employed borrower's adjusted gross income, as reported on Internal Revenue Service Form 1040, to arrive at effective income. Based on a review of the borrower's individual tax return and any related tax schedules, the lender's staff must decrease adjusted gross income by the amount of actual business cash expenses and may increase it by the amount of depreciation and other non-cash expenses.

The overstatement occurred because the underwriter's method did not include adjusting self-employment income by all actual cash expenses, as the handbook requires. The underwriter just added depreciation to the net profit reported on the return to arrive at self-employment income. As a result, the underwriter did not take into consideration two cash business expenses:

- $1,870 in self-employment tax and
- $2,709 in meals and entertainment

The two items reduce the borrower's monthly effective income $190, from $1,390 to $1,200 per month. This reduction in income increases the borrower's mortgage payment to income ratio to 42.95 percent, which exceeds HUD's 29 percent limit.

The reduction also increases the borrower's fixed payments to income ratio to 42.95 percent, which exceeds HUD's 41 percent limit. With such high ratios and no qualifying compensating factor, the underwriter should have rejected this loan.

The borrower defaulted on the loan on March 1, 2004. The lender foreclosed on October 1, 2004, and conveyed the property to HUD on November 1, 2004. According to HUD's Single Family Data Warehouse system, HUD incurred a $37,086 loss when it sold the property on February 1, 2005.

Lender Did Not Verify Source of Funds Paid Outside Closing

For case number 421-3899957, the lender did not verify the source of funds the borrower paid outside of closing. The lender also did not verify the borrower had enough funds to close. The lender did not have procedures to ensure it included the borrower's costs paid outside of closing when verifying the borrower's funds required to close. As a result, the lender subjected HUD to unnecessary risk when it approved this loan for $62,879.

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-10, requires the lender to verify and document all funds required for closing. The borrower's settlement statement listed four items amounting to $865 paid outside of closing. The lender had not verified the source of $503 used to pay these costs. Based on funds the lender did verify, the borrower would not have had enough funds left to close. The lender should indemnify HUD because it did not verify a substantial amount required for closing, which equals 26 percent of the borrower's required investment.

Recommendations

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

1A. Require the lender to reimburse HUD $37,086 for its loss on Federal Housing Administration case number 421-3979299.

1B. Require the lender to indemnify HUD from loss on Federal Housing Administration case number 421-3899957 for $62,879.

Finding 2: Lender Did Not Review Loans That Defaulted within the First Six Payments

Neither the lender's staff nor its quality control contractor reviewed all early payment default loans as required by HUD. The lender's quality control plan did not require review of all early payment default loans; it only required a review of these loans on a discretionary basis. As a result, the lender had no consistent way to identify correctable causes of early payment defaults.

Lender Did Not Review All Early Payment Defaults

We examined the lender's quality control reports to determine whether the lender included ten loans that defaulted within the first six payments in its quality control reviews. In making quality control reviews, the lender or its contractor had not reviewed nine of the loans. HUD Handbook 4060.1, REV 1, CHG-1, paragraph 6-6D, requires review of all early payment defaults. In February 2003, the HUD Quality Assurance Division reported, "First Mortgage failed to perform quality control reviews on early payment default loans."

The lender's quality control plan did not comply with HUD requirements. It stated that the lender would review early payment default loans on a discretionary basis. The lender did not monitor for defaults and ensure that its staff or contractor conducted a review of each early payment default loan. As a result, the lender did not identify correctable causes of early payment defaults.

Recommendations

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

2A. Ensure the lender implements procedures to monitor defaults and ensure its staff or contractor conducts the required quality control reviews on early payment defaults.

2B. Take the appropriate administrative actions, including civil monetary penalties, against the lender for not reviewing early payment default loans, a recurrence of a finding that HUD reported in February 2003.

SCOPE AND METHODOLOGY

To accomplish the objectives, we selected thirteen Federal Housing Administration loans for review that the lender originated in its Oklahoma City office. We selected the loans from HUD's Neighborhood Watch system,[1] which showed 54 loans that defaulted within the first three years that were originated by the lender's Oklahoma City office during the two-year period that ended January 31, 2005. We selected all loans that met the following conditions:

1. Amortized between February 1, 2003, and January 31, 2005;
2. Either reported first default after five or fewer mortgage payments or had an unknown number of payments before first default was reported; and
3. Had high debt to income and/or mortgage payment to income ratios.

We reviewed relevant federal regulations, HUD handbooks, title company closing files, and Federal Housing Administration and lender loan origination files. We interviewed HUD Quality Assurance Division staff and the lender's executives and staff. We performed our fieldwork at the lender's office and reviewed Federal Housing Administration case binders in our office in Oklahoma City, Oklahoma. We conducted our audit survey in accordance with generally accepted government auditing standards.

[1] We did not perform procedures to assess the data contained in either HUD's Neighborhood Watch or HUD's Single Family Data Warehouse systems. The survey did not include other computer-generated data.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

We determined the following internal controls were relevant to our 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 it complies with HUD quality control requirements.

Significant Weaknesses

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

- The lender had not implemented procedures consistent with HUD requirements for computing self-employment income and for ensuring all funds needed for closing are verified and documented as discussed in Finding 1.

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

APPENDIXES

Appendix A

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

Recommendation Number	Ineligible 1/	Funds to be Put to Better Use 2/
1A	$37,086	
1B		$62,879

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 Office of Inspector General (OIG) recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

FIRST MORTGAGE
COMPANY

July 11, 2005

Mr. Frank E. Baca
Regional Inspector General for Audit, 6AGA
U.S. Department of Housing and Urban Development
819 Taylor Street, Room 13A09
Fort Worth, Texas 76102

Dear Mr. Baca:

I am replying to your letter of June 29, 2005 that provided a draft report on the Inspector General's survey of First Mortgage. We appreciate the opportunity to provide our comments on the findings and recommendations included in your report.

First Mortgage takes great pride in its participation in the FHA programs and the fact that we are the largest originator of FHA loans in the State of Oklahoma. We also recognize our responsibilities and accountability in the administration of the FHA program and devote considerable resources to ensure compliance with FHA's regulations and guidelines. We are pleased that the Inspector General concluded that our company has "generally complied with HUD loan origination requirements" and that additional audit work is not merited. I can assure you that First Mortgage is committed to conducting all of its mortgage operations in accordance with FHA rules and directives.

Comment 1

Before responding to the specific findings on the two cases cited in your survey and our review procedures of early payment defaults, I would like to comment on the reason cited by the Office of Inspector General for selecting First Mortgage for this review. On the first page of the audit report it states that First Mortgage was selected "because of its high number of defaults and claims." As I noted above, First Mortgage is the largest originator of FHA loans in Oklahoma. First Mortgage early default/claim rate of 2.78 percent is virtually identical (i.e. 101 percent "compare ratio") to FHA's overall early default/claim rate in the state of 2.75 percent. (Source: FHA Neighborhood Watch database). Accordingly, while First Mortgage may have been selected for review because of its number of early defaults, your report leaves the impression that First Mortgage was selected because of a serious problem. We request that the report include a reference to our actual early default/claim performance, which is good.

We have the following specific comments on the three findings.

6501 North Broadway, Suite 250 • Oklahoma City, OK 73116 • (405) 302-0009 • Fax (405) 302-0977

Comment 2

1. Case #4213979299

In reviewing the above FHA loan, the self employed borrower took advantage of the IRS Section 179 expense option for upgrading new equipment for his company. This is a specific one time expense allowed by the IRS relating to improvement of company assets. This is not a reoccurring expense and therefore not included in the balance sheet and income calculation. Beth Howard, HUD IG member was faxed the self employed worksheets used by First Mortgage. Therefore, in our opinion, there was not an overstatement of income and an indemnification is not warranted.

Comment 3

2. Case # 421-3899957

First Mortgage recognizes the importance of accounting for all funds that are part of a transaction. In this case the borrower is well known by the employees of our company. Source of the funds borrower paid outside of closing were verified but not documented in the file. Procedures are in place to require the approval sheet from the underwriter, if amended, to be reconfirmed to by the closer and underwriter that funds are available to complete the transaction according to the HUD/FHA Handbook. First Mortgage recognizes the error on this loan and will indemnify HUD accordingly.

Comment 4

3. Review of early payment defaults

First Mortgage strives to follow FHA quality control procedures to the fullest extent possible. I can assure your office and the Department that First Mortgage has not willfully ignored any FHA requirements and our responsibilities to review early payment defaults in particular. At the same time, however, First Mortgage has limited access to early payment delinquency information. We only become aware of these problems when they are reported in FHA's Neighborhood Watch database. Let me explain.

As a regional mortgage lender, First Mortgage does not possess the resources to service mortgages. We sell the servicing rights of virtually all of the FHA loans that First Mortgage originates. As noted above, we are notified of early defaults when they appear in the Neighborhood Watch database and currently loans are only reported when borrowers are at least three payments behind on their payments. First Mortgage reviews these loans in accordance with HUD quality control requirements.

FHA, in recognition of this problem, has published a proposed rule requiring servicers to report loans that are 30 and 60 days delinquent. (See HUD Proposed Regulation published in the Federal Register on January 21, 2005.) Once this rule is implemented, First Mortgage will have access to the information about all delinquent loans that will enable us to review early defaults after two missed payments.

In conclusion, First Mortgage values its participation in the FHA program and makes every effort to adhere to FHA requirements and guidelines. Our commitment to operate in a responsible manner is exemplified by our good early default performance.

Thank you for the opportunity to provide our comments.

Sincerely,

Ron J. McCord, CMB
Chairman

FIRST MORTGAGE
COMPANY

July 20, 2005

Mr. Jerry R. Thompson, CFE
Assistant Regional Inspector General
U. S. Dept. of Housing and Urban Development
819 Taylor Street, Room 13AO9
Ft. Worth, TX 76102

Dear Mr. Thompson:

I want to thank you, Lon, and Beth again for giving First Mortgage Company the opportunity to further respond to the draft report on the Inspector General's survey of First Mortgage Company. As a result of our discussion at the exit conference and upon further review of Case Number 4213979299, I am providing you the following comments:

Comment 5

1. FHA Handbook 4155.1 is clear on what can be added back in to the net income for qualifying.

2. FHA Handbook 4155, Chapter 2, Section 2 states "depreciation or depletion may be added by to adjusted gross income."

3. We can find nowhere in the FHA Handbook which indicates that depreciation should not be included in income if Schedule 4562 includes an entry on Line 2 from Section 179 for assets placed in service.

4. The depreciation in question on the above referenced loan is from the 2001 return. In 2002 there was no entry on Form 4562 for assets placed in service. His 12-month average income for 2002 was $1,662, which is much greater than the income of $1390, which was used by our underwriter.

   While we recognize the borrower's housing expense ratios were slightly higher, the overall ratio for housing and other debt and obligations was acceptable.

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Mr. Jerry T. Thompson, CFE
July 20, 2005
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We also further believe that HUD/FHA should provide training analysis for tax returns. When I asked our underwriters, which have an average of over 25 years experience each in FHA underwriting, none have ever had or been offered a training session for analyzing tax returns on FHA loans. We believe this would be another valuable training tool for FHA underwriters and lenders such as First Mortgage Company.

I would appreciate your adding this letter to our previous response and again, I appreciate the professional courtesy that you and your staff afforded First Mortgage Company during this survey process.

If you should have any questions, please do not hesitate to contact me at (405) 302-0009.

Sincerely,

Ron J. McCord, CMB
Chairman

RJM/j

OIG Evaluation of Auditee Comments

Comment 1 We revised our report based on the lender's comments and added the number of loans the lender originated during the previous two-year period, the number of loans in default and claim status, and the compare ratio according to HUD's Neighborhood Watch system as of January 31, 2005.

Comment 2 The underwriter relied on the borrower's income tax returns to calculate the borrower's effective income. The underwriter should have considered all of the information the returns provided when making this calculation. As indicated by the finding, the underwriter did not consider two cash business expenses to adjust the borrower's effective income. Properly considered, these expenses reduced the borrower's effective income so that the borrower's debt to income ratios exceeded HUD's guidelines for approval without other compensating factors. We agree that assets placed in service during the tax return periods were one-time expenditures and would not affect the effective income used for loan approval. We removed reference to the depreciable assets in our final report.

Comment 3 The lender acknowledged an error in originating this loan.

Comment 4 The lender acknowledged the problem with reviewing early payment defaults and indicated it does not receive notice of defaulted loans in a timely manner. However, as indicated by the finding, the loan originations of nine of ten early payment defaults were not reviewed by the lender. The Neighborhood Watch system clearly showed these early defaults. We believe the lender could have identified the loans it should have reviewed by periodically checking the Neighborhood Watch system.

Comment 5 We agree that Handbook 4155.1 is clear on what can be added back to adjusted gross income for qualifying. Adding depreciation back to adjusted gross income was never an issue in our draft report. Our draft report referenced this section of the handbook that permits this, as our final report does. Regarding the income used by the underwriter to qualify the borrower for the loan, as indicated by the finding, the underwriter did not make proper adjustments to income. Therefore, the borrower's debt to income ratios exceeded HUD's guidelines for approval without compensating factors.

Appendix C

CRITERIA

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

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

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

Paragraph 2-9C. Analyzing Income. The lender must establish the borrower's earnings trend over the previous two years.

Paragraph 2-9C1. The amount shown on the IRS [Internal Revenue Service] Form 1040 as "adjusted gross income" must be either increased or decreased based on the lender's analysis of the individual tax returns and any related tax schedules.

Paragraph 2-9C1b. Business Income or Loss (from Schedule C). Depreciation or depletion may be added back to adjusted gross income.

Paragraph 2-9C1h. Adjustments to Income. Certain adjustments to income shown on the IRS [Internal Revenue Service] Form 1040 may be added back to the adjusted gross income.

Paragraph 2-10. Funds to Close. The cash investment in the property must equal the difference between the amount of the insured mortgage, excluding any upfront MIP [Mortgage Insurance Premium], and the total cost to acquire the property including prepaid expenses and closing costs as described in paragraph 1-9. All funds for the borrower's investment in the property must be verified and documented.