Issue Date September 12, 2005	
Audit Report Number 2005-FW-1014	

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

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

SUBJECT: Realty Mortgage Corporation Did Not Follow HUD Requirements When Processing a Federal Housing Administration Loan

HIGHLIGHTS

What We Audited and Why

We reviewed a Federal Housing Administration loan sponsored by Realty Mortgage Corporation (Realty) of Flowood, Mississippi. During an audit of a Federal Housing Administration-approved loan correspondent, we identified a loan sponsored by Realty that was not properly originated according to U.S. Department of Housing and Urban Development (HUD) regulations. Because the sponsor of the loan is ultimately responsible for loan processing deficiencies, we addressed these deficiencies to Realty to determine whether it complied with HUD requirements.

What We Found

Realty did not comply with HUD regulations, procedures, and instructions in the processing of a Federal Housing Administration-insured single-family mortgage. Realty did not ensure the appraisal included an analysis of the subject sales contract or list price. It also allowed the loan correspondent to charge $1,277 in ineligible fees: a $400 processing fee and $877 in unearned discount points. As a result, the risk to HUD’s insurance fund was increased, and the borrower incurred excessive costs for the loan.

What We Recommend

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner take appropriate administrative action against Realty. This action, at a minimum, should include requiring reimbursement of the $1,277 in ineligible fees to the appropriate parties.

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

Auditee’s Response

On September 2, 2005, Realty provided a written response to our report. Realty generally agreed with our findings. Its response included corrective action taken to ensure appraisals include an analysis of the sales contract. In separate correspondence, Realty also agreed to principal reductions for the $400 processing fee and the $877 in loan discount points. The complete text of Realty’s response can be found in Appendix B of this report.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVES

Realty Mortgage Corporation (Realty) is a nonsupervised lender that began originating Federal Housing Administration loans in 1989.

During the audit of a loan correspondent, we identified one Federal Housing Administration loan sponsored by Realty that was not originated according to U.S. Department of Housing and Urban Development (HUD) requirements. To resolve the deficiencies, we performed a review of Realty's underwriting of the loan.

Our objective was to determine whether Realty complied with HUD regulations, procedures, and instructions when processing the Federal Housing Administration mortgage that it sponsored for a loan correspondent.

RESULTS OF AUDIT

Finding: Realty Mortgage Corporation Did Not Follow HUD Requirements When Processing a Federal Housing Administration Loan

Realty did not comply with HUD regulations, procedures, and instructions in the processing of a Federal Housing Administration-insured single-family mortgage. Realty did not ensure the appraisal included an analysis of the subject sales contract or list price. It also allowed the loan correspondent to charge $1,277 in ineligible fees: a $400 processing fee and $877 in unearned discount points. As a result, the risk to HUD's insurance fund was increased, and the borrower incurred excessive costs for the loan.

Realty Did Not Follow HUD Requirements

Realty did not ensure the appraisal met HUD standards. In determining the appraised value, the appraiser did not analyze the subject sales contract or list price. The sales contract showed the property was under contract for $86,000, with the seller agreeing to pay $5,000 in borrower closing costs and other expenses. HUD requires the appraiser to analyze all agreements of sale, options, or listings in determining the appraised value. According to Realty, the appraiser explained that he had not performed the analysis because it was not a requirement until HUD issued Mortgagee Letter 2005-02, on January 4, 2005. However, the appraiser's assertion is incorrect. HUD Handbook 4150.2, effective July 1, 1999, requires strict compliance with Uniform Standards of Professional Appraisal Practice, which require the appraiser to perform the analysis. Since the appraiser did not consider the list price or sales contract terms, Realty cannot be certain of the accuracy of the appraised value.

Realty charged a $400 processing fee to the borrower. HUD does not allow lenders to charge borrowers processing fees. Realty concurred that the fee should not have been charged to the borrower.

Realty allowed the loan correspondent to charge $877 in loan discount points without reducing the borrower's interest rate. Instead, the loan correspondent charged the borrower an above-market interest rate. Realty compensated the loan correspondent for the higher interest rate through the payment of a yield spread premium. HUD believes yield spread premiums can be a legitimate tool to reduce borrowers' closing costs through a higher interest rate. However, the loan correspondent could not provide documentation to show that the borrower received anything of value for the discount points charged. The Real Estate

Settlement Procedures Act prohibits giving or accepting any part of a charge for services not performed. Realty does not believe that the unearned fees were improper since the seller, not the borrower, paid them. However, the Real Estate Settlement Procedures Act does not limit the prohibition of unearned fees to fees paid by the borrower. Since the loan correspondent charged loan discount points without reducing the interest rate, the discount points were unearned fees in violation of the Real Estate Settlement Procedures Act.

The underwriting deficiencies on this loan unnecessarily increased the risk to the insurance fund. Further, the ineligible fees unfairly increased the cost of the loan to the borrower. Realty should take steps to ensure its controls over appraisals are adequate and repay the appropriate parties for the $1,277 in ineligible fees.

Recommendations

We recommend the Assistant Secretary for Housing – Federal Housing Commissioner and Chairman, Mortgage Review Board:

1A. Require Realty to reimburse the appropriate parties for the $400 processing fee improperly charged.

1B. Require Realty to reimburse the appropriate parties for the $877 in unearned fees.

1C. Ensure Realty's controls over appraisals are adequate to provide reasonable assurance that its appraisals include an analysis of the subject sales contract.

SCOPE AND METHODOLOGY

We reviewed Realty's processing of one Federal Housing Administration loan that it sponsored for a Federal Housing Administration-approved loan correspondent. During our audit of that loan correspondent, we reviewed loans closed from July 1, 2002, through June 30, 2004, that defaulted within the first three years of closing. We identified a loan, sponsored by Realty, which appeared to be improperly underwritten. Because the sponsor of the loan is ultimately responsible for loan processing deficiencies, we addressed the deficiencies to Realty.

To accomplish our objective, we prepared a case narrative of the loan processing deficiencies identified and provided the information to Realty. We allowed Realty an opportunity to provide additional information that could resolve the deficiencies identified. Realty provided a written response. We evaluated the response when reaching our conclusions.

In conducting our audit, we used computer-processed data contained in HUD's Neighborhood Watch system. However, we did not rely on the data to accomplish our audit objective. Accordingly, we did not assess the reliability of the data in the system.

We did not assess Realty's underwriting controls because they were not significant to our objective of reviewing the loan.

We performed the work from May through August 2005. The audit was conducted in accordance with generally accepted government auditing standards.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/
1A	$400
1B	$877

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 policies or regulations.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

Realty Mortgage Corporation
2080 N. Highway 360
Suite 425
Grand Prairie, TX 75050
Phone (972)623-3912
Fax (972)623-3929

September 1, 2005

U.S. Department of Housing and Urban Development
Region IV, Office Inspector General
819 Taylor Street, Room 13A09
Fort Worth, Texas 76102

Attn: Laura Nixon

Re: [redacted] Case # 491-8298201

Dear Ms. Nixon:

Thank you for your letter regarding the deficiencies found on the above mentioned file.

Comment 1

In regards to appraiser, Dean Johnson, no reviewing and analyzing the sales contract as it relates to this transaction, Mr. Johnson was under the impression at the time that it was not necessary. We have reminded Mr. Johnson and the DE Underwriters here at Realty that this is and has been a requirement per the 4150.2 Handbook.

We have attached the memo to underwriting and the letter sent to Mr. Johnson for you perusal. Please do not hesitate to call me at 972-352-4734 with any questions or concerns in this matter.

Respectfully,

Betty Mayes

Betty Mayes
Underwriting Manager
Phone: 972-352-4734
Email: bmayes@rnfcorp.com

REALTY MORTGAGE CORPORATION

August 31, 2005

Dean Johnson Residential Appraisals
1211 South Bowen Road, Suite 215
Arlington, Texas 76013

Re: [redacted]

Dear Mr. Johnson:

Thank you for your response on May 18th to Karen Macharelli regarding the HUD audit findings on the above referenced property. This audit has now been completed, and we would like to share with you HUD's findings and the memo sent to our DE underwriters here at Realty.

Per HUD Handbook 4150.2, dated January 24, 1999, all agreements of sale, options or listings must be analyzed in determining the appraised value. Appraisers and underwriters we reminded of this standard in Mortgagee Letter 2005-02.

Thank you again for your assistance in this matter.

Sincerely,

Betty Mayes

Betty Mayes
Underwriting Manager
Realty Mortgage Corporation

Phone
972-623-3912

2080 N. Hwy. 360, #425
Grand Prairie, TX 75050

Fax
972-623-3929

Realty Mortgage Corporation
2080 N. Hwy 360, Ste. 425
Grand Prairie, TX 75050
Phone800-706-7779
Fax 972-623-3942

MEMO

DATE: August 31, 2005
TO: Underwriting
FROM: Betty Mayes, Underwriting Manager

RE: FHA appraisals

When reviewing FHA appraisals, please remember that we, as DE Underwriters, are responsible for ensuring that the appraiser has analyzed the sales contract pertaining to our subject property. This can be found in HUD Handbook 4150.2, dated January 24th, 1999 and was re-iterated in ML 2005-02. Please review the Handbook and Mortgagee Letter to prevent any further issues regarding the accuracy of our HUD appraisals.

OIG Evaluation of Auditee Comments

Comment 1 Realty agreed that the appraisal should have included an analysis of the sales contract. In separate correspondence, Realty also agreed to principal reductions for the $400 processing fee and the $877 in loan discount points.

Appendix C

CASE STUDY OF IMPROPERLY ORIGINATED LOAN

Case number: 491-8298201

Mortgage amount: $84,733

Gift amount: $5,126

Date of loan closing: February 2, 2004

Status as of March 31, 2005: Foreclosure started (October 1, 2004)

Payments before first default reported: 1

Summary:

Appraisal Did Not Include an Analysis of the Subject Sales Contract or List Price

The appraiser did not analyze the subject sales contract or property listing. The appraiser notes that the property was under contract for $86,000. The sales contract, dated before the date of the appraisal, showed the property was under contract for $84,000. It also showed the seller agreed to pay $5,000 in borrower closing costs and other expenses. HUD Handbook 4150.2, paragraph 4.0, requires strict compliance with Uniform Standards of Professional Appraisal Practice. Standards rule 1-5(a) requires the appraiser to analyze all agreements of sale, options, or listings of the subject property in determining a property's appraised value. Standards rule 2-2(a)(ix) states that if the information is unobtainable, the appraiser must provide a statement on efforts made to obtain the information.

Ineligible Closing Costs Charged to Borrower

Realty allowed the loan correspondent to charge a $400 processing fee to the borrower. HUD Homeownership Center Reference Guide, page 2-15, does not allow processing fees to be charged to the borrower.

Realty allowed the loan correspondent to charge $877 in loan discount points without reducing the borrower's interest rate. Instead, it charged the borrower an above-market interest rate, resulting in a yield spread premium of $2,755. The loan correspondent did not provide documentation to show the borrower received anything of value for the discount points charged. HUD allows lenders who originate Federal Housing Administration-insured loans to charge borrowers a 1 percent loan origination fee and eligible closing and prepaid costs; however, additional fees should be for specific services performed beyond the normal loan processing and underwriting. Section 8 of the Real Estate Settlement Procedures Act prohibits giving or accepting any part of a charge for services not performed. Since the loan correspondent charged loan discount points without reducing the interest rate, the discount points were unearned fees in violation of the Real Estate Settlement Procedures Act.