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TO: John C. Weicher, Assistant Secretary for Housing–Federal Housing
Commissioner and Chairman, Mortgage Review Board, H

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FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: Mortgage Express’s Quality Control Process Did Not Comply with
HUD Requirements

HIGHLIGHTS

What We Audited and Why

We audited Mortgage Express, Inc. (Mortgage Express), a Federal Housing Administration-approved loan correspondent located in La Vista, Nebraska, because its default rate has been significantly higher than the U.S. Department of Housing and Urban Development (HUD) Des Moines field office’s average over the past two years.

Our audit objectives were to determine whether Mortgage Express properly developed and implemented a quality control plan and properly originated Federal Housing Administration mortgages.

What We Found

Mortgage Express’s quality control process did not comply with HUD requirements. Mortgage Express’s written quality control plan lacked many required elements. In addition, Mortgage Express did not conduct all required quality control reviews, nor did its management review completed quality control reports and take prompt corrective action when the reports identified deficiencies.

Mortgage Express also did not follow HUD requirements when originating 18 of 41 Federal Housing Administration mortgages reviewed. Because Mortgage Express’s Federal Housing Administration sponsors are ultimately responsible to

HUD for these deficiencies, we will address these deficiencies to the appropriate sponsors in separate reports.

What We Recommend

We recommend that the Assistant Secretary for Housing–Federal Housing Commissioner and Chairman, Mortgage Review Board, require Mortgage Express to implement controls to ensure that it follows HUD’s quality control requirements and verify that Mortgage Express has implemented proper controls. We also recommend that HUD take appropriate administrative action against Mortgage Express for continuing to operate without an adequate quality control process.

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

Auditee’s Response

We provided a draft report to Mortgage Express on April 1, 2005, and received written comments on April 15, 2005, as requested. Mortgage Express generally agreed with our conclusions, and responded that it has updated its Quality Control Manual to conform to HUD requirements. Mortgage Express also plans to hire quality control staff and have its quality control function in compliance with HUD rules and regulations by the end of April 2005.

The complete text of the auditee’s response can be found in appendix A of this report.

TABLE OF CONTENTS

Background and Objectives	4
Results of Audit	
Finding: Mortgage Express's Quality Control Process Did Not Comply with HUD Requirements	5
Scope and Methodology	8
Internal Controls	9
Appendix	
A. Auditee Comments	10

BACKGROUND AND OBJECTIVES

Mortgage Express is a loan correspondent located in La Vista, Nebraska. A loan correspondent is a lender that has as its principal activity the origination of Federal Housing Administration-insured mortgages for sale or transfer to its sponsors.

Mortgage Express began operations in 1995 and became an approved loan correspondent for the Federal Housing Administration in June 1998. Mortgage Express currently operates 18 branches located in 11 states. Approximately 20 percent of Mortgage Express's overall business involves origination of Federal Housing Administration loans. Mortgage Express originated 804 Federal Housing Administration-insured loans that closed from June 1, 2002, through May 31, 2004.

We selected Mortgage Express for review because its default rate has been significantly higher than the U.S. Department of Housing and Urban Development (HUD) Des Moines field office's average over the past two years. At the beginning of our audit period, the percentage of Federal Housing Administration loans originated by Mortgage Express that had defaulted within the first two years was 140 percent of the national average, and its default rate had reached 150 percent of the national average by the end of our audit period. When compared to regional averages, Mortgage Express's default rate at the end of our audit period was 390 percent of the Des Moines field office's average and 232 percent of the Omaha field office's average.

Our audit objectives were to determine whether Mortgage Express properly developed and implemented a quality control plan and complied with HUD regulations, procedures, and instructions in the origination of Federal Housing Administration mortgages.

RESULTS OF AUDIT

Finding: Mortgage Express's Quality Control Process Did Not Comply with HUD Requirements

Mortgage Express had not established and implemented an adequate quality control process. Mortgage Express's written quality control plan did not include many required elements, and its staff did not conduct all quality control reviews required by HUD. Further, Mortgage Express's management did not review the quality control reports of completed reviews and take prompt corrective action on identified deficiencies. This occurred because Mortgage Express's senior management had not made quality control a priority. As a result, Mortgage Express is unable to ensure the accuracy, validity, and completeness of its loan origination operations.

Mortgage Express's Process Did Not Meet HUD Standards

Mortgage Express's written quality control plan lacked many HUD-required elements specified in HUD Handbook 4060.1. HUD requires all Federal Housing Administration-approved lenders, including loan correspondents, to implement and continuously have in place a quality control plan for the origination of insured mortgages. The more significant deficiencies in Mortgage Express's quality control plan included the absence of guidance on conducting onsite branch reviews at least once per year, reviewing all loans going into default within the first six months or first six payments due (i.e., early payment defaults), or completing quality control reviews within 90 days of loan closing.

Further, Mortgage Express did not conduct all quality control reviews required during our audit period. It also did not perform the completed reviews in accordance with HUD regulations and did not take prompt corrective action when these reviews identified deficiencies. HUD Handbook 4060.1 requires lenders to conduct quality control reviews of loans within 90 days closing, and requires reviews either monthly or quarterly, depending on the number of loans closed each month. HUD also sets parameters on the sample size and selection of loans for review and requires lenders to review all early payment defaults.

Mortgage Express provided quality control reports for June 2002 through December 2003. However, the reports did not demonstrate that Mortgage Express had conducted the reviews in accordance with HUD requirements. For example, the reports did not show that Mortgage Express had

- Conducted reviews of at least 10 percent of the Federal Housing Administration loans closed during each review period.
- Conducted onsite reviews of branch offices.
- Reviewed all loans defaulting within six months of the closing date or within the first six payments due. HUD's systems showed that nine loans

had defaults reported within the early default timeframe; however, Mortgage Express had reviewed only two of these loans.

Additionally, Mortgage Express's senior management did not review the quality control reports; therefore, it could not ensure prompt action was taken to correct deficiencies noted in the reports.

Mortgage Express could not provide reports for the remainder of our audit period, January through May 2004, because it has not performed quality control reviews since December 2003. Mortgage Express told us that in October 2003, it terminated the employee responsible for quality control reviews but did not hire a replacement until May 2004.

Mortgage Express has been aware of its inadequate quality control program for more than two years, but it has not taken the necessary actions to ensure that its quality control program meets HUD requirements. HUD's Quality Assurance Division reviewed Mortgage Express in 2002 and reported several problems with its quality control program. In response, Mortgage Express certified to HUD in August 2003 that it had updated its plan and that the updated plan met HUD requirements. However, as of December 2004, Mortgage Express had not updated its quality control plan and was still using its plan of July 1998—the same plan that HUD had previously determined did not comply with applicable requirements. Mortgage Express told us that it is updating its quality control plan to comply with HUD Handbook 4060.1.

Conclusion

Mortgage Express did not establish and implement a quality control process that complied with HUD requirements. Its written plan lacked many significant elements necessary to conduct proper quality control reviews, and it did not ensure that it conducted quality control reviews in accordance with HUD regulations. Without a properly implemented quality control process, Mortgage Express cannot ensure that its loan origination operations comply with HUD requirements; that it is protecting itself and HUD from unacceptable risk; and that it is guarding against errors, omissions, and fraud.

Recommendations

We recommend that the Assistant Secretary for Housing—Federal Housing Commissioner and Chairman, Mortgagee Review Board,

- 1A. Require Mortgage Express to establish and implement an adequate quality control process.
- 1B. Verify that Mortgage Express's quality control process is fully implemented in accordance with HUD regulations.

- 1.C. Take appropriate administrative action against Mortgage Express for continuing to operate without an adequate quality control process.

SCOPE AND METHODOLOGY

Mortgage Express originated 804 Federal Housing Administration-insured loans that closed from June 1, 2002, through May 31, 2004. Of these 804 loans, we reviewed 41 loans that defaulted within the first two years of the loan.

To achieve our objectives, we reviewed HUD's rules, regulations, and guidance for proper origination of Federal Housing Administration loans. We also reviewed previous HUD reviews of Mortgage Express and the HUD case binders for the 41 defaulted loans. In addition, we interviewed HUD staff to obtain background information on HUD requirements and Mortgage Express.

We interviewed Mortgage Express's management and staff to obtain information regarding its policies, procedures, and management controls. We reviewed Mortgage Express's written policies and procedures to gain an understanding of how its processes are designed to function. We also reviewed Mortgage Express's case binders for the 41 defaulted loans and its quality control plan and available quality control reports.

We relied upon computer-processed data contained in HUD's Single Family Data Warehouse system. We assessed the reliability of these data, including relevant general and application controls, and found them to be adequate. We also performed sufficient tests of the data, and based on the assessments and testing, we concluded that the data are sufficiently reliable to be used in meeting our objectives.

We performed audit work from November 2004 through March 2005. The audit was conducted 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:

- Controls over origination of Federal Housing Administration loans.

We assessed the relevant controls identified above.

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

Significant Weaknesses

Based on our review, we believe the following item is a significant weakness:

- Mortgage Express has not properly implemented a quality control plan and process (see finding).

Appendix A

AUDITEE COMMENTS



7200 South 84th St. * La Vista, NE 68128 * (402) 334-5878 * www.mortgageexpress.com

April 15, 2005

Mr. Ronald J. Hosking; Regional Inspector General
Office of Inspector General
Gateway Tower II -5th Floor
400 State Avenue
Kansas City, Kansas 66101-2406

Dear Ronald,

Mortgage Express, Inc. would like to address the Audit performed by the OIG. We agree with the majority of their assessment of Mortgage Express, Inc. Our Quality Control has had significant deficiencies since we terminated our independent Quality Control in August of 2003. We had already hired a person, [REDACTED] to perform the Quality Control in-house. His performance was sub par, and he quit in October of 2003. He was originally responsible for updating our program to HUD's revised Handbook and never started the revision. We then hired [REDACTED] to restructure our QC dept. He had over 35 years of lending experience and was an approved delegated underwriter. We believed he was the best person to head our QC. He started with Mortgage Express in May of 2004. He quit and went to work for a bank in November of 2004. He was also responsible for updating our plan to conform to HUD's revised Handbook, but never completed it.

We would like to address what steps have been taken since [REDACTED] has quit and the OIG has performed their Audit. We have updated our Quality Control Manual to conform to HUD's Handbook 4060.1. We have explored several options as to who or whom will perform our Quality Control. We have looked at hiring a service, exchanging services with a local bank, or hiring someone in-house. Hiring a service is not monetarily beneficial to Mortgage Express, Inc. Exchanging services with the bank has not turned out like it should. The people at the bank concluded they would not have time to perform the Quality Control for Mortgage Express, Inc. We have decided to hire a person to perform our Quality Control. As of April 15, 2005, we have 2 potential candidates to run our Quality Control and have ran an add in the local newspaper. We will have a qualified individual hired by the end of the month.

The OIG has also indicated another reason for the Audit is our default rate was 140% of the national average. The OIG did not find any fraudulent activity or patterns indicating that one loan officer, branch, or processor were involved with the delinquent loans. We have reviewed the loans and have found at least one thing common among the majority, that the majority used a down payment assistance program.



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Mortgage Express, Inc. does not underwrite FHA loans. We understand we are liable for the loans submitted to our lenders, but we do rely on them to assure the loans meet guidelines set forth by all Federal Agencies. We rely on them more to assure our loans conform to all guidelines when they underwrite the loans, as is the case with all of our FHA loans.

Finally, Mortgage Express, Inc. went through 2 previous audits performed by HUD. We did cure the deficiencies from those audits. We had some setbacks with our Quality Control since the previous audits, but believe we will have a Quality Control that conforms to HUD's guidelines by the end of April. We would enjoy the opportunity for HUD to visit and review our Quality Control to assure it meets their guidelines.

Please give me a call if you have any questions or concerns.

Sincerely,


Mike Akromis
Vice President