



Issue Date	September 23, 2005
Audit Report Number	2005-LA-1010

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

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: First Magnus Financial Corporation Did Not Comply with Federal Housing
Administration Guidelines When Underwriting Five Mortgage Loans and
Implementing Its Quality Control Program

HIGHLIGHTS

What We Audited and Why

We reviewed five Federal Housing Administration loans sponsored by First Magnus Financial Corporation's (First Magnus) branch office in Las Vegas, Nevada. During an audit of a Federal Housing Administration-approved loan correspondent, we identified loans sponsored by First Magnus that did not appear to be originated according to U.S. Department of Housing and Urban Development (HUD) regulations. Because the sponsor is ultimately responsible for approving the loans, we reviewed the underwriting deficiencies with First Magnus to determine whether it complied with HUD requirements.

What We Found

First Magnus did not comply with HUD requirements when underwriting the five Federal Housing Administration-insured mortgages as the sponsoring lender.

First Magnus approved the loans for borrowers who were ineligible for the insured mortgages because the loan files contained false and otherwise questionable documentation. In addition, First Magnus did not perform quality control reviews during the time that four out of five loans in our sample were closed. Therefore, the quality control plan at that time was not fully implemented. As a result, it improperly placed the insurance fund at risk.

What We Recommend

We recommend that the assistant secretary for housing - federal housing commissioner take appropriate administrative action against First Magnus. This action, at a minimum, should include requiring First Magnus to repay \$204,826 in claims and losses incurred on four loans, and, indemnify HUD \$127,893 for any future losses associated with one loan that is presently in foreclosure.

We also recommend that First Magnus require its branch offices to respond in writing to quality control review findings, and establish timeframes for completion of corrective actions.

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 First Magnus with the discussion draft report on August 24, 2005, and held an exit conference on September 8, 2005. First Magnus provided written comments on September 13, 2005. First Magnus agreed with our report findings. The complete text of First Magnus' response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

Background

The First Magnus Financial Corporation (First Magnus) is a wholesale lender that was incorporated and approved by the U.S. Department of Housing and Urban Development (HUD) as a nonsupervised lender in 1996. Its corporate office is located in Tucson, Arizona. First Magnus currently has 251 active branch offices and sponsors 1,870 Federal Housing Administration-approved loan correspondents. As a wholesale lender, First Magnus underwrites and funds loans received by its loan correspondents and other brokers.

First Magnus' Las Vegas branch office sponsored 283 HUD loans that were originated by First Source Financial USA (First Source) of Henderson, Nevada, between April 1, 2001, and March 31, 2003. The chart below shows the current status of those loans.

Description	Number	Percentage	Amount
HUD loans sponsored	262		\$30,018,096
Defaults reported	16	6.1%	\$1,950,599
Loans to claim	5	1.9%	\$638,813

We reviewed five of the 283 loans originated during this period.

Objectives

Our objectives were to determine if First Magnus complied with HUD requirements when underwriting the five loans originated by its loan correspondent First Source Financial USA (First Source), and, to determine whether First Magnus' current and past quality control plans complied with HUD requirements and were adequately implemented.

RESULTS OF AUDIT

Finding 1: First Magnus Did Not Follow HUD Requirements When Underwriting Five Mortgage Loans and Implementing Its Quality Control Program

First Magnus did not comply with HUD regulations, procedures, and instructions in the processing of five Federal Housing Administration-insured single-family mortgages. The lender did not adequately support the borrowers' eligibility by verifying income and clarifying questionable documentation. We reviewed five loans processed by First Magnus and found instances where borrowers were approved for loans with false documents, overstated income, or questionable loan documentation. In addition, First Magnus did not perform quality control reviews during the time that four of the five loans reviewed were closed. Therefore, the quality control plan at the time was not fully implemented. As a consequence, HUD incurred an unnecessary risk to the Federal Housing Administration insurance fund and suffered losses associated with the loans totaling \$204,826.

General HUD Handbook Requirements

Paragraph 2-5 of HUD Handbook 4000.4, REV-1, requires the lender to obtain and verify information with at least the same care that would be exercised in originating a loan in which the lender would be entirely dependent on the property as security to protect its investment.

HUD Handbook 4155.1, REV-4, describes the basic mortgage credit underwriting requirements for single-family mortgage loans insured under the National Housing Act. For each loan HUD insures, the lender must establish that the borrower has the ability and willingness to repay the mortgage debt. This decision must be predicated on sound underwriting principles consistent with the guidelines, rules, and regulations described throughout the handbook and must be supported by sufficient documentation.

First Magnus Did Not Follow HUD Requirements When Underwriting Five Federal Housing Administration Loans

One Loan Was Approved with False Documentation

Loan Number 332-3619948

First Magnus did not verify the borrower's loan documentation and approved the loan based on false documents. The loan file contained false employment verifications, Internal Revenue Service W-2 forms, and pay stubs. The borrower's alternative credit documentation was also false. The First Magnus loan file contained a faxed copy of a telephonic verification of employment for a company for which the borrower never worked.

Mortgagee Letter 2001-01 holds lenders responsible for verifying the authenticity of faxed loan documentation. The letter states that among other things, the documentation must contain a telephone number of an individual who can verify the accuracy of the information provided. First Magnus did not comply with this requirement.

Three Loans Were Approved with Overstated Income and High Debt-to-Income Ratios

For three of the five loans we reviewed, the borrower's income was overstated. In addition, the debt-to-income ratios in four of the loans exceeded the HUD benchmark ratios of 29/41. For three loans, either the underwriter gave no compensating factors, or the compensating factors provided were not sufficient to warrant loan approval.

Loan Number 332-3709163

First Magnus improperly used income that the borrower had received for only five months to calculate the borrower's debt-to-income ratios. The borrower's monthly income before loan approval averaged at least \$1,000 less than the income used to calculate debt-to-income ratios. If the borrower's actual income had been considered, First Magnus would have calculated the borrower's ratios at 56/57, far exceeding the HUD benchmark ratios of 29/41. At the time of our audit fieldwork, the property had gone into foreclosure twice.

On June 1, 2005, the property went into foreclosure for the third time (\$127,893).

Loan Number 332-3690171

First Magnus disregarded the lower income stated on the borrower's previous two years' tax returns and used a higher income taken from a budget letter supplied by the self-employed borrower. The borrower's income was overstated by \$194 per month. Using the lower income from the borrower's tax returns resulted in debt-to-income ratios of 40/40. These ratios exceeded HUD's benchmark ratios of 29/41.

This loan was a 12-payment default and is in claim status (\$138,969).

Loan Number 332-3690901

The underwriter included undocumented overtime as effective income, and as a result, income was overstated by \$812 per month. The overtime was not documented over two years as is required and should not have been included in the underwriter's calculations. Using the overtime, the underwriter calculated debt-to-income-ratios of 33/33. However, if overtime pay had been omitted from the calculation, the ratios would have increased to 43/43.

This loan was a one-payment default, and a claim was paid (\$27,748).

**No Compensating Factors or
Insufficient Justifications Were
Provided**

For three of the five loans we reviewed, either no compensating factors were provided when the borrower's ratios exceeded HUD's benchmark ratios or the compensating factors given were not sufficient to justify loan approval.

HUD Handbook 4155.1, REV-1 states that compensating factors may be used in justifying approval of mortgage loans with ratios exceeding HUD benchmark guidelines. The underwriter must state the compensating factors used to support loan approval on the remarks section of the HUD 92900-WS.

Loans 332-3709163 and 332-3690901 had no compensating factors to offset the borrowers' excessive ratios. The compensating factors used for loan 332-3690171 were not plausible. One compensating factor stated that the borrower's housing expense would only be a minimal increase over his present rent expense. However, we calculated the increase to the borrower's housing expense to be as much as 33 percent. Another compensating factor stated that the borrower was a

minimal user of credit. The borrower's credit report reflected only six accounts; however, four had gone into collection.

**Loan Was Approved with
Inappropriate Third Party
Intervention**

HUD Handbook 4155.1 REV-4 prohibits verification documents from passing through the hands of a third party.

Loan Number 332-3688870

We found evidence in the file that loan documents including a pay stub passed through the hands of the seller as indicated by the seller's name in the fax line of the document. We located and interviewed the borrower, who told us she never met the loan officer, all business was conducted with one of the sellers, and she signed the paper work at the sellers' home. In addition, the loan was submitted for late endorsement without evidence of current payment on the part of the borrower.

The loan was a zero-payment default and a claim was paid (\$8,932).

**First Magnus Performed Partial
Quality Control Reviews in 2001**

First Magnus' quality control program was not consistent and not fully performed during calendar year 2001. Based on our review of quality control documents, we determined that First Magnus performed quality control reviews for the period January 2001 through May 2001. Four of the five loans in our sample closed later in 2001, when reviews were not performed. Management explained that some reviews were not performed during the time of an office move, and that they hoped to complete them, but never did.

Branch Offices Did Not Respond to Identified Deficiencies resulting from Quality Control Reviews

First Magnus has established a written plan for on-site quality control reviews that complies with the latest revision to HUD Handbook 4060.1, REV-1. However, we reviewed documentation for 69 on-site reviews that were conducted by First Magnus' risk management department between February 2004 and December 2004 and determined that of the 69 branches reviewed, 17 branches had significant findings that were noted, but only two (12 percent) provided responses back to the risk management department. There were no final resolutions to the significant findings identified for the other 15 branches.

In addition, First Magnus had not fully implemented its early payment default program. We reviewed four quarters of early default reports between July 22, 2003, and July 6, 2004, and found that the overall response rate was less than 60 percent. Therefore, we concluded that the quality control review program has not been fully implemented.

Conclusion

Due to lack of due diligence during the underwriting process and a lack of quality controls, First Magnus underwrote the five loans in our sample with false documentation, overstated income, high debt-to-income ratios, and inadequate compensating factors. Compensating factors either were not provided or were not adequate to support approval of the loans. These deficiencies caused an unnecessary risk to the Federal Housing Administration's insurance fund and caused HUD to suffer losses associated with the loans totaling \$204,826.

In addition, First Magnus performed quality control reviews for the first five months of 2001 there was no evidence reviews performed for the remaining seven months of the year. Four of the five loans in our sample closed during the time that no reviews were performed.

First Magnus' branch offices frequently did not respond to significant deficiencies identified by its corporate risk management department. As a result, First Magnus' quality control process has not been fully implemented and in practice is not sufficiently effective in ensuring that loans are processed in accordance with HUD requirements.

Recommendations

We recommend that the assistant secretary for housing – federal housing commissioner require First Magnus to

1A. Repay \$204,826 in claims and losses that HUD incurred on four loans.

1B. Indemnify HUD for any future loss associated with one loan in foreclosure status for \$127,893.

1C. Require its branch offices to respond in writing to quality control findings, and establish timeframes for completion of corrective actions.

SCOPE AND METHODOLOGY

We performed audit work from April through July 2005. The audit period covered April 2001 through December 2004.

To accomplish our review objectives, we

- Reviewed five Federal Housing Administration-insured loans that were underwritten by First Magnus during the period April through September 2001,
- Interviewed First Magnus' Las Vegas branch management and its corporate office management in Tucson, Arizona, and
- Performed a review of First Magnus' present and 2001 Quality Control plan.

We relied on computer-processed data contained in HUD's Neighborhood Watch system. During the audit of the loan correspondent, we assessed the reliability of the 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 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:

- Underwriting – Policies and procedures that management has in place to reasonably assure that the loan underwriting process complies with HUD program requirements.
- Quality Control Process – Policies and procedures established by management to ensure the quality control plan has been implemented and related reviews are performed.

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

First Magnus did not underwrite five loans in accordance with all applicable HUD requirements, and based on our review, we believe that the quality control process, as it relates to implementation of the auditee's prior and current quality control plans, is a significant weakness.

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Unreasonable or unnecessary 3/	Funds to be put to better use 4/
1A	\$204,826			
1B				\$127,893

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/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ Unreasonable/unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, and/or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.

4/ “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



September 13, 2005

VIA E-MAIL: JHOBBS@HUDOIG.GOV
AND U.S. MAIL

Joan S. Hobbs
Regional Inspector General for Audit
U.S. Department of HUD
Office of Inspector General
611 West Sixth Street, Suite 1160
Los Angeles, California 90017

Re: Draft Audit Report
Las Vegas, Nevada Branch Office
Tucson, Arizona Corporate Office
First Magnus Financial Corporation

Dear Ms. Hobbs:

First Magnus Financial Corporation ("FMFC") is in receipt of the discussion draft report issued by your office on August 24, 2005. In addition, representatives from FMFC met with Ms. Pamela Martin and Mr. Clyde Granderson on September 8, 2005 to discuss the audit findings.

Recommendations were made in two areas:

1. That FMFC remit \$204,826 that will reimburse the insurance fund for claims paid on four loans approved and funded by the Las Vegas branch office for First Source Mortgage. In addition, FMFC is to execute an indemnification agreement for a fifth loan which is presently in foreclosure.

FMFC performed its own audit of the files in questions and concur with the auditors findings. Therefore, FMFC will agree to remit the amount owed and will execute the indemnification when it is presented to us. FMFC understands that there will be no other reviews completed on any loan originated by First Source as they relate to FMFC and that all loan level issues are resolved with FMFC's payment.

2. That FMFC require its branch offices to respond in writing to quality control review findings, and establish timeframes for completion of corrective actions.

FMFC has elected to split "quality control measures" between the Quality Control Department and the Risk Management division. FMFC's QC Department is responsible for the monthly analysis of loans recently funded. FMFC's QC plan was vetted by Marilyn Nowak of the office of HUD in Washington, D.C. on July 19, 2005. It is FMFC's

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ADMITTED IN ARIZONA

Comment 1

understanding that although the QC plan in effect in 2001 was found to be insufficient, FMFC's current plan is acceptable.

The "six-month default" process and the "on-site branch review" process are handled by the Risk Management division. FMFC agrees that the level of branch response to findings issued in these areas is insufficient. FMFC will implement a program to increase the response rate.

The program is currently in development but will include at a minimum:

- A directive from our CFO that responses to QC-type findings issued by the corporate office are mandatory for all branches.
- A "clearinghouse" formed at corporate to monitor the release of information as well as the return of information from the branches.
- A system to analyze the data being returned by the branches to ensure that it is both accurate and addresses corrective action.
- A "penalty" process for non-compliance.

FMFC is committed to creating a program that will increase the response rate and ensure that corrective action is taken.

During the exit interview, FMFC disagreed with the audit findings regarding onsite branch audits for two reasons. First, FMFC was cited for a lack of branch response to "significant findings." However, the auditors were unable to identify what the significant findings were. And the auditors were unable to identify what would and would not constitute a significant finding. FMFC cannot properly respond if the auditors cannot identify the significant findings, and cannot define what a significant finding includes.

Second, the handbook which details the requirements for onsite branch audits, does not require file review during branch audits. FMFC includes file reviews during branch audits in order to add value to those audits. The details of the loan-level reviews are included in the file report for the branch visit. The information about those findings is conveyed to appropriate branch personnel during an exit interview held after each audit. Despite this, the OIG cited FMFC for not having a written response to findings that are not required by the handbook, are undertaken for FMFC's own purposes and are discussed at the exit interview.

In the future, FMFC will separate file review findings from its branch audit reports. Loan-level review will still be performed, but file review findings will not be inserted in the branch report.

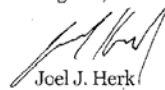
Comment 2

Comment 3

Joan S. Hobbs
Page 3
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The program mentioned above will ensure that FMFC branches respond to issues raised during independent loan-level file review. The program will also ensure that corrective action is taken by the branch.

Regards,



Joel J. Herk
Deputy General Counsel

JJH/jb

cc: Pamela Martin (via e-mail: pmartin@hudoig.gov)

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OIG Evaluation of Auditee Comments

Comment 1 First Magnus Financial Corporation (First Magnus) agreed with our recommendation to reimburse the insurance fund for claims paid on four loans and agreed to remit \$204,826. First Magnus also agreed to execute an indemnification agreement for a fifth loan (\$127,893), which is presently in foreclosure. However, the response also stated, "...First Magnus understands that there will be no other reviews completed on any loan originated by First Source as they relate to First Magnus and that all loan level issues are resolved with First Magnus' payment." The OIG makes no such agreement and in fact at the exit conference, we explained that we plan to return and follow up on issues found during the audit that did not specifically relate to only the five loans reported in this audit. We also told First Magnus that our follow-on work would not be limited to only transactions dealing with First Source.

Comment 2 The term "significant findings" is not a term that was used by the OIG to describe the results of branch office report reviews First Magnus conducted at its branches. The term significant issues was used by First Magnus in a statement contained in its "On-Site HUD Compliance Review" reports to describe items that its Risk Management department said needed to be addressed and response obtained within 45 days. The statement reads as follows:

"In pursuing a constructive audit process, Risk Management requests your response in increasing compliance levels as it pertains to ensuring that loan files contain complete and accurate borrower disclosure and First Magnus' policy-required information. **Please respond to Risk Management within 45 days, from the date of this report, covering significant issues noted above (if any).**" As stated in our draft report, we found that of 69 branch office reviews, 17 had issues that were identified as significant by First Magnus. The issues were either contained on the on-site compliance review report or in appendices that were attached to the report. In the 69 reviews that were provided to us, only two contained responses to the significant findings identified in the reports.

At the exit conference when we were asked to provide examples of "significant issues" we responded that they used this term in their correspondence, not us. We did not bring copies of their correspondence with us to the exit conference since they were the originator of the information. At the exit conference the one example we recalled was where the underwriters did not sign mortgage credit analysis worksheets. Other issues identified by First Magnus in its compliance reviews included:

- Loan documents that were signed by borrowers when they were blank and filled in later.
- Loan applications that were not signed by applicants, loan officers or brokers.
- Files contained no copy of the mortgage credit analysis worksheets.
- Good Faith Estimates and Truth in Lending statements were not issued to borrowers within three days of the loan application.
- Calculated borrower income was either overstated or unsupported.

The items above violated HUD and/or RESPA requirements. In each of the above cases, First Magnus requested that the reviewed branch office respond to the Risk Management department within 45 days from the date of the report covering significant issues that were either noted on the report or in appendices attached to the report. However, there was no evidence that responses to the above issues were provided by their branches.

Comment 3

HUD Handbook 4060.1, REV-1, paragraph 6-3G states that a site review of branch offices must be conducted to determine if they are in compliance with the department's requirements. The handbook goes on to list which review items, at a minimum, must be included in reviews. In addition, the handbook states that the review is not necessarily limited to confirmation of the items listed in the handbook. Paragraph 6-3E, states "...the file review must evaluate the accuracy and adequacy of the information and documentation used in reaching decisions either the origination process or servicing processes."

In its verbal and written responses, First Magnus indicated that in addition to the stated minimum handbook requirements, it is performing file reviews during on-site branch visits, and although it agreed to take steps to improve the response rate amongst its branches, First Magnus also indicated that it considers a discussion of the findings with branch personnel during an exit interview as sufficient resolution of findings. However, it is our belief that if there is no requirement to document resolution of findings, there is no assurance that resolution of the identified issues occurred. As stated by the handbook, the goals of quality control is to assure compliance with HUD's and the mortgagee's own origination or servicing requirements throughout its operations, protect the mortgagee and HUD from unacceptable risk, guard against errors, omissions and fraud, and, assure swift and appropriate corrective action.

Appendix C

SCHEDULE OF DEFICIENCIES AND RELATED CLAIM AMOUNTS

Case No.	Loan Amount	Claims Paid	Loan Status	False W-2, VOE, URLA, Paystubs & Credit Report	Overstated Income	Excessive Debt to Income Ratios	Insufficient/No Compensating Factors When Ratios Exceeded Guidelines	Questionable Loan Documentation				Loan Late Endorsed w/o Evidence of Current Mortgage Payments	3rd Party Handling of Loan Documentation
								Earnest Money Deposit	Alternative Credit	Expired VOEs	Profit & Loss Stmt.		
332-3619948		\$29,177	Claim	X									
332-3690171		138,969	Claim(1)		X	X	X				X	X	
332-3690901		27,748	Claim(2)		X	X	X	X		X			
332-3688870		8,932	Claim		X	X						X	X
332-3709163	\$127,893		Foreclosure			X	X		X				
Totals	\$127,893	\$204,826		1	3	4	3	1	1	1	1	2	1

(1) Still in HUD's REO Inventory for resale as of March 4, 2005

(2) Partial Claim as result of Pre-foreclosure sale program May 23, 2002