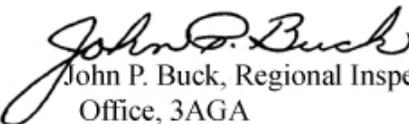




Issue Date December 2, 2005

Audit Report Number 2006-PH-1004

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

FROM:  John P. Buck, Regional Inspector General for Audit, Philadelphia Regional
Office, 3AGA

SUBJECT: Homestead Funding Corp., Allentown, Pennsylvania, Issued and Submitted for
Endorsement Loans with an Increased Risk of Defaults and Claims

HIGHLIGHTS

What We Audited and Why

We audited the Allentown, Pennsylvania, branch of Homestead Funding Corp. (Homestead), a nonsupervised direct endorsement lender approved to originate Federal Housing Administration single-family mortgage loans, because its default rate was above the state's default rate and it was recommended by the U.S. Department of Housing and Urban Development's (HUD) Quality Assurance Division. Our audit objective was to determine whether Homestead complied with HUD's regulations, procedures, and instructions in the origination of Federal Housing Administration loans.

What We Found

Homestead's Allentown branch office did not originate all Federal Housing Administration loans in accordance with HUD's loan origination requirements. Of the 11 loans we selected for review,¹ the branch office did not fully comply

¹ Originally valued at \$895,638

with Federal Housing Administration requirements for 4 of the loans valued at \$270,701. Homestead did not exercise due diligence in the review of assets and accepted faxed documents from realtors. These deficiencies were caused by a lack of due professional care and contributed to an increased risk to the Federal Housing Administration insurance fund. In addition, required quality control reviews were not done in a timely manner. This occurred because Homestead did not have adequate internal controls in place to ensure the reviews were completed timely. As a result, Homestead did not identify or correct problems with the accuracy, validity, and completeness of its loan origination in a timely manner.

What We Recommend

We recommend that the assistant secretary for housing – federal housing commissioner request from Homestead an indemnification of \$95,107 on two loans which it issued contrary to HUD’s loan origination procedures, and \$175,594 on two loans that went into default causing HUD to pay a claim. Further, we recommend that Homestead develop internal procedures to more closely monitor its underwriting procedures. In addition, we recommend that Homestead strengthen its internal controls to ensure that required quality control reviews are completed within HUD’s required timeframe.

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 the draft report to Homestead on October 28, 2005, and requested a response by November 28, 2005. Homestead provided written comments on November 21, 2005. Homestead Funding Corp. generally agreed with our findings. After considering Homestead’s comments on a case that has been paid in full, we decided to remove the case from the report.

The complete text of Homestead’s response, along with our evaluation of that response, can be found in appendix B of this report.

TABLE OF CONTENTS

Background and Objectives	4
Results of Audit	
Finding 1: Homestead’s Allentown Branch Office Did Not Fully Comply with HUD Requirements When Originating Loans	5
Finding 2: Homestead Did Not Complete Quality Control Reviews Timely	8
Scope and Methodology	10
Internal Controls	11
Appendixes	
A. Schedule of Questioned Costs and Funds to Be Put to Better Use	12
B. Auditee Comments and OIG’s Evaluation	13
C. Schedule of Case File Discrepancies	15
D. Narrative Case Presentations	16

BACKGROUND AND OBJECTIVES

The U.S. Department of Housing and Urban Development's (HUD) strategic plan states that part of its mission is to increase homeownership, support community development, and increase access to affordable housing free from discrimination.

The National Housing Act, as amended, established the Federal Housing Administration, an organizational unit within HUD. The Federal Housing Administration provides insurance for lenders against loss on single-family home mortgages.

Beginning in 1983, HUD implemented the direct endorsement program, which authorized approved lenders to underwrite loans without HUD's prior review and approval. HUD can place them on credit watch status or terminate their approval if their rate of defaults and claims exceeds the normal rate for the area. Many sanctions are available for taking actions against lenders or others who abuse the program.

The Allentown branch of Homestead Funding Corp. (Homestead) is one of its nine active branches with direct endorsement approval. Homestead, whose main office is located in Albany, New York, issued 5,584 Federal Housing Administration loans worth \$606,797,431 between May 1, 2003, and April 30, 2005, of which 381 were issued by the Allentown branch at a value of \$36,698,478. Of the 381 loans issued, 17 loans worth \$1,580,317 went into default within the first two years. Of these, we reviewed 11 loans worth \$895,638 that were in default status with 12 payments or fewer after closing.

The specific objectives of our review were to determine whether Homestead originated Federal Housing Administration-insured loans in accordance with prudent lending practices and HUD requirements and whether the lender implemented a quality control plan that meets HUD's requirements. We reviewed case files from both the Homeownership Center and the lender and reviewed Homestead's oversight of its branches.

RESULTS OF AUDIT

Finding 1: Homestead's Allentown Branch Office Did Not Fully Comply with HUD Requirements When Originating Loans

Homestead did not always originate Federal Housing Administration-insured loans in accordance with HUD requirements. For 4 of the 11 loans we reviewed, originally valued at \$895,638, Homestead did not exercise due diligence in the review of assets and accepted faxed documents from realtors. The deficiencies stem from the lack of due professional care at the branch office. These deficiencies contributed to an increased risk to the Federal Housing Administration insurance fund. Therefore, Homestead should indemnify \$95,107 for two defaulted loans and \$175,594 for claims paid on two loans.

Homestead Did Not Properly Verify the Borrower's Funds to Close

HUD requirements state that if the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds.

HUD requires the lender to verify savings and checking accounts. A verification of deposit, along with the most recent bank statement, may be used to accomplish this. If there is a large increase in an account or the account was opened recently, the lender must obtain a credible explanation of the source of those funds. In addition, as an alternative to obtaining a verification of deposit, the lender may obtain from the borrower original bank statements covering the most recent three-month period. Provided the bank statement shows the previous month's balance, this requirement is met by obtaining the two most recent, consecutive statements.

For four of the cases reviewed, Homestead did not adequately verify the borrower's funds to close. For case number 441-7352967, the earnest money could not be verified because of an unsupported gift and escrow deposit. In case number 441-7433339, the bank statement provided for the savings account was not in the borrower's name, and there was no documentation showing that the borrower was added to the account. If the earnest money and savings account had not been used for cases 441-7352967 and 441-7433339, respectively, the borrowers would not have had the funds to close. Further, case number 441-7189755 had an unexplained

large deposit, and case number 441-7302787 did not have consecutive bank statements.

Homestead Accepted Faxes from Third-Party Participants

HUD requirements state that a lender may not accept or use documents relating to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties (e.g., real estate agents, builders, sellers) or by using their equipment.

For case numbers 441-7352967 and 441-7302787 Homestead accepted faxes from interested third-party participants. Both cases had multiple documents that were faxed from the realtor. Those documents included rent receipts, gift letters, bank statements, employment earnings statements, and a child support court order.

Miscellaneous Items

Although these issues do not require an indemnification, in three of the case files we reviewed, Homestead did not follow the loan origination requirements of HUD. The issues include

- Allowing the use of overtime when it could not be determined whether it would continue,
- Allowing the use of commission when it could not be determined whether it would continue, and
- Accepting an amount that was “to be saved” as an asset on the loan application.

The above cases illustrate that HUD assumed unnecessarily high risk when insuring the loans originated by Homestead. The deficiencies associated with Homestead’s loan origination activities stem from the lack of due care in applying HUD loan requirements. Therefore, Homestead should indemnify \$95,107 for two defaulted loans and \$175,594 for claims paid on two loans. See appendix C for the Schedule of Case File Discrepancies and appendix D for the Narrative Case Presentations, which contain the specific HUD regulations cited.

Recommendations

We recommend that the assistant secretary for housing – federal housing commissioner

- 1A. Request Homestead indemnify \$95,107 on two defaulted loans and \$175,594 for claims paid on two loans, in which Homestead's loan origination procedures did not comply with HUD requirements.
- 1B. Require Homestead to develop internal procedures to more closely monitor its underwriting procedures.

Finding 2: Homestead Did Not Complete Quality Control Reviews Timely

Homestead did not complete its quality control reviews within 90 days as required by HUD regulations. This problem occurred because Homestead did not have adequate internal controls in place to ensure the reviews were completed timely. As a result, Homestead did not identify or correct problems with the accuracy, validity, and completeness of its loan origination in a timely manner.

Quality Control Reviews Were Not Completed within the 90-Day Requirement

HUD Handbook 4060.1 states that loans must be reviewed within 90 days of the closing of the loan. Homestead's quality control plan states one of its policies is to ensure sufficient controls to measure results and discrepancies within two or three months of loan closing.

Homestead usually did not complete its quality control reviews within 90 days. We reviewed Homestead's 249 quality control review reports from May 2003 through March 2005 and found that only one review was performed within the 90-day requirement. The remaining 248 loans were reviewed from 103 to 660 days after loan closing.

Homestead's compliance officer stated that Homestead is known for its streamline loans and that this causes an influx of work. Homestead adjusted its plan to consider this; however, due to the lack of adequate staff, it is still not reviewing the loans within the timeframe required by HUD regulations. Homestead employs one quality control analyst to perform the reviews and has another employee who helps when time permits. The compliance officer stated that she needs additional staff to do the quality control reviews in a timely manner.

As a result of the untimely reviews, problems are not identified as early as possible after the loan closing. Early detection of common problems may prevent future unacceptable loans from being approved.

Recommendations

We recommend that the assistant secretary for housing – federal housing commissioner

- 2A. Require Homestead to strengthen its internal controls to ensure that the quality control reviews are completed within HUD's required timeframe.

SCOPE AND METHODOLOGY

To accomplish our objectives, we

- Reviewed Federal Housing Administration-insured loans (11 cases) originated by Homestead's Allentown branch between May 1, 2003, and April 30, 2005, that had gone into default at least once. The 11 loans were part of a universe of 381 loans originated by the Allentown branch during that time. The results of the detailed testing apply to the 11 loans reviewed only and cannot be projected to the universe of Federal Housing Administration-insured loans.
- Examined records and related documents of Homestead.
- Reviewed applicable HUD handbooks and mortgagee letters.
- Conducted interviews with officials and employees of Homestead and the HUD Quality Assurance Division.

In addition, we relied, in part, on data maintained by HUD in the Single Family Data Warehouse and Neighborhood Watch systems. We did not perform a detailed analysis of the reliability of these programs.

The audit generally covered the period from May 1, 2003, to April 30, 2005. When applicable, the audit period was expanded to include current data through July 31, 2005. We conducted our fieldwork from June through September 2005.

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.

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:

- Homestead did not operate in accordance with HUD requirements as they relate to loan issuance and quality control.

The deficiencies are discussed in detail in the Results of Audit section of this report.

APPENDIXES

Appendix A

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

Recommendation number	Unsupported costs 1/	Funds to be put to better use 2/
1A	\$175,594	\$95,107

- 1/ Unsupported costs are those whose eligibility or reasonableness cannot be clearly determined during the audit since they were not supported by adequate documentation or due to other circumstances. Under federal cost principles, a cost must be adequately supported to be eligible.
- 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

HOMESTEAD FUNDING CORP.

LICENSED MORTGAGE BANKER • NYS BANKING DEPARTMENT

November 21, 2005

J. Phillip Griffin
Assistant Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Wanamaker Building, Suite 1005
100 Penn Square East
Philadelphia, PA 19107-3380

Re: Response to Draft Audit Report

Dear Mr. Griffin:

We are in receipt of your October 28, 2005 letter concerning the draft report on the results of your audit of our Allentown, Pennsylvania branch. Please consider this letter a response to your audit findings.

Finding #1

Pursuant to 24 CFR 202.3, Homestead Funding Corp. monitors the default and claim rate performances of our main office and branch offices in the geographic areas served by HUD field offices as well as on a national basis. Based on this information and quality control reviews, we had recognized underwriting deficiencies in our Allentown branch. As a result, management implemented improved internal controls in 2005 to monitor underwriting procedures in the Allentown branch prior to your visit.

While we understand your review of the Allentown branch was precipitated by its default rate exceeding the state's default rate, we would like to point out that this branch represents a fraction of the FHA loans originated by Homestead Funding Corp.. Of the 5,584 FHA loans issued between May 1, 2003 and April 30, 2005, our main office located in Albany, New York issued 4,960 FHA loans with default and claim rate performances well within acceptable levels.

Concerning the recommendation to indemnify the five (5) loans in question, we request Homestead Funding Corp. be given the right of first refusal, so to speak, to purchase the corresponding subject properties after foreclosure by the servicer and conveyance to HUD, but before HUD's REO management company markets the subject properties to the general public in order that we may be assured the properties are not disposed of at discounted or under market values. In addition, Neighborhood Watch indicates one of the five (5) loans (FHA Case No. 441-7401683) has been paid in full, therefore we question the necessity to execute an Indemnification Agreement.

Finding #2

Although we agree that quality control reviews were not completed within 90 days of closing, we do not believe it is accurate that the latest review was completed 660 days after loan closing. Based on the quality control reviews we provided, the only way one might arrive at 660 days is if one were to use the closing date of early default loans, which is not representative of the date the loan is chosen for review, i.e. sixty (60) days after the payment date that first went past due in the first six (6) months of the loan. In any event, in order to facilitate early detection of common problems and to ensure reviews are completed within HUD's required timeframe, we have increased the quality control review staff.

If you require further information, please do not hesitate to contact me at 518-464-1100 x330.

Sincerely,


Jacqueline L. Varrone
Vice President

8 Airline Drive • Albany, New York 12205 • (518) 464-1100 • FAX (518) 464-1141

 EQUAL HOUSING LENDER

Comment 1

OIG Evaluation of Auditee Comments

Comment 1 After checking the HUD database, Neighborhood Watch, we discovered that case 441-7401683 was indeed “Paid in Full.” We have removed this case from the report.

Appendix C

SCHEDULE OF CASE FILE DISCREPANCIES

Case number	Mortgage amount	Unpaid principal balance	Claim paid	Unsupported assets	Acceptance of third-party faxes
441-7433339	\$39,992	\$39,621		X	
441-7352967	\$55,957	\$55,486		X	X
441-7302787	\$66,970		\$70,514	X	X
441-7189755	\$96,239		\$105,080	X	
TOTALS	\$259,158	\$95,107	\$175,594	4	2

Appendix D

NARRATIVE CASE PRESENTATIONS

Case number: 441-7433339

Mortgage amount: \$39,992

Date of loan closing: February 6, 2004

Status: Foreclosure started

Payments before first default reported: Two

Unpaid principal balance: \$39,621

Summary:

Homestead did not properly verify the borrower's funds to close.

Pertinent Details:

Funds to Close Were Not Properly Verified or Supported

A verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase, the lender must verify the source of funds (HUD Handbook 4155.1, paragraph 2-10B). All funds for the borrower's investment in the property were not properly verified. The savings account provided was not in the buyer's name, and there was no documentation showing that the buyer was added to the account. If the savings account had not been used, the buyer would not have had the funds to close.

Case number: 441-7352967

Mortgage amount: \$55,957

Date of loan closing: October 23, 2003

Status: Reinstated by mortgagor who retains ownership

Payments before first default reported: Four

Unpaid principal balance: \$55,486

Summary:

Homestead (1) did not properly verify the borrower's funds to close and (2) accepted faxed documents from interested third-party participants.

Pertinent Details:

Funds to Close Were Not Properly Verified or Supported

HUD Handbook 4155.1, paragraph 2-10A, states that if the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds. Homestead did not properly verify the borrower's funds to close. The earnest money deposit, which exceeded 2 percent of the sales price, included a gift, cash, and a returned security check for renting the property previously. Homestead did not verify that the gift money was given from the donor's account. In addition, Homestead could not verify whether the cash for the earnest money deposit was given by the borrower and deposited into an escrow account.

Homestead Inappropriately Accepted Faxed Documents from Interested Third-Party Participants

No document used in the processing or underwriting of a loan may be handled or transmitted by or through an interested third party to the transaction (e.g., real estate agents, builders, sellers) or by using its equipment (HUD Handbook 4155.1, paragraph 3-1). Homestead accepted faxed documents from a realtor. These documents included the borrower's rent receipts, gift letter, and bank statements.

Case number: 441-7302787

Mortgage amount: \$66,970

Date of loan closing: August 1, 2003

Status: Property conveyed to insurer

Payments before first default reported: Eight

Claim paid: \$70,514

Summary:

Homestead (1) did not properly verify the borrower's funds to close and (2) accepted faxed documents from interested third-party participants.

Pertinent Details:

Funds to Close Were Not Properly Verified or Supported

A verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts (HUD Handbook 4155.1, paragraph 2-10 B). As an alternative to obtaining a verification of deposit, the lender may obtain from the borrower original bank statements covering the most recent three-month period. Provided the bank statement shows the previous month's balance, this requirement is met by obtaining the two most recent, consecutive statements (HUD Handbook 4155.1, paragraph 3-1 F). All funds for the borrower's investment in the property were not properly verified. A verification of deposit was not obtained; in addition, the two most recent consecutive bank statements were not obtained. There were two bank statements in the file; however, they were not consecutive. There was a two-month gap between the statements.

Homestead Inappropriately Accepted Faxed Documents from Interested Third-Party Participants

No document used in the processing or underwriting of a loan may be handled or transmitted by or through an interested third party to the transaction (e.g., real estate agents, builders, sellers) or by using its equipment (HUD Handbook 4155.1, paragraph 3-1). Homestead accepted faxed documents from a realtor. These documents included the gift letters, bank statements, court order for child support, and employment earnings statements.

Case number: 441-7189755

Mortgage amount: \$96,239

Date of loan closing: May 1, 2003

Status: Property conveyed to insurer

Payments before first default reported: 10

Claim paid: \$105,080

Summary:

Homestead did not properly verify the borrower's funds to close.

Pertinent Details:

Funds to Close Were Not Properly Verified

A verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase, the lender must verify the source of funds (HUD Handbook 4155.1, paragraph 2-10 B). A majority of the funds for the borrower's investment in the property was not properly verified. A large deposit into the savings account was not explained.