



Issue Date July 31, 2006

Audit Report Number: 2006-CH-1014

TO: Brian D. Montgomery, Assistant Secretary for Housing-Federal Housing
Commissioner, H
John W. Herold, Associate General Counsel for Program Enforcement, CE

FROM: 
Heath Wolfe, Regional Inspector General for Audit, 5AGA

SUBJECT: National City Mortgage Company, Nonsupervised Lender, Miamisburg, Ohio,
Did Not Comply with HUD's Requirements Regarding Underwriting of
Loans and Quality Control Reviews

HIGHLIGHTS

What We Audited and Why

We audited National City Mortgage Company (National City), a nonsupervised lender approved to originate, underwrite, and submit insurance endorsement requests under the U.S. Department of Housing and Urban Development's (HUD) single family-direct endorsement program. The audit was part of the activities in our fiscal year 2005 annual audit plan. We selected National City for audit as a continuation to our previous audit of its late requests for endorsement (see audit report 2005-CH-1015, dated August 23, 2005). Our objectives were to determine whether (1) National City complied with HUD's regulations, procedures, and instructions for underwriting Federal Housing Administration loans and (2) its quality control plan met HUD's requirements and was properly implemented.

What We Found

National City approved 20 of 41 Federal Housing Administration loans in our statistical sample that did not fully meet HUD's requirements. The 20 loans defaulted early and/or went to claim between February 1, 2004, and August 31,

2005. The underwriting deficiencies were material as well as technical and included errors and documentation omissions clearly contrary to prudent lending practices. Further, National City incorrectly certified to the integrity of the data supporting the underwriting deficiencies and to the due diligence used in underwriting the 20 loans. While National City's Federal Housing Administration lending decisions overall have proved well within acceptable risk levels, its quality control plan was not fully implemented during our audit period and may have contributed to the underwriting deficiencies. For the loans in question, the risk to the Federal Housing Administration fund was increased as HUD paid more than \$94,000 in claims for two loans and incurred a loss of nearly \$48,000 for another two loans.

What We Recommend

We recommend that HUD's assistant secretary for housing-federal housing commissioner require National City to indemnify HUD for any future losses on nine loans with a total mortgage value of more than \$1 million, reimburse HUD more than \$94,000 for the claims paid on two loans once the associated properties are sold, reimburse HUD nearly \$48,000 for the loss incurred on two loans since the properties were already sold, buy down two active loans by \$2,900, improve its existing procedures and controls to ensure its underwriters follow HUD's underwriting requirements, implement its quality control plan for reviewing loans with early payment defaults, and ensure that quality control reviews under its quality control plan are timely, accurate, and properly documented.

We also recommend that HUD's associate general counsel for program enforcement determine legal sufficiency and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act against National City and/or its principals for the 20 incorrect certifications cited in this audit report.

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 results of our underwriting and quality control reviews to National City's management during the audit. We also provided our discussion draft audit report to National City's president, senior vice president, and vice president of operations risk asset management and HUD's staff during the audit. We conducted an exit conference with National City's management on June 1, 2006.

We asked National City's president to provide written comments on our discussion draft audit report by July 3, 2006. National City's president provided written comments to the discussion draft report dated June 30, 2006. National City generally disagreed with our findings, but agreed with finding 2's recommendations. The complete text of the written comments, except for four attachments that were not necessary to understand the comments, along with our evaluation of that response, can be found in appendix B of this report. We provided HUD's director of quality assurance division with a complete copy of National City's written comments plus the four attachments.

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BACKGROUND AND OBJECTIVES

National City Mortgage Company (National City), a division of National City Bank of Indiana, is headquartered in Miamisburg, Ohio. In May 1955, the Federal Housing Administration approved National City as a nonsupervised direct endorsement lender to originate Federal Housing Administration-insured loans. As a direct endorsement lender, National City determines that the proposed mortgage is eligible for insurance under the applicable program regulations and submits the required documents to U.S. Department of Housing and Urban Development (HUD) without its prior review of the origination and closing of the mortgage loan. National City is responsible for complying with all applicable HUD regulations and handbook instructions.

As of July 24, 2006, National City had 113 loan correspondents, 314 principals, and 138 authorized agents. National City is a full service mortgage company, originating, marketing, and servicing loans. National City has 300 mortgage offices in 37 states as of July 2006. It also services the continental United States through its direct-to-consumer telephone and Internet preferred lending centers in Ohio and California.

We audited National City as part of the activities in our fiscal year 2005 annual audit plan. We selected National City for audit as a continuation to our previous audit of its late requests for endorsement (see audit report 2005-CH-1015, dated August 23, 2005). Between February 1, 2004, and August 31, 2005, National City originated/sponsored 34,838 Federal Housing Administration loans totaling more than \$4.5 billion in original mortgage amounts. Of these, 1,476 loans totaling more than \$190 million in original mortgage amounts went to claim and/or the borrowers defaulted on their mortgage payments within the first six payments. National City's default to claim rate was 2.18 percent for February 2004 through August 2005.

Our objectives were to determine whether (1) National City complied with HUD's regulations, procedures, and instructions in underwriting Federal Housing Administration loans and (2) its quality control plan met HUD's requirements and was properly implemented.

RESULTS OF AUDIT

Finding 1: National City's Underwriting of 20 Federal Housing Administration Loans Contained Deficiencies

National City approved 20 of 41 Federal Housing Administration loans in our statistical sample that did not fully meet HUD's requirements. The 20 loans defaulted early and/or went to claim between February 1, 2004, and August 31, 2005. The underwriting deficiencies were material as well as technical and included errors and documentation omissions clearly contrary to prudent lending practices. Further, National City incorrectly certified to the integrity of the data supporting the underwriting deficiencies and to the due diligence used in underwriting the 20 loans. The problems occurred because National City lacked adequate procedures and controls over its underwriting of Federal Housing Administration-insured loans, and failed to implement its HUD-approved quality control plan. As a result of the improperly underwritten loans, the risk to the Federal Housing Administration fund was increased, and HUD paid more than \$94,000 in claims for two loans and incurred a loss of nearly \$48,000 for another two loans.

Underwriting Deficiencies of Federal Housing Administration Loans

National City sponsored and closed 34,838 Federal Housing Administration-insured loans totaling more than \$4.5 billion between February 1, 2004, and August 31, 2005. Of these, 1,476 loans totaling more than \$190 million in original mortgage amounts went to claim and/or the borrowers defaulted on their mortgage payments within the first six payments. Of the 1,476 loans, we statistically selected using EZ-Quant computer software 41 to review for compliance with HUD's underwriting requirements.

National City improperly underwrote 20 of the 41 loans reviewed with a total mortgage value of more than \$2.6 million. Of the 20 loans, 10 were refinances and 10 were purchase loans. As of July 24, 2006, HUD had paid \$94,372 in claims on two loans with underwriting violations, HUD lost \$47,829 on two other loans since the properties were already sold, and five loans were paid in full. The remaining 11 loans hold active Federal Housing Administration insurance as of July 24, 2006.

Excessive Debt-to-Income Ratios

National City improperly approved two loans (case numbers 492-7198799 and 137-2892405) when the borrowers' debt-to-income ratios exceeded HUD's requirements and submitted them for insurance endorsement without valid

compensating factors. Paragraphs 2-12 and 2-13 of HUD Handbook 4155.1, REV-4 and REV-5, specify that the ratio of mortgage payments to effective income (front ratio) generally may not exceed 29 percent and the ratio of total fixed payments to effective income (back ratio) may not exceed 41 percent unless significant compensating factors are presented. The handbook allows greater latitude in considering compensating factors for the front ratio than the back ratio. However, National City approved the loans when the borrowers' mortgage payments to effective income were 31.6 and 31.5 percent, respectively, without valid compensating factors.

Delinquent Mortgage Accounts and Related Expenses

For six refinanced loans (case numbers 381-7487573, 151-7563379, 261-8815770, 023-1991951, 483-3481641, and 292-4480217), National City included mortgage payments due and/or delinquent expenses when calculating the mortgage amounts for their new Federal Housing Administration loans. Although the borrowers had the current month's mortgage payment due, there was no documentation in the loans' casebinders or National City's files to support that the payments or delinquent expenses were made before or at settlement. The mortgage payments, ranging from \$485 to \$1,583, were refinanced into the new loans.

Credit Discrepancies

National City did not comply with HUD's credit report requirements. For two loans (case numbers 151-7671875 and 201-3401739), the borrowers did not provide adequate written explanations for the derogatory accounts identified on their credit reports. For one loan (case numbers 492-7198799), the casebinder contained a residential merged credit report that did not (1) include a detailed account of the borrowers' employment history or a statement attesting to the certification of employment and date verified, and (2) verify the borrowers' current employment and income.

Underwriting Approval Conditions

National City did not ensure that the borrowers satisfied their underwriting approval conditions. For six loans (561-8087045, 483-3481641, 561-8072040, 381-7487573, 031-3181600, and 023-1991951), the liabilities required to be paid and/or required documentation for loan approval were not documented in the loans' casebinders or National City's loan files.

Inaccurate Documentation

National City did not verify that a borrower provided accurate information before approving the loan. For loan number 492-7198799, the borrower's prior address, the verification of employment form, and the utility company credit reference in

the borrower's loan file were not accurate. When we contacted the borrower's employer and the utility company, we were informed that the borrower was never employed by the company and utility service was never provided to the borrower's residence. Also, the borrower's prior address listed on such documentation as the uniform residential loan application and the verification of employment in the loan's casebinder does not exist.

Overstated/Unsupported Assets or Income

National City did not properly assess income or employment history for two loans. For loan numbers 561-8072040 and 137-2892405, a two-year work history was not verified for the borrowers. For example, for loan number 137-2892405, the uniform residential loan application and the verification of employment form showed the coborrower was employed for two years by her present employer. However, when we contacted the coborrower's employer, we determined the coborrower was employed by the company for less than two years. Also, the coborrower's employer reported that the coborrower's employment information on the verification of employment form was not accurate.

For loan number 151-7712123, overtime income was included in the borrower's income calculation without National City developing an average of overtime and establishing an earnings trend. In accordance with HUD's requirements, we excluded the income in our analysis and calculated the borrower's debt-to-income ratio at 31.3 percent, which exceeds HUD's requirement of 29 percent. For loan number 201-3401739, the borrower's income was supported by a letter from the employer; however, the information reported did not correspond to the verification of employment form or the borrower's actual earning statements obtained by National City. Using the borrower's pay statements, we calculated the borrower's monthly income as \$3,207 which differs from the \$3,791 amount listed on the mortgage credit analysis worksheet prepared by National City. Therefore, the borrower's fixed payment-to-income ratio exceeded HUD's requirements.

Insufficient Gift Documentation

For all 41 loans reviewed that received gift funds from a charitable organization, National City did not document the transfer of the funds in accordance with HUD's requirements. We contacted the settlement/closing agents to obtain the missing documentation. For loan number 137-2900156, the borrower received an income and tax credit; however, there was no documentation in the loan's casebinder or National City's file to support the credit. For loan number 137-2892405, the borrower received a gift of equity without the relationship of the donor to the borrower being disclosed on the gift letter.

Overinsured Mortgages

For six loans, National City overestimated the financing costs or unpaid principal balances, thereby exceeding HUD's maximum insurable mortgage limit as outlined in Mortgagee Letter 2001-12 and HUD Handbook 4155.1, REV-5. These six loans were funded in the amount of \$677,099 instead of the maximum amount of \$671,570. Therefore, the six loans exceeded HUD's maximum mortgage limit by \$5,529. The following table identifies the overinsured loans. HUD later paid a claim from the Federal Housing Administration insurance fund for loan number 483-3481641.

Loan number	Mortgage amount	Maximum mortgage amount	Overinsured amount
483-3481641	\$85,670	\$85,149	\$521
137-2840495	94,547	93,749	798
381-7487573	118,669	118,143	526
151-7653379	156,411	156,087	324
493-7780858	111,779	109,677	2102
261-8815770	<u>110,023</u>	<u>108,765</u>	<u>1,258</u>
Totals	<u>\$677,099</u>	<u>\$671,570</u>	<u>\$5,529</u>

Incorrect Underwriters' Certifications Submitted to HUD

Of the 20 improperly underwritten loans, 17 were underwritten manually and three were underwritten using an automated system. We reviewed the certifications for all 20 loans for accuracy. National City's direct endorsement underwriters incorrectly certified the integrity of the data for three loans and that due diligence was used in underwriting the remaining 17 loans.

After underwriting a loan using an automated underwriting system, HUD requires direct endorsement underwriters to certify the integrity of the data supplied for a lender used to determine the quality of the loans and that the loans were eligible for insurance. When underwriting a loan manually, HUD requires a direct endorsement lender to certify that it used due diligence and reviewed all associated documents during the underwriting of a loan.

Appendix C of this report provides details of federal requirements regarding the underwriting of Federal Housing Administration loans as well as a citation under the Program Fraud Civil Remedies Act.

National City's Underwriting Procedures and Controls Inadequate

National City needs to improve its existing procedures and controls over its underwriting of Federal Housing Administration-insured loans by implementing its HUD-approved quality control plan. Additionally, it needs to ensure that underwriters continue to receive necessary training on HUD's underwriting requirements. Such procedures and controls should ensure the accuracy of National City's underwriting certifications submitted to HUD.

HUD's Office of Inspector General (OIG) issued four prior audit reports on National City's underwriting practices. The four reports were issued between August 2004 and September 2005 (see Followup on Prior Audits section in this report). The four reports include underwriting findings that are repeated in this report. Further, HUD's Quality Assurance Division performed quality assurance reviews of National City in July 2004 and April, July, and August 2005. The reviews resulted in findings related to loan origination and underwriting. The underwriting deficiencies cited in this audit report, along with the prior OIG audits and HUD's reviews, clearly demonstrate that National City's existing underwriting procedures and controls need to be improved to ensure compliance with HUD's requirements.

As previously mentioned, National City incorrectly certified the integrity of the data or that due diligence was used in underwriting 20 loans. Using the 20 loans with incorrect certifications from the 41 we tested (26 active loans with \$3,223,966 in outstanding mortgage amounts, four loans that HUD paid \$492,466 in claims, three loans where the properties were sold and HUD lost \$89,750, and eight loans paid in full as of July 24, 2006), we estimate the risk to the Federal Housing Administration to be at least \$379,832 for the next year if National City does not improve its underwriting certification procedures and controls.

Recommendations

We recommend that HUD's assistant secretary for housing-federal housing commissioner require National City to

- 1A. Indemnify HUD for any future losses on the nine loans with a total mortgage value of \$1,027,177 cited in this finding. The estimated risk to the Federal Housing Administration insurance fund is \$297,881.
- 1B. Buy down the two overinsured loans (\$798 for loan number 137-2840495 and \$2,102 for loan number 493-7780858) by \$2,900.

- 1C. Reimburse HUD for any future losses from the \$94,372 in claims paid on two loans (483-3481641 and 151-7712123) with a total mortgage value of \$144,613 once the associated properties are sold.
- 1D. Reimburse HUD \$47,829 for the actual losses it incurred on two loans (429-7198799 and 137-2900156) improperly underwritten since the associated properties were sold.
- 1E. Improve existing procedures and controls to ensure its underwriters follow HUD's underwriting requirements. These procedures and controls include but should not be limited to implementing its HUD-approved quality control plan (see finding #2), continuing to provide training to its underwriters regarding HUD's underwriting requirements to adequately resolve any discrepancies involving documentation associated with the loans, adequately supporting borrowers' income, obtaining and reviewing documentation that adequately supports the borrowers' income stability and expenses, including only the proper amounts when calculating the loan amounts to be funded, and providing effective oversight or monitoring of its underwriting certifications before submission to HUD. These procedures and controls should help reduce risks to the Federal Housing Administration fund by \$379,832.

We recommend that HUD's associate general counsel for program enforcement

- 1F. Determine legal sufficiency and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act against National City and/or its principals for incorrectly certifying the integrity of the data and/or that due diligence was exercised during the underwriting of the 20 loans.

Finding 2: National City Did Not Always Perform Adequate Quality Control Reviews on Early Payment Defaulted Loans

National City did not adequately perform quality control reviews on loans that went into early payment defaults. It did not always ensure that reviews were performed accurately and in a timely manner and that review results were properly documented. The problems occurred because National City did not use its quality control plan when performing quality control reviews on the loans that defaulted within the first six payments. Further, in July 2005, when its early payment default quality control plan received HUD's approval, National City did not monitor its staff's quality control reviews. As a result, National City did not always minimize or prevent improper underwriting of loans, thus increasing the risk to the Federal Housing Administration insurance fund.

Loan Universe and Sample Selections

Using HUD's Single Family Data Warehouse system, we identified 1,476 loans totaling more than \$190 million in original mortgage amount that were sponsored or originated by National City and closed between February 1, 2004, and August 31, 2005. The loans went to claim and/or the borrowers defaulted within the first six payments. Of the 1,476 loans, we statistically selected using EZ-Quant computer software 41 loans to review National City's compliance with HUD's quality control requirements.

Further, we obtained a listing of 399 loans from National City to identify the early payment default loans that were quality control reviewed after August 31, 2005. Of the 399 loans, we statistically selected using Audit Command Language computer software 39 loans to review National City's compliance with its early payment default quality control plan and HUD's quality control requirements.

Inadequate Quality Control Reviews

National City performed inadequate quality control reviews for loans that defaulted within the first six payments. National City uses the Loan Review System to review the underwriting performed on early payment defaulted loans. The Loan Review System checklist consists of a series of questions that require a yes, no, or not applicable answer. When we reviewed the results of National City's quality control reviews, we determined that 33 of the 41 loans reviews (80.5 percent) were not adequately performed as follows:

Thirty quality control review checklists did not contain responses to pertinent questions,

Six quality control reviews identified questions on the Loan Review System checklist that were incorrectly answered, and

Four quality control loan reviews were not performed in a timely manner.

Quality Control Reviews Performed under HUD- Approved Plan

In July 2005, National City's quality control plan for reviewing early payment defaults was approved by HUD. As previously mentioned, we statistically selected 39 loans that closed after August 31, 2005, and were reviewed after National City's plan was approved. For the 39 loans, 27 (69.2 percent) contained deficiencies as follows:

- Nine of the quality control review checklists indicate that the loans' reviews were not performed in a timely manner,
- Fourteen quality control review checklists contained discrepancies in their data, and
- Fourteen quality control review checklists contained relevant questions that were marked incorrectly or not answered at all.

Quality Control Process Inadequate

National City did not implement its quality control plan's procedures for reviewing loans that went to early payment default. In 2004, National City implemented the Loan Review System to efficiently review loans that defaulted within the first six payments. However, it did not use the procedures identified in its quality control plan because it believed the procedures were too stringent.

In July 2005, National City established and HUD approved a supplemental plan in addition to its quality control plan for reviewing loans that defaulted within the first six months.

Due to the delayed implementation of National City's approved quality control plan, it cannot assure quality control reviews were performed in accordance with HUD's requirements. Additionally, it did not adequately monitor the quality control reviews performed by its staff to ensure they were performed accurately and in a timely manner and were properly documented. As a result, National City did not always minimize or prevent improper underwriting of loans, thus increasing the risk to the Federal Housing Administration insurance fund.

Appendix E of this report provides a summary of the quality control deficiencies by National City using HUD's requirements. Appendix F of this report provides a summary of the quality control deficiencies by National City using its requirements.

Recommendations

We recommend that HUD's assistant secretary for housing-federal housing commissioner require National City to

- 2A. Implement its quality control plan for reviewing loans that are early payment defaults to ensure compliance with HUD's requirements and the HUD-approved plan.
- 2B. Implement procedures and controls to ensure that reviews performed under its quality control plan are timely, accurate, and properly documented.

SCOPE AND METHODOLOGY

We performed our audit work between August 2005 and March 2006. We conducted the fieldwork at National City's Miamisburg, Ohio, office and HUD's Chicago Regional Office. The audit covered the period of February 1, 2004, through August 31, 2005. We extended this period as necessary. We conducted the audit in accordance with generally accepted government auditing standards.

To achieve our objectives, we relied on computer-processed data contained in HUD's Single Family Data Warehouse and National City's electronic data files. In addition, we interviewed HUD's and National City's management and staff, borrower's employers. Further, we reviewed HUD's rules, regulations, and guidance for the underwriting and quality control review of Federal Housing Administration loans.

Using HUD's data systems, we identified that National City originated/sponsored 34,838 Federal Housing Administration loans with closing dates from February 1, 2004, to August 31, 2005. The total mortgage value of these loans is more than \$4.5 billion. Of these, 1,476 loans totaling more than \$190 million in original mortgage amounts went to claim and/or the borrowers defaulted on their mortgage payments within the first six payments. Of the 1,476 loans, we statistically selected using EZ-Quant computer software 41 to review for compliance with HUD's underwriting and quality control requirements. Our sampling criteria used a 90 percent confidence level, 15 percent estimated error rate, and a precision of plus or minus 10 percent. We also reviewed the certifications for all 20 loans that were improperly underwritten for accuracy.

Further, we obtained a listing of 399 loans from National City to identify early payment defaults that were quality control reviewed after August 31, 2005. Of the 399 loans, we statistically selected using Audit Command Language computer software 39 loans to review National City's compliance with its early payment default quality control plan and HUD's quality control requirements.

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,
- Compliance with applicable laws and regulations, and
- Safeguarding resources.

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:

- Program operations - Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Validity and reliability of data - Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with laws and regulations - Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding resources - Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

A significant weakness exists if internal 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 audit, we believe the following items are significant weaknesses:

- National City needs to implement adequate procedures and controls for underwriting and quality control reviewing Federal Housing Administration loans (see findings 1 and 2).
- National City needs to implement its quality control plan for reviewing loans that are early payment defaults to ensure compliance with HUD's requirements and its HUD-approved plan (see finding 2).

FOLLOWUP ON PRIOR AUDITS

HUD's OIG issued four prior audit reports on National City's underwriting practices. The four reports include findings that are repeated in this report. All of the four reports' findings/recommendations except for one were closed as of July 25, 2006.

OIG report number	Issue date	Findings	Status of recommendations
2005-SE-1002	December 16, 2004	National City did not comply with HUD's underwriting requirements	Closed
2005-AT-1014	September 15, 2005	Two branch offices of National City did not fully comply with HUD's underwriting requirements	Open
2005-LA-1006	August 10, 2004	National City failed to resolve questionable credit and employment documents when underwriting Federal Housing Administration loans	Closed
2001-NY-1004	August 23, 2001	Inadequate loan origination practices resulted in approval of HUD Federal Housing Administration-insured loans for unqualified borrowers	Closed

The two most recent independent auditor's reports for National City covered the years ending December 31, 2003 and 2004. Both reports resulted in no findings.

In July 2004 and April, July, and August 2005, HUD's Quality Assurance Division performed quality assurance reviews of National City. The reviews resulted in findings related to loan origination and underwriting. All of the findings were closed as of April 5, 2006.

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A			\$297,881(A)
1B	\$2,900		
1C		<u>\$94,372</u>	
1D	<u>47,829</u>		
1E			<u>379,832(B)</u>
Totals	<u>\$50,729</u>	<u>\$94,372</u>	<u>\$677,713</u>

- 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.
- 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 the 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(A)/ “Funds to be put to better use” are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. Implementation of our recommendation to indemnify loans that were not originated in accordance with Federal Housing Administration requirements will reduce the Federal Housing Administration’s risk of loss to the insurance fund. The amount above reflects that, upon sale of the mortgaged property, the Federal Housing Administration’s average loss experience is about 29 percent of the claim amount based upon statistics provided by HUD.
- 3(B)/ In this instance, if National City implements our recommendation, it will reduce the risk to the Federal Housing Administration insurance fund for loans that do not meet HUD’s underwriting requirements and that have an incorrect underwriting certification and, instead will make available insurance funds for loans that meet HUD’s underwriting requirements. Once National City successfully improves its controls, this will be a recurring benefit. Our estimate reflects only the initial year of these recurring benefits

and reflects that, upon sale of the mortgaged property, the Federal Housing Administration's average loss experience is about 29 percent of the claim amount based upon statistics provided by HUD.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

National City[®]
Mortgage Co.

National City Mortgage
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U.S. Department of Housing and Urban Development
Office of Inspector General for Audit, Midwest
Ralph H. Metcalfe Federal Building
77 West Jackson Boulevard, Suite 2646
Chicago, Illinois 60604-3507
Attention: Heath Wolfe
Regional Inspector General for Audit
Region V

June 30, 2006

National City Mortgage (NCM) is committed to originating FHA loans in accordance to the underwriting and quality control guidelines and as one of the highest volume FHA lenders, values this relationship.

NCM has delinquency and default rates for the 150,092 loans serviced as of March 31, 2006 equal to 9.40% versus the national average of 12.57%. We attribute our upstanding default rates to our strong underwriting policies, which were supported by HUD/FHA in their 2002-03 institutional review of NCM that rated NCM satisfactory.

This letter is in response to the draft HUD OIG audit report on findings 1 and 2 covering the origination period of February 1, 2004 through August 31, 2005.

National City Mortgage would like to take this opportunity to address the findings and describe some of the controls implemented in the years 2004-2005 in an effort to continually improve loan quality. As the audit report states, National City Mortgage generally complied with HUD's underwriting requirements as most errors uncovered on the findings were oversights by the underwriter or the closing agent. National City Mortgage understands the importance of complying with investor requirements and strives to provide adequate feedback to underwriting and production through continual education to reduce and eliminate errors.

During the audit period, National City Mortgage originated 57,732 FHA loans. Of the 21 loans examined for the period, we agree there were underwriting errors in seven loans. These errors were the result of failing to list compensating factors and adding in the borrower's current house payment on a streamline refinance creating an over-insured loan (adding in payment is now acceptable).

National City Mortgage continues to adhere to FHA requirements; we have in the past and continue to perform audits to ensure compliance with the laws, regulations and policies governing this program. National City Mortgage performs quality control reviews on all loans that are 60 days delinquent in the first six payments as defined by HUD Handbook 4060. Throughout 2004 and into 2005, National City Mortgage adopted a more stringent EPD audit policy and performed audits on all FHA loans that were 30 days delinquent as opposed to HUD's requirement of 60 day defaults.

Listed below is a summary of the controls implemented in 2004-2005 to continually improve loan quality.

In an effort to provide greater control of the broker process, a broker central registry was activated in 2004 to provide a database of all approved, terminated and banned brokers. This central registry is shared by our sister companies- First Franklin and National Home Equity (non-prime and second mortgages) so that if a broker is banned through another channel, they are banned from originating with National City. The Operations Risk Department meets monthly with production and representatives from the

Auditee Comments

sister companies to discuss findings and to recommend action steps. The status of the broker- active to banned- is captured in the loan origination systems so that new originations can be monitored.

The Wholesale Broker department also monitors broker performance through delinquency reports and HUD compare ratio reports. In September of 2005, the broker department enhanced the existing broker scorecard with 7 different metrics in an attempt to identify early trends/patterns. The Broker Scorecard was provided to you at the exit interview.

A broker can be terminated for any of the following reasons:

- Fraud/misrepresentation
- Low volume
- Delinquency higher than product standard/submitting poor quality loans or failure to comply with federal or investor regulations
- High HUD compare ratio above or close to 150-200%
- Delivering poor loan quality

The Operations Risk Department along with the Production Risk Group in Wholesale and Retail monitor and distribute the following risk analysis reports to our Underwriting network, all Sales staff and Back office Operation departments:

- Post funding audit reports from Quality Control representing a statistically sound sample of FHA loans highlighting the trends and recommending necessary training. Target audits are performed on any party to the mortgage transaction with reports distributed and action plans specifically addressing the issue or individual concerns uncovered during the audit.
- Fraud Summary Reports, Repurchase and EPD trend reports are distributed monthly
- The post funding, EPD, Repurchase, Due Diligence and Fraud databases are pulled together on a monthly basis to identify any trends or to potentially ban an appraiser/broker. The data is also used to address trends uncovered during our audit processes. "Quick Hit" training flyers were distributed throughout the year to all of production and underwriting focusing on various FHA guidelines (e.g. gift documentation, asset documentation, acceptable income calculation, acceptable credit, appraisal checklist, etc). NCM Intranet underwriting training modules were developed for underwriters to test their knowledge. Examples of the Quick Hit Flyers were provided at the exit interview.
- A Quality Improvement Report, which captures the frequency of errors and lists actions taken to prevent future errors, is distributed and reviewed weekly with Production Risk and Senior Management.

The following operational procedures were put in place in 2004-2006

- National City Mortgage received approval from FHA on our Quality Control Plan in 2003 and an updated plan in March and July 2005
- National City Mortgage contracted with MDI, an audit outsource company, to review an additional post funding sample of loans based on an 10% sample of each branch's production. The audit drills into specific errors occurring at the branch level. Branch specific action plans are then implemented and monitored.
- National City Mortgage is committed to preventing errors prior to funding and as a result instituted Core Logic (formerly known as C & S Marketing), a fraud-overvaluation and identity check tool, that is ordered automatically at time of approval through our loan origination system on all loans originated in 2004 and thereafter (manual ordering process was in place in 2003). This fraud prevention tool provides the underwriter with a score that indicates the potential degree of possible valuation concerns and checks the identity of the borrower.

The loan safe report lists the following:

- closed home sales within the subject's market area,
- market conditions,
- title transfer data
- a neighborhood evaluation
- an estimated value range
- any social security identity check concerns.

If the loan receives a "flag" indicating possible overvaluation concerns, possible property flipping, title transfer issues within 90 days, or possible social security number identity issue, then the underwriter must investigate and document the file with the reason for overriding the flag. All underwriter overrides are captured and monitored within the loan origination system. This fraud prevention tool has assisted the underwriters in evaluating property values, preventing identity theft, and reducing the number of overvaluation and fraud for housing loans at National City Mortgage.

Auditee Comments

- NCM monitors their FHA default ratio through the HUD compare ratio reports. Potomac Partners and NCM meet regularly to identify any branches nearing the high compare ratio threshold. The loans contributing to the compare ratio are analyzed to determine individual branch action plans. For example, a second signature from an underwriting manager on all loans with FICO scores below 620 may be implemented.
- Production Risk Management and Operation Risk conduct semi monthly training conference calls with underwriting and processing management. Mortgagee letter, Ops Risk trends, new product roll-out and general underwriting concerns are discussed during these calls

Another avenue to improve quality is to continue the education of the underwriters and support staff. In 2005 the underwriters in both Wholesale and Retail attended the following training classes:

- NCM contracted with a third party training team to provide FHA underwriting training to all underwriters
- Internal regional training was conducted on A minus products, understanding investor quality monitoring, and how to package (require underwriter comments on all files to explain any issues) and document a loan file.
- non prime and new product automated underwriting training (through NCM Intranet)- although not specific to FHA loans, the underwriting training assists the underwriter with how to properly document concerns or issues within files that can be applied to any product
- basic and advanced appraisal classes including appraisal fraud prevention
- Core Logic (formerly known as C & S Marketing) training on their fraud tool to detect property flipping and overvaluation. The classes focused on appraisal review and documentation necessary to address property valuation concerns.
- How to calculate self- employed borrower income.

Finding #1

National City's Underwriting & Quality Control
February 1, 2004 through august 31, 2005

OIG Finding #1 (see Exhibit A for detail):

The report states that National City Mortgage Company generally complied with HUD's underwriting requirements. However, the report continues to state that for 21 loans, National City Mortgage did not use due diligence in their underwriting of the following files.

National City Mortgage Response:

Excessive debt to income: Three loans were cited with this error. Two of the loans noted (492-7198799 and 137-2892405) were approved at 29.5/37 and 29.76/29.76 ratios, which is less than 1% over the FHA recommended housing ratio. Both loans had compensating factors listed on the worksheets (non- purchasing spouse, no "other" debt, and conservative approach to income). Had the underwriter who approved the 29.5% used the borrower's documented shift differential, then the housing ratio would have been 28%. We agree that the third loan noted (561-8087045) did not have adequate compensating factors for approving the loan.

Delinquent Mortgage Accounts and Related Expenses: Six loans cited for these errors (National City disputes the finding on loan 381-7487573 as it is not over insured and 292-4480217). Four of the loans included the borrower's current house payment in the loan pay off. Although adding in the borrower's payment was an error at the time of the origination, FHA has since permitted this practice on loans originated in late 2005 and thereafter. The one loan (292-4480217) was cited for delinquent mortgage payment; however, the late was isolated and explained as a one time occurrence by the borrower within a letter to National City. The last loan cited 381-7487573, is an acceptable loan and not over insured. The payoff did include the borrower's current house payment; however the error must have been caught as the borrower brought more than enough to closing to cover the inclusion of the payment.

Credit Discrepancies: Four loans cited with this error. NCM agrees that the borrower should have provided a letter of explanation for the late payments on loans 151-7671875 and 201-3401739; however in both cases, the late payments appear to be medical related and the underwriter commented on the medical nature of the late payments on the worksheets. Although two of the loans cited the credit report for not listing the borrower's employment, the loans both had acceptable income

Comment 1

Comment 2

Comment 3

Auditee Comments

Comment 4

documentation in the file. Loan number 521-6046673 was a Loan Prospector Accept (therefore credit was accepted) loan with all conditions satisfied. On the last loan cited, 492-7198799, the non-purchasing spouse states in the file that she does not have a valid social security number and the borrower on this loan did not have any credit, either.

Underwriting Approval Conditions: Six loans were cited with this error. Three of the loans cited had all underwriting conditions met with the exception that they were closed incorrectly (same loans cited below for inclusion of prior mortgage payment). The other two loans (381-7487573 and 561-8072040) had the underwriting conditions satisfied and are acceptable FHA loans. The last loan (031-3181600 did not have all conditions satisfied. FHA does not require collections to be paid, but the AU certificate questioned the inclusion of the collection accounts into the debt ratio. The collections should have been addressed by underwriter; however, FHA does not require them to be paid and therefore conditions were met.

Comment 5

Inaccurate documentation: One loan cited. This loan is acceptable as the information in the file contained a transposed street number which accounted rental history confusion on this loan. Also, NCM verified through the work number given on the application that the borrower did work at the auto sales company during the period of November 2001 to present. This file did not contain inaccurate documentation.

Comment 6

Overstated/Unsupported Assets or Income: Four loans cited. National City Mortgage believes three of the loans are in compliance with FHA guidelines with the fourth (201-3401739) cited for failure to document sufficient compensating factors.

Comment 7

Insufficient Gift Documentation: One loan cited. NCM failed to document the income and tax credit.

Comment 8

Over-insured Mortgages: Six loans cited. One loan, 381-7487573 is not over-insured; however, the other loans were over insured largely due to addition of previous mortgage payment (practice permitted with loans originated in 2005, thereafter).

Finding #2

OIG Finding #2:

The report states that National City did not adequately perform quality control reviews on loans that went into early payment defaults. It did not always ensure that reviews were performed accurately and in a timely manner and that review results were properly documented.

National City Mortgage Response:

National City Mortgage continues to adhere to FHA requirements; we have in the past and continue to perform audits to ensure compliance with the laws, regulations and policies governing this program. National City Mortgage performs quality control reviews on all loans that are 60 days delinquent in the first six payments as defined by HUD Handbook 4060. National City Mortgage has maintained a quality control plan, and a FEPD audit process, where audits are completed to identify the reason for default in addition to underwriting deficiencies or possible fraud. Throughout 2004 and into 2005, National City Mortgage adopted a more stringent EPD audit policy and performed audits on all FHA loans that were 30 days delinquent as opposed HUD's requirement of 60 day defaults. Due to the volume of loans during this time, some audits, while completed, were not completed in a timely manner. Throughout 2004, outsourcing was utilized to assist in completing the defaulted loan audits.

OIG

Inadequate Quality Control Reviews

The report states, "National City performed inadequate quality control reviews for the loan that defaulted within the first six payments. National City uses the Loan Review System to review the underwriting performed on early payment defaulted loans. The Loan Review System checklist consists of a series of questions that require a yes, no, or not applicable answer. When we reviewed the results of National City's quality control reviews, we determined that 37 loans were not adequately performed as follows":

Auditee Comments

Comment 9

- Thirty-one quality control review checklists did not contain responses to pertinent questions.

National City Mortgage Response: National City Mortgage made an enhancement to our EPD tracking system, LRS, during the timeframe of the audit. These updates to the system will show newly added questions and revisions to existing questions to the database and previously completed audits will show these questions as not answered which occurred on 21 of the 30 noted loans. One loan (No. 581-2602152) is shown twice on the table so the total loan count is 30 loans, not 31 loans as noted by the auditor. In addition, questions within LRS are comprehensive to cover all types of loans, i.e. stated income, streamline refinances, etc; and as a result some questions that are not answered may not be relevant to the loan type. NCM agrees that the auditor should have answered questions on 9 of the 30 loans. See exhibit B for detail.

- Six quality control reviews identified questions on the Loan Review System checklist that were incorrectly answered. National City Mortgage responds to the findings in detail in Exhibit C. All 6 of the loans cited had some questions not answered; however, the response to the questions would not have changed the overall EPD audit.
- Six quality control loan reviews were not performed in a timely manner. National City Mortgage responds to the findings in Exhibit C. NCM agrees that 4 of the loans were not performed in a timely manner; however, 483-3481641 and 493-7902846 were performed in the required timeframe.
- One quality control review checklist (292-4480217) contained evidence that the loan file had been reviewed after the completion date identified on the form. The loan was assigned to an auditor on October 13, 2004 with the audit completed November 15, 2004. National City Mortgage disagrees with this finding.

OIG

Quality Control Reviews Performed under HUD-Approved Plan

The report states, "In July 2005, National City's quality control plan for reviewing early payment defaults was approved by HUD. As previously mentioned, we statistically selected 39 loans that closed after August 31, 2005, and were reviewed after National City's plan was approved. For the 39 loans, 30 contained deficiencies as follows"

- Fifteen of the quality control review checklists indicate that the loan reviews were not performed in a timely manner. National City Mortgage responds to the findings within Exhibit C. National City agrees that 8 of the loans were not performed in a timely manner with 6 in dispute as the audit was completed within the proper timeframe.
- Fourteen quality control review checklists contained discrepancies in their data. National City Mortgage responds to the findings in Exhibit D. OIG commented on 64 issues with NCM disputing 56 of the cited deficiencies.
- Fourteen quality control review checklists contained relevant questions that were marked incorrectly or not answered at all. National City Mortgage responds to the findings in Exhibit D. OIG commented on 69 issues with NCM disputing 44 of the cited deficiencies.

Quality Control Process Inadequate

The report states, "National City did not implement its quality control plan's procedures for reviewing loans that went to early payment default. In 2004, National City implemented the Loan Review System to efficiently review loans that defaulted within the first six payments. However, it did not use the procedures identified in its quality control plan because it believed the procedures were too stringent.

In July 2005, National City established and HUD approved a supplemental plan in addition to its quality control plan for reviewing loans that defaulted within the first 6 months.

Auditee Comments

Comment 10

Due to the delay implementation of National City's approved quality control plan, it cannot assure quality control reviews were performed in accordance with HUD's requirements. Additionally, it did not adequately monitor the quality control reviews performed by it staff to ensure they were performed accurately and in a timely manner and were properly documented. As a result, National City did not always minimize or prevent improper underwriting of loans, thus increasing the risk to the Federal Housing Administration insurance fund."

National City Response:

Prior to February 2005, National City Mortgage performed EPD audits on all FHA loans that were 30 days delinquent in the first 6 payments which was more aggressive than HUD's requirement of 60 days delinquent. In February 2005, National City Mortgage adopted HUD's 60 day delinquent policy on EPD audits and also worked with HUD in having them approve our EPD audit process. National City Mortgage has maintained a quality control plan to their EPD audits and in July 2005, we obtained formal approval of our EPD audit process. National City Mortgage did not view the HUD guidelines of too stringent; however, we view a defaulted loan has additional risk that must be reviewed for such risk factors.

OIG Recommendations

We recommend that HUD's assistant secretary for housing-federal housing commissioner require National City to:

- 2A. Implement its quality control plan for reviewing loans that are early payment defaults to ensure compliance with HUD's requirements and the HUD-approved plan.
- 2B. Implement procedures and controls to ensure that reviews performed under its quality control plan are timely, accurate, and properly documented.

National City Response:

- 2A. National City Mortgage will continue to perform EPD audits on all FHA loans per HUD's requirements.
- 2B. National City Mortgage has implemented training within the EPD audit group to insure a thorough understanding of reviewing HUD loans and how to completely and accurately disclose audit findings within the LRS tracking system. In addition, National City Mortgage is completing audits within 30 days of the 60 day default date and will continue to monitor for program compliance.

As stated earlier, National City Mortgage values their longstanding relationship with FHA. National City Mortgage is committed to quality and adhering to investor regulations. To recap, NCM has implemented many risk mitigation procedures over the past few years in an effort to continue to improve investor quality.

Sincerely,



Rick Smalldon
President & Chief Operating Officer
National City Mortgage Co.

OIG Evaluation of Auditee Comments

Comment 1 Although loan number 137-2892405 may have only exceeded one of HUD's qualifying ratios by 1 percent, the coborrower's income was not verified for the required two year period. When we contacted the coborrower's employer, we were informed that information contained on the verification of employment form in the loan file was inaccurate, in particular the coborrower's dates of employment. Therefore, the stability of the coborrower's income was not properly assessed, and excluding this unstable income the qualifying ratio was exceeded by a greater percentage. Additionally, the mortgage credit analysis worksheet stated stable employment as the compensating factor. This compensating factor was not justifiable considering the coborrower's income stability was not properly verified and the borrowers' housing expense was going to increase by more than \$300 monthly. Additionally, the borrowers had two judgments on their credit report that were not explained.

We also did not remove the remaining loan 492-7198799 because based on our recalculation of the borrower's income; HUD's qualifying ratio was exceeded by more than 3 percent. Furthermore, the borrower's address was not consistent throughout the file, and the credit reference letters, which contained another address for the borrower, was inaccurate. Additionally, the borrower's employment was questionable.

Comment 2 We disagree with National City's comment regarding the over insurance of loan number 381-7487573. Based on our calculations, this loan was overinsured due to the inclusion of the overdue mortgage payment as indicated on the mortgage payoff statement. Further, the amount indicated on the HUD-1 settlement statement exceeds the amount on the payoff statement, which includes the payment that was currently due on the borrower's prior mortgage.

For loan number 292-4480217, no letter was provided for our review from the borrower explaining the delinquent mortgage account in the borrower's loan file. The mortgage account was not current and the borrower received \$250 at closing, instead of paying the amount due on the mortgage. We acknowledge that HUD has since permitted this practice on loans in late 2005; however, the loans selected for review closed before HUD allowed the inclusion of delinquent expenses in the financing for the refinanced loan.

Comment 3 For loan number 521-6046673, we agree that even though the lender used the used a residential merged credit report that did not (1) include a detailed account of the borrowers' employment history or (2) a statement attesting to the certification of employment and date verified, the borrower was rated acceptable using an automated underwriting system. Therefore, we removed the loan from this audit report.

OIG Evaluation of Auditee Comments

Comment 4 According to the Notification of Loan Action-Approval forms contained in the borrowers' files for loan numbers 561-8087045, 483-3481641, 023-1991951, and 381-7487573, as a condition for approval, the underwriters required that the mortgage payments currently due of the borrowers' accounts be paid at or prior to closing; however, the payments were not made (see comment 2). For loan number 561-8072040, the the feedback certificate conditioned that the underwriter verify a two-year work history; however, the loan file did not contain evidence of this documentation. In addition, National City's Quality Control Department reviewed the loan and cited the loan for the same underwriting deficiency. Without verification of a two-year work history, the borrower's income/job stability was not supported. Further, the borrowers' income and value of their assets as inputted on the automated underwriting system was overstated.

For loan number 031-3181600, we agree that HUD does not require collections to be paid; however, the collections/liabilities were included on the automated feedback certification as being paid when they were not. Additionally, the certificate required that documentation be included in the file to support the omission of these liabilities in the borrower's debt reconciliation.

Comment 5 We disagree with National City that loan number 492-7198799 does not contain inaccurate information. The credit references in the borrower's file were not accurate. For instance, one of the credit references was from a utility company; however, we confirmed with the company that service was never provided to the borrower's address and the person never had an account. Additionally, the borrower's documentation, such as W-2s, loan application, credit references, and credit report, which did not contain any address, contained conflicting information. We also contacted the U.S. Postal Service to verify the varying addresses and were informed the borrower's address does not exist. Also, we contacted the borrower's employer and were informed the borrower never worked for the company.

Comment 6 We disagree that three of the loans were supported. For loan numbers 561-8072040 and 137-2892405, the lender did not verify a two-year work history for the borrowers. For loan number 151-7712123, overtime income was included in the borrower's income calculation without the underwriter developing an average of overtime and establishing an earnings trend to determine whether this income will more than likely continue for a least three years. Therefore, excluding the overtime income, this loan exceeds one of HUD's qualifying ratios.

Comment 7 National City's response indicated that our audit report only cited one loan for insufficient gift documentation. However, our report cites two loans.

Comment 8 See comment 2.

OIG Evaluation of Auditee Comments

Comment 9 We agree that one of the loans in our draft audit report was counted twice; therefore, the number should be 36 instead of 37. We further reduced this number based on National City's comments. We adjusted this report and appendix accordingly. National City contends that only 21 of the 30 Loan Review Data quality control review sheets contained unanswered questions; however, we disagree. All 30 loans contained unanswered questions, majority if not all, pertained to the Uniform Residential Loan Application, which is required to be reviewed for both refinance and purchase loans. According to National City, updates made to the loan review sheets changed some of the answers on the quality control sheets. Therefore, this is a weakness in National City's system controls. National City's inability to maintain documentation supporting its quality control reviews and its results do not comply with HUD's quality control requirements.

All of the questions contained of the Loan Review System checklist serve as a control mechanism to ensure underwriting deficiencies are minimal. Therefore, questions answered incorrectly or not at all reduce the effectiveness of the quality control system.

We agree that two of the six quality control reviews were performed timely; therefore, we removed them for this audit report. However, the remaining four remained in this report. Additionally, we also agree that the one quality control checklist was completed within acceptable timeframes. This audit report was adjusted to reflect the one checklist.

Comment 10 Based on the information provided, we reduced the number of loans included in this audit report as being reviewed untimely to nine. We disagree with National City regarding the 14 quality control review sheets that contained inaccurate/data discrepancies, and the 14 loan review sheets that contained questions that were marked incorrectly or not at all. The Loan Review System, if used correctly, would prevent some of the underwriting errors; therefore, the questions contained on the sheet should all be answered.

Appendix C

FEDERAL REQUIREMENTS AND NATIONAL CITY'S REQUIREMENTS

Loan Underwriting Requirements

Mortgage Letter 2001-12, dated May 7, 2001, provides mortgage amount calculations for streamlined refinances. The mortgagee letter states that borrowers are expected to make their monthly mortgage payments when due even when refinancing, and it is not appropriate to include in the new mortgage amount the sum of any mortgage payments “skipped” by the homeowner. Borrowers are not permitted to roll payments due into the new Federal Housing Administration loan amount. Borrowers must make the payment due or bring the mortgage payment check to settlement.

HUD Handbooks 4155.1, REV-4, CHG-1, chapter 1, section 1-12 (d)(7), and REV-5, section 1-12 (d)(6), state that delinquent mortgages are generally not eligible for streamline refinancing until the loan is brought current; however, if two months or less delinquent, the lender may pay the mortgage current providing the borrower is under no obligation to repay the funds used to bring the mortgage current.

Chapter 2, section 2-3, of the handbooks states that when delinquent accounts are revealed, the lender must determine whether late payments were due to a disregard for or inability to manage financial obligations or to factors outside of the borrower’s control. Major indications of derogatory credit, including judgments or collections or recent credit problems require sufficient written explanation from the borrower. When reviewing the borrower’s credit report, the lender must pay particular attention to recent and undisclosed debts. The lender must account for any significant debt shown on the credit report but not listed on the loan application and must obtain explanation for all credit report inquiries.

Chapter 2, section 2-7(a), of the handbooks states that both overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of bonus or overtime income for the past two years and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes.

Chapter 2, section 3, paragraph 2-10, of the handbooks states that all funds for the borrower’s investment in the property must be verified and documented. Paragraph 2-10c states that the lender must document the gift funds by obtaining a gift letter signed by the donor and borrower that specifies the dollar amount of the gift; states that no repayment is required; shows the donor’s name, address, and telephone number; and states the nature of the donor’s relationship to the borrower. In addition, the lender must document the transfer of funds from the donor to the borrower.

Chapter 2, section 5, paragraph 2-12, of the handbooks states that debt to equity ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership. If the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total fixed payment-to-effective income exceeds 41 percent, significant compensating factors should be documented and recorded on the mortgage credit analysis worksheet.

Quality Control Requirements

HUD Handbook 4060.1, REV-1, "Mortgagee Approval Handbook," chapter 6, requires

- The quality control plan to be in writing. Lenders must have fully functioning quality control programs from the date of their initial Federal Housing Administration approval until final surrender or termination of the approval.
- Quality control of servicing must be an ongoing function. Due to the importance of the aspects of servicing, lenders must perform monthly reviews of delinquent loan servicing, claims, and foreclosures.
- The quality control program must provide for the review and confirmation of information on all loans selected for review.
- A new credit report must be obtained for each borrower whose loan is included in a quality control review unless the loan was a streamline refinance or was processed using a Federal Housing Administration-approved automated underwriting system that is exempted from this requirement.
- Documents contained in the loan file should be checked for sufficiency and subjected to written reverification. Examples include the borrower's employment or other sources of income, deposits, gift letters, alternate credit sources, rent payments, and other sources of funds.
- Each direct endorsement loan selected for a quality control review must be reviewed for compliance with HUD's underwriting requirements, sufficiency of documentation, and soundness of the underwriting.
- Each loan selected for quality control review must be reviewed to determine whether required conditions were met before closing, and the quality control review report and followup, including review findings and actions taken plus procedural information, must be retained by the lender for a period of two years.

National City's Early Payment Default Quality Control Plan Requirements

National City's servicing department generates a report for the Fidelity Servicing system to identify all loans that went 60 days delinquent within the first six payments. All government loans that are 60 days delinquent are targeted for review, and the selection of the loans is based solely upon the timing of the defaults. The purpose of the review of the early payment default is

to evaluate the accuracy, validity, and completeness of the loan's origination operation and note any patterns of deficiencies.

The review process includes verifying the accuracy of the residential loan application as compared to the documents in the loan file; comparing the new credit report to the original credit report in the file and noting any discrepancies or additional debts to aid in the determination of the delinquency; verifying the automated underwriting system findings as compared to the documents in the file; verifying that the underwriting conditions are documented in the loan file; verifying the accuracy of the income and assets as compared to documents in the loan file; performing verbal re-verification of employment for the borrower/coborrower and if unobtainable, forwarding a written verification of employment to the employer; verifying the accuracy of the purchase contract as compared to documents in the loan file; reviewing the appraisal for issues using the history pro/prefunding report and if discrepancies are noted, ordering automated value models; and verifying unallowable service fees and requesting refund to borrower if applicable.

All loans are rated good, average, or poor based on the investment quality standards. The reviewer is responsible for completing the loan review detail report. This report will include results of the review and possible general comments as a result of findings. The early payment default does not seek missing documentation, which may affect the final review results. All loans suspected of possible fraud are forwarded to National City's special investigative unit. Each early payment default review will include a Loan Review System detailed audit report, all re-verification documents, an updated credit report, and a prefunding report of automated value models if applicable.

Program Fraud Civil Remedies Act Of 1986

Title 31, *United States Code*, section 3801, "Program Fraud Civil Remedies Act of 1986," provides federal agencies, which are the victims of false, fictitious, and fraudulent claims and statements, with an administrative remedy to recompense such agencies for losses resulting from such claims and statements; to permit administrative proceedings to be brought against persons who make, present, or submit such claims and statements; and to deter the making, presenting, and submitting of such claims and statements in the future.

Appendix D

SUMMARY OF UNDERWRITING DEFICIENCIES

Loan number	Mortgage amount	Underwriting method	Insurance status	Amount of claim	Exceed ratios	Skipped mortgage payment or included unallowable expenses	Credit issues	Inaccurate documentation	Overstated/ unsupported assets or income	Determine income stability	Over-insured loan
241-7423366	\$69,882	Manual	Paid			X					X
483-3481641	85,670	Manual	Claim	\$30,103		X					X
561-8072040	223,300	Automated	Paid						X	X	
492-7198799	97,470	Manual	Claim	103,780	X		X	X			
352-5189728	169,302	Manual	Paid		X		X		X		
151-7671875	120,785	Manual	Active				X		X		
137-2840495	94,547	Manual	Active								X
381-7487573	118,669	Manual	Active			X					X
151-7563379	156,411	Manual	Active			X					X
137-2892405	154,812	Manual	Active		X				X		
201-3401739	103,279	Manual	Active				X		X		
493-7780858	111,779	Manual	Active								X
241-7453453	207,973	Manual	Paid								X
031-3181600	70,887	Automated	Active				X				
561-8087045	203,453	Manual	Paid		X						
137-2900156	89,483	Automated	Claim	99,908					X		
261-8815770	110,023	Manual	Active			X					X
023-1991951	115,517	Manual	Active			X					
151-7712123	58,943	Manual	Claim	64,269					X		
292-4480217	76,794	Manual	Active			X					
Totals	\$2,438,979			\$298,060	4	7	5	1	7	1	8

Appendix E

SUMMARY OF QUALITY CONTROL DEFICIENCIES USING HUD'S REQUIREMENTS

<i>Loan number</i>	<i>All relevant questions were not answered</i>	<i>Questions answered incorrectly</i>	<i>Untimely quality control review</i>
031-3181600	X		
521-6046673	X		
137-2892405	X		X
261-8815770	X		
493-7790021	X		
151-7549007	X		
241-7453453			X
137-2840495	X		
151-7563379	X	X	
137-2900156	X	X	
352-5242195	X	X	
201-3401739	X		
381-7487573	X	X	
151-7671875	X		
493-7780858	X		
151-7585368	X		
105-1750980	X		
581-2602152	X		
461-3916389	X		
352-5189728	X		
271-9085200	X		
249-4949210	X	X	
521-5939934	X		
241-7423366	X		
352-5214897	X		
151-7712123	X		
023-1947964	X		
492-7198799	X		X
561-8072040	X		
132-1762615	X		
052-3525382	X		
052-3501334			X
105-1764451		X	
Totals	<u>30</u>	<u>6</u>	<u>4</u>

Appendix F

SUMMARY OF QUALITY CONTROL DEFICIENCIES USING NATIONAL CITY'S REQUIREMENTS

<i>Loan number</i>	<i>Untimely quality control review</i>	<i>Data discrepancies</i>	<i>Questions answered incorrectly/did not answer all relevant questions</i>
052-3333828	X		X
161-2119111	X		
411-3852924			X
023-2155918	X		X
381-7674151		X	
372-3160787	X	X	X
095-0038635	X		X
261-8890867		X	
571-0731929			X
052-3619024		X	X
541-7200743			X
151-7813964		X	
052-3621273			X
262-1573029		X	X
137-3129369			X
151-7806141			X
137-3191019		X	
052-3653303		X	
413-4373100		X	
052-3295476	X	X	
031-3172065	X		
561-8108066		X	
261-8793357	X	X	
531-0221192		X	X
441-7614348			<u>X</u>
441-3819278		<u>X</u>	
352-5189366	<u>X</u>		
Totals	<u>9</u>	<u>14</u>	<u>14</u>

Appendix G

NARRATIVE CASE PRESENTATIONS

Loan number: 241-7423366

Mortgage amount: \$69,882

Section of Housing Act: 203(b)

Date of loan closing: May 19, 2004

Status as of April 5, 2006: Terminated, paid in full

Prior status: Active

Payments before first default reported: Not available

Summary:

National City's underwriter (AZ97) over estimated the financing costs; therefore, the loan was overinsured by more than \$856. At settlement, the borrower was provided with a credit to his escrow accounts. This credit reduced the amount of prepaid expenses due for the loan.

Additionally, the borrower was not current with his prior mortgage payments. According to the payoff statement in the borrower's loan file, the loan was current, and the May 1, 2004, payment was not due. However, at settlement, the amount due to payoff the prior mortgage included the May 1, 2004, principal and interest payments. The borrower did not pay any funds at closing and received cash back in the amount of \$200.

Loan number: 483-3481641

Mortgage amount: \$85,670

Section of Housing Act: 203(b)

Date of loan closing: September 24, 2004

Status as of July 24, 2006: Claim

Prior status: Active

Payments before first default reported: Five

Claim paid by HUD: \$30,103

Summary:

National City's underwriter (O001) overestimated the financing costs; therefore, the loan was overinsured by more than \$521. Additionally the payoff amount from the prior mortgage listed on the HUD-1 settlement statement included delinquent expenses and late charges. The borrower paid money at closing; however, the amount of funds was not sufficient to pay the delinquent charges from the prior mortgage.

Loan number: 561-8072040

Mortgage amount: \$223,300

Section of Housing Act: 203(b)

Date of loan closing: August 30, 2004

Status as of July 24, 2006: Terminated, paid in full

Prior status: Not applicable

Payments before first default reported: Not available

Summary:

National City underwrote this loan using Fannie Mae's Desktop automated underwriting system. The automated feedback certificate listed conditions for approval that included providing documentation to support the borrower's employment for the most recent full two years. However, when we reviewed the loan's files, we determined that the underwriter did not verify or provide documentation to support the borrower's employment history. Therefore, the lender did not verify the borrower's income stability.

Additionally, the borrower's assets were overstated. The automated underwriting system indicated that the borrower had \$1,164 in available assets; however, the borrower's bank account in National City's and HUD's files listed the borrower's assets as \$615. Further, the coborrower's income was overstated and the information entered in the automated underwriting system was not accurate.

Loan number: 492-7198799

Mortgage amount: \$97,470

Section of Housing Act: 203(b)

Date of loan closing: May 21, 2004

Status as of July 24, 2006: Claim

Prior status: Active

Payments before first default reported: One

Claim paid by HUD: \$103,780

Loss to HUD: \$20,473

Summary:

National City's underwriter (AK25) approved this loan, which contained significant underwriting deficiencies. The borrower's file contained a residential merged credit report or a factual data credit report that did not provide a detailed account of the borrower's employment history, contain verification of the borrower's current employment and income (if obtainable), and include a statement attesting to the certification of employment and date verified in accordance with HUD Handbook 4155.1, REV-5.

Further, although the borrower's spouse was a nonpurchaser, her liabilities must be included in the calculation of the qualifying ratios. The credit report obtained for the coborrower did not comply with the credit report requirements outlined in HUD Handbook 4155.1, REV-5. In particular, the credit report did not contain a valid Social Security number.

The borrower's qualifying ratios without the inclusion of the coborrower's debt exceeded HUD's effective payment-to-income ratio by 2.25 percent.

Additionally, the borrower's previous homes address was not accurate. We determined the address listed for the borrower does not exist; however, there was a verification of rental history form in the loan's file. The borrower did not have a credit history so he provided a letter from a utility company to show he made the required payments in a timely manner; however, when we contacted the company, we were informed that service was never provided to the borrower's address as identified on the letter.

When we reverified the borrower's employment, we were informed by the office manager that the borrower was never employed by the company.

Loan number: 352-5189728

Mortgage amount: \$169,302

Section of Housing Act: 203(b)

Date of loan closing: March 5, 2004

Status as of April 5, 2006: Terminated, paid in full

Prior status: Not applicable

Payments before first default reported: Five

Summary:

National City's underwriter (L778) did not document compensating factors for exceeding the income ratios. Additionally, the borrower did not provide evidence that all of the collection and judgment accounts were paid off before closing. The borrower also did not provide written explanations for the judgment accounts.

National City did not document the gift funds by obtaining a gift letter signed by the donor and the borrower. Additionally, the gift letter did not state that no repayment was required. Although the gift letter identified the borrower, it did not provide the borrower's address and telephone number. Further, National City did not document the transfer of funds from the donor to the borrower.

The borrower's income was overstated, which resulted in the income ratios, which already exceeded HUD's requirement, to be even higher. The coborrower's income was inflated due to the inclusion of overtime income; however, National City did not develop an average of bonus or overtime income for the past two years or justify and document in writing the reason for using the income for qualifying purposes in accordance with HUD Handbook 4155.1, REV-5.

Loan number: 151-7671875

Mortgage amount: \$120,785

Section of Housing Act: 203(b)

Date of loan closing: August 18, 2004

Status as of July 24, 2006: Active

Prior status: Not applicable

Payments before first default reported: Four

Summary:

National City's underwriter (P396) did not obtain written explanations from the borrower for the collections and judgments identified on the borrower's credit report. According to HUD's requirements, major indications of derogatory credit including judgments, collections, and any recent credit problems require sufficient written explanation from the borrower. The borrower must explain in writing all collections and judgments.

Additionally, the verification of deposit form used to support to borrower's downpayment was not accompanied by a bank statement. According to HUD Handbook 4155.1, REV-5, verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts.

Loan number: 137-2840495

Mortgage amount: \$94,547

Section of Housing Act: 203(b)

Date of loan closing: February 2, 2004

Status as of July 24, 2006: Active

Prior status: Not applicable

Payments before first default reported: Not available

Summary:

National City's underwriter (N208) included inappropriate expenses in the calculation of the mortgage amount; therefore, the inclusion of these expenses, such as commitment fees and overdue taxes, resulted in the loan being overinsured by more than \$785.

Loan number: 381-7487573

Mortgage amount: \$118,669

Section of Housing Act: 203(b)

Date of loan closing: September 20, 2004

Status as of April 5, 2006: Refinanced

Prior status: Active

Payments before first default reported: Not available

Summary:

The borrower's prior mortgage loan was due for the next payment. The payoff amount indicated on the HUD-1 settlement statement included the payment that was due on the prior loan. Instead of the borrower paying the prior mortgage payment at closing, the amount was netted against the new insured mortgage amount.

Additionally, National City's underwriter (AZ97) wrote on the notification of loan action form that the September 2004 payment must be made at/before closing. The loan file did not contain any documentation to determine that the payment was made. Also, this loan was overinsured by more than \$526 due to the underwriter's overestimation of the financing costs.

Loan number: 137-2892405

Mortgage amount: \$154,812

Section of Housing Act: 203(b)

Date of loan closing: February 24, 2004

Status as of July 24, 2006: Active

Prior status: Not applicable

Payments before first default reported: Not available

Summary:

National City's underwriter (T398) did not provide sufficient compensating factors for exceeding one of HUD's qualifying ratios. It stated on the mortgage credit analysis worksheet that the borrower had stable employment. Although this may have been accurate, it was not a justifiable compensating factor since the borrower's housing expense was going to increase from the amount the borrower paid for rental expenses.

When we reverified the coborrower's employment, we were informed that some of the salary information provided on the form was not completed by her, such as the date of the coborrower's salary increase and the coborrower's start date. Therefore, using the employment date provided by the employer, we determined that National City did not verify a two-year period of employment history for the coborrower.

The borrowers had two judgments identified on their credit report. One of the judgments was satisfied; however, there was no documentation in the loan file to determine that the other judgment was also satisfied. The borrowers did not provide written explanations for both of the judgment accounts.

Loan number: 201-3401739

Mortgage amount: \$103,279

Section of Housing Act: 203(b)

Date of loan closing: June 29, 2004

Status as of July 24, 2006: Active

Prior status: Not applicable

Payments before first default reported: 10*

Summary:

National City's underwriter (U640) did not properly determine the borrower's income. The underwriter used a written letter from the borrower's employer to determine the borrower's income. However, the borrower's earnings statements and verification of employment form, also completed by another person at the same company, identified two different amounts. The underwriter did not resolve the inconsistencies with the borrower's employer. Therefore, using the start date indicated on the verification of employment form and the borrower's earnings statements, we determined the borrower's income was overstated.

The borrower's credit report identified collection accounts and a civil judgment. However, the borrower did not provide any written documentation to explain the collections and the judgment.

- - In HUD's Neighborhood Watch system, this loan is not reported as an early payment default. However, in HUD's Single Family Data Warehouse system and National City's Loan Review System, the loan is reported as an early payment default.

Loan number: 493-7780858

Mortgage amount: \$111,779

Section of Housing Act: 203(b)

Date of loan closing: April 30, 2004

Status as of July 24, 2006: Active

Prior status: Not Applicable

Payments before first default reported: 13*

Summary:

The loan was overinsured by more than \$2,100. At closing, National City provided the borrower with a credit to closing expenses; however, this credit was not included on the mortgage credit analysis worksheet when National City's underwriter (7777) determined the maximum insurable mortgage amount for this loan.

* - In HUD's Neighborhood Watch system, this loan is not reported as an early payment default. However, in HUD's Single Family Data Warehouse system and National City's Loan Review System, the loan is reported as an early payment default.

Loan number: 241-7453453

Mortgage amount: \$207,973

Section of Housing Act: 203(b)

Date of loan closing: April 26, 2004

Status as of April 5, 2006: Terminated, paid in full

Prior status: Active

Payments before first default reported: Not available

Summary:

National City's underwriter (AZ97) overestimated the maximum mortgage amount for this streamline refinanced loan. The principal payoff amount due on the prior mortgage was overestimated; therefore, the loan was overinsured by more than \$698.

The borrower received \$450 cash back when the maximum amount that the borrower can receive on a streamline refinance is \$250. According to HUD's requirements, streamline refinances are designed to lower the monthly principal and interest payments on a current Federal Housing Administration-insured mortgage and must not involve cash back to the borrower, except for minor adjustment at closing not to exceed \$250.

Loan number: 031-3181600

Mortgage amount: \$70,887

Section of Housing Act: 203(b)

Date of loan closing: May 28, 2004

Status as of July 24, 2006: Active

Prior status: Not applicable

Payments before first default reported: 12*

Summary:

This loan was underwritten using an automated underwriting system, Fannie Mae Desktop. All of the collections listed on the automated underwriting feedback certificate as needing to be paid were not.

The borrowers received gift funds from a parent; however, the gift funds were not properly documented. For instance, the source of funds and the transfer of the funds were not disclosed.

* - In HUD's Neighborhood Watch system, this loan is not reported as an early payment default. However, in HUD's Single Family Data Warehouse system and National City's Loan Review System, the loan is reported as an early payment default.

Loan number: 561-8087045

Mortgage amount: \$203,453

Section of Housing Act: 203(b)

Date of loan closing: October 08, 2004

Status as of April 5, 2006: Terminated, paid in full

Prior status: Active

Payments before first default reported: Three

Summary:

National City's underwriter (5525) underwrote the loan when one of HUD's qualifying ratios was exceeded and did not provide compensating factors. The borrower provided bank statements for two months; however, the ending balance recorded on the first month's statement was not the beginning balance on the next month's statement. The verification of deposit in National City's file was for a recently opened account. The borrower did not provide explanations for the bank statements and the source of funds for the recently opened account, which was opened four days before the loan closed.

Loan number: 137-2900156

Mortgage amount: \$89,483

Section of Housing Act: 203(b)

Date of loan closing: March 19, 2004

Status as of July 24, 2006: Claim

Prior status: Active

Payments before first default reported: Five

Claim paid by HUD: \$99,908

Loss to HUD: \$27,356

Summary:

This loan was underwritten using an automated underwriting system, Fannie Mae's Loan Prospector. The borrower's file did not contain any documentation to support the downpayment assistance provided to the borrower in the amount of \$3,803 or a tax credit in the amount of \$2,750. Without the supporting documentation, the borrower did not have enough funds to close.

Loan number: 261-8815770

Mortgage amount: \$110,023

Section of Housing Act: 203(b)

Date of loan closing: August 25, 2004

Status as of July 24, 2006: Active

Prior status: Not applicable

Payments before first default reported: Not available

Summary:

National City's underwriter overestimated the financing costs; therefore, this loan exceeded HUD's maximum mortgage amount. Due to the overestimation, this loan was overinsured by more than \$1,258.

The borrower did not make the prior mortgage payment that was due before or at the settlement closing. Before closing on the new mortgage, the borrower was due for the current month's mortgage payment. The amount listed on the borrower's payoff statement included the current month's mortgage payment, and when the loan settled, the amount listed on the HUD-1 settlement statement included the principal and interest payment for current month. The borrower did not pay any money at closing, and the borrower's file did not indicate that the borrower made this payment before closing.

Loan number: 023-1991951

Mortgage amount: \$115,517

Section of Housing Act: 203(b)

Date of loan closing: February 13, 2004

Status as of July 24, 2006: Active

Prior status: Not applicable

Payments before first default reported: Not available

Summary:

National City's underwriter (O112) approved this loan without determining whether the borrower made the payment that was currently due on his previous Federal Housing Administration-insured mortgage. The payoff amount listed on the HUD-1 settlement statement included interest payments for January and February 2004; therefore, the borrower did not make his mortgage payment before closing. The borrower paid \$892 and received \$15 at closing as reflected on the HUD-1 settlement statement. This amount does not accurately represent the monthly mortgage payment amount of \$938 as shown on the borrower's mortgage credit report.

Loan number: 151-7712123

Mortgage amount: \$58,943

Section of Housing Act: 203(b)

Date of loan closing: August 25, 2004

Status as of July 24, 2006: Claim

Prior status: Not applicable

Payments before first default reported: One

Claim paid by HUD: \$64,269

Summary:

National City's underwriter (U674) used overtime income in the borrower's income calculation without averaging the income over a two-year period or establishing an earnings trend for the income. Therefore, we excluded the borrower's overtime income and determined HUD's qualifying ratio was exceeded by 2.3 percent.

Loan number: 292-4480217

Mortgage amount: \$76,794

Section of Housing Act: 203(b)

Date of loan closing: April 20, 2004

Status as of July 24, 2006: Active

Prior status: Not applicable

Payments before first default reported: Not available

Summary:

National City's underwriter (N748) did not ensure that the borrower made the prior mortgage payment that was due before or at the settlement. Before closing on the new mortgage, the borrower was due for the prior mortgage's April 2004 payment. The amount listed on the borrower's payoff statement included the April 2004 mortgage payment, and when the loan settled, the amount listed on the HUD-1 settlement statement included the principal and interest for the prior mortgage's April 2004 payment. The borrower received cash back at closing in the amount of \$250.

Loan number: 151-7563379

Mortgage amount: \$156,411

Section of Housing Act: 203(b)

Date of loan closing: April 30, 2004

Status as of July 24, 2006: Active

Prior status: Not applicable

Payments before first default reported: Not available

Summary:

National City's underwriter (AR96) approved this loan without determining whether the borrower made the payment that was currently due on his previous Federal Housing Administration-insured mortgage. The payoff dated April 21, 2004, indicated that the loan was due for the April 1, 2004 payment. However, the payoff amount shown on the HUD-1 settlement statement included the due payment of \$880 and late charges of \$47.