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September 25, 2006

Audit Report Number:
2006-CH-1015

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


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

SUBJECT: Birmingham Bancorp Mortgage Corporation, Nonsupervised Lender, West
Bloomfield, Michigan, Substantially Complied with HUD's Requirements
Regarding Underwriting of Loans but Not Its Quality Control Reviews

HIGHLIGHTS

What We Audited and Why

We audited Birmingham Bancorp Mortgage Corporation (Birmingham), 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 2006 annual audit plan. We selected Birmingham for audit because of its high default to claim rate. Our objectives were to determine whether (1) Birmingham's quality control plan, as implemented, met HUD's requirements and (2) Birmingham complied with HUD's regulations, procedures, and instructions in the underwriting of Federal Housing Administration-insured loans.

What We Found

Birmingham's quality control review process did not comply with HUD's requirements. While Birmingham's quality control plan fully met HUD's requirements, it was not properly implemented. Birmingham substantially complied with HUD's underwriting requirements on loans that went to claim between October 1, 2003, and September 30, 2005. It approved only one of 17 Federal Housing

Administration loans reviewed that did not meet HUD's requirements. Because of Birmingham's poor quality control reviews, HUD's Federal Housing Administration insurance fund is at an increased risk for loss and abuse.

What We Recommend

We recommend that HUD's assistant secretary for housing-federal housing commissioner require Birmingham to reimburse HUD for any future loss from the claim paid on one loan once the associated property is sold and implement its quality control plan for reviewing loans with early payment defaults.

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 Birmingham's management during the audit. We also provided our discussion draft audit report to Birmingham's president and HUD's staff during the audit. We conducted an exit conference with Birmingham's president on August 28, 2006.

We asked Birmingham's president to provide written comments on our discussion draft audit report by September 07, 2006. Birmingham's president provided written comments to the discussion draft report dated September 06, 2006. Birmingham generally agreed with our finding and recommendation regarding its quality control reviews, but not finding 2 regarding its underwriting. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

TABLE OF CONTENTS

Background and Objectives	4
Results of Audit	
Finding 1: Birmingham’s Quality Control Review Process Did Not Comply with HUD’s Requirements	5
Finding 2: Birmingham Substantially Complied with HUD’s Underwriting Requirements	7
Scope and Methodology	9
Internal Controls	10
Followup on Prior Audits	12
Appendixes	
A. Schedule of Questioned Costs	13
B. Auditee Comments and OIG’s Evaluation	14
C. Federal Requirements and Birmingham’s Requirements	20
D. Summary of Quality Control Deficiencies Using Birmingham’s Requirements	22

BACKGROUND AND OBJECTIVES

Birmingham Bancorp Mortgage Corporation's (Birmingham) headquarters and one lending office are located in West Bloomfield, Michigan. Incorporated in the State of Michigan in 1985, Birmingham was approved by the U.S. Department of Housing and Urban Development (HUD) as a nonsupervised direct endorsement lender to originate Federal Housing Administration-insured loans in July 1988. As a direct endorsement lender, Birmingham determines that the proposed mortgage is eligible for insurance under the applicable program regulations and submits the required documents to HUD without its prior review of the origination and closing of the mortgage loan. Birmingham is responsible for complying with all applicable HUD regulations and handbook instructions.

As of September 15, 2006, Birmingham had 203 loan correspondents, seven principals, and two authorized agents. Birmingham is primarily a wholesale and retail residential lender offering Federal Housing Administration, U.S. Department of Veterans Affairs, and conventional financing. It also offers commercial financing through private investors. For its retail operations, Birmingham is authorized to originate loans in Michigan, Ohio, Indiana, and Florida. For its wholesale operations, it conducts business in Michigan, Ohio, Indiana, Kentucky, Tennessee, Georgia, Florida, and Texas.

We audited Birmingham as part of the activities in our fiscal year 2006 annual audit plan. Between October 1, 2003, and September 30, 2005, Birmingham originated/sponsored 1,301 Federal Housing Administration loans totaling more than \$142 million in original mortgage amounts. Of these, 52 loans totaling more than \$5.4 million in original mortgage amounts went to claim, and/or the borrowers defaulted on their mortgage payments within the first six payments. Birmingham's default-to-claim rate was 8.27 percent for October 2003 through September 2005.

Our objectives were to determine whether (1) Birmingham's quality control plan, as implemented, met HUD's requirements and (2) Birmingham complied with HUD's regulations, procedures, and instructions in the underwriting of Federal Housing Administration-insured loans.

RESULTS OF AUDIT

Finding 1: Birmingham's Quality Control Review Process Did Not Comply with HUD's Requirements

Birmingham did not comply with HUD's quality control requirements. The written plan fully met HUD's requirements; however, it was not properly implemented. The deficiencies occurred because of Birmingham's disregard of HUD's quality control requirements and its HUD-approved plan. As a result, HUD lacked assurance of the accuracy, validity, and completeness of Birmingham's loan origination files.

Loan Universe and Sample Selections

Using HUD's Single Family Data Warehouse system and hard-copy payment history documentation provided by its servicing lender, we identified 52 loans totaling more than \$5.4 million in original mortgage amounts that were sponsored by Birmingham between October 1, 2003, and September 30, 2005. The loans went to claim, and/or the borrowers defaulted within the first six payments. We statistically selected 21 loans totaling more than \$2 million in original mortgage amounts from the universe of the 52 loans that Birmingham quality control reviewed to determine whether the reviews complied with HUD's quality control requirements.

Birmingham's Quality Control Plan Not Implemented

Birmingham did not comply with HUD's quality control requirements. The written plan fully met HUD's requirements; however, we statistically selected 21 early payment defaulted loans to determine whether Birmingham's quality control reviews were in compliance with HUD's requirements. Birmingham could not provide the quality control review sheets for two of the loans; therefore, we only reviewed 19 of the quality control review sheets. None of the 19 quality control reviews was performed in compliance with Birmingham's quality control plan and/or HUD's requirements as follows:

- Three quality control reviews were not performed in a timely manner. The number of days in which these loans were reviewed after the borrowers defaulted on their mortgage accounts ranged from 130 to 163 days;

- Five quality control review sheets did not contain the date the quality control reviewer completed the review;
- Fifteen quality control review sheets did not contain evidence that a reverification of borrowers' employment, deposits, gift letters, credit reports, or other sources of funds was performed; and
- Fifteen quality control review sheets did not contain the results and/or findings, and did not identify the action taken to resolve the deficiencies found during Birmingham's reviews when applicable.

Birmingham's Quality Control Plan Not Followed

Birmingham did not follow its quality control plan, which was in compliance with HUD's quality control plan requirements. According to the president, Birmingham quality control reviewed the loans that went into a 90-day default within the first seven payments instead of the loans that went into a 60-day default within the first six payments as required by HUD. Birmingham indicated that it used HUD's Neighborhood Watch system to identify the early payment defaulted loans; however, the system does not report on the loans that default in less than 90-days.

Birmingham did not follow its quality control plan procedures because it believed that certain components, in particular reverification of the borrowers' employment, assets and income, were not necessary because it did not have a history of fraud or misrepresentation.

As a result of Birmingham's disregard of its HUD-approved quality control plan, HUD cannot be assured of the accuracy, validity, and completeness of the loan origination files. Appendix D of this report provides a summary of Birmingham's quality control deficiencies.

Recommendation

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

- 1A. Implement its quality control plan for reviewing loans that are early payment defaults to ensure its compliance with HUD's requirements and its HUD approved plan.

Finding 2: Birmingham Substantially Complied with HUD's Underwriting Requirements

Birmingham substantially complied with HUD's underwriting requirements for Federal Housing Administration loans. For the 17 loans reviewed, only one did not meet HUD's requirements. The 17 loans went to claim between October 1, 2003, and September 30, 2005. The one improperly underwritten loan contained underwriting deficiencies that were material as well as technical. The deficiencies occurred because Birmingham's quality control plan was not adequately implemented. As a result of the improperly underwritten loan, HUD paid a claim.

Underwriting Deficiencies of Federal Housing Administration Loans

Birmingham sponsored and closed 1,301 Federal Housing Administration-insured loans totaling more than \$142 million between October 1, 2003, and September 30, 2005. Of these, 17 loans totaling more than \$2 million in original mortgage amounts went to claim. We reviewed all 17 loans for compliance with HUD's underwriting requirements.

Birmingham improperly underwrote one (loan number 151-7683555) of the 17 loans with a total mortgage value of more than \$155,000. The one loan was a purchase transaction. As of September 15, 2006, HUD had paid more than a \$162,000 claim for the loan.

Loan number 151-7683555

Birmingham improperly approved the loan using the borrower's regular earnings and commission income without developing an average for the commission income and providing a sound rationalization for acceptance. The mortgage credit analysis worksheet listed compensating factors that were valid; however, they did not adequately justify the inclusion of the borrower's commission income due to the conflicting pay documentation contained in the Federal Housing Administration casebinder. For example, the loan application, mortgage credit analysis worksheet, and paystubs in the casebinder contained different monthly earning amounts.

Further, the borrower's commission income was not consistent or supported by the pay documentation. The paystubs in the casebinder identified year-to-date balances that did not change although the borrower earned wages or commission for two consecutive pay periods. Based on the inconsistencies in the borrower's income information, we excluded the borrower's commission income from the calculation of the borrower's debt-to-income ratios. Therefore, Birmingham approved the loan when the borrower's mortgage payment-to-effective income

ratio was 49.2 percent and total fixed payment to effective income ratio was 80 percent.

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.

Underwriting Procedures and Controls Adequate

Birmingham's underwriting procedures and controls for Federal Housing Administration-insured loans were adequate. Further, in December 2005, Birmingham implemented the Data Integrity Search and Score report, which is a comprehensive electronic fraud prevention and identification tool to assist with the detection and prevention of fraud. Although Birmingham implemented the Data Integrity Search and Score report, it needs to ensure that it implements its HUD-approved quality control plan (see finding 1 of this report). The plan serves as a control mechanism to minimize or prevent improper underwriting of loans; protect Birmingham and HUD from unacceptable risk and guard against errors, omissions, and fraud; thus decreasing the risk to the Federal Housing Administration fund. Using the Data Integrity Search and Score report in conjunction with an implemented control process would provide greater assurance that the risk to the Federal Housing Administration was at an acceptable level.

Recommendation

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

- 2A. Reimburse HUD for any future loss from the \$162,425 claim paid on the one loan (151-7683555) with a total mortgage value of more than \$155,000. The estimated risk to the Federal Housing Administration fund is \$47,103.

SCOPE AND METHODOLOGY

We performed our audit work between January and August 2006. We conducted our audit at Birmingham's West Bloomfield, Michigan, headquarters office and HUD's Chicago regional office. The audit covered the period October 1, 2003, through September 30, 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 hard-copy payment histories provided by Birmingham obtained from the loan servicers, since it service release its Federal Housing Administration loans after closing. In addition, we interviewed HUD's and Birmingham's management and staff and borrowers' 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 system, we identified that Birmingham sponsored and closed 1,301 Federal Housing Administration-insured loans totaling more than \$142 million between October 1, 2003, and September 30, 2005. Of these, 17 loans totaling more than \$2 million in original mortgage amounts went to claim. We reviewed all 17 loans for compliance with HUD's underwriting requirements.

Additionally, using HUD's Single Family Data Warehouse system and hardcopy payment history documentation provided by Birmingham obtained from the loan servicers, since it service release its Federal Administration loans after closing, we identified 52 loans totaling more than \$5.4 million in original mortgage amounts that were sponsored by Birmingham between October 1, 2003, and September 30, 2005. The loans went to claim and/or the borrowers defaulted within the first six payments. We statistically selected 21 loans totaling more than \$2 million in original mortgage amounts using statistical sampling software to review for compliance with HUD's requirements. Our sampling criteria used a 90 percent confidence level, 5 percent estimated error rate, and a precision of plus or minus 10 percent.

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 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 Weakness

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

- Birmingham 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 1).

FOLLOWUP ON PRIOR AUDITS

This is the first audit of Birmingham by HUD's Office of Inspector General (OIG). The two most recent independent auditor's reports for Birmingham covered the years ending December 31, 2003, and 2004. Both reports resulted in no findings. During the week of November 1, 2004, HUD's Quality Assurance Division performed a quality assurance review of Birmingham. The review resulted in findings related to loan origination and underwriting. All of the findings were closed as of August 3, 2005.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Unsupported 1/
2A	<u>\$47,103</u>
Total	<u>\$47,103</u>

- 1/ 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. 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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

	<p style="text-align: center;">BIRMINGHAM <small>REGIONS OF AMERICA</small> BANCORP MORTGAGE <small>INCORPORATED</small></p> <p style="text-align: center;">2006 SEP -7 AM 11:05 RECEIVED</p> <p style="text-align: right;">September 6, 2006</p> <p>U.S. Department of Housing and Urban Development Office of Inspector General - Audit Ralph H. Metcalf Federal Building 77 West Jackson Boulevard, Suite 2646 Chicago, Illinois 60604-3507</p> <p>Attention: Heath Wolfe Regional Inspector General for Audit Region V</p> <p>RE: Response to the discussion draft of the Audit Report of HUD's Office of Inspector General for Audit received on August 24, 2006</p> <p>The audit of Birmingham Bancorp Mortgage Corporation by the Office of Inspector General was begun on January 20, 2006 and continued for eight months. During this time we have made all of our staff available for interview and have produced a prodigious amount of documentation to substantiate the integrity of our lending process with respect to loans underwritten and insured on behalf of the Federal Housing Administration. The results of the audit show that Birmingham Bancorp has complied with all HUD regulations and guidelines with respect to its lending operations.</p> <p style="text-align: center;">Response to Findings</p> <p>The results of the audit confirm that Birmingham Bancorp Mortgage operates in compliance with the underwriting standards of FHA. After auditing all loans that went to claim in the two year period covered by the audit, one loan was determined to have a documentation deficiency based on the inconsistency of an employer's internal payroll documentation. The pay stubs referenced in the audit report were generated from the employer's intranet which was described by the payroll manager, in a recent conversation I had with him, as having some "glitches". In particular, all pay stubs printed off the intranet at any given time reflect the most recent YTD numbers and not the YTD numbers at the time the pay stub was issued. The one copy of an actual payroll check in</p> <hr/> <p style="text-align: center;">BBC MORTGAGE IS A FEDERALLY APPROVED MORTGAGE BANKER 6230 Orchard Lake Road • Suite 280 • West Bloomfield, MI 48322 Phone (248) 737-2929 • Fax (248) 855-2031 • www.birminghambancorp.com</p>	
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Comment 1

Ref to OIG Evaluation

Auditee Comments

Comment 2

the file corresponds to the most recent intranet YTD. This employee is still employed and I am confident that, if asked to do so, the documentation can be better explained. These discrepancies do not affect the actual YTD numbers used to determine qualifying income and so represent no additional risk to HUD. Since there is no material deficiency, Birmingham Bancorp should not be required to indemnify HUD on this loan.

The second finding is with respect to our quality control procedures. As per HUD guidelines, 10% of all newly originated loans are sent for third party quality control review to an independent firm. This review includes re-verification of all third party documentation. The Office of Inspector General confirmed that Birmingham Bancorp was in compliance with HUD's quality control requirements for all newly originated loans. The issue that arose was with HUD's requirement that all loans which become a 60 day default within the first six payments should also be subjected to the same quality review process.

Birmingham Bancorp Mortgage Corporation sells all of its loans servicing released. Once a loan is sold, the payment history of the loan is no longer available. We were told by one of our largest investors that this information was now considered protected under the financial privacy laws. Our investors report delinquency totals to us, but no longer give us loan level detail as they did five years ago. Therefore, we have no information by which we can determine if a Borrower becomes 60 days delinquent in the first six months. The problem of how to determine 60 day delinquencies becomes even more complicated when servicing is resold. It would require that a purchaser of servicing rights would report all delinquencies to the entity that originally bought the loan, then that entity would have to re-report to the originator, a totally unworkable situation.

Our quality control procedures reflect this reality and require instead that we monitor all loans which are reported in Neighborhood Watch as having gone down 90 days. To insure that an adequate number of loans are reviewed we look at all loans which become 90 days delinquent in the first two years. In order to better understand the data, we created our own review sheet covering 15 different parameters and we log all the resulting data into a database which is subjected to statistical analysis. We include in our database reviews of current loans as well in order to establish a baseline. This data base was started over six years ago and currently comprises almost 900 loans, a far larger number than would have been examined based on the 6 month rule.

With respect to defaulted loans our Quality Control Plan, revised 3/01/05 states, specifically:

“Review on a monthly basis the default figures for both retail and wholesale, published on Neighborhood Watch. Monitor all new defaults to determine if any patterns can be determined by state, originator, or broker.”

Comment 3

The Office of Inspector General is correct in stating that, because we have found no history of fraud in our retail or correspondent lending, we chose to devote our resources to this broader based factor review rather than a more limited review of loans that had

Ref to OIG Evaluation

Auditee Comments

Comment 4

gone down 90 days in the first 6 months (data on 60 day delinquents being generally unavailable). However, since December, 2005, we have also been utilizing an on-line fraud detection model (Data Integrity Search and Score Report (DISSCO), through which we re-verify every loan before it closes. This system checks social security numbers, property values and ownership history, and does reverse phone look-ups for both Borrowers and Employers. When necessary we are also able to order full social security number confirmations and IRS tax returns. Therefore we do have an on line re-verification system in place for every loan before it closes. This automated reverification system on every loan combined with our database approach on all 90 day defaults provides a superior form of quality control when properly understood and analyzed.

The audit report states, on page 5, that OIG identified 109 loans that should have been quality control reviewed and that to identify these loans they used HUD's Single Family Data Warehouse system and Birmingham's hard copy payment history documentation. In fact, Birmingham has no hard copy payment history documentation. We obtained this documentation by requesting it from the servicers of these loans. This information is not routinely sent to Birmingham or any other lender who sells their loans servicing released.

Comment 5

Of the 21 loans that were selected from the quality control reviews that Birmingham did, six were reported as not having been completed in a timely manner. However, this conclusion is based on the 60 day default date in the payment histories. These reviews were completed timely based on when they were reported as having become 90 days delinquent in Neighborhood Watch, which is when we became aware of them.

It appears that HUD has already identified the problem of obtaining 60 day delinquency data and found a solution as well. Beginning with the October reporting period HUD will require that servicers report 30 and 60 day delinquencies as well as 90 day. If HUD is able to report 60 day defaults in Neighborhood Watch, then lenders should be able to comply with their requirements to quality control review them.

Actions Already Taken

Comment 6

Based not only on the audit findings, but on conversations with the auditors over the course of the audit, Birmingham Bancorp has already taken several steps to strengthen its lending operations.

1. Beginning with the May reporting period in Neighborhood Watch we have been sending all loans reported as 90 days delinquent before the first 6 payments have been made to our outside quality control company for a full review including reverifications.
2. We continue to do our previous method of quality review on defaulted loans as well. If, as anticipated above, HUD does begin to report 60 day defaults we will send these for third party review and reverification as well.

3. We have held several training sessions with the underwriting staff regarding attention to detail in all areas of documentation so as to eliminate any inconsistencies.
4. Also as stated above, beginning in December, 2005, we have been doing on-line reverifications on every loan before it closes through the DISSCO module of AppIntelligence. This reverification includes employer, borrower, social security number, and property.
5. Another thing we have begun to concentrate on this year is appraisals. We often use AVM's to corroborate values and have required additional comps or explanation on a far greater percentage of loans than we used to.

Summary

The level of diligence required of mortgage lenders has never been greater. In an era where internet and computer fraud continue to grow, foreclosures are at a historical high and property values are declining, we are being forced to scrutinize every aspect of our business. Volumes are down, margins are down and profits are down, yet we're being asked to indemnify for every mistake we make or error we don't catch. For the first time in the twenty-seven years I've been in the business, lenders are voluntarily giving up their FHA lending status because they can't afford the liability, not for intentional, egregious acts of fraud, but for being victimized by ever more complicated schemes or market circumstances beyond their control.

Birmingham Bancorp has been an FHA lender for nearly 20 years. During that time we have put thousands of deserving families into homes and have been an asset to the communities we serve. The audit report of the Office of the Inspector General shows that we are underwriting within the HUD guidelines, and that we have performed our quality control in the spirit as well as the letter of the requirements. For years now we have selected a greater number of loans for review than HUD requires, though not always the same loans, and provided that feedback to our staff to improve our systems. For almost a year now we have been electronically reverifying every loan on a number of parameters before it closes. Our efforts have gone above and beyond the minimums required by HUD.

Based on the all of the above, as well as the results of the audit, we believe we have performed at a level consistent with HUD's expectations and the requirements of the single family program.

Respectfully,


Mark E. McCartin
President

OIG Evaluation of Auditee Comments

- Comment 1** Birmingham believes it should not be required to indemnify HUD on loan number 151-7683555 because there was no material underwriting deficiencies. We disagree. The commission income used by Birmingham to qualify the borrower for a Federal Housing Administration loan was not consistent or supported by the pay documentation. Additionally, Birmingham improperly approved the loan using the borrower's regular earnings and commission income without developing an average for the commission income and providing a sound rationalization for acceptance, since this income was earned for less than two years. Consequently, the borrower defaulted within the first three payments. Birmingham did not use due diligence when it approved this loan for Federal Housing Administration insurance because the loan did not meet HUD's requirements.
- Comment 2** Birmingham contends that it is unable to determine when borrowers default less than 90 days on their mortgage loans within the first six payments due to the information not being available. We contacted HUD and were informed that Neighborhood Watch identifies loans, reported by the servicing lender, that are 90 days or more delinquent. We also contacted the lender that serviced approximately 88 percent of Birmingham's Federal Housing Administration loans and were informed that the company can provide payment history information to the originating lender if it is stated in the sales contract and the information is not considered protected applicable laws. Since Birmingham was not aware that it could obtain loan payment information data from this particular lender on a regular basis if it is stipulated in the sales contract, and HUD does not have another system that reports 60 day defaulted loans, we removed the 57 loans identified as early payment defaults that were not quality control reviewed from this audit report.
- Comment 3** We stated in the audit report that Birmingham implemented the Data Integrity Search and Score system. However, Birmingham needs to implement the procedures identified in its quality control plan as required by HUD.
- Comment 4** We agree that Birmingham does not have hardcopy payment documentation since it service release its Federal Housing Administration loans after closing; therefore, we adjusted the audit report.
- Comment 5** We agree that Birmingham reviewed two of the five loans timely. However, the remaining three loans were not. The number of days in which these loans were reviewed after the borrowers' mortgage accounts went into default, based on the borrowers defaulting more than 90-days within the first six payments, ranged from 130 to 163 days after the borrowers defaulted.
- Comment 6** During our review of Birmingham's processes for underwriting and quality control reviewing its Federal Housing Administration loans, Birmingham

made several improvements to its operations to ensure compliance with HUD's requirements.

Appendix C

FEDERAL REQUIREMENTS AND BIRMINGHAM'S REQUIREMENTS

Quality Control Requirements

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

- The quality control plan must 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.

Birmingham's Early Payment Default Quality Control Plan Requirements

Birmingham, on a monthly basis, reviews the default figures, both retail and wholesale, published on Neighborhood Watch. It also monitors all reports received from those wholesalers to whom the company sells loans to review all loans reported as having gone into default within

the first six payments due. 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 also includes the monitoring of 10 percent of retail closed loan production and 20 percent of all wholesale production randomly selected its independent reviewer from Birmingham's loan portfolio on a monthly basis. Birmingham ensures that all loans selected by way of random or discretionary sampling are reviewed within 60 days of the end of the month in which they closed for compliance with the policies and requirements of HUD and those of its investors. The compliance review will include reverification and may include borrower interviews. In all cases, this will include the verifications of employment, deposits, credit reports, gift funds or other sources of funds and financial statements and whether the settlement statement and universal residential loan application statement are filled out and properly certified.

In the file review of all selected cases, documents will be compared to order to identify any discrepancies and exceptions to company policy and the requirements of HUD or its investors. The review will note any material exceptions, errors or omissions, or unacceptable patterns or trends, as well as suspected fraud and/or intentional violation of law or regulation. This would involve comparison of the preliminary loan application; original verification of employment, deposit, credit report, and other relevant loan documents with the final loan application; and all reverified documents. Upon thorough review of the file, a written report of the findings shall be submitted to the senior management outlining any deficiencies and procedural recommendations to correct them.

On a monthly basis Birmingham's quality control committee shall determine whether there are identified any material deficiencies in the loan files or lending procedures and if so, whether all conflicting information or discrepancies were resolved and properly documented in writing before submission to HUD for insurance endorsement.

HUD's Underwriting Requirements

Chapter 2, section 2-7(d), of HUD Handbook 4155.1, REV-4, CHG-1, states that commission income must be averaged over the previous two years. The borrower must provide copies of signed tax returns for the last two years, along with the most recent pay stub. Borrowers with commission income received for more than one but less than two years may be considered favorable provided the underwriter is able to make a sound rationalization for acceptance and can document the likelihood of continuance.

Chapter 2, section 5, paragraph 2-12, of the handbook 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.

Appendix D

SUMMARY OF QUALITY CONTROL DEFICIENCIES USING BIRMINGHAM'S REQUIREMENTS

<i>Loan number</i>	<i>Untimely quality control review</i>	<i>Quality control completion date missing</i>	<i>Reverification was not performed</i>	<i>No evidence of the quality control results and/or findings</i>
261-8761593		X	X	X
413-3859629			X	X
261-8157173			X	X
261-8280307			X	X
261-8657444	X		X	X
151-7529678		X	X	X
263-3723350				
263-3709161		X	X	X
263-3738644				
262-1496269			X	X
261-8296053			X	X
411-3764224				
151-7662628		X	X	X
261-8328599			X	X
201-3339864	X		X	X
151-6767382			X	X
261-8684275				
151-7613384		X	X	X
263-3384038	X		X	X
Totals	<u>3</u>	<u>5</u>	<u>15</u>	<u>15</u>