Issue Date August 31, 2006	
Audit Report Number 2006-DE-1006	

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

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

SUBJECT: Nexgen Lending, Inc.'s Lakewood Branch Did Not Follow HUD Requirements in Underwriting Two Insured Loans

HIGHLIGHTS

What We Audited and Why

We audited the Lakewood, Colorado, branch of Nexgen Lending, Inc. (Nexgen), a Federal Housing Administration-approved direct endorsement lender, to determine whether it properly processed insured loans and to determine whether its quality control plan met the U.S. Department of Housing and Urban Development's (HUD) requirements. We audited this branch because of its high default rate.

What We Found

For two of the thirteen loans we reviewed, Nexgen did not follow HUD underwriting requirements. As a result, Nexgen placed HUD's insurance fund at risk for as much as $207,000 and overinsured one mortgage for more than $1,100. Nexgen's quality control plan met HUD's requirements.

What We Recommend

We recommend that the assistant secretary for housing – federal housing commissioner require Nexgen to indemnify HUD for the potential loss on the one loan with a significant deficiency and reimburse the appropriate parties for the overinsured mortgage on the other loan.

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

Auditee's Response

We provided the draft audit report to Nexgen on August 17, 2006, and requested its comments by August 31, 2006. Nexgen provided its written response on August 25, 2006, and generally agreed with the finding and recommendations.

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

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVES

Nexgen Lending, Inc.'s (Nexgen) home office and one of its branch offices are located in Lakewood, Colorado. The U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration approved Nexgen as a nonsupervised mortgage company in 2003. Nexgen's branch office controls the in-house processing, on-site underwriting, creation of the closing package, and funding for all residential mortgages.

The branch office, located in Lakewood, Colorado, originated 358 Federal Housing Administration-insured loans with beginning amortization dates from March 1, 2004, through February 28, 2006. The original mortgage amount of these loans totaled more than $60 million. Thirty-five of these loans (9.78 percent) defaulted within the first two years of closing. The original mortgage amount of the defaulted loans totaled more than $6.5 million.

The objectives of the audit were to determine whether Nexgen acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination and/or underwriting of the Federal Housing Administration-insured loans selected for review and to determine whether Nexgen's quality control plan, as implemented, met HUD requirements.

RESULTS OF AUDIT

Finding: Lakewood Branch Did Not Follow HUD Requirements in Underwriting Two Insured Loans

For two of the thirteen files we reviewed, the branch did not follow HUD underwriting requirements. As a result, Nexgen placed HUD's insurance fund at risk for as much as $207,000 and overinsured one mortgage for more then $1,100. Since Nexgen's oversight of underwriting appeared to be strong and errors noted in the file reviews were low, we did not consider these problems to indicate patterns of noncompliance.

Two loans had underwriting deficiencies

The Lakewood branch of Nexgen did not follow HUD requirements in underwriting two of the thirteen Federal Housing Administration-insured loans we reviewed. For one of the loans, Nexgen did not assess the borrower's future ability to pay as is required for loans with buydown agreements. For the other loan, a streamlined refinance, the mortgage was overinsured because the underwriters did not follow proper underwriting guidelines. See appendix C for more details.

Undue Risk to HUD's Insurance Fund

Nexgen placed HUD's insurance fund at unnecessary risk by not following HUD underwriting requirements. The insurance fund is at risk for the potential loss to HUD totaling $207,075, the original insured mortgage amount of the loan. In addition, Nexgen overinsured one mortgage for $1,171.

Recommendations

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

1A. Indemnify the one actively insured loan originated at $207,075, which it issued contrary to HUD's requirements.

1B. Pay down the principal balance of the one overinsured loan totaling $1,171. If HUD has paid a claim on this loan, Nexgen should remit the payment to HUD.

SCOPE AND METHODOLOGY

The Lakewood branch originated 358 Federal Housing Administration-insured loans with beginning amortization dates from March 1, 2004, through February 28, 2006. Thirty-five of the loans defaulted within first two years of closing. We reviewed 13 of the defaulted loans.

To accomplish the audit objectives, we

- Reviewed regulations and reference materials related to single-family requirements.
- Reviewed the Federal Housing Administration case binders for compliance with regulations.
- Reviewed Nexgen's loan case files.
- Interviewed Nexgen's corporate officials and staff to obtain information regarding its policies and procedures.
- Reviewed Nexgen's quality control plan and quality control reviews.
- Discussed findings with the Denver HUD Quality Assurance Division office.

We used data maintained by HUD in the Single Family Data Warehouse and Neighborhood Watch systems for background information and in selecting our sample of loans. We did not rely on the data to base our conclusions. Therefore, we did not assess the reliability of the data.

We classified $60,051 as funds to be put to better use. This is 29 percent of the $207,075 original mortgage amount for the one loan that did not meet HUD's requirements. We used 29 percent because HUD has determined that 29 percent is the average loss on indemnified loans.

We performed the review work from April to June 2006. We conducted our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal controls were relevant to our audit objectives:

- Origination policies and procedures – Policies and procedures established by management to ensure that Federal Housing Administration-insured loans are originated in accordance with HUD requirements.

- Underwriting policies and procedures – Policies and procedures established by management to ensure that Federal Housing Administration-insured loans are underwritten in accordance with HUD requirements.

- Quality control process – Policies and procedures established by management to ensure that the quality control plan has been implemented and related reviews are performed in accordance with HUD requirements.

We assessed the relevant controls identified above.

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

Significant Weaknesses

We did not identify any significant weaknesses.

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A		$60,051
1B	$1,171	

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local polices or regulations.

2/ "Funds to be put to better use" are quantifiable savings that are anticipated to occur if an Office of Inspector General (OIG) recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

We classified $60,051 as funds to be put to better use. This is 29 percent of the $207,075 original mortgage amount for the one loan issued contrary to HUD's requirements. We used 29 percent because HUD is using a 29 percent loss rate on indemnified loans.

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Appendix B

AUDITEE COMMENTS

NEXGEN LENDING

August 25, 2006

Amber Eyster
HUD OIGA
UMB Plaza Building
1670 Broadway, 24th Floor
Denver, CO 80202

Dear Ms. Eyster:

Upon review of the audit report for NexGen Lending, Inc. we concur with your findings for case number 052-3413200/[redacted] and case number 052-3435389/[redacted].

We appreciate your diligence in performing the audit and the manner in which the findings were presented. If you find you are in need of further information, please do not hesitate to contact me at 303-200-6572.

Sincerely,

\\signed\\

Kathy Miller
Vice President
NexGen Lending, Inc.

Appendix C

NARRATIVE CASE SUMMARIES

HUD case number:	0523435389
Loan amount:	$207,075
Closing date:	May 17, 2004
Status:	Active

Lack of Assessing Borrower's Future Ability to Pay

Nexgen underwrote and approved the mortgage without assessing the borrower's future ability to pay as is required for loans with buydown agreements. Nexgen did not establish that the eventual increase in mortgage payments would not affect the borrower adversely. Therefore, HUD insured the loan based on Nexgen's inaccurate representation that the borrower met HUD qualifying guidelines.

HUD Requirements

HUD Handbook 4155.1, REV-5, CHG-1, chapter 2, section 6, paragraph 2-14.B.2
The lender must establish that the eventual increase in mortgage payments will not affect the borrower adversely and likely lead to default.

HUD case number:	052-3413200
Loan amount:	$213,454
Closing date:	April 26, 2004
Status:	Active

Inaccurate Maximum Mortgage Calculation

Nexgen underwrote and approved the refinanced mortgage at a mortgage amount greater than the allowable maximum mortgage amount. In determining the maximum mortgage amount, Nexgen included an escrow overdraft, recording fees, and fax fees. Nexgen did not calculate the maximum mortgage within HUD requirements, and it overinsured the loan by $1,171. Therefore, HUD insured the loan based on Nexgen's inaccurate representation that the mortgage amount met HUD's qualifying guidelines.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 1-12A; Mortgagee Letters 01-12 and 96-18
Streamline refinances without an appraisal are limited to the unpaid principal balance (but no interest), minus any refund of mortgage insurance premium, plus the new up-front mortgage insurance premium if it is to be financed in the mortgage.