Issue Date
July 26, 2006

Audit Report Number
2006-LA-1018

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

Joan S. Hobbs

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

SUBJECT: First Magnus Financial Corporation Did Not Comply with HUD Guidelines When Underwriting Six Federal Housing Administration-Insured Loans

HIGHLIGHTS

What We Audited and Why

We completed an audit of loan origination and business practices at the First Magnus corporate office, in Tucson, Arizona. The objective of the audit was to determine whether First Magnus originated and processed Federal Housing Administration-insured loans in accordance with applicable HUD rules and regulations.

What We Found

First Magnus did not comply with U.S. Department of Housing and Urban Development (HUD) requirements when underwriting six Federal Housing Administration-insured loans as the sponsoring lender.

What We Recommend

We recommend the Assistant Secretary for Housing-Federal Housing Commissioner take appropriate administrative action regarding First Magnus. This action, at a minimum, should include indemnifying HUD $95,151 for estimated losses incurred for the three loans processed and originated outside HUD rules and regulations.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3.

Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the draft report to First Magnus on June 20, 2006, and held an exit conference on July 11, 2006. First Magnus generally disagreed with our report.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report. Due to the volume of the exhibits to the auditee's response, the exhibits will be made available upon request.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVE

Background

First Magnus Financial Corporation (First Magnus) is a wholesale lender that was incorporated and approved by the U.S. Department of Housing and Urban Development (HUD) as a non-supervised lender in 1996. Its corporate office is located in Tucson, Arizona. As of April 24, 2006, First Magnus had 333 active branch offices and sponsors 2,031 Federal Housing Administration-approved loan correspondents. As a wholesale lender, First Magnus underwrites and funds loans received by its loan correspondents and other brokers.

First Magnus operates First Magnus Lender Services, which provides the following services to its customers: full-service credit reporting, flood determination, appraisals, full-service insurance and title/escrow. In addition, First Magnus operates Charter Funding (Charter), the retail-lending arm of the mortgage company. Charter's corporate office is located in Tucson, Arizona. Charter has affiliates in Arizona that provide the following services to its customers: appraisals, insurance, credit reporting and title/escrow.

First Magnus' Tucson corporate office originated 503 Federal Housing Administration-insured loans totaling more than $56 million, between January 1, 2003, and December 31, 2005. The chart below shows the current status of those loans.

Description	Number	Percentage	Amount
HUD loans originated	480	95.0	$54,245,204.00
Defaults reported	22	4.37	$2,430,682.00
Loans to claim	1	0.02	$90,081.00

We reviewed 8 of the 503 loans originated during this period.

Objective

Our objective was to determine whether First Magnus originated and processed Federal Housing Administration-insured loans in accordance with applicable HUD rules and regulations.

RESULTS OF AUDIT

Finding 1: First Magnus did not follow HUD requirements when underwriting six Federal Housing Administration-insured loans

First Magnus did not comply with HUD rules, regulations, procedures and instructions in the processing and origination of six Federal Housing Administration-insured single family loans. The lender disregarded HUD requirements when it originated and processed the six Federal Housing Administration-insured loans sampled during our review. As a result, HUD has been exposed to unnecessary insurance risks because the lender approved borrowers for Federal Housing Administration-insured loans totaling $640,517 for which the borrowers may not be able to make the monthly mortgage payments. This amount represents the total insured amount for the six of eight loans reviewed that had deficiencies.

False lease and third-party document handling

First Magnus did not verify the borrower's loan documentation and approved a loan based on false documents for Federal Housing Administration insured-loan #023-2090700. The First Magnus loan file had a rental agreement that indicated the borrower owned a previously occupied mobile home and would collect a rental amount of $550 per month. The claimed rental income generated from the rental property was disclosed on the borrower's loan application as supplemental income to support the borrower's ability to make monthly mortgage payments on the subject property. The lender used his information, along with other factors and information, to approve the borrower for the $90,538 loan. However, we did not find a copy of the lease agreement in the Federal Housing Administration loan file submitted to HUD. During an onsite visit, the borrower said he never owned the property and said he was a renter. The borrower stated that the property was a trailer home, but was unsure whether it still existed. He also stated he did not know why the application would show rental earnings for the property. Based on the discussion, it appears the lease agreement found in First Magnus' loan file was a false document.

In addition, a real estate firm handled and faxed documents to First Magnus for loan approval and received a $2,760 commission. Those documents included W-2s, pay stubs, and a 1040A Federal Income Tax form.

HUD Handbook 4155.1 REV-5, Paragraph 3-1, states, no document used in the processing or underwriting of a loan may be handled or transmitted by or through an interested third party to the transaction. These documents should not have been accepted and this loan should not have been submitted for endorsement until documents that had not passed through interested third parties had been obtained and re-verified. In addition, Mortgagee Letter 2001-01 holds lenders responsible for verifying the authenticity of those documents faxed to it through telephone verifications. There was no evidence First Magnus complied with these requirements.

A prior HUD Quality Assurance Division review report dated February 2004 cited First Magnus for the same practice of allowing third parties to handle borrower documents used to approve Federal Housing Administration-insured loans.

Incorrect branch identification number used to originate and process loans

Five of the eight Federal Housing Administration-insured loans reviewed were originated and processed using incorrect HUD approved branch identification numbers (see appendix C). In addition, one of the loans (#022-1767707) was originated and processed by an unapproved branch by using the corporate office’s identification number (7979400002). According to Neighborhood Watch, HUD's single-family database system, the branch was not HUD approved to originate and process Federal Housing Administration-insured loans until January 2004. However, Federal Housing Administration-insured loan #022-1767707 was originated and processed in November 2003 by the unapproved branch.

As part of processing the loan, loan processors entered both the lender identification number and borrower information obtained from the loan officer into the lender’s own Point computer system. The information and lender identification number is downloaded from the Point system into an automated underwriting system for use in approval of the respective loan. First Magnus' failure to use the correct lender identification number to originate and process Federal Housing Administration-insured loans compromises HUD's ability to track the performance of HUD-approved branch offices through systems such as Neighborhood Watch. Further, unapproved or problem branches may use HUD-approved branch office’s lender identification numbers to process Federal Housing Administration-insured loans.

HUD handbook 4060.1 REV-1 states lender identification numbers are assigned to each branch and lender for exclusive use in originating and processing Federal Housing Administration-insured loans and monitoring purposes.

During our audit, First Magnus acknowledged this problem and reportedly corrected this issue.

A prior HUD Quality Assurance Division review report dated February 2004 cited First Magnus for the same practice of using the incorrect lender identification numbers to originate and process Federal Housing Administration-insured loans. In response to the Quality Assurance Division report, in April 2004 First Magnus indicated it would correct the problem. However, a second Quality Assurance Division report was issued in October 2005 and First Magnus continued to disregard HUD’s requirement regarding exclusive use of lender identification numbers. In its January 2006 response to the Quality Assurance Division finding, First Magnus stated that it concurs with the finding and its Compliance Department has sent emails to each branch providing them with correct identification numbers. However, we have no information confirming the problem has actually been corrected.

Lack of documentation for source of gift funds

Federal Housing Administration-insured loan (#022-1719928) had insufficient documentation to determine whether the $13,300 in gift funds was provided from the donor to the borrower. The file did not include a withdrawal document (e.g. bank statements, transaction slips) or cancelled check as is required by Mortgagee Letter 00-28 and as a result, the underwriting/approval did not comply with HUD requirements.

HUD Mortgagee Letter 2000-28 requires adequate documentation to support the donor’s ability to provide gift funds to the borrower.

A prior HUD Quality Assurance Division report, dated February 2004, cited First Magnus for failing to obtain adequate documentation to support gift funds provided to the borrower.

Spouse’s debt not included in loan approval

One streamlined refinanced Federal Housing Administration-insured loan (#022-1759781) was tied to a prior Federal Housing Administration-insured loan (#022-1658467) that did not include the debts of the borrower's spouse. Both loans were processed and originated by First Magnus. The spouse's debt was not submitted to the lender’s Automated Underwriting System in order to approve the original purchase loan.

HUD Handbook 4155.1 REV-4 Paragraph 2-2D states "...the debts of the non-purchasing spouse must be considered in the qualifying ratios if the borrower resides in a community property state."

Both the borrower and the non-purchasing spouse reside in the state of Arizona, which is a community property state. The non-purchasing spouse's debt should have been considered in determining the debt-to-income ratios, as well as whether the purchased loan should have been approved. If the lender had included the non-purchasing spouse's debt of $1,532 instead of $1,212 determined by the automated underwriting system, the borrower's debt-to-income ratio would have increased from 36/53 to 36/66. The $320 difference ($1,532 minus $1,212) in excluded debt resulted in a 24.5 percent increase in the ratio. This increase in the borrower’s debt-to-income ratio may have adversely affected the borrower's ability to pay the monthly mortgage to the Federal Housing Administration-insured loan. Further, the borrower would not have been able to obtain a refinanced Federal Housing Administration-insured loan if the original purchase loan had not been approved.

Conclusion

First Magnus disregarded HUD requirements by using false documentation, incorrect branch indentification numbers, third party handling of documents, lack of documentation for gift sources and excluding spouse’s debts to originate and process six of the eight loans in our sample (see appendix C). HUD Quality Assurance Division reports issued in February 2004 and October 2005 cited similar deficiencies against the lender. Yet, there was no information to confirm whether the lender actually corrected the deficiencies. These deficiencies caused unnecessary risk to the Federal Housing Administration’s insurance fund totaling $640,517. In addition, the deficiencies increased the risk of borrower’s defaulting or foreclosing on the Federal Housing Administration-insured loans.

Recommendations

We recommend the assistant secretary for Housing-Federal Housing Commissioner require First Magnus to

1A. Indemnify HUD $25,408 for estimated loss on Federal Housing Administration-insured loan #023-2090700 which was approved based on a false lease and documents handled by a real estate firm (see appendix C).

1B. Indemnify HUD $41,232 for estimated loss on Federal Housing Administration-insured loan #022-1767707, which was originated and processed by an unapproved branch (see appendix C).

1C. Indemnify HUD $28,511 for estimated loss on Federal Housing Administration-insured loan #022-1759781 (see appendix C). This Federal Housing Administration-insured refinance loan was tied to the original Federal Housing Administration-insured purchase loan #022-1658467, which was approved without taking into consideration the spouse's debt.

1D. Ensure and provide evidence that all branch offices, including loan processors and loan officers, now use the correct lender identification number when originating and processing loans.

1E. Pay civil money penalties for the four loans identified in this report that were originated and processed using the incorrect branch lender identification number. This is also a repeated finding from previous HUD Quality Assurance Division reviews (see appendix D).

SCOPE AND METHODOLOGY

We performed audit work from October 2005 through May 2006. The audit period covered January 2003 through December 2005.

To accomplish our objective, we

- Reviewed eight Federal Housing Administration-insured loans that were originated by First Magnus during the period of January 2003 through December 2005;
- Interviewed First Magnus employees, independent contract loan officers and processors and sponsor underwriters;
- Interviewed borrowers, title company employees, neighbors and borrowers' employers;
- Reviewed First Magnus financial records, employee personnel files and employee benefits documents; and,
- Reviewed public records and databases.

We obtained information from HUD's Neighborhood Watch system that showed there were 23 defaults reported during the audit period. Of those 23, there was one loan in claim status, two loans that were paid off and two loans indemnified by HUD. We selected eight loans for review.

During the review, we identified information indicating Real Estate Settlement Procedures Act violations by First Magnus involving the payment of quality incentives, also known as volume-based incentives, to brokers for originating and processing federally related mortgage loans. The results will be addressed later in a separate report.

We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

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

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:

- Reliability of loan documents used to approve the Federal Housing Administration-insured loans.

- Processing and origination of Federal Housing Administration-insured loans in compliance with HUD rules and regulations.

- Safeguarding Federal Housing Administration-insured loans from high risk exposure.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- First Magnus disregarded applicable HUD rules and regulations when it processed and originated Federal Housing Administration-insured loans.

APPENDIXES

Appendix A

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

Recommendation Number	Funds To Be Put to Better Use 1/
1A	$25,408
1B	$41,232
1C	$28,511

1/ "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 Federal Housing Administration's risk of loss to the insurance fund. The amount above reflects that, upon sale of the mortgaged property, 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**

FIRST MAGNUS
FINANCIAL CORPORATION

July 6, 2006

VIA E-MAIL AND U.S. MAIL

Joan S. Hobbs
Regional Inspector General for Audit
U.S. Department of HUD
Office of Inspector General
611 West Sixth Street, Suite 1160
Los Angeles, CA 90017-3101

Re: Discussion Draft Audit Report
First Magnus Financial Corporation

Dear Ms. Hobbs:

Thank you for your June 20, 2006 letter, together with the draft report (the "Report") resulting from the recently completed audit of First Magnus Financial Corporation's ("FMFC") corporate office. FMFC reviewed the Report and appreciates the opportunity to present its comments. FMFC's comments track the topics addressed in the Report.

FALSE LEASE AND THIRD-PARTY DOCUMENT HANDLING

The Report states that FHA-insured loan file no. 023-2090070 contained false documentation. Specifically, the auditors interviewed the borrower who allegedly stated that he did not own the property listed on the application as a rental unit (the "Property"). The borrower also allegedly stated that he did not know why rental income would have been shown on his application. Based only on the borrower's alleged comments, the Report recommends that FMFC indemnify HUD in the amount of $25,408.00.

FMFC respectfully disagrees. The loan documentation reflects that the borrower owned the Property and received rental income. First, the borrower executed an initial application that stated the Property was his current residence (880 N. 1st Avenue, San Luis, Arizona) and that he had owned and occupied the Property for the previous two years (*see* Uniform Residential Loan Application, Exhibit 1, pg. 1, Section III). Second, the real estate owned portion of the application stated that the Property would be rented for $550/month (Exhibit 1, pg. 3, Section VI). Third, the liabilities section of the application reflected a loan on the Property with Bank One. The current balance was shown as $7,707 with a monthly payment of $115/month (Exhibit 1, pg. 2, Section VI). And the Property was also listed on the real estate owned section of the application with a monthly payment of $115/month (Exhibit 1, pg. 3, Section VI).

603 NORTH WILMOT ROAD • TUCSON, AZ 85711 • OFFICE: 520.618.9275 • FAX: 520.202.0275
E-MAIL: joel.herk@firstmagnus.com
ADMITTED IN ARIZONA
00021170.DOC

Joan S. Hobbs
Regional Inspector General for Audit
U.S. Department of HUD
Office of Inspector General
July 6, 2006
Page 2 of 7

Comment 1

Fourth, the supplemental credit report reflected a "Secured Credit Line" with Bank One with a balance of $7,707 and monthly payments of $115.00 (*see* Supplemental Report, Exhibit 2, pg. 1). (Secured credit lines are typically used for loans with collateral, i.e., a mobile home.) Fifth, the "Source of Info" section of the supplemental credit report shows that Equifax reported that the Property was the borrower's residence (Exhibit 2, pg. 1). Sixth, the merged in-file credit report stated that all three credit bureaus showed the Property as the borrower's residence (*see* Match Merge Infile Credit Report, Exhibit 3, pg. 1). Seventh, the lease agreement for the Property was properly executed and reflected rent payments at $550/month (*see* Residential Lease, Exhibit 4, pg. 1). Finally, all of the preceding information was confirmed on the final loan application that was executed by the borrower at closing (*see* Uniform Residential Loan Application, Exhibit 5, pg. 4).

It should be noted that it is common practice for an underwriter to request additional evidence of ownership of property if an application reflects that a property is owed free of any liens. That, however, is not the case here because there was a lien reflected on the credit report which supported the information listed on the application.

There was no indication in the file that the Property was not owned by the borrower or that the rental agreement was false. Indeed, every document appeared in good order and tied the Property to the borrower. Thus, all FHA loan guidelines were satisfied.

The Report also states that the lease agreement could not be located in the file submitted to FHA for insuring. OIG Auditor, [redacted], stated during his interview with underwriter, [redacted] that he could not locate the lease agreement in the file supplied to him by FMFC. Upon further review, the lease agreement was located in the file submitted to the auditors. Thus, the statement that the lease was not in the file is incorrect. Indeed, [redacted] agreed that he must have missed the lease during his initial review as it was located in the middle of the credit section of the loan file. It is unclear why this fact was left out of the Report.

Comment 2

During the interview with [redacted] [redacted] made comments such as: "We all know that *these borrowers* are uneducated, unsophisticated migrant workers and probably lived with all of their family and other relatives in a trailer in the middle of nowhere" and he also said, "Probably the borrowers rented the trailer to one of their relatives since they were living there together anyway."

Although these remarks were derogatory and offensive regarding the borrower's presumed lifestyle and race, they do indicate that even [redacted] believed that the borrower owned the home at the time of loan application. In any

00021170.DOC

Names have been redacted for privacy

event, FMFC does not make lending decisions based on such prejudices and presumptions.

FMFC understands that the borrower now allegedly recants his ownership and rental of the Property, but at the time of loan approval, everything in the file pointed to ownership of the Property by the borrower along with a valid lease agreement. It is also likely that the borrower felt intimidated by questions being asked by OIG auditors two years after defaulting on his FHA loan and that he would have said anything to end the interview.

Comment 3

The Report goes on to state that the realtor handled and faxed documents to FMFC for loan submission. It does appear that the real estate agent working with the borrower on this transaction may have faxed the W-2 forms, pay stubs and income tax forms to FMFC. However, the borrower was a migrant field worker. Thus, the real estate agent likely assisted the borrower and faxed the documents on behalf of the borrower as a courtesy and not as an attempt to provide altered documentation. It is also possible that the borrower faxed the documentation from the agent's office since it is highly unlikely that the borrower had access to another fax. The auditors have provided no information to suggest otherwise.

More importantly, the borrower's current employment was verified by a written Verification of Employment that was faxed to FMFC by the employer prior to funding the loan (*see* Request for Verification of Employment, Exhibit 6). In addition, the borrower's current employment was verified by the loan processor via a verbal verification of employment (*see* Phone Certification of Employment, Exhibit 7). Accordingly, the information provided was supported by other documentation in the file obtained directly from the borrower's employer. There is no evidence that the income information used in underwriting the loan was inaccurate.

In conclusion, loan no. 023-2090070 was properly underwritten and FMFC, therefore, disagrees with the OIG's conclusions and recommendation for a $25,408.00 indemnification.

INCORRECT BRANCH IDENTIFICATION NUMBER USED TO ORIGINATE AND PROCESS LOANS

Comment 4

The Report states that loan no. 022-1767707 was originated and processed by an unapproved branch (Long Mortgage) in November, 2003 when the branch was not actually approved and listed on the HUD system until November, 2005.

Comment 5

FMFC's records indicate that the application for Long Mortgage was submitted to HUD on October 2, 2003 (*see* letter, Exhibit 8) and approved on January 20, 2004 (*see* letter and approved application, Exhibit 9). Thus, loan no. 022-1767707 was originated after the application was submitted and within two

00021170.DOC

months of application approval. Thus, loan no. 022-1767707 was not funded two years before approval as the Report suggests. And loan no. 022-1767707 is currently not in default. For those reasons, an indemnification of $41,223.00 appears unwarranted.

The Report states five of the eight loans reviewed were originated and processed using incorrect FHA approved branch identification numbers ("ID"). And that a prior Quality Assurance Division ("QAD") audit in February, 2004 cited FMFC for this violation and another QAD review in July, 2005 cited FMFC for the same issue. The Report, however, mistakenly suggests that FMFC did not, and has not, taken steps to correct the problem.

The Report also fails to explain that the prior QAD reviews focused on specific branches and that FMFC had taken steps to ensure that the branches audited in both 2004 and 2005 corrected the issue. FMFC was unaware that the issue affected more than the branches previously audited until FMFC began to prepare for this audit.

FMFC became aware of the problem, and before the auditors arrived, FMFC had already taken steps to fix the issue companywide. FMFC apprised the auditors of this during the initial interview in October, 2005. FMFC also told the auditors the steps FMFC had taken to correct the problem. Unfortunately, the Report fails to mention that when FMFC determined that more branches might be using incorrect identification numbers, FMFC immediately took the following steps to correct the problem:

- Multiple e-mail messages were sent by FMFC's compliance department requiring every branch to confirm that they were using their correct ID number and to immediately cease using any incorrect number.
- FMFC instructed every branch to label every computer used by loan processors who input ID data into FHA Connection to reflect the correct branch ID number.
- FMFC instituted a new process in the FHA insuring department that requires team leaders to check the branch ID number on every file for accuracy before the file is sent to HUD for endorsement.

During the auditors' numerous interviews of FMFC employees, it was noted on several occasions that FMFC had taken those steps. Additionally, the auditors were made aware that:

- Loan processors and not underwriters are responsible for the branch ID input into FHA Connection. Processors in Southern Arizona had frequently trained at the corporate office and during their training would have been instructed to use the "corporate ID" for FMFC and thus, when sent to their respective branches after training would quite naturally continue to use the ID number they had memorized during their training.

- The underwriters interviewed all acknowledged that they had been made aware of the problem via e-mails and conversations with upper management. They also all acknowledged that corrective measures had been placed in effect at their branches to prevent similar errors in the future.

- The Branch Manager interviewed during a branch visit [redacted] acknowledged receipt of e-mail messages from the compliance department that discussed the issue of incorrect ID numbers and that corrective measures were required. During a site visit, [redacted] also showed auditors, [redacted] and [redacted] the computers in her branch office that had been labeled with the correct ID numbers.

The Report also leaves out the fact that three of the loans cited were originated in 2003 and, therefore, corrective action taken based on findings from the QAD audit in February, 2004 would not have been possible. And two of the loans cited were originated in April, 2004, the same month FMFC issued a reply to HUD about this issue. FMFC cannot be expected to have both replied to HUD, implemented corrective action, and achieved full compliance in such a short a timeframe.

FMFC provided the auditors with the information above in various formats throughout the audit process. As stated above, upper management stated in interviews that the problem was being addressed, corporate mandated specific corrective actions that were implemented, interviewees confirmed implementation of those steps in interviews, and the auditors were shown the branch IDs on FMFC processors' computer terminals. FMFC, therefore, is mystified as to how the conclusion can be made that nothing has been provided to confirm that the problem has been corrected.

FMFC acknowledges that the corruption of data in Neighborhood Watch that results from branches using incorrect ID numbers can render default data inaccurate. And that such a problem *could* prevent HUD from monitoring branch operations that truly had a default problem. However, default information compiled for each branch that originated one of the loans under review revealed that the *default ratios*

Joan S. Hobbs
Regional Inspector General for Audit
U.S. Department of HUD
Office of Inspector General
July 6, 2006

combining every branch did not come close to the national FHA default rate. While FMFC recognizes the seriousness of this issue and has taken corrective action, in this case, the FHA fund has not been put at risk because of a runaway default rate ascribed to the wrong FMFC branch.

In conclusion, FMFC had a branch ID problem that it took seriously and corrected. And the auditors were made aware of the corrective action taken. More importantly, this issue did not cause unnecessary risk to the FHA insurance fund. FMFC, therefore, believes a civil penalty of $151,660.00 is unwarranted. FMFC also believes a $41,223.00 indemnification for loan no. 022-1767707 is unwarranted since the loan is not in default and since the Report mistakenly infers that the loan was originated two years prior to the branch becoming an approved FHA branch.

LACK OF DOCUMENTATION OF SOURCE OF GIFT FUNDS

Comment 6

The Report states that FHA-insured loan no. 022-1719928 had insufficient documentation to determine whether the gift funds were provided from the donor to the borrower. The Report is incorrect. A review of the loan file indicates that the gift funds were provided from the donor to the title company for the borrower's benefit.

First, the file contained a gift letter from [redacted] (the donor and borrower's sister) for the amounts of $10,000.00 and $2,300.00. Second, the file contained a letter from [redacted] bank verifying that she carried an average balance of $13,000.00 which is in excess of the gift amount. Third, the file contained copies of cashier's checks made payable to the title company in the amounts of $10,000.00 and $2,300.00 which reflect [redacted] as the remitter. Finally, the file contained copies of receipts from the title company for the cashier's checks and noted that they were "For Credit Of: [redacted]"

Mortgagee Letter 00-28 states that the purpose of requiring documentation relative to gift funds is so that the lender may "determine that the gift funds were not ultimately provided from an unacceptable source and were indeed the donor's own funds." The documentation contained in the loan file was sufficient to determine that the borrower's sister had the desire and the capacity to provide [redacted] with the funds to close on this transaction. Accordingly, FMFC believes an indemnity of $31,432.00 is unwarranted.

SPOUSE'S DEBT NOT INCLUDED IN LOAN APPROVAL

Comment 7

FMFC concurs that the underwriter who approved the purchase transaction in 2002 for [redacted] failed to include a debt reflected on her husband's credit report. However, the subsequent refinance (FHA-insured loan no. 022-1759781) was properly underwritten and approved with the correct debt ratios. Therefore, FMFC believes an indemnification of $28,511.00 is unwarranted.

00021170.DOC

Joan S. Hobbs
Regional Inspector General for Audit
U.S. Department of HUD
Office of Inspector General
July 6, 2006

RECOMMENDATIONS

1A. FMFC respectfully declines to indemnify HUD on loan no. 022-2090700.

1B. FMFC respectfully declines to indemnify HUD on loan no. 022-1767707.

1C. FMFC respectfully declines to indemnify HUD on loan no. 022-1759781.

1D. FMFC already provided evidence to the auditors on site that corrective measures have been taken to ensure that all branches now use the correct branch ID.

Comment 8

1E. FMFC respectfully declines to pay civil money penalties totaling $151,660 for the five loans identified in the Report as having been processed using the incorrect branch ID.

CONCLUSION

FMFC respectfully disagrees with the majority of the Report's conclusions. FMFC does not believe that the FHA insurance fund has been put at risk in an amount totaling $640,517.00. The loans to claim rate for the years covered by this audit is .02%, evidence of the quality of the loans originated by FMFC.

FMFC has performed its duties as a good business partner with HUD since its doors opened in 1996. When errors have been discovered via branch and mortgagee audits, FMFC has agreed to indemnify HUD. When demands for indemnification losses have been presented, FMFC has paid them promptly. FMFC welcomes constructive criticism and the opportunity to improve loan quality. In this case, however, FMFC does not believe the indemnities and fines are warranted.

As required, a copy of FMFC's response will be sent via electronic copy to jhobbs@hudoig.gov and a hard copy will be sent to you via regular mail.

Regards,

Joel J. Herk
Deputy General Counsel

JJH/jh
Enclosures

00021170.DOC

OIG Evaluation of Auditee Comments

Comment 1 Contrary to HUD requirements, an interested third party (Realtor) handled and faxed documents. We interviewed and confirmed with the borrower that he did not own the mobile home and instead was a renter. We have no indicators that the borrower created the false lease and believe it was created by an interested third party.

Regarding the lender's claim that the supplemental credit report showed a secured credit line of $7,707 for an asset it contends was for a mobile home, the credit report did not state that it was for a mobile home or any other type of residence. It could have been for an automobile, a secured credit card, etc., but the lender did not practice due diligence to follow up and determine the ownership of the claimed asset. The underwriter stated she did not notice that many of the documents were faxed and that without the lease income the debt-to-income ratios would have been too high to qualify the borrower for the mortgage.

Comment 2 OIG is conducting a follow-up of the alleged comments and have interviewed both lender staff and OIG staff. We take such allegations of derogatory and offensive remarks very seriously. Once the review is completed, we will take whatever actions are deemed appropriate.

Comment 3 During a follow-up discussion, the underwriter stated she did not notice the questioned documents were faxed by a real estate company when the loan was underwritten. HUD Handbook 4000.4 REV-1 CHG-2 (July 13, 1994), Paragraph 2-4 provides a list of responsibilities the underwriter must take. Among them, the underwriter must have an awareness of the warning signs that may indicate irregularities, and an ability to detect fraud, as well as the responsibility that the underwriting decisions are performed with due diligence in a prudent manner. This responsibility includes ensuring a third party (e.g. real estate) is not involved in the handling of borrower documents.

In addition to the referenced HUD Handbook 4155.1 REV-5, Paragraph 3-1 criteria in the report, the handbook states that lenders may not accept or use documents relating to the credit, employment or income of borrowers that are handled by or transmitted from or through interested third parties (e.g., real estate agents, builders, sellers) or by using their "equipment" (e.g., fax machines, E-mail). The use of the realtor's fax machine to transmit borrower's document to the lender constitutes a violation of the HUD handbook. For this loan, after interviewing the borrower we determined that the lender received and used a false lease to improperly qualify the borrower for the loan (see comment 1 above for additional comments on this loan).

Comment 4 First Magnus provided us with documentation showing the branch (Long Mortgage) was approved on January 20, 2004. We revised the report to reflect the actual date HUD approved the branch. However, the facts remain that the branch office was not approved at the time loan number 022-1767707 was originated and processed in November 2003.

Comment 5 The issue of incorrect branch identification numbers being used to originate and process loans was in the Draft Report because it had been previously addressed during HUD's Quality Assurance Division site visits in November 2003, December 2003 and July 2005 but the practice had continued. On 7/12/06, subsequent to our exit conference to confirm statements made to us in various interviews, First Magnus provided us documentation and evidence to show it implemented corrective actions in August/September 2005 and February 2006 to ensure branches used the correct branch identification number to originate and process FHA mortgage loans. We reviewed the documentation and evidence presented at the exit conference and concluded it to be sufficient to resolve this part of the finding and the related recommendation. Recommendation 1D will be considered closed upon report issuance.

Comment 6 First Magnus contends the documents in the loan file for gift funds provided to the borrower were sufficient. The facts in the report are correct and we disagree with First Magnus' statement that the report is incorrect. Mortgage Letter 2000-28 requires that if the donor purchased a cashier's check as a means of transferring the gift funds, then the donor must provide a withdrawal document (e.g. bank statements, withdrawal slip) or canceled check for the amount of the gift showing the funds came from the donor's personal bank account. Neither the First Magnus file nor the HUD loan file have the required documentation to show the gift funds came from the donor's personal bank account.

In addition, First Magnus misquoted Mortgagee Letter 2000-28 in the report. Mortgage Letter 2000-28 states the lender must, not may (as mentioned by First Magnus), be able to determine that the gift funds were not ultimately provided from an unacceptable source and were indeed the donor's own funds. There was no evidence First Magnus obtained the necessary documentation to determine whether the gift funds were from an unacceptable source and were actually the donor's own funds.

Comment 7 Even though First Magnus agreed the underwriter who approved the purchase loan in 2002 did not include the husband's debt, it contends the refinance loan was correctly underwritten and approved and should not be indemnified. The lender's response fails to mention that this was a streamline refinance and as such HUD allows these to be underwritten without mortgage credit underwriting and no credit report with the presumption that the original HUD-insured loan met HUD's requirements. The borrower's ability to obtain a stream-lined refinance loan was predicated on First Magnus' approval of the original purchase loan in 2002.

According to HUD's Neighborhood Watch System, as of June 6, 2006, the loan was in default and the last payment received was for January 2006.

Comment 8 First Magnus incorrectly assumed the amount in civil penalties was $151,660 for the five loans identified in the report (Schedule D) as having been processed using the incorrect branch ID. HUD can impose civil money penalties up to the maximum amount of $6,500 per loan. However, HUD's assessment of civil money penalties to the lender is on a case-by-case basis and it is up to HUD to determine the assessment amounts.

Appendix C

SCHEDULE OF DEFICIENCIES

Loan case number	Closing date	Loan amount	Unpaid balance**	29 percent estimate loss*	Loan status	1	2	3	4	5
022-1751765	August 25, 2003	$90,081.00	$89,116.00	$25,844.00	Claim		x			
022-1759781	September 29, 2003	$101,398.00	$98,313.00	$28,511.00	Active but Delinquent		x			x
023-2090070	May 7, 2004	$90,538.00	$87,613.00	$25,408.00	Active	x	x	x		
022-1795425	April 28, 2004	$107,998.00	$0.00	$0.00	Terminated***		x			
022-1767707	November 7, 2003	$137,837.00	$142,181.00	$41,232.00	Active		x			
022-1719928	May 23, 2003	$112,665.00	$108,387.00	$31,432.00	Active				x	
TOTAL						**1**	**5**	**1**	**1**	**1**

History: 1 - False documentation
2 - Branch office used the incorrect lender ID
3 - 3rd party handling of documents
4 - Insufficient documentation for source of gift funds
5 - Spouse's debts not included in loan approval
* - Unpaid balance multiplied by 29 percent of claim amount, based upon statistics provided by HUD
** - The unpaid mortgage loan balances reflect data obtained from NeighborhoodWatch on June 6, 2006
*** - Non-conveyance foreclosure – third party sale

Appendix D

CIVIL MONEY PENALTIES

	FHA Case #	Loan Amount	Unpaid Balance	29 percent estimated loss*
1	022-1751765	$90,081.00	$89,116.00	$25,844.00
2	022-1767707	$137,837.00	$142,181.00	$41,232.00
3	022-1759781	$101,398.00	$98,313.00	$28,511.00
4	023-2090070	$90,538.00	$87,613.00	$25,408.00