OFFICE OF AUDIT
REGION 5
CHICAGO, IL

Mortgage Now Inc., Shrewsbury, NJ

FHA Loan Underwriting and Quality Control

2012-CH-1014

SEPTEMBER 28, 2012

Issue Date: September 28, 2012

Audit Report Number: 2012-CH-1014

TO: Charles S. Coulter, Deputy Assistant Secretary for Single Family Housing, HU

Kelly Anderson

FROM: Kelly Anderson, Regional Inspector General for Audit, 5AGA

SUBJECT: Mortgage Now Inc. Did Not Always Comply With HUD's Underwriting and Quality Control Requirements

Enclosed is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), results of the audit of Mortgage Now's underwriting of Federal Housing Administration loans in Region 5.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8L, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at (312) 353-7832.

September 28, 2012

Mortgage Now Inc. Did Not Always Comply With HUD's Underwriting and Quality Control Requirements

Highlights

Audit Report 2012-CH-1014

What We Audited and Why

We audited Mortgage Now Inc., a Federal Housing Administration (FHA)-approved nonsupervised direct endorsement lender approved to originate, underwrite, and submit mortgages for insurance. We selected Mortgage Now based on its compare ratio of 223 percent for a 2-year FHA performance period.[1] Its average compare ratio for the loans originated in our jurisdiction[2] was 287 percent. The audit was part of the activities in our fiscal year 2012 audit plan. Our audit objective was to determine whether Mortgage Now complied with HUD's regulations, procedures, and instructions in the underwriting of FHA loans and implementing its quality control plan.

What We Recommend

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require Mortgage Now to (1) indemnify HUD for the five loans cited in this report, with an estimated loss of $555,678, and (2) implement a quality control program that complies with HUD requirements.

What We Found

Mortgage Now did not comply with HUD's regulations, procedures, and instructions in the underwriting of 5 of 20 FHA-insured loans reviewed. This noncompliance occurred because Mortgage Now's underwriters did not exercise due diligence in underwriting these loans. As a result of the improperly underwritten loans, Mortgage Now increased the risk to the FHA Mutual Mortgage Insurance Fund by $555,678.

Additionally, Mortgage Now did not follow HUD requirements when implementing its quality control program. Specifically, it did not ensure that its routine quality control reviews of FHA-insured loans were performed frequently and in a timely manner as required by HUD, and its written quality control plan did not contain all of the required provisions. The problems occurred because Mortgage Now disregarded HUD requirements and did not properly oversee its quality control contractor's reviews to ensure that they met HUD requirements. As a result, Mortgage Now increased the risk to FHA's insurance fund due to a lack of assurance of the accuracy, validity, and completeness of its loan underwriting activities.

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[1] Period ending September 30, 2011

[2] For Illinois, Indiana, Ohio, Michigan, and Minnesota only. The lender did not originate any loans in Wisconsin during the selected performance period.

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BACKGROUND AND OBJECTIVE

The National Housing Act, as amended, established the Federal Housing Administration (FHA), an organizational unit within the U.S. Department of Housing and Urban Development (HUD). FHA provides insurance to private lenders against loss on buyers financing homes. The basic home mortgage insurance program is authorized under Title II, section 203(b), of the National Housing Act and governed by regulations in 24 CFR (Code of Federal Regulations) Part 203. In 1983, HUD implemented the direct endorsement program, which authorizes approved lenders to underwrite FHA loans without HUD's prior review and approval.

Mortgage Now Inc. is an FHA-approved nonsupervised direct endorsement lender that was established in 1994 and approved by FHA on September 25, 1997, to originate mortgage loans. On November 24, 1997, Mortgage Now became an unconditional direct endorsement lender. It maintains two offices, with its home office located in Shrewsbury, NJ, and a branch office located in Willow Grove, PA. While a majority of its loans are FHA insured, Mortgage Now also originates U.S. Department of Veterans Affairs and conventional loans.

Initially, Mortgage Now's home office was located in Cleveland, OH, falling under Region V's jurisdiction.[3] However, at the start of our audit, the lender was in the process of transferring all of its operations from the Cleveland office to Shrewsbury, NJ, and as of February 2012, it had updated its home office in HUD's systems to Shrewsbury, NJ. Based upon our risk assessment of single-family lenders with home offices in our region and the performance of Mortgage Now's loans originated in our region, an audit was initiated.

According to HUD's Neighborhood Watch Early Warning System[4], as of November 9, 2011, Mortgage Now had originated 1,265 FHA-insured loans with beginning amortization dates between October 1, 2009, and September 30, 2011. Of the 1,265 loans, 53 were seriously delinquent or had claim insurance status. In addition, Mortgage Now had a compare ratio[5] of 223 percent for the 2-year FHA performance period ending September 30, 2011, and a 287 percent compare ratio for loans originated in Region 5 during the same period.

Our audit objective was to determine whether Mortgage Now complied with HUD's regulations, procedures, and instructions in the underwriting of FHA loans and implementing its quality control plan.

[3] The six states in Region V's jurisdiction include Illinois, Michigan, Minnesota, Ohio, Wisconsin, and Indiana.
[4] Neighborhood Watch is a Web-based software application that displays loan performance data for lenders and appraisers using FHA-insured single-family loan information. The system is designed to highlight exceptions so that potential problems are readily identifiable.
[5] Compare ratio is the value that reveals the largest discrepancies between the subject's default percentage and the default percentage to which it is being compared. The percentages being compared are the percentages of originations that first defaulted during a selected period; for example, defaults within the first two years. A higher ratio is indicative of an area or lender that has an unusually high default percentage in comparison with that region or lender's surrounding area.

RESULTS OF AUDIT

Finding 1: Mortgage Now Did Not Comply With HUD's Underwriting Requirements

Mortgage Now did not comply with HUD's underwriting requirements for 5 of 20 loans reviewed. Specifically, it did not properly analyze or support borrowers' income and include all required recurring obligations to qualify the borrowers for loans. The noncompliance occurred because Mortgage Now's underwriters did not exercise due diligence in underwriting these loans. As a result of the improperly underwritten loans, Mortgage Now increased the risk to FHA's Mutual Mortgage Insurance Fund by $555,678.[6]

Mortgage Now Did Not Properly Analyze or Support Borrowers' Income

Mortgage Now did not properly analyze or support borrowers' income for four loans reviewed. HUD requires a lender to analyze a borrower's income and the probability of continued employment to determine the borrower's capacity to repay the mortgage debt.[7] Additionally, income may not be used in calculating a borrower's income ratios if it is unverifiable, unstable, or will not continue.[8] For example, for FHA case number 412-6321767, Mortgage Now incorrectly used the primary borrower's income, which was seasonal, not full-time as indicated, to qualify the borrower for the loan. The loan file did not contain sufficient documentation to support the borrower's income of $1,820. Using the year-to-date earnings on the borrower's most recent pay stub, we recalculated the borrower's income as $1,326, a difference of $494, which increased the total fixed payment-to-income ratio[9] from 54 to 63 percent.

Mortgage Now Did Not Include All Required Recurring Debts in Its Underwriting Analysis

[6] We classified $555,678 as funds to be put to better use. This amount is 66 percent of the $841,936 in unpaid principal balances pulled from HUD's Neighborhood Watch system for the five loans as of July 25, 2012. The 66 percent is the estimated percentage of loss HUD would incur when the FHA property is foreclosed upon and resold as supported by the HUD Single Family Acquired Asset Management System's case management profit and loss by acquisition as of December 2011.

[7] HUD Handbook 4155.1, paragraphs 1.A.4.a; 4.D.1.c; and 4.D.2.a

[8] HUD Handbook 4155.1, paragraph 4.D.1.a

[9] Total fixed payment-to-income ratio is the relationship of total obligations to income, which is determined by dividing a borrower's total mortgage payment and monthly recurring obligations by his or her monthly gross effective income. FHA's benchmark for this ratio is 43 percent.

Mortgage Now did not include all required recurring obligations to qualify the borrowers for two loans. HUD requires a lender, when computing the debt-to-income ratio, to include recurring obligations, such as monthly housing expenses, and additional recurring charges extending 10 months or more, such as payments on installment accounts, child support or separate maintenance payments, revolving accounts, and alimony.[10] For example, for FHA case number 262-1868669, Mortgage Now omitted a monthly installment debt of $598 from the underwriting analysis. The borrowers' credit report, dated June 29, 2009, contained a monthly installment debt of $598 with a balance owed of $16,932. The Desktop Underwriter findings printout required the lender to provide documentation that supported the omission of a liability account from the underwriting analysis during liability reconciliation. However, the loan file did not contain supporting documentation for the omission of the debt. Considering the omitted monthly liability of $598, the borrowers' total fixed payment-to-income debt ratio would increase from 42.31 to 48.17 percent.

Mortgage Now Did Not Exercise Due Diligence in Underwriting Loans

Mortgage Now did not exercise due diligence when underwriting the five loans for FHA insurance to ensure compliance with HUD requirements. According to HUD requirements, a lender must determine that a borrower has the ability and the willingness to repay a mortgage debt, which includes considering the type of income the borrower needs to qualify; analyzing the borrower's liabilities to determine creditworthiness; and reviewing ratios, including debt-to-income, and compensating factors.[11] Regulations at 24 CFR 203.5(c) require a direct endorsement lender to exercise the same level of care it would exercise in obtaining and verifying information for a loan in which the lender would be entirely dependent on the property as security to protect its investment.

Mortgage Now did not establish policies and procedures to ensure its underwriters were accurately and consistently calculating the borrowers' income. The loan files generally lacked documentation supporting the calculations of the borrowers' income. As of June 29, 2012, the lender stated that it had started implementing procedures that would address the underwriting deficiencies cited.[12] For example, Mortgage Now's underwriting department will use a separate worksheet to recalculate a borrower's income, and income will be calculated twice, at a minimum, during the loan underwriting.

Conclusion

[10] HUD Handbook 4155.1, paragraph 4.C.4.b
[11] HUD Handbook 4155.1, paragraph 1.A.1.c
[12] We did not review the implementation of the lender's new procedures and thus, are unable to express an opinion on the effectiveness of those procedures.

Mortgage Now failed to follow HUD requirements in underwriting 5 of the 20 loans reviewed (25 percent). This noncompliance occurred because Mortgage Now's underwriters did not exercise due diligence in underwriting the loans. As a result, Mortgage Now increased the risk to the FHA insurance fund by $555,678.

Appendix C of this report contains the case narratives for the five loans with material underwriting deficiencies.

Recommendations

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require Mortgage Now to

1A. Indemnify HUD for the five loans with an estimated loss of $555,678. The estimated loss was based on the loss severity rate of 66 percent of the total unpaid principal balance of $841,936 as of July 25, 2012.

1B. Develop and implement written policies and procedures to ensure that loans comply with HUD requirements and underwriting decisions are properly supported.

Finding 2: Mortgage Now Did Not Follow HUD Requirements When Implementing Its Quality Control Program

Mortgage Now did not follow HUD requirements when implementing its quality control program. Specifically, it did not review all early payment defaults[13] or ensure that its routine quality control reviews were performed frequently and in a timely manner as required by HUD, and its quality control contractor did not always perform employment reverification or reverify occupancy when occupancy was suspect. Further, Mortgage Now's written quality control plan did not contain all of the required provisions. The problems occurred because Mortgage Now disregarded HUD requirements and did not properly oversee its quality control contractor's reviews to ensure that they met HUD requirements. As a result, Mortgage Now increased the risk to the FHA insurance fund due to a lack of assurance of the accuracy, validity, and completeness of its loan underwriting activities.

Mortgage Now Did Not Review All Early Payment Defaults

Mortgage Now did not review all early payment defaults as required by HUD. HUD requires lenders to review all loans going into default within the first six payments, in addition to the loans selected for routine quality control reviews. Early payment defaults are defined as loans that become 60 days past due.[14] Mortgage Now's quality control contractor, QCS & Associates LLC, which was contracted to only perform routine quality control reviews, incidentally reviewed 2 of 10 early payment defaults identified by the audit team. Mortgage Now did not provide the requested documentation for the early payment defaults. Further, its quality control contractor explained that it was not in its contract with Mortgage Now to perform the reviews of the early payment defaults and it believed those reviews were being performed by Mortgage Now or another contractor.

Mortgage Now Failed To Perform Routine Quality Control Reviews Frequently and in a Timely Manner

Mortgage Now did not ensure that its routine quality control reviews were performed frequently and in a timely manner as required by HUD. HUD requires that for lenders closing more 15 loans a month, those lenders must conduct quality control reviews at least monthly and address 1 month's activity.[15] However,

[13] Early payment defaults are loans that become 60 days past due within the first six payments.
[14] HUD Handbook 4060.1, REV-2, paragraph 7-6(D)
[15] HUD Handbook 4060.1, REV-2, paragraph 7-6(B)

Mortgage Now's quality control contractor did not perform the reviews monthly or review 10 percent of the FHA loans originated as required by HUD. According to its quality control contractor's records, routine quality control reviews were not conducted for 17 of the 24 months in our audit period.

Additionally, Mortgage Now's quality control contractor did not perform routine quality control reviews in a timely manner. HUD requires loans to be reviewed within 90 days from the end of the month in which the loan closed. This requirement is intended to ensure that problems left undetected before closing are identified as early after closing as possible.[16] From October 1, 2009, through September 30, 2011, Mortgage Now's contractor reviewed 118 of 146 loans (81 percent) after 90 days from the end of the month in which the loans closed, with 36 of these reviews completed after 6 months, and 8 completed after 9 months.

Mortgage Now Did Not Reverify Employment or Occupancy When Required

Mortgage Now's quality control contractor did not always perform employment reverification or reverify occupancy when occupancy was suspect. HUD requires a lender to check documents contained in the loan file for sufficiency and subject the loan documents to written reverification, including employment or other income.[17] During our audit, Mortgage Now's contractor acknowledged that it did not have a contractual arrangement with Mortgage Now to reverify income as part of the quality control reviews. Additionally, there was no indication in the quality control summary reports that employment or income reverification was performed.

Further, no evidence was provided that Mortgage Now's contractor performed occupancy reverification, when applicable. HUD requires, in cases in which the occupancy of the subject property is suspect that a lender attempt to determine whether the borrower is occupying the property.[18] For four quality control reviews, Mortgage Now's quality control contractor questioned the borrowers' current residence. However, there was no documentation supporting that Mortgage Now or its contractor attempted to reverify the occupancy of the subject properties.

Mortgage Now's Quality Control Plan Did Not Include All Required Provisions

[16] HUD Handbook 4060.1, REV-2, paragraph 7-6(A)
[17] HUD Handbook 4060.1, REV-2, paragraph 7-6(E)(2)
[18] HUD Handbook 4060.1, REV-2, paragraph 7-6(E)(4)

Mortgage Now's quality control plan did not contain all HUD-required provisions. Specifically, contrary to HUD Handbook 4060.1, REV-2, Mortgage Now's plan did not provide that

- A lender contracting out any part of its quality control function is responsible for ensuring that the outside source complies with HUD's requirements. The agreement between these parties must be in writing and state the roles and responsibilities of each party and be available for review by HUD staff.
- Loans that are 60 days past due are defined as early payment defaults.
- If written verification is not returned, telephone reverification is attempted.
- For appraisal desk reviews, if serious deficiencies or patterns are uncovered, lenders must report these items, in writing, to the Quality Assurance Division in the HUD Homeownership Center having jurisdiction.
- Lenders must determine whether all corrections have been initialed by the borrower or employees of the lender.
- Lenders must determine whether verifications of employment and deposit or credit reports are suspect due to handling by any interested third party or the borrower.
- If the borrower is self-employed, the file contains a financial statement.
- The quality control program must verify that the lender ensures that none of the participants in a mortgage transaction (excluding the seller of a principal residence) is debarred, suspended, or under a limited denial of participation for the program and jurisdiction. Procedures must exist that determine whether the mortgage applicant is ineligible due to a delinquent Federal debt.
- When late endorsements are submitted, the quality control program should verify that the mortgage was current when submitted and met payment requirements.

Mortgage Now Did Not Properly Oversee and Follow Up on Quality Control Reviews Performed

Mortgage Now did not implement a quality control program that complied with HUD's requirements. It failed to properly oversee and follow up on the quality control reviews performed by its quality control contractor. According to its quality control contractor, Mortgage Now failed to provide loan file documentation in a timely manner for the completion of routine quality control reviews. Further, it was Mortgage Now's decision that its contractor would perform routine quality control reviews quarterly instead of monthly as required.

Mortgage Now also did not discuss the findings and conclusions of the completed quality control reviews with its contractor.

Since our audit period, Mortgage Now has instituted a procedure in which it immediately sends the loan files to its contractor every month and consistently tracks the quality control reviews to ensure that it complies with HUD requirements concerning the frequency and timeliness of the reviews. In addition, the lender now has a staff member, who is more familiar with the quality control process, to serve as the contact for its quality control contractor.

Conclusion

Mortgage Now did not follow HUD requirements when implementing its quality control program. The problems occurred because Mortgage Now disregarded HUD requirements and did not properly oversee its quality control contractor's reviews to ensure that they met HUD requirements. Additionally, it did not provide loan file documentation to its contractor in a timely manner for the completion of routine quality control reviews. As a result, Mortgage Now increased the risk to the FHA insurance fund due to a lack of assurance of the accuracy, validity, and completeness of its loan underwriting activities.

Recommendations

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing

2A. Require Mortgage Now to develop and implement a quality control program that complies with HUD requirements. Specifically, the lender needs to establish a written plan with HUD's required provisions, ensure that routine quality control reviews meet HUD requirements, and review all early payment defaults as required.

2B. Review Mortgage Now's quality control program within 9 months to determine whether the required provisions have been included in the lender's written plan and quality control reviews are conducted in compliance with HUD's requirements.

SCOPE AND METHODOLOGY

We performed our audit work from November 2011 through June 2012 at Mortgage Now's main office in Shrewsbury, NJ, and our offices located in Chicago, IL, and Columbus, OH. The audit covered the period October 1, 2009, through September 30, 2011, and was adjusted as necessary.

To accomplish our objectives, we reviewed applicable HUD handbooks, regulations, mortgagee letters, and other reports and policies related to the FHA mortgage insurance programs. Further, we reviewed Mortgage Now's electronic loan credit and closing files, quality control plan, and quality control documentation. We contacted borrowers' employers to confirm employment and income data. We also reviewed the corporate roster, a list of fees, the organization chart, and financial audits for prior years' information. We interviewed Mortgage Now's employees and external quality control contractor.

Using HUD's data maintained in Neighborhood Watch, we determined that Mortgage Now had 53 loans that were seriously delinquent or in claim status that were underwritten during the scope of our audit. Of the 53 loans, 24 were originated to borrowers located in Region 5's jurisdiction. Of these 24, there were 4 that had been made current as of the beginning of the scope and were removed from the universe. The remaining 20 loans, with mortgage amounts totaling more than $2.5 million, were comprised of 3 streamline refinances, 2 conventional to FHA refinances, and 15 home purchase loans. We reviewed the 20 loans to determine whether they were underwritten in compliance with HUD's requirements. The results of our underwriting review apply only to the loans reviewed and cannot be projected to the entire universe of loans.

For our review of Mortgage Now's quality control program, we reviewed 100 percent of the 146 quality control reviews completed during our audit period for compliance with HUD requirements. A third-party contractor, QCS & Associates, performed routine quality control reviews for Mortgage Now.

We relied on information maintained in HUD's Neighborhood Watch and Single Family Data Warehouse systems for informational and sampling purposes only. We also relied on data maintained in Mortgage Now's system such as electronic loan files and payment records. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequately reliable for our purposes. The testing consisted of comparing data in the electronic files to the FHA case binders, and reconciling Mortgage Now's payment history documentation to the servicers' information maintained in HUD's systems. The audit results were based on our review of electronic and supporting hardcopy documentation maintained by Mortgage Now.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

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

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Reliability of financial reporting – 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 applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- Mortgage Now did not comply with HUD's underwriting requirements for five FHA-insured loans (see finding 1).

- Mortgage Now did not follow HUD requirements when implementing its quality control program (see finding 2).

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use 1/
1A	$555,678
Total	$555,678

1/ Recommendations that funds 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. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments[19]**

mortgage NOW inc.

September 10, 2012

Mr. Jesse Hale
U.S. Department of Housing and Urban Development
Office of Inspector General
200 N. High Street, Room 334
Bricker Federal Building
Columbus, OH 43215-2499

Subject: Mortgage Now, Inc. OIG Audit
Lender ID No. 10980-00002

Dear Mr. Hale:

Mortgage Now, Inc. is an FHA-approved nonsupervised direct endorsement lender since September 25, 1997. Mortgage Now, Inc. has always taken great pride in their originations of FHA mortgage loans. Mortgage Now, Inc. has originated over 8,312 FHA loans since its original approval. In this time frame, we have only had to indemnify 2 FHA mortgage loans.

We have attached some findings summaries and exhibits of our calculations to the audit results in Finding 1. Please see the attached on the following case numbers:

412-6321767
262-1868669
264-0336553

Mortgage Now, Inc. has always had policies and procedures in place to ensure our underwriters were calculating income with separate worksheets and checking their own work, our Post-Closing and Insuring departments did not make copies of our documentation into our scanned files on the server under the miscellanrious file of the FHA loan. We have now insured that all supporting documentation on our underwriter's notes and calculations stay in our miscellaneous file; it may not be necessary for our end investor and/or FHA HUD insuring case binder.

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[19] This response excludes 37 pages of exhibits that were not necessary for understanding Mortgage Now's comments.

Ref to OIG Evaluation | **Auditee Comments**

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Comment 1

Mortgage Now, Inc. is requesting that four of the five loans not be indemnified based on our enclosed exhibits. In reference to FHA Case # 264-0534519; the borrower made 14 payments before a 90 day delinquent was reported. The borrower is currently in a repayment status and is working hard to bring his payments current.

Comment 2

Mortgage Now, Inc. has developed written policies and procedures on all loans going into default within the first six payments. If this occurs on any loans originated by Mortgage Now, Inc., our credit committee will be reviewing these loans immediately as well as these will be sent to our new quality control company for additional review and compliance. We will have meetings scheduled with our committee and our new quality control company to discuss all findings and ensure HUD's guidelines and requirements.

Comment 3

Mortgage Now, Inc. has hired a new quality control company and has implemented written policies and procedures for our Post-Closing and Insuring department to send to our quality control company our required amount of loans for audit twice a month. We will always ensure that a minimum of 10 percent of the FHA loans originated are reviewed by our quality control contractor along with our Conventional, VA and denied loans monthly.

Our new quality control plan will always comply with all of HUD's requirements. Our plan will document the roles and responsibilities of both Mortgage Now, Inc. and our quality control contractor. We have added to our quality control plan the following items that will be maintained at all times within our plan and contract.

- Loans that are 60 days past due are defined as early payment defaults.
- If written verification is not returned, telephone reverification is attempted until obtained.
- For appraisal desk reviews, if serious deficiencies or pattern are uncovered, we will report these items in writing, to the Quality Assurance Division in the HUD Homeownership Center for the appropriate region immediately.
- We will always ensure that all corrections have been initialed by the borrower, employees and appropriate officer of the lender.
- We will determine whether verifications of employment and deposit or credit reports are suspect due to handling by any interested third party or the borrower.
- If the borrower is self-employed, the file will always contain a financial statement.
- Our quality control program will verify that we ensure that none of the participants in a mortgage transaction (excluding the seller of a principal residence) is debarred, suspended, or under a limited denial of participation for the program and jurisdiction. Procedures will exist that determine whether the mortgage applicant is ineligible due to a delinquent Federal debt.
- When late endorsements are submitted, the quality control program will verify that the mortgage and all appropriate tax payments were current when submitted to HUD for endorsement.

Ref to OIG Evaluation	Auditee Comments

Mortgage Now, Inc. will implement policies and procedures of setting up meetings upon the completion or our quality control reviews with our contractor to discuss the diligence of the reports and determine if anything else needs to be implemented at all times per HUD's requirements.

Comment 4

Comment 5

Mortgage Now, Inc. respectfully submits that the Office of Inspector General recognizes, in its audit and findings, the tremendous financial and regulatory challenges the economic crisis placed upon this Lender. Moreover, we ask the OIG to note that the ensuing massive overhaul to both the state and federal governmental regulations which govern this entity. In light of facing said challenges; Mortgage Now, Inc. still maintained its adherence to easing the credit crisis by lending in economically challenged states such as Ohio and Michigan. Mortgage Now, Inc request the OIG to acknowledge the tremendous burden the State of Ohio's grant program known as "OHFA Down Payment assistant program" placed upon the corporation and that 50% of the defaults realized by Mortgage Now, Inc in the region were directly caused by borrowers in this program. Mortgage Now, Inc is committed to quality underwriting, governmental cooperation and fair lending.

If you have any further questions or concerns, please do not hesitate to contact me at 330-460-6026 or at Lmann@mtgnow.com

Thank you for your cooperation in this matter.

Laura Mann
Laura Mann
Sr. Vice-President/COO

Cc: Marcie Ibizugbe, US Department of Housing and Urban Development
Kelly Anderson, US Department of Housing and Urban Development
James L. Marchese, CEO, Mortgage Now, Inc.
Michael Perry, Sr. Vice-President, Mortgage Now, Inc.

Enclosures

Ref to OIG Evaluation | **Auditee Comments**

FINDINGS REVIEW OUTLINE

Mortgage Now Did Not Comply with HUD's Underwriting Requirements. Mortgage Now did not comply with HUD's underwriting requirements for 5 of 20 loans reviewed. It did not properly analyze or support borrower's income, and include all required recurring obligations to qualify the borrowers for loans.

Based upon the review of the loans and above findings, Mortgage Now requests that the documents attached and findings be reviewed and delete appropriate files from your list:

1. FHA Case # 262-1868669

Property address: [redacted]

Findings: Did not include all required recurring obligations to qualify the borrowers. Specifically, it omitted a monthly installment debt of $598 from the underwriting analysis for the conventional to FHA refinance loan .

Comment 6

Rebuttal findings: Although it was found that underwriting did not include monthly debt of $598 in the DTI, it was found that monthly income for borrower was slightly higher than income utilized by underwriting. We have included income calculation for ytd income on latest paystub submitted by borrower and income for 2008 & 2007 W2s. Income used was the lower of two calculations. We request that you review the calculation form and the W2s which clearly reflect more income than what was used in the qualifying . DTI increased to 47.65% which we feel that would have been acceptable in obtaining an approve/eligible. Compensating factors exists due to excellent employment stability due to length of employment and profession. Rate and term refinance with interest rate going from 6. 875% to 5.50% and P& I reduction from $2062 to $1718.73.

Exhibits attached 8

* Property addresses were redacted for privacy reasons.

Ref to OIG Evaluation **Auditee Comments**

Comment 7

2. FHA Case # 412-6321767

Address: [redacted]

Findings: Incorrectly used borrower's part time income as full-time employment income to qualify the borrower for the loan. When properly using the part time income supported by the pay stub and our employment re-verification, the back ratio increased from 54 percent to 63 percent.

Rebuttal findings: Documentation located in file revealed although borrower had started working on a part time basis, he was a permanent employee and became a full time employee on August 10, 2009. Pay stub reflected 40 hours worked for pay period 8/14/2009 to 8/27/2009. We have re-calculated income to qualify based upon YTD income for period ending 8/27/2009 notwithstanding letter in file showing borrower as full time employee. We have also reviewed liabilities used in qualifying and found that underwriting used monthly obligation of $ 585 in DTI. This debt reflected a balance of $585 and a monthly payment of $585. Since this obligation should not have been used in qualifying, we have reduced monthly obligation from $ 1955.62 to $ 1293.62 which brings our qualifying ratios to 43.71%/55.73%. We refer you to exhibits attached for our re-calculations. Based upon changes, we firmly believe that an approve/eligible would have been obtained on this file. Compensating factors exists due to potential for increased earnings, limited use of credit and minimal increase in monthly housing expense.

Exhibits attached 8

Ref to OIG Evaluation **Auditee Comments**

3. FHA Case # 264-0336553

Address: [redacted]

Findings: Did not properly analyze or support borrower's income. Improperly used a drawdown from retained earnings of the borrower's business instead of net income to calculate the monthly income. Desktop Underwriter approved the loan using the borrower's $4500 base employment income. However, there was no documentation in the loan file showing how the underwriter calculated the borrower's monthly income of $4500. The business has not been profitable for the two most recent tax periods.

Comment 8

Rebuttal findings: Cash flow analysis has been included for your review showing calculation of income based upon 1040s. We have reflected income from the 1120 form but have not used in qualifying the borrower. You will note that we have broken down income based upon borrowers W2 earnings received from Corporation as well as total income from line 22 of 1040s, negating the W2 earnings. Based upon our calculations, borrowers income is much more than income utilized by underwriter. Our review shows that the business has been profitable with dividends paid to borrower from the business greater in the 2008 than 2007.

Exhibits attached 16

OIG's Evaluation of Auditee Comments

Comment 1 Mortgage Now requested that four of the five loans not be indemnified based on the exhibits provided. However, based on our evaluation presented below, the recommendation for the indemnification of these four loans will remain.

Mortgage Now stated the borrower made 14 payments for FHA case number 264-0534519 before the 90-day delinquency was reported, and is currently in a repayment status. However, the Neighborhood Watch FHA case details reveal that the borrower has had an inconsistent payment history with multiple delinquencies since the loan closed. For instance, the loan entered delinquent status in August 2010, after only three mortgage payments. As soon as the loan was reinstated by the borrower, it re-entered delinquent status in December 2010 for another two months.

Mortgage Now did not provide supporting documentation to address the underwriting deficiency cited in the report for this loan. It improperly used the borrower's overtime income, which was not expected to continue, to qualify the borrower for the loan. Without the overtime income of $575, the borrower's monthly effective income decreased by more than 10 percent from the amount of $5,478 that was used to approve the loan. The Desktop Underwriter Findings printout for the loan provides that overtime income may be used to qualify if the borrower has received such income for approximately two years and there are reasonable prospects of continuance. However, the loan file documentation did not support that the overtime income was likely to continue. Therefore, this finding item will remain in the report.

Comment 2 We acknowledge Mortgage Now's development of written policies and procedures that would address all loans going into default within the first six payments. Since Mortgage Now did not provide us its updated written policies and procedures, we were unable to confirm the changes that it has indicated.

Comment 3 We acknowledge the changes made by Mortgage Now to its quality control program, including hiring a new quality control company; implementing written policies and procedures to ensure the completion of required quality control reviews; and updating its quality control plan to comply with HUD's requirements. However, we did not receive any documentation from Mortgage Now to support the changes presented in its comments.

Comment 4 We recognize the financial and regulatory challenges the economic crisis has placed on the industry. However, lenders are still required to exercise due diligence when underwriting loans for FHA insurance to ensure compliance with HUD requirements.

Comment 5 Mortgage Now stated it maintained adherence to easing the credit crisis by lending in economically challenged states like Ohio and Michigan. Additionally, it indicated that the Ohio Housing Finance Administration (OHFA) Down Payment Assistance program placed a tremendous burden on Mortgage Now, and attributed 50 percent of its defaults to borrower participation in the down payment assistance program. During the audit, Mortgage Now informed the audit team that the State of Ohio required it to use the OHFA program and establish grant participation as a performance metric. However, Mortgage Now did not provide any documentation to support its assertions. The OHFA program was not exclusive to Mortgage Now; it was also used by other lenders in Ohio, who had compare ratios lower than Mortgage Now for the 2-year performance period reviewed. In a response to the results of a review performed by its quality control contractor, Mortgage Now acknowledged that it had removed a staff member for risky underwriting decisions.

Comment 6 Mortgage Now agreed the underwriting did not include a monthly debt of $598 in the debt-to-income calculation for FHA case number 262-1868669; however, it stated the borrower's monthly income was slightly higher than the income used in underwriting the loan. Although we agree that the underwriter could have used a slightly higher income to qualify the borrower for the loan; however, the borrower's monthly income increased by only $50. Further, the borrower's weekly paystub for the period ending August 9, 2009, was questionable; the year-to-date wages presented was not accurate. The paystub showed the year-to-date wages as $62,757.99; based on our recalculation, it should have been $62,227.29.

Mortgage Now noted compensating factors that included employment stability, reduction in rates from the refinance, and a principal and interest reduction that resulted in lowering the payment from $2,062 to $1,719. HUD Handbook 4155.1, paragraph 4.F.3.a states all compensating factors must be supported by documentation. Employment stability and interest rate reduction are not considered compensating factors, based on HUD Handbook 4155.1, paragraph 4.F.3.b. Further, the borrower's total mortgage payment increased from $2,062 to $2,393.

Comment 7 For FHA case number 412-6321767, Mortgage Now stated that the borrower was a full time employee on August 10, 2009, and also added that a monthly obligation of $585, which was the same as the balance owed, should have been excluded from the computation of the qualifying ratios for the loan.

We disagree with Mortgage Now's explanation for the borrower's employment and income. The loan file documentation concerning the borrower being a permanent employee was inconsistent with statements by the borrower or his pay stubs. Based on an employment reverification with the borrower's employer, we determined the permanent status only meant that the borrower had completed his probationary period and was no longer a temporary employee. Further, the borrower's pay stub for August 14 through August 27, 2009, showed that the borrower worked approximately 60 hours for a 2-week period. Our recalculation of the borrower's income, based on the year-to-date earnings, revealed the borrower’s monthly income was approximately $661 ($5,200.71 / 7.87 months), which is a difference of $1,159 from the amount used by underwriter to qualify the borrowers for the loan ($1,820 - $661).

We also disagree with Mortgage Now’s assessment of the borrowers’ liabilities. The borrowers’ credit report included a monthly payment of $585 for a revolving line of credit account in the credit report, which was also in the automated underwriting analysis. According to the Desktop Underwriter Findings printout, the underwriter had already excluded installment debt with less than 10 months remaining and less than or equal to a $100 monthly payments from the qualifying ratio calculation. Since the monthly payment of $585 was not less than $100, it was included. Further, HUD Handbook 4155.1, paragraph 4.C.4.b states that debts lasting less than ten months must be included if the amount of the debt will affect the borrower’s ability to pay the mortgage during the months immediately after loan closing, especially if the borrower will have limited or no cash assets after loan closing. The Mortgage Credit Analysis Worksheet indicated the borrowers had cash reserves totaling $521.

The borrowers’ recomputed total fixed payment-to-income (back) ratio, which includes the reduced income of $661 and the monthly debt of $585 for the revolving account, was 80 percent.

Comment 8 Mortgage Now provided a cash flow analysis for FHA case number 264-0336553, in which it showed its calculation of the borrower’s income. Mortgage Now stated that based on its calculations, the borrower’s income was actually greater than the income of $4,500 used by the underwriter. Additionally, it presented that the borrower had $5,419.50 in cash flow income from a corporation. We disagree with both amounts presented by Mortgage Now. The borrower’s 2008 W-2 wages totaling $15,748 resulted in a monthly income of $1,312, which was less than than the $4,500 calculated by the lender.

Further, the cash flow analysis exhibit provided does not support the borrower’s monthly cash flow income of $5,419.50. The cash flow analysis appears to be a screen print from a software program that calculates self-employed income by inputting tax return line items into the software. Since Mortgage Now did not provide sufficient documentation to support its calculation of the borrower’s monthly income of $4,500 or the cash flow of $5,419.50, this finding item will remain in the audit report as cited.

Appendix C

CASE NARRATIVES

Case Narrative – FHA Case Number 262-1868669

Mortgage amount: $302,706

Date of loan closing: September 11, 2009

Status as of July 25, 2012: First legal action to commence foreclosure

Payments before first default reported: Five

Unpaid principal balance: $301,034

Underwriting Deficiencies:

- The loan file lacked supporting documentation for debt omission.

Summary:

Excluded Liability Not Supported

Mortgage Now did not include all required recurring obligations to qualify the borrowers for the loan. Specifically, it omitted a monthly installment debt of $598 from the underwriting analysis for the conventional to FHA refinance loan. The loan file contained no supporting documentation for the omission of the debt. Considering the omitted monthly liability of $598, the borrowers' total fixed payment-to-income debt ratio would increase from 42.31 to 48.17 percent.

Desktop Underwriter approved the loan with $1,929 in monthly debt. However, we identified one account with a balance totaling $16,932 that was not entered into Desktop Underwriter. The balance was manually removed from the credit and liabilities section of the underwriter findings report. The initial loan application provided by Mortgage Now included the debt in the liabilities section. Additionally, the borrower's most recent credit report indicated that the debt was current, and the bankruptcy documentation in the loan file showed that the debt was not included under the bankruptcy.

The Desktop Underwriter findings identified a debt to Oxford Bank and described it as an account that was omitted from the underwriting analysis during liability reconciliation. According to the underwriting analysis document, for each liability, the lender was required to provide documentation that supported the omission of the liability.

Case Narrative – FHA Case Number 264-0534519

<u>Mortgage amount:</u> $161,426

<u>Date of loan closing:</u> March 26, 2010

<u>Status as of July 25, 2012:</u> Delinquent

<u>Payments before first default reported:</u> 14

<u>Unpaid principal balance:</u> $156,757

<u>Underwriting Deficiencies:</u>

- Overtime income was not effective income.

<u>Summary:</u>

Overtime Income Not Effective Income

Mortgage Now improperly used the borrower's overtime income, which was not expected to continue, to qualify the borrower for the loan. Therefore, in excluding this income, the borrower's total fixed payment-to-effective income ratio (back ratio) increased from 49 to 54 percent. The borrower's income decreased by more than 10 percent from the amount reported on the loan application. The verification of employment in the case file indicated that the overtime or bonus income the borrower had received in prior years was not likely to continue. There was a letter in the loan file explaining the variation in hours staff worked during January and February; however, there was no explanation of why overtime hours could still be used. The pay stubs indicated that the borrower did not work overtime for the first 2 months of the year. When we verified income with the employer, it indicated that at that time, overtime was not expected to continue and that for the full year of 2010 (9 months after the loan had closed), the borrower earned only $53.78 in overtime.

The lender entered $4,903 base income and $575 overtime into the automated underwriting system. The Desktop Underwriter findings stated that overtime or bonus income from the application was used to approve the loan. Both may be used to qualify the borrower if the borrower had received such income for approximately 2 years and it was likely to continue. HUD Handbook 4155.1, paragraph 4.D.2.b, states that overtime and bonus income can be used to qualify the borrower if the borrower had received this income for the past 2 years and it would likely continue. Therefore, if the borrower's employment verification stated that the overtime and bonus income were unlikely to continue, it should not have been used to qualify the borrower for the loan.

Case Narrative – FHA Case Number 412-6321767

Mortgage amount: $122,637

Date of loan closing: October 5, 2009

Status as of July 25, 2012: First legal action to commence foreclosure

Payments before first default reported: 10

Unpaid principal balance: $120,735

Underwriting Deficiencies:

- Part-time income was incorrectly used as full time.

Summary:

Part-Time Income Counted as Full-Time Income

Mortgage Now incorrectly used the borrower's part-time income as full-time employment income to qualify the borrower for the loan. The loan file did not contain sufficient documentation to support the borrower's income of $1,820, which was based on a 40-hour work week. The lender relied upon written statements from the borrower and an administrative staff member at the borrower's employer that the borrower worked full time, 40 hours per week. However, we determined that the borrower did not work 40 hours a week because he was a part-time employee. Therefore, using the borrower's year-to-date earnings, we recalculated his income as $661, a difference of approximately $1,159, thus increasing the borrower's total fixed payment-to-income ratio to 80 percent.

HUD requires a lender to establish a borrower's income and the likelihood of its continuance to determine a borrower's capacity to repay the mortgage debt. Additionally, HUD Handbook 4155.1, paragraph 4.D.1.a, states that income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue.

Case Narrative – FHA Case Number 412-6478082

Mortgage amount: $122,637

Date of loan closing: October 30, 2009

Status as of July 25, 2012: Ineligible for loss mitigation

Payments before first default reported: Nine

Unpaid principal balance: $121,516

Underwriting Deficiencies:
- Self-employment income was not stable and effective.
- Excluded liability was not supported.

Summary:

Self-Employment Income Not Stable and Effective
Mortgage Now improperly used the borrower's self-employment income, which was not considered stable and effective. The borrower's income was from a business that had been open less than a year before the loan closed. Therefore, this business income could not be considered as effective. The borrower provided a personal statement, in which her name was misspelled, that described the steps she undertook to start her home childcare business, and she explained the timing of the classes the county required her to take. However, she did not have her first client until December 2008, which was only 11 months before the loan closed on October 30, 2009. Further, there was no documentation in the loan file to support that the training classes she took, along with her 11-month self-employment, would have added up to 1 year. Further, the loan file contained conflicting information regarding when the business started. The income and expense statement that was used to support the business's income and existence went only up to September 30, 2009. Desktop Underwriter approved the loan with $3,990 in income, of which $3,116 was self-employment income.

HUD Handbook 4155.1, paragraph 4.D.4.c, states that income from self-employment is considered stable and effective if the borrower has been self-employed for 2 or more years. Due to the high probability of failure during the first few years of a business, the requirements are necessary for borrowers who have been self-employed for less than 2 years. If the period of self-employment is less than 1 year, the income from the borrower may not be considered effective income.

Excluded Liability Not Supported
Mortgage Now did not include all required recurring obligations to qualify the borrower for the loan. Specifically, it omitted the borrower's monthly car payment of $278 from the underwriting debt analysis without sufficient documentation to support the business's use of the car. Desktop Underwriter approved the loan with $522 in monthly debt. However, we identified one account with a balance totaling $278 that was not entered into Desktop Underwriter. The balance was

manually removed from the credit and liabilities section of the underwriter findings report. The underwriter findings section of the report contained an annotation referring to the income statement in the file. The income statement indicated that for the first three quarters of the year, the borrower had $1,850 in automobile expenses, with no further documentation or support that the automobile expenses were related to the liability payment appearing on the credit report that had been removed for underwriting.

Case Narrative – FHA Case Number 264-0336553

Mortgage amount: $147,283

Date of loan closing: October 9, 2009

Status as of July 25, 2012: Reinstated by borrower without loss mitigation claim

Payments before first default reported: Four

Unpaid principal balance: $141,894

Underwriting Deficiencies:

- A drawdown of the borrower’s business retained earnings was improperly used instead of net income to calculate the borrower’s monthly income.

Summary:

Retained Earnings Improperly Used as Income
Mortgage Now improperly used a drawdown from retained earnings of the borrower’s business instead of net income to calculate the monthly income. Desktop Underwriter approved the loan using the borrower’s $4,500 base employment income. The borrower provided 2 years of tax returns and tax return transcripts indicating that he was the business’s owner along with Internal Revenue Service (IRS) forms W-2. There was no documentation in the loan file showing how the underwriter calculated the borrower’s monthly income of $4,500; thus, this amount was not supported. Further, on IRS forms 1120 (Corporate Tax Return), the borrower reported a loss of $23,724 in 2007 and no taxable income in 2008. Also, after the borrower drew down the funds from retained earnings, the borrower’s equity in the business was $0.

HUD Handbook 4155.1, paragraph 4.D.4.g, requires that for self-employed borrowers, the underwriter is to analyze the business’s financial strength to determine whether the business is likely to generate income for the borrower’s needs. The underwriter must analyze the business’s strength including the source of the business’s income. Further paragraph 4.D.6.c of the handbook indicates that cash withdrawals such as retained earnings may have a severely negative impact on the business’s ability to continue operating. Using this guidance, the underwriter should have not used dividends from the borrower’s business since the withdrawal depleted his business’s retained earnings, thus hindering its ability to operate.

Further, when we attempted to support the information on the borrower’s tax return using the 2007 and 2008 IRS forms 1040, the income did not agree with the $4,500 entered into Desktop Underwriter. For 2008, the borrower’s adjusted gross income was $67,917, but this amount was comprised of the $60,000 in retained earnings (dividends) drawdowns from the business, which was not effective income. Both of the tax returns contained notations in these areas. Additionally, the 2007 tax return showed adjusted gross income of $61,140; again this was comprised of a $60,000 retained earnings drawdown from the business, which was not effective income. HUD Handbook 4155.1, paragraph 4.D.5.b, states that when calculating IRS form

1040, taxable and nontaxable dividends may be added back to income only if paid for the last 2 years and expected to continue. If the liquid-bearing asset will be liquidated as a source of the cash investment, the lender must adjust the amount. Because the retained earnings from the business were reduced to $0 after the last withdrawal, this income could not be used. When we recalculated the borrower's net income using IRS forms 1040 for 2007 and 2008, we determined his monthly income to be approximately $3,442 per month. As a result, the borrower's total fixed payment-to-income ratio increased from 47 to 61 percent.