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Audit Report Number 2007-FW-1009
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TO: Brian D. Montgomery  
Assistant Secretary for Housing – Federal Housing Commissioner, H

*Frank E. Baca*  
FROM: Frank E. Baca  
Regional Inspector General for Audit, Fort Worth Region, 6AGA

SUBJECT: Countrywide Home Loans, Inc., Houston, Texas, Generally Complied with HUD  
Requirements in Originating FHA-Insured Single-Family Mortgages

## **HIGHLIGHTS**

### **What We Audited and Why**

We reviewed branch number 358 of Countrywide Home Loans, Inc. (branch), a direct endorsement lender. The objective of the review was to determine whether the branch complied with U. S. Department of Housing and Urban Development (HUD) regulations, procedures, and instructions in the origination of Federal Housing Administration (FHA)-insured single-family mortgages. We selected this branch for review because it had the fourth highest number of defaults (423 loans and an 11.58 percent default rate) within the first two years in the Houston HUD office jurisdiction as of December 13, 2006.

## What We Found

The branch generally complied with HUD regulations, procedures, and instructions in the origination of FHA-insured single-family mortgages. Nine of the ten loan files reviewed contained minor deficiencies; however, one of the files contained significant deficiencies, which placed the FHA insurance fund at unnecessary risk.

## What We Recommend

We recommend the assistant secretary for single family housing require the branch to indemnify HUD for one loan with an original mortgage amount of \$112,237 that contained significant deficiencies. We also recommend the assistant secretary require the branch to improve its policies, procedures, and controls to ensure that FHA-insured loans are originated, processed, and underwritten according to HUD requirements.

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 a draft to the auditee on April 10, 2007, and requested a response by May 1, 2007. The branch provided a written response on April 25, 2007. The branch acknowledged its need for procedures and reported it had implemented new procedures and increased training. In addition, they offered additional information to offset our recommendation of indemnification for the one loan. We maintain that HUD should seek indemnification for this loan. We also discussed our initial findings with the Denver Homeownership Center's Quality Assurance Division (QAD). QAD did not submit a written response to the draft; however, they agreed with our initial finding. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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## **BACKGROUND AND OBJECTIVES**

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Countrywide Home Loans, Inc. (Countrywide), is a direct endorsement lender for Federal Housing Administration (FHA)-insured loans. Countrywide's branch number 358 (branch) is located at 2424 South Highway 6 in Houston, Texas. We selected this branch for review because it had the fourth highest number of defaults (423 loans and an 11.58 percent default rate) within the first two years in the Houston U.S. Department of Housing and Urban Development (HUD) office jurisdiction as of December 13, 2006. The branch is comprised of two separate divisions. The sales division, which is managed by a branch manager, is comprised of loan officers who take the initial loan applications from the applicant and collect preliminary documentary evidence. The operations division, which is managed by a branch operations manager, completes the loan processing and underwriting functions.

The objective of our survey was to determine whether the branch complied with HUD regulations, procedures, and instructions in the origination of FHA-insured single-family mortgages.

## RESULTS OF AUDIT

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### Finding: One of Ten Loan Files Reviewed Contained Significant Deficiencies

All 10 loan files reviewed had underwriting deficiencies; however, only one contained significant issues that present a material risk of loss to FHA and warrant indemnification by the branch. The deficiencies occurred because the branch's quality control procedures did not always ensure its staff processed and underwrote loans according to HUD policies and procedures. As a result, HUD should seek indemnification of one loan with an original mortgage amount of \$112,237 and require the branch to strengthen its procedures and controls to prevent further errors from occurring.

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#### One File Had Significant Deficiencies

The 10 loan files reviewed contained numerous procedural, compliance, and documentation deficiencies. Most of the files reviewed had minor underwriting deficiencies; however, one file had errors that should result in indemnification by the branch.

Minor deficiencies are those errors which HUD has determined do not present a material risk to the FHA insurance fund. These include documentation errors, such as missing borrower explanations for collection accounts, and procedural and compliance errors, such as the lender's failing to complete a block on the mortgage credit analysis worksheet indicating the verification of certain eligibility requirements. Of 10 loan files reviewed, nine had minor underwriting deficiencies like those described above.

Significant deficiencies are errors that HUD has determined are unacceptable and present a material risk of loss to FHA. An example given by HUD of an unacceptable deficiency is the lender's improperly calculating the borrower's income, resulting in an excessive back-end debt ratio. One of the 10 files reviewed contained the significant errors of improperly excluding liabilities and exceeding the HUD-approved back-end debt ratio. This loan had a \$112,237 original mortgage. See appendix C for detailed information on this loan.

## **The Branch's Quality Control Procedures Need Strengthening**

The branch's policies and procedures for originating and underwriting FHA loans were not always effective. It lacked effective written policies and procedures because both the branch manager and the operations manager relied upon their knowledge of the mortgage origination and underwriting process to originate loans correctly. Additionally, they used their knowledge, not policies and procedures, to train their staff. However, their knowledge was not always in agreement with HUD's requirements. For example, the operations manager told us that she did not include medical debts in her determination of the creditworthiness of the borrower. However, HUD's policies require all collections to be explained by the borrower. There is no exclusion for medical collection debts.

## **Conclusion**

The branch generally complied with HUD's written regulations and instructions in originating and underwriting FHA-insured mortgages. All 10 loan files reviewed contained errors, although most were minor. However, one of the files contained significant deficiencies, which warrant indemnification by Countrywide. HUD should seek indemnification of one loan with an original mortgage amount of \$112,237.

## **Recommendations**

We recommend HUD's assistant secretary for single family housing require Countrywide to

- 1A. Indemnify HUD for one loan with an original mortgage amount of \$112,237, which contained significant deficiencies that present a material risk to the FHA insurance fund as shown in appendix C. The projected loss to HUD is \$32,549, based on HUD's insurance fund average loss rate of 29 percent.
- 1B. Strengthen and improve its quality control environment to ensure that FHA-insured loans are originated, processed, and underwritten according to HUD requirements.

## SCOPE AND METHODOLOGY

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To accomplish our objectives, we

- Reviewed background information and the criteria that control single-family housing loan origination.
- Reviewed various reports, databases, and documents to determine existing conditions at the branch. The data included Countrywide's quality control plan and HUD's Quality Assurance Division's recent comprehensive review of Countrywide.
- Obtained a listing of loans from HUD's Neighborhood Watch system, which included loans originated at Countrywide's branch number 358 that defaulted within the first two years of origination. The total universe was 46 loans (all the loans related to a single underwriter).
- Compared the survey universe of 46 loans to data in HUD's Public and Indian Housing Information Center database to determine whether any of the loan applicants were also participants in the Section 8 voucher program.
- Selected a nonrepresentative sample of 10 loans: five that defaulted in three or fewer payments and five on which HUD paid a claim.
- Reviewed HUD's and the branch's files for the 10 sample loans to determine whether the branch complied with HUD's loan origination requirements.
- Conducted interviews with branch managers and HUD's quality assurance staff.

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

We conducted our fieldwork during December 2006 and January 2007. We conducted the review at the offices of Countrywide, branch number 358, and the local HUD office in Houston, Texas. Our review covered the period October 1, 2004, through September 30, 2006. We performed our review in accordance with generally accepted government auditing standards.

# INTERNAL CONTROLS

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

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

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

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## Relevant Internal Controls

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

- Origination and underwriting policies and procedures – Policies and procedures established by management to ensure that FHA-insured loans are originated and underwritten in accordance with HUD requirements.
- Quality control process – Policies and procedures established by management to ensure that the quality control plan has been implemented and related reviews are performed in accordance with HUD requirements.

We assessed the relevant controls identified above.

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

## Significant Weaknesses

Based on our review, we did not identify any significant weaknesses.



## APPENDIXES

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### Appendix A

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

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Recommendation number	Funds be put to better use <u>1/</u>
1A	\$32,549

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. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy 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 FHA requirements will reduce FHA's risk of loss to its insurance fund. The amount above reflects that, upon sale of the mortgaged property, FHA'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

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### Ref to OIG Evaluation

### Auditee Comments



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HOUSTON, TEXAS 77077  
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April 24, 2007

Theresa A Carroll, Assistant Regional Inspector General  
Frank E Baca, Regional Inspector General for Audit

U.S. Department of Housing and Urban Development  
Region VI, Office of Inspector General  
819 Taylor Street, Room 13A09  
Fort Worth, TX 76102

Dear Ms. Carroll, and Mr. Baca:

In response to the recent review of Branch 358, I would like to offer a response to the recommendation that Countrywide Home Loans indemnify loan 493-7969962-703.

The debt in question was an auto loan that was a joint debt with the borrower and a non-purchasing spouse. The debt as shown on the credit report had nine payments left, not normally considered in the debt ratios, however, because of the amount of the monthly payment, it was considered to affect the borrower's ability to make the first mortgage payments.

The borrower's made a double payment on the debt in question, thus brining down the remaining term to six payments. While there was documentation in the file directly from the creditor verifying the payments, processing failed to follow thru with the underwriting condition to have the credit report update to reflect the correct loan balance.

Had this been done, the balance would have reflected only the six payments remaining, and only four would have been left at the time the first mortgage payment would have been due, thus eliminating the need for the debt to be included in the overall debt ratio.

We have implemented many new procedures at the branch since this survey was started by your office. All underwriting conditions must be returned to the authorized underwriter to be cleared, rather than allowing the processing staff the authority to clear their own. This should eliminate many problems such as the one listed above.

**Comment 1**

**Comment 1**

**Comment 2**

**Comment 2**

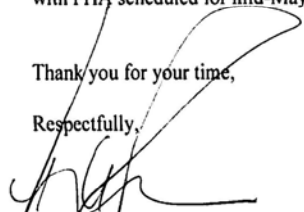
Furthermore, all Government files are to be submitted for "up-front" underwriting, once all credit documents are in an approved FHA underwriter will review the file in its entirety for compliance and qualifications per guidelines.

Many of the errors sighted were caused by sloppy processing and failure to accurately clear conditions required for loan approval.

We are continuing an on-going training for all staff, and have a training set up directly with FHA scheduled for mid-May.

Thank you for your time,

Respectfully,



Kimberly A Rehor  
Branch Operations Manager  
Countrywide Home Loans, Branch 358

## **OIG Evaluation of Auditee Comments**

### **Comment 1**

Countrywide acknowledged that its loan processor failed to update the borrower's credit report to reflect a corrected loan balance as required. Countrywide also stated that this corrected balance would have eliminated the need to include the debt in the borrower's overall debt ratio. We maintain that HUD should seek indemnification. Since the file lacked the amended credit report, Countrywide's Quality Assurance staff also showed a recalculation of the back-end debt ratio to 52.75 percent, and they rated the file as unsatisfactory. In addition, the file contained indications of other **unexamined** liabilities such as payday loans. **Further, the discrepancies in the total liabilities are significant.** Countrywide should have followed up on these liabilities as HUD's Neighborhood Watch system shows the cause of the loan default to be excessive obligations.

### **Comment 2**

Countrywide stated that they have implemented new procedures at the branch to address the errors caused by "sloppy processing and failure to accurately clear conditions required for loan approval." Countrywide further stated that they have scheduled increased training. We commend Countrywide for the proactive efforts taken to improve loan processing and approval.

## Appendix C

### CASE NARRATIVE

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Mortgage amount: \$112,237

Gift amount: None

Date of loan closing: February 23, 2005

Status as of December 30, 2006: Delinquent (three months); special forbearance on October 1, 2006

Payments before first default reported: 10

Summary: This loan should be indemnified based on unresolved credit issues and violation of the back ratio limit.

#### Loan Exceeded Back Ratio Due to Undisclosed Liabilities

The borrower's bank statements and credit report showed liabilities that the lender did not consider when qualifying the borrower. The borrower's credit report showed a car loan that the lender improperly excluded from consideration. The borrower's bank statements also showed a history of payday loans. Despite having a copy of the bank statements, the lender did not consider the payday loans. The borrower's credit report also showed several collections accounts for the borrower; however, the branch incorrectly attributed them to the nonpurchasing spouse. The discrepancies in the liabilities are significant, and branch staff should have further questioned them. At the time the branch originated this mortgage loan, HUD allowed back ratios of 41 percent, but due to the additional auto liability, the borrower's back ratio was 52.75 percent.