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

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FROM: Ronald J. Hosking, Regional Inspector General for Audit, 8AGA

SUBJECT: First National Bank, Gillette, Wyoming, Did Not Follow HUD Requirements in Originating and Underwriting Insured Loans and Did Not Have a Quality Control Plan

HIGHLIGHTS

What We Audited and Why

We audited First National Bank of Gillette (First National Bank), a Federal Housing Administration (FHA)-approved direct endorsement lender, to determine whether it properly processed insured loans and to determine whether its quality control plan met the U.S. Department of Housing and Urban Development's (HUD) requirements. We audited First National Bank because of its high default rate and the Office of Inspector General's strategic goal to reduce fraud in single-family insurance programs.

What We Found

First National Bank did not follow HUD regulations when originating and underwriting 18 FHA loans. The originating and underwriting deficiencies occurred because First National Bank management did not properly train its originators and underwriters and it did not develop effective procedures for monitoring their actions to ensure compliance with HUD directives.

In addition, First National Bank did not have a written quality control plan, and its third-party contractor, who performed the quality control reviews, did not perform all reviews in accordance with HUD requirements. These deficiencies were due

to management's not placing a high priority on the quality control process and not adequately training new staff.

What We Recommend

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner take appropriate action against First National Bank for not following HUD requirements. At a minimum, HUD should require First National Bank to bring its procedures for the origination and underwriting of insured loans into full compliance with HUD regulations and to develop and implement a written quality control plan.

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 National Bank on September 9, 2008 and requested written comments to the report by September 24, 2008. First National Bank concurred with the report and declined to provide formal written comments.

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BACKGROUND AND OBJECTIVES

First National Bank of Gillette (First National Bank) is located in Gillette, Wyoming. The U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) approved First National Bank as a supervised mortgage company on June 3, 1965.

First National Bank originated 298 FHA-insured loans, with beginning amortization dates from May 1, 2006, through April 30, 2008, with a total original mortgage amount of more than \$50.1 million. Twenty of these loans (6.71 percent) defaulted within the first two years of closing. The original mortgage amount of the defaulted loans totaled more than \$3.2 million.

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

RESULTS OF AUDIT

Finding 1: First National Bank Did Not Follow HUD Regulations When Originating and Underwriting 18 FHA Loans

First National Bank violated HUD requirements in originating and underwriting 18 FHA-insured loans. One of the loans contained deficiencies that affected the credit quality (insurability) of the loan. The originating and underwriting deficiencies occurred because First National Bank management did not properly train its originators and underwriters and it did not develop effective procedures for monitoring their actions to ensure compliance with HUD directives. As a result, HUD insured improperly underwritten loans, and there was an increased risk to the FHA insurance fund.

First National Bank Violated HUD Underwriting Requirements

First National Bank violated HUD requirements in originating and underwriting 18 FHA-insured loans. One loan contained significant underwriting deficiencies because First National Bank used unacceptable income sources. Specifically, an underwriter used income from part-time employment received for less than two years, and the justification provided by the lender did not substantiate that the income was likely to continue.

First National Bank also underwrote 17 loans that contained minor underwriting deficiencies. While these deficiencies did not affect the overall insurability of the loans, they indicated a lack of commitment to quality underwriting. The lender needs to ensure that it follows all facets of HUD requirements when originating FHA loans. We provided details of these deficiencies to First National Bank during our review. Appendix C summarizes the deficiencies in each of the 17 loans.

Originators and Underwriters Lacked Training and Supervision

The underwriting deficiencies occurred because First National Bank management did not properly train its originators and underwriters and it did not develop effective procedures for monitoring their actions to ensure compliance with HUD directives. Additionally, there was a high turnover in staff, which meant that inexperienced staff originated the FHA-insured loans.

There Was an Undue Risk to HUD's Insurance Fund

First National Bank placed HUD's insurance fund at risk by not following HUD originating and underwriting requirements. The one loan with significant deficiencies was sold by the loan servicer after our audit work was completed, and there was no resulting loss to HUD. We verified with HUD that the loan's status was terminated and no claims or fees would be requested from HUD.

Conclusion

One of the loans we reviewed contained deficiencies that affected the credit quality (insurability) of the loan. However, the loan servicer sold this loan after our audit work was completed. There was no loss to HUD. Seventeen of the loans contained deficiencies that did not affect the credit quality (insurability) of the loans. First National Bank needs to better train and supervise its staff so that these types of deficiencies do not continue.

Recommendations

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner

- 1A. Require First National Bank to develop and implement procedures for monitoring its origination and underwriting processes.
- 1B. Require First National Bank to train its staff who originate and underwrite FHA-insured loans.

Finding 2: First National Bank Did Not Have an Adequate Quality Control Program

First National Bank did not have a written quality control plan, nor did it comply with other HUD requirements concerning its quality control program. These deficiencies are due to management not placing a high priority on the quality control process and not adequately training new staff. Without a quality control plan, management cannot effectively monitor the origination and underwriting of FHA loans to ensure compliance with HUD requirements.

First National Bank Did Not Have an Adequate Quality Control Program

First National Bank did not have a written quality control plan. Management officials stated that they believed they had a quality control plan at one time but were unable to locate it. They explained that First National Bank is in the process of developing and implementing a new quality control plan.

First National Bank used a third-party contractor to perform its quality control reviews, but it did not always get loans for review to the contractor in a timely manner. Consequently, the contractor could not complete the quality control reviews within 90 days of closing as required by HUD.

In addition, First National Bank did not always take action regarding the quality control review report findings. Management stated that it reviewed the quality control review report findings during the biweekly staff meetings. However, it only reviewed 5 of the 23 quality control review reports covering our audit period. Further, when management conducted staff meetings to discuss the quality control review reports, it did not document planned or actual corrective action.

First National Bank did not ensure that the contractor followed HUD requirements. The contractor did not review the FHA-insured loans with early defaults and did not perform field reviews of appraisals on 10 percent of the loans reviewed during the quality control process.

To help resolve these deficiencies, First National Bank contacted its third-party contractor. Additionally, it contacted its investors to ask that they inform it of early defaults so that it can perform quality control reviews on the early defaulted loans.

First National Bank Did Not Place a High Priority on the Quality Control Process

First National Bank's management considered its main priority to be the day-to-day operations of the bank and did not place a high enough priority on the quality control process. Additionally, when staff responsible for the quality control process left, management did not ensure that the new staff were adequately trained in the quality control process.

Monitoring of Origination and Underwriting Was Ineffective

Without an adequate quality control program, First National Bank's management could not effectively monitor the origination and underwriting of FHA loans to ensure compliance with HUD requirements.

Conclusion

First National Bank had not developed and implemented a written quality control plan in accordance with HUD requirements. Without proper establishment of a quality control process, First National Bank was unable to ensure the accuracy, validity, and completeness of its loan origination operations. Therefore, potential deficiencies might not be identified and corrected in a timely manner, resulting in an increased risk to the insurance fund.

Recommendations

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner

- 2A. Require First National Bank to develop and implement a written quality control plan in accordance with HUD requirements.
- 2B. Require First National Bank to train its staff regarding the quality control program requirements.
- 2C. Review First National Bank's written quality control plan and its implementation to ensure that it meets HUD requirements.

SCOPE AND METHODOLOGY

First National Bank originated 298 FHA-insured loans with beginning amortization dates from May 1, 2006, through April 30, 2008. Twenty of these loans defaulted within the first two years of closing. We excluded a terminated loan because it was no longer active. We reviewed the remaining 19 defaulted loans that had active status.

To accomplish the audit objectives, we

- Reviewed regulations and reference materials related to single-family requirements.
- Reviewed the FHA case binders for compliance with regulations.
- Reviewed First National Bank's loan case files.
- Interviewed First National Bank's real estate loan staff to obtain information regarding its policies and procedures.

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

We performed the review work from June to July 2008.

We conducted our review 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 objectives.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Management's controls to ensure that it originates and underwrites FHA-insured loans in accordance with HUD requirements.
- Management's policies and procedures to ensure that it implements a quality control plan and performs related reviews 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 believe the following items are significant weaknesses:

- First National Bank did not have adequate procedures to ensure that it followed HUD requirements in the origination and underwriting of FHA-insured loans (finding 1).
- First National Bank did not have a quality control plan for effectively monitoring the origination and underwriting of FHA-insured loans (finding 2).

APPENDIXES

Appendix A

NARRATIVE CASE SUMMARY

HUD case number:	5911010949
Loan amount:	\$123,892
Closing date:	August 28, 2007
Status at time of review:	First 90-day default reported after one payment
Current status:	Terminated

Unallowable Use of Part-Time Income in Borrower Qualification

First National Bank underwrote and approved the mortgage using part-time income for a job the borrower had held for less than one month. The borrower had not worked in the same line of work for the previous eight months. The justification and documentation provided by First National Bank were not adequate to establish the stability and effectiveness of the part-time income. Therefore, HUD insured the loan based on First National Bank's inaccurate representation that the borrower met HUD qualifying guidelines.

As of August 5, 2008, this loan was nine months delinquent. The servicer sold this loan on August 15, 2008, after our audit work was completed. There was no loss to HUD associated with the sale of this property, and the servicer did not submit fees to HUD for reimbursement.

HUD Requirements

HUD Handbook 4155.1, REV-5, CHG-1, chapter 2, section 2, paragraph 2-7.B

The lender must establish that it reasonably expects the income of the borrower to continue. The lender may use part-time income in qualifying if it documents that the borrower has held the part-time job, uninterrupted, for the past two years and will continue to do so. Income received for less than two years from a part-time position may be included as effective income, provided the lender justifies and documents that the income's continuance is likely.

Appendix B

SCHEDULE OF MINOR DEFICIENCIES

FHA case number	Unsupported income	Unsupported employment history	Unsupported assets	Unsupported credit history	Incorrect liability amounts used	Unsigned documents
591-0975702						X
591-0976402				X		
591-0981924	X					
591-0982472				X		
591-0987428					X	
059-0991229	X	X				
591-0992037		X	X			
591-0992899			X			
591-0993645				X		
591-0993968	X			X		X
591-0998256		X		X		
591-0998335	X			X		
591-1001460					X	
591-1004388	X			X		
591-1005183				X		
591-1012043	X			X		
591-1016097	X					
Totals	7	3	2	9	2	2