



Issue Date November 10, 2010

Audit Report Number 2011-PH-1004

TO: Vicki Bott, Deputy Assistant Secretary for Single Family Housing, HU

//signed//

FROM: John P. Buck, Regional Inspector General for Audit, Philadelphia Region,
3AGA

SUBJECT: NFM, Inc., Linthicum, MD, Did Not Fully Implement Its Quality Control Plan
in Accordance With HUD Requirements

HIGHLIGHTS

What We Audited and Why

We audited NFM, Inc. (NFM), a nonsupervised¹ lender approved to originate Federal Housing Administration (FHA) single-family mortgage loans. We selected NFM based on significant risk indicators, which included a high percentage of loans with front- and/or and back-end ratios in excess of U.S. Department of Housing and Urban Development (HUD) requirements and loans defaulting within six or fewer payments. Our objective was to determine whether NFM complied with HUD requirements in the origination and quality control review of FHA loans.

What We Found

NFM generally complied with HUD requirements in the origination of FHA loans. We reviewed cash assets used to meet the minimum required investment, employment and income records, liabilities, and credit characteristics for a sample of six loans and found no significant discrepancies. However, we found that

¹ A nonsupervised lender is an FHA-approved lending institution that has as its principal activity the lending or investing of funds in real estate mortgages.

NFM did not implement certain aspects of its quality control plan in accordance with HUD requirements. It did not perform routine quality control reviews within the timeframe required by HUD. It also did not review all loans that defaulted within the first six payments in a reasonably timely manner. These conditions occurred because NFM did not emphasize HUD requirements and did not fully implement its quality control plan. Consequently, the effectiveness of the plan, which was designed to ensure accuracy, validity, and completeness in its loan underwriting process, was lessened.

What We Recommend

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing direct NFM to fully implement its quality control functions as required and follow up in 9 months to ensure the lender's compliance.

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 report to NFM on October 19, 2010. We discussed the audit results with NFM during the audit and during an exit conference on October 26, 2010. NFM provided written comments to our draft report on November 2, 2010. It agreed with our report. The complete text of the auditee's response can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVE

The U.S. Department of Housing and Urban Development's (HUD) strategic plan states that part of its mission is to increase home ownership, support community development, and increase access to affordable housing free from discrimination.

The National Housing Act, as amended, established the Federal Housing Administration (FHA), an organizational unit within HUD. FHA provides insurance for lenders against loss on single-family home mortgages.

In 1983, HUD implemented the direct endorsement program, which authorized approved lenders to underwrite loans without HUD's prior review and approval. There are three types of approved direct endorsement lenders—supervised, nonsupervised, and governmental institutions. A supervised lender is an FHA-approved financial institution that is a member of the Federal Reserve System or an institution with accounts insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration. A nonsupervised lender is an FHA-approved lending institution that has as its principal activity the lending or investing of funds in real estate mortgages. A governmental institution includes a Federal, State, or municipal government agency; a Federal Reserve Bank; a Federal Home Loan Bank; the Federal Home Loan Mortgage Corporation; and the Federal National Mortgage Association. HUD requires lenders to use its Neighborhood Watch system to monitor and evaluate their performance and has many sanctions available for taking actions against lenders or others that abuse the direct endorsement program.

NFM, Inc. (NFM), is a nonsupervised direct endorsement lender for FHA loans. Its main office is located in Linthicum, MD. NFM originated 332 loans between April 2008 and March 2010 that defaulted within the first 2 years. Of the 332 loans valued at about \$71 million, we identified 22 valued at approximately \$5 million that were underwritten by NFM. Prior to August 2008, NFM was a loan correspondent. Therefore, it did not underwrite all the defaulted loans identified. We reviewed 6 of the 22 loans valued at more than \$1.2 million.

On August 20, 2008, HUD approved NFM's request for unconditional direct endorsement. Accordingly, NFM was permitted to underwrite and close mortgage loans without prior HUD review. Participation in the direct endorsement program is a privilege accorded only to lenders who continue to demonstrate the ability to originate mortgage loans in accordance with HUD's underwriting policy.

Our objective was to determine whether NFM complied with HUD requirements in the origination and quality control review of FHA loans.

RESULTS OF AUDIT

Finding: NFM Did Not Fully Implement Its Quality Control Plan in Accordance With HUD Requirements

NFM did not follow HUD requirements related to the timeliness of routine quality control reviews. It also did not review all loans that defaulted within the first six payments (early payment defaults) in a reasonably timely manner. These conditions occurred because NFM did not emphasize HUD requirements and did not fully implement its quality control plan. Consequently, the effectiveness of the plan, which was designed to ensure accuracy, validity, and completeness in its loan underwriting process, was lessened.

Reviews Not Within the Required Timeframe

HUD Handbook 4060.1, paragraph 7-6A, states that lenders must review loans routinely selected for quality control reviews 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. In accordance with HUD's requirement, NFM's quality control plan states that quality control reviews must be performed within 90 days from the end of the month in which the loan closed. NFM did not always perform quality control reviews within the timeframe required by HUD. We randomly selected 10 of 319 FHA loans, which NFM indicated that it had reviewed, to determine whether the quality control reviews were conducted in a timely manner. We determined that all 10 of the FHA loans were not reviewed in a timely manner. The loans were reviewed between 96 and 208 days from the end of the month in which they closed. NFM acknowledged that it did not perform quality control reviews in a timely manner. It stated that quality control reviews were late during part of the audit period because the contractor responsible for performing the reviews was going through bankruptcy proceedings. It also stated that the timeliness requirement would be enforced going forward.

Early Payment Default Loans Not Reviewed in a Reasonably Timely Manner

HUD Handbook 4060.1, paragraph 7-6D, requires lenders to review all loans going into default within the first six payments. HUD defines early payment defaults as loans that become 60 days past due within the first 6 payments. NFM's quality

control plan states that all loans going into default within the first 6 months must be reviewed. HUD does not indicate a timeframe within which these loans must be reviewed; however, it states that one of the basic overriding goals of quality control is to ensure swift and appropriate corrective action. Therefore, prudence would dictate that these loans be reviewed shortly after being identified as early payment defaults.

NFM did not review all early payment defaults as required by HUD and its own quality control plan. It did not conduct quality control reviews of 54 of 56 early payment defaults that occurred during the audit period. NFM acknowledged that it did not review early payment defaults as required and stated that the requirement would be enforced going forward.

During the audit, NFM took action and reviewed the 54 loans. Although NFM reviewed the loans, the reviews were not performed in a reasonably timely manner. The 54 loans were reviewed a minimum of 7 months after default. Therefore, while NFM reviewed the loans it had not previously reviewed, its review process did not fully meet the intent of the quality control process as defined by HUD.

Conclusion

NFM did not perform routine quality control reviews within the required timeframe and did not review its early payment defaults in a reasonably timely manner. These conditions occurred because NFM did not emphasize HUD requirements and did not fully implement its quality control plan. As a result, the effectiveness of the plan, which was designed to ensure accuracy, validity, and completeness in its loan underwriting process, was lessened.

Recommendations

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

- 1A. Implement its quality control functions as required and follow up with the lender in 9 months to ensure its compliance.

SCOPE AND METHODOLOGY

We performed our audit work between July and August 2010 at NFM's main office located at 505 Progress Drive, Linthicum, MD. Our review period was from April 2008 through March 2010.

We queried HUD's Neighborhood Watch system for information on lenders' default rates. HUD's Neighborhood Watch system is a Web-based software application that displays loan performance data for lenders and appraisers by loan types and geographic areas, using FHA-insured single-family loan information. The loan information is displayed for a 2-year origination period and is updated on a monthly basis. HUD requires lenders to use the Neighborhood Watch system to monitor and evaluate their performance.

Based on the Neighborhood Watch query results, we identified and selected NFM for review based on significant risk indicators, which included a high percentage of loans with front- and/or back-end ratios in excess of HUD requirements and loans defaulting within six or fewer payments. NFM had 190 loans with front- and/or back-end ratios in excess of HUD requirements. It also had 132 loans which defaulted within 6 or fewer payments.

NFM originated 332 loans between April 2008 and March 2010 that defaulted within the first 2 years. After eliminating terminated and streamline refinanced loans, 259 defaulted loans remained. The 259 loans, valued at more than \$54.2 million, defaulted after 12 payments or fewer. We selected the top six loans with the highest back-end ratios and underwritten by NFM, valued at approximately \$1.3 million, for review.

To determine whether NFM complied with HUD requirements in its origination and quality control of FHA loans, we performed the following:

- Reviewed applicable HUD handbooks and mortgagee letters,
- Reviewed case files for the six sample loans,
- Examined records and related documents of NFM, and
- Conducted interviews with officials of NFM and discussed issues with HUD employees.

In addition, we relied in part on data maintained by HUD in its Neighborhood Watch system. 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.

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:

- Loan origination process – Policies and procedures that management has in place to reasonably ensure that the loan origination process complies with HUD program requirements.
- Quality control plan – Policies and procedures that management has in place to reasonably ensure implementation of HUD quality control requirements.

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 Deficiency

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

- NFM did not implement its quality control plan to ensure full compliance with HUD's quality control requirements.

Appendix A

AUDITEE COMMENTS



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VIA FEDERAL EXPRESS AND EMAIL

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November 2, 2010

**RE: RE: Response to Audit Report Dated [TBD]
NFM, Inc. FHA Lender ID: 19951-0000-7
Audit Report Number [TBD]**

Dear Regional Inspector General Buck :

Please find enclosed NFM's response to the draft Audit Report issued on October 28, 2010. NFM appreciates the opportunity to respond to the Report. Please contact me if you should require any additional information.

Sincerely,

Stephanie A. Bogan, Esq.
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Enclosures

Confidential

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November 2, 2010

**RE: Response to Audit Report Dated [TBD]
 NFM, Inc. FHA Lender ID: 19951-0000-7
 Audit Report Number [TBD]**

Dear Regional Inspector General Buck:

NFM, Inc. (NFM) is in receipt of the draft Audit Report issued on October 28, 2010 ("Report"). NFM values its relationship with the U.S. Department of Housing and Urban Development ("HUD"), and NFM takes the findings and its responsibilities as an approved mortgagee very seriously.

NFM has always been committed to compliance with HUD requirements and originating quality mortgages. NFM respectfully submits that the findings cited in the Report are not representative of our commitment to compliance or NFM's overall performance as an approved mortgagee. NFM embraces its responsibility to comply with the regulatory requirements discussed in the Report, and NFM submits that its current practices and procedures are in compliance with HUD requirements.

NFM appreciates the opportunity to respond to the Report, and NFM provides a response to each issue as follows.

* * * * *

FINDING 1

During the audit period, NFM did not perform quality control reviews on ten files within ninety days from the end of the month in which the loan closed.

RESPONSE 1

NFM acknowledges that quality control reviews on the ten referenced files were not completed within ninety days from the end of the month in which the loans closed. Although NFM's external, independent quality control vendor ("QC Company") performed the quality reviews, the reviews were performed after the requisite period. In reference to the ten files noted, the QC

Company exceeded the established sixty day turn-time to complete the required report on those ten files.¹

Prior to the audit, NFM took significant measures to ensure a robust quality control program, and NFM's Compliance Department added a new staff member whose responsibility was to improve the quality control review process with its QC Company. Under the management of that person, the QC Company sufficiently responded to NFM's requests to improve turn times.

During the audit, NFM provided documentation that the QC Company reports were high quality and that by January 2010 the QC Company completely corrected its process. NFM also was able to demonstrate strict compliance with the requirement that quality control reviews were performed on the closed loan sample within ninety days from the end of the month in which the loan closed. NFM currently maintains the same procedure thereby ensuring compliance with the above reference requirement.

FINDING 2

During the audit period, NFM did not review all loans that went into default within the first six payments in a reasonably timely manner.

RESPONSE 2

NFM acknowledges that a formal quality control review of all loans that went into early payment default within the first six payments identified during the audit period April 2008 through March 2010² were not completed within a reasonably timely manner. NFM relied on its QC Company to select the files that needed to be reviewed to comply with the HUD-FHA requirements and to ensure compliance with its quality control plan, and the QC Company did not timely select the early payment default files for review.

Prior to the audit, NFM's Compliance Department immediately implemented a monthly quality control process whereby early payment default loans would be selected and reviewed. NFM also submitted all early payment default files for a formal quality control review.

During the audit, NFM provided documentation that since June 2010 it had implemented a formal quality control review on all loans that went into default within the first six payments on a recurring monthly basis.

NFM also was able to demonstrate to the auditor that although a formal quality control review was not performed on all files defaulting within first 6 months during the period April 2008 through March 2010 in a timely manner, NFM executed and performed quality control measures at various stages of the loan origination process, including but not limited to, the

¹ The QC Company's delayed turn times were attributable to a pending bankruptcy.

² During the audit, NFM was able to demonstrate for the loans referenced in the audit period that: (1) NFM had no defaults in 2010; (2) eighty percent of the defaults were 2008; and (3) sixty-three percent of the defaults were underwritten by a different approved mortgagee.



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application stage, the prefunding stage, and at post closing. NFM provided documentation that as a part of the post closing stage the Compliance Department performed a thorough analysis of all FHA defaulted loans regardless of the number of payments to ensure a robust risk assessment. NFM demonstrated that on a monthly basis NFM's Compliance Department performs a monthly analysis of the Early Warning 2-Year Performance Period of Seriously Delinquent report, Mortgagee Performance Report, 30-60-90 Delinquency Reports, Late Endorsement Report, Late UPMIP report, and Uninsured Loans Report. NFM also demonstrated that it performed an extensive analysis on its defaults, along with other risk items. NFM also was able to demonstrate that the Compliance Department provided the detailed analysis to management. During the audit, samples of the monthly default analysis provided to management were provided to the auditor. In addition, NFM was able to discuss in detail with the auditor the metrics of the defaults, further evidencing that NFM performs a thorough review of the defaults to identify risk factors and trends and patterns.

During the audit, NFM provided documentation that by June 2010, NFM had established an operating procedure to ensure that all files defaulting within the first 6 months were reviewed on a monthly basis, and that NFM had successfully implemented that procedure. NFM currently maintains the same procedure thereby ensuring compliance with the above reference requirement.

* * * * *

NFM, Inc. appreciates the opportunity to respond to the Report. NFM, Inc. is committed to the highest standards of compliance, integrity and ethics, and it values its relationship with consumers and regulators. NFM respectfully submits that it currently is in compliance with HUD requirements, and NFM will continue to embrace its responsibility to comply with all HUD requirements. I hope that I have adequately addressed concerns, as well as demonstrated our commitment to abide by the regulations and guidelines of HUD. Thank you for your consideration of this response.

Sincerely,

M. David Silverman, President