



Issue Date November 20, 2007

Audit Report Number 2008-PH-1002

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

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

SUBJECT: National City Mortgage, Plymouth Meeting, Pennsylvania, Generally
Complied with HUD Requirements in Originating FHA-Insured Single-
Family Loans

HIGHLIGHTS

What We Audited and Why

We audited the Plymouth Meeting, Pennsylvania, branch of National City Mortgage (branch office), a supervised direct endorsement lender approved to originate Federal Housing Administration (FHA) single-family mortgage loans. We selected the branch office because its default rate was above the state's default rate. Our objective was to determine whether the branch office complied with U.S. Department of Housing and Urban Development (HUD) regulations, procedures, and instructions in the origination and quality control review of FHA loans.

What We Found

The branch office generally complied with HUD regulations, procedures, and instructions in the origination and quality control review of FHA-insured single-

family loans. However, two of eight loans selected for review¹ were not originated in accordance with HUD requirements. The branch office did not properly document borrowers' qualifying ratios and did not properly verify assets for the two loans, originally valued at more than \$181,000. The deficiencies occurred because the branch office did not exercise due diligence in the underwriting of the loans, causing an unnecessary increased risk to the FHA insurance fund.

In addition, the branch office charged ineligible commitment fees and/or overcharged for credit reports, contrary to HUD regulations, in six of the eight cases reviewed. As a result, borrowers incurred \$857 in unnecessary costs.

What We Recommend

We recommend that HUD's Assistant Secretary for Housing – Federal Housing Commissioner require National City Mortgage to

- Indemnify HUD \$198,389² for two loans, which it issued contrary to HUD's loan origination requirements;
- Reimburse borrowers \$857 in overcharges; and
- Emphasize its policies, procedures, and controls to branch office staff to ensure that the underwriters consistently follow HUD's underwriting 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 report to the branch office on October 31, 2007. We discussed the report with the branch office during the audit and at an exit conference on November 6, 2007. We requested a written response by November 15, 2007. The branch office provided written comments to our draft report on November 13, 2007. The complete text of the branch office's response, along with our evaluation of that response, can be found in appendix B of this report.

¹ The eight loans were originally valued at more than \$789,000.

² This amount is the unpaid principal balance of \$198,389. The projected loss to HUD is \$57,533 based on HUD's insurance fund average loss rate of 29 percent.

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BACKGROUND AND OBJECTIVES

The U.S. Department of Housing and Urban Development's (HUD) strategic plan states that part of its mission is to increase homeownership, 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. HUD can place them on credit watch status or terminate their approval if their rate of defaults and claims exceeds the normal rate for the area. Many sanctions are available for taking actions against lenders or others who abuse the program.

National City Mortgage is a direct endorsement lender for FHA loans. Its corporate office is located in Miamisburg, Ohio. National City Mortgage's Plymouth Meeting, Pennsylvania, branch office issued 20 FHA loans between April 2005 and March 2007 that defaulted within the first two years. Of the 20 loans, valued at more than \$2.4 million, 16, valued at approximately \$2 million, defaulted after 12 or fewer payments. We reviewed 8 of the 16 loans valued at approximately \$789,000.

Our objective was to determine whether National City Mortgage's Plymouth Meeting, Pennsylvania, branch office complied with HUD regulations, procedures, and instructions in the origination and quality control review of FHA loans.

RESULTS OF AUDIT

Finding 1: The Branch Office Generally Complied with HUD Requirements in the Origination and Quality Control Review of FHA-Insured Single-Family Loans

The branch office generally complied with HUD requirements in its origination and quality control review of FHA loans; however, it did not properly document borrowers' qualifying ratios and did not properly verify assets in accordance with HUD requirements for two of eight loans reviewed, originally valued at more than \$789,000. The deficiencies occurred because the branch office did not exercise due diligence in the underwriting of the loans, causing an unnecessary increased risk to the FHA insurance fund. Therefore, National City Mortgage should indemnify HUD \$198,389³ for the two defaulted loans.

The Branch Office Did Not Properly Document a Borrower's Qualifying Ratios

In one of the sample cases reviewed, the branch office did not adequately support the borrower's rental income when calculating the qualifying ratios. The rental income was not reflected on the borrower's tax returns, and should not have been included in the calculation of the borrower's qualifying ratios. When using the supportable income only (i.e., without the rental income), the total fixed payment-to-income ratio was approximately 52 percent, which exceeded HUD's established guideline.

HUD requirements state that the ratio of total fixed payment to effective income may not exceed the benchmark guideline of 43 percent. HUD requirements also state that rental income may be considered effective income if shown on the borrower's tax returns. Otherwise, the income only may be considered a compensating factor and must be documented adequately by the lender. Further, HUD requirements state that a Schedule E of IRS (Internal Revenue Service) Form 1040 and a current lease are required to verify all rental income.

³ See footnote 2.

The Branch Office Did Not Properly Verify a Borrower's Funds to Close

For one of the sample cases reviewed, the branch office did not properly verify the borrower's cash on hand in the amount of \$1,000, which was used for the earnest money deposit. In addition, the borrower's checking account had an unexplained deposit in the amount of \$800. There was no verification of deposit or other evidence to indicate the sources of funds were properly verified.

HUD requirements state⁴ that borrowers who have saved cash at home and are able to adequately demonstrate the ability to do so are permitted to have this money included as an acceptable source of funds to close the mortgage. To include such funds in assessing the homebuyer's cash assets for closing, the money must be verified—whether deposited in a financial institution or held by the escrow/title company—and the borrower must provide satisfactory evidence of the ability to accumulate such savings. The asset verification process requires the borrower to explain in writing how such funds were accumulated and the amount of time taken to do so. The lender must determine reasonableness of the accumulation of the funds based on the borrower's income stream, the period during which the funds were saved, the borrower's spending habits, documented expenses, and the borrower's history of using financial institutions. In addition, HUD requires⁵ the lender to verify savings and checking accounts. A verification of deposit, along with the most recent bank statement, may be used to accomplish this verification. If there is a large increase in an account or the account was opened recently, the lender must obtain a credible explanation of the source of those funds.

The Branch Office Charged Ineligible Commitment Fees and Overcharged for Credit Reports

HUD Handbook 4000.2, paragraph 1-9, provides that lenders are permitted to charge a commitment fee to guarantee in writing the interest rate and discount points for a specific period or to limit the extent to which they may change. Lenders are expected to honor such commitments. The branch office charged ineligible commitment fees in four of the eight loans reviewed totaling \$800. Three loans lacked documentation, and one loan contained an unsigned lock-in fee agreement to substantiate that the borrowers agreed to lock in their loans.

⁴ HUD Handbook 4155.1, REV-5, paragraph 2-10(M).

⁵ HUD Handbook 4155.1, REV-5, paragraph 2-10(B).

HUD Handbook 4000.2, paragraph 5-2, identifies the type of costs, such as obtaining credit report fees, that a lender is allowed to charge a borrower. The charges are limited to actual cost. The branch office overcharged borrowers for credit report fees in three of the eight loans reviewed. The overcharge totaled \$57.

Conclusion

The branch office generally complied with HUD regulations, procedures, and instructions in the origination and quality control review of FHA loans. However, it did not properly document borrowers' qualifying ratios and did not properly verify assets in accordance with HUD requirements for two of the loans it originated. The deficiencies occurred because the branch office did not exercise due diligence in the underwriting of the loans, causing HUD to assume unnecessarily high risk when it insured the loans. Therefore, National City Mortgage should indemnify HUD \$198,389⁶ for the two defaulted loans (see appendixes C and E for more detail).

Recommendations

We recommend that HUD's Assistant Secretary for Housing – Federal Housing Commissioner require National City Mortgage to

- 1A. Indemnify HUD \$198,389⁷ for two loans, which it issued contrary to HUD's loan origination requirements.
- 1B. Reimburse borrowers \$857 in overcharges; and
- 1C. Emphasize its policies, procedures, and controls to branch office staff to ensure that the underwriters consistently follow HUD's underwriting requirements.

⁶ See footnote 2.

⁷ See footnote 2.

SCOPE AND METHODOLOGY

We targeted lenders with high default rates and selected National City Mortgage's Plymouth Meeting, Pennsylvania, branch office because its percentage of defaults in the first two years was 5.48 percent, compared with the Pennsylvania state average of 3.66 percent. We then ran queries in HUD's Neighborhood Watch system to identify the branch office's number of defaulted loans within the first two years and the number of payments made against those loans. We found that the branch office issued 20 loans, valued at more than \$2.4 million, that defaulted within the first two years. Of the 20 loans, 16, valued at approximately \$2 million, defaulted after 12 or fewer payments. We sampled eight loans with nine or fewer payments for our survey review. The eight loans were valued at approximately \$789,000. To determine whether the branch office complied with HUD regulations, procedures, and instructions in the origination and quality control review of FHA loans, we performed the following:

- Reviewed applicable HUD handbooks and mortgagee letters;
- Reviewed case files for the eight sample loans;
- Examined records and related documents of National City Mortgage and its Plymouth Meeting, Pennsylvania, branch office; and
- Conducted interviews with officials and employees of National City Mortgage and its Plymouth Meeting, Pennsylvania, branch office, as well as employees of the HUD Quality Assurance Division.

In addition, we relied in part on data maintained by HUD in the 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 adequately reliable for our purposes.

Our review period was from April 2005 through March 2007. When applicable, the review period was expanded to include data through August 2007.

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

INTERNAL CONTROLS

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

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, 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:

- 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 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

We did not identify any significant weaknesses.

APPENDIXES

Appendix A

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

Recommendation number	Ineligible costs 1/	Funds to be put to better use 2/
1A		\$57,533
1B	\$857	

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local polices or regulations.
- 2/ 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. In this instance, implementation of our recommendation to indemnify loans that were not originated in accordance with HUD requirements will reduce the risk of loss to the FHA insurance fund. The above amount reflects HUD statistics, which show that the FHA, on average, loses 29 percent of the claim paid for each property (see appendix C).

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

National City
Mortgage Co.

National City Mortgage Co.
A Subsidiary of National City Bank
3232 Newmark Drive • Miamisburg, Ohio 45342
Telephone (937) 910-1200

Mailing Address:
P.O. Box 1820
Dayton, Ohio 45401-1820

November 6, 2007

U.S. Department of Housing and Urban Development
Office of Inspector General for Audit
John P. Buck, Regional Inspector General for Audit
100 Penn Square East, Ste. 1005
Philadelphia, Pennsylvania 19107-3380

Re: Draft Audit Report for Audit of Plymouth Meeting, Pennsylvania, branch

Dear Mr. Buck:

National City Mortgage would like to thank you for the opportunity to reply to issues presented in the above referenced audit.

Finding: [441-7654833]

The Branch Office Did not Properly Verify a Borrower's Funds to Close.

National City Response to Finding:

We respectfully disagree with this finding based on the below information. We would request that this finding be overturned.

The auditor states that our office did not properly verify the borrower's cash-on-hand in the amount of \$1,000 which was used for the earnest money deposit. Documentation requirements from both the *4155.1 REV-5, paragraph 2-10 (A)* and from Fannie Mae's Desktop Underwriting Approve/Eligible Recommendation (Feedback # 32) specifically states, "If the amount of the earnest money deposit exceeds 2 percent of the sales price or seems excessive based on the borrower's history of accumulating savings, the lender must verify the deposit amount and the source of funds according to current FHA guidelines." In this instance, 2% would equal \$1,160. Our borrowers deposit was only \$1,000 and thus not subject to the requirement of being verified. With that said, National City did verify the deposit with copies of the money orders and a statement from the borrower reflecting that the money was saved from employment and the time period that it was saved in. The documentation of the money saved at home meets the requirements set forth in the *4155.1 REV-5, paragraph 2-10 (M)*. Specifically, we have the statement from the borrower, the time period that the cash was accumulated (Dec 2004 – Mar 2005) and where the funds were saved from. It does seem reasonable that the borrower could save \$1,000 in a 3-4 month period; specifically, when you look at the fact the borrower has overtime earnings that were not included in the qualifying ratios.

No one Cares More !

Comment 1

Finding: 441-7670050

The Branch Office Did Not Properly Document a Borrower's Qualifying Ratios.

National City concurs with the finding on this loan.

Finding:

The Branch Office Charged Ineligible Commitment Fees and Overcharged for Credit Reports.

National City concurs with this finding and will reimburse borrowers \$857.00 in overcharges.

National City is committed to originating FHA loans in accordance with the underwriting and quality control guidelines set forth by HUD. We will continue to emphasize its policies, procedures and controls to our staff to ensure that underwriters consistently follow HUD's underwriting requirements.

Thank you for the opportunity to address the issues identified in this audit.

Sincerely,



Duane Gilkison
Vice President, Asset Quality Manager
Operations Risk Management

Cc:
B. Bibb
J. Cartellone
R. Crowl
T. Otto
J. Bollman

OIG Evaluation of Auditee Comments

Comment 1 We acknowledge that the earnest money deposit was not subject to verification because it did not exceed 2 percent of the sales price. However, HUD requires lenders to verify cash saved at home that a borrower uses towards closing costs. In addition to other factors, lenders must consider a borrower's history of using financial institutions and spending habits when determining the reasonableness of the borrower's cash on hand used towards mortgage closing costs (HUD Handbook 4155.1 REV-5, paragraph 2-10 (M)). The borrower's mortgage case file included evidence of three checking accounts and one savings account. At least one of the checking accounts was active during the time frame in which the loan was underwritten. The account statement showed that the borrower was charged unavailable funds fees for three transactions, as well as an overdraft fee for one transaction. The mortgage case file did not include sufficient documentation to indicate that the branch office considered the borrower's history of using financial institutions and spending habits in determining the reasonableness of the \$1,000 cash on hand which made up more than 25 percent of the borrower's funds needed to close.

In addition, the borrower's checking account had an unexplained deposit in the amount of \$800. HUD requires lenders to obtain a credible explanation of the source of funds when a borrower's account shows a large increase (HUD Handbook 4155.1 REV-5, paragraph 2-10 (B)). With the exception of \$1,700 in verified gift funds, the bank account statements for the two-month period covered in the underwriting review indicated that the borrower generally made deposits ranging from \$50 to \$357. As a result, we believe the branch office should have obtained and documented a credible explanation for the source of the borrower's \$800 deposit.

Appendix C

SCHEDULE OF CASE FILE DISCREPANCIES

Case number	Mortgage amount	Unpaid principal balance	Estimated loss*	Unsupported assets	High ratio
441-7670050	\$124,019	\$138,726	\$40,231		X
441-7654833	\$ 57,545	\$ 59,663	\$17,302	X	
Totals	\$181,564	\$198,389	\$57,533	1	1

* This amount was calculated by taking 29 percent of the unpaid principal balance for the loans. On average, HUD loses 29 percent of the claim amount paid.

Appendix D

SCHEDULE OF INELIGIBLE AND OVERCHARGED FEES

Case number	Ineligible commitment fees	Overcharged credit report fees	Total ineligible and overcharged fees
441-7670050	\$200.00		\$200.00
441-7668300	\$200.00		\$200.00
441-7648052	\$200.00		\$200.00
441-7651538	\$200.00	\$17.03	\$217.03
441-7710382		\$28.80	\$28.80
441-7701295		\$11.22	\$11.22
Total	\$800.00	\$57.05	\$857.05

Appendix E

NARRATIVE CASE PRESENTATIONS

Case number: 441-7670050

Mortgage amount: \$124,019

Date of loan closing: July 19, 2005

Status: Repayment

Payments before first default reported: Three

Unpaid principal balance: \$138,726

Summary:

The branch office did not properly document qualifying ratios and charged a commitment fee without a lock-in agreement.

Pertinent Details:

The branch office did not properly document qualifying ratios.

The total fixed payment-to-effective income ratio may not exceed the benchmark guideline of 43 percent (HUD Mortgagee Letter 2005-16). Rental income may be considered effective income if shown on the borrower's tax returns. Otherwise, the income only may be considered a compensating factor and must be documented adequately by the lender. A Schedule E of IRS Form 1040 and a current lease are required to verify all rental income (HUD Handbook 4155.1, REV-5, paragraph 2-7(M)).

In this case, the branch office did not adequately support the borrower's rental income when calculating the fixed payment-to-income ratio. The rental income was not reflected on the borrower's tax returns, and should not have been included in the calculation of the borrower's qualifying ratios. Based on the borrower's supportable income only (i.e., without the unsupported rental income), the total fixed payment-to-income ratio is almost 52 percent, which is above the acceptable ratio according to HUD's guidelines.

The branch office charged a lock-in fee without a written agreement.

Lenders are permitted to charge a commitment fee to guarantee an interest rate and discount points. The guarantee must be in writing (HUD Handbook 4000.2, paragraph 1-9). In this case, the branch office charged the borrower a \$200 lock-in fee without a written agreement.

Case number: 441-7654833

Mortgage amount: \$57,545

Date of loan closing: April 20, 2005

Status: First legal action to commence foreclosure

Payments before first default reported: Seven

Unpaid principal balance: \$59,663

Summary:

The branch office did not properly verify the borrower's funds to close.

Pertinent Details:

According to HUD requirements, borrowers who have saved cash at home and are able to demonstrate adequately the ability to do so are permitted to have this money included as an acceptable source of funds to close the mortgage. To include such funds in assessing the homebuyer's cash assets for closing, the money must be verified—whether deposited in a financial institution or held by the escrow/title company—and the borrower must provide satisfactory evidence of the ability to accumulate such savings. The asset verification process requires the borrower to explain in writing how such funds were accumulated and the amount of time taken to do so.

The lender must determine reasonableness of the accumulation of the funds based on the borrower's income stream, the period during which the funds were saved, the borrower's spending habits, documented expenses, and the borrower's history of using financial institutions (HUD Handbook 4155.1, REV-5, paragraph 2-10(M)). In addition, if the amount of the earnest money deposit appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds. Satisfactory documentation includes a copy of the borrower's cancelled check. A certification from the deposit holder acknowledging receipt of funds and separate evidence of the source of funds is also acceptable. Evidence of source of funds includes a verification of deposit or bank statement showing that at the time the deposit was made, the average balance was sufficient to cover the amount of the earnest money deposit.

HUD also requires verification of savings and checking accounts. A verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account or the

account was opened recently, the lender must obtain a credible explanation of the source of those funds (HUD Handbook 4155.1, REV-5, paragraph 2-10(B)).

In this case, the branch office did not properly verify the borrower's cash on hand in the amount of \$1,000, which was used for the earnest money deposit. In addition, the borrower's checking account had unexplained deposit in the amount of \$800. There was no verification of deposit or other evidence to indicate the sources of funds were properly verified.