



Issue Date	June 1, 2012
Audit Report Number	2012-CH-1008

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

Kelly Anderson

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

SUBJECT: Nations Lending Corporation, Independence, OH, Needs To Improve Its Quality Control Reviews of Early Payment Defaulted Loans

HIGHLIGHTS

What We Audited and Why

We audited Nations Lending Corporation, a Federal Housing Administration (FHA)-approved nonsupervised direct endorsement lender approved to originate, underwrite, and submit mortgages for insurance under the U.S. Department of Housing and Urban Development's (HUD) direct endorsement program. We selected Nations for audit based on our risk assessment of single-family lenders with home offices located in our region.¹ The audit was part of the activities in our fiscal year 2012 annual audit plan. Our audit objective was to determine whether Nations complied with HUD's regulations, procedures, and instructions in the underwriting of FHA-insured loans and quality control.

What We Found

Nations generally complied with HUD's requirements for underwriting FHA-insured loans. Specifically, it generally complied with HUD's regulations, procedures, and instructions in the underwriting of 10 FHA-insured loans

¹ The region includes five States: Illinois, Indiana, Ohio, Michigan, Minnesota, and Wisconsin.

reviewed. Additionally, Nations' written quality control plan was generally adequate, and its routine quality control reviews were completed in accordance with HUD's requirements. However, its quality control reviews for early payment defaults² were deficient. Specifically, Nations did not adequately document its quality control reviews for early payment defaulted loans or perform the reviews in a timely manner.

Additionally, it did not maintain evidence of follow-up or corrective actions taken based on the review results. As a result, Nations could not ensure the accuracy, validity, and completeness of its loan underwriting activities. Further, it may not be able to identify potential deficiencies and make necessary corrections in a timely manner; thus, potentially increasing the risk to FHA's Mutual Mortgage Insurance Fund.

What We Recommend

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require Nations to (1) implement an adequate quality control program that complies with HUD's requirements for early payment defaults and (2) amend its quality control plan to include the requirements for timely reviews of early payment defaults.

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

Auditee's Response

We provided our discussion draft audit report to Nations and HUD's staff on April 17, 2012, and held an exit conference with Nations on April 23, 2012.

We asked Nations to provide comments on our discussion draft audit report by April 27, 2012. Nations provided written comments, dated April 27, 2012, and generally agreed with our finding and recommendations. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix A of this report.

² HUD Handbook 4060.1, REV-2, paragraph 7-6(D), requires lenders to review all loans going into default within the first six payments. These loans, which are referred to as early payment defaults, are loans that become 60 days past due.

TABLE OF CONTENTS

Background and Objective	4
Results of Audit	
Finding: Nations' Quality Control Reviews of Early Payment Defaults Were Deficient	5
Scope and Methodology	8
Internal Controls	9
Appendixes	
A. Auditee Comments and OIG's Evaluation	11

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 loans without HUD's prior review and approval.

Nations Lending Corporation is an FHA-approved nonsupervised direct endorsement lender located in Independence, OH. A nonsupervised lender is an FHA-approved lending institution that has as its principal activity the lending or investment of funds in real estate mortgages and may originate, sell, purchase, hold, or service FHA-insured mortgages. Nations also provides U.S. Department of Veterans Affairs and conventional loans.

Nations was established in July 2003 as a Cleveland, OH, based limited liability corporation mortgage banker. It was approved as an FHA lender on May 26, 2006, and became an unconditional direct endorsement lender on October 10, 2008. Nations has three active branch offices located in Ohio. The lender outsources the performance of its routine quality control reviews to its contractor, Mortgage Compliance Advisors, LLC.

According to HUD's Neighborhood Watch Early Warning System,³ as of October 31, 2011, Nations had originated 1,647 FHA-insured loans with beginning amortization dates between October 1, 2009, and September 30, 2011. Of the 1,647 loans, 69 were seriously delinquent or had a claim insurance status. Further, Nations had a compare ratio⁴ of 223 percent for a 2-year FHA performance period ending September 30, 2011. Nations participated in HUD's lender insurance program. The program enables high-performing FHA-approved direct endorsement lenders with acceptable default and claim rates⁵ to endorse FHA loans without having a preendorsement review conducted by FHA. However, as of October 19, 2011, HUD had terminated Nations' participation in the program.

Our objective was to determine whether Nations complied with HUD's regulations, procedures, and instructions in the underwriting of FHA-insured loans and quality control.

³ Neighborhood Watch refers to 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.

⁴ 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.

⁵ Acceptable default and claim rate is at or below 150 percent of national average.

RESULTS OF AUDIT

Finding: Nations' Quality Control Reviews of Early Payment Defaults Were Deficient

Nations' written quality control plan was generally adequate, and its routine quality control reviews were completed in accordance with HUD's requirements. However, its quality control reviews of early payment defaults were deficient. Specifically, Nations did not adequately document its quality control reviews for early payment defaulted loans or perform the reviews in a timely manner. Additionally, it did not maintain evidence of follow-up or corrective actions taken based on the review results. These deficiencies occurred because Nations lacked the capacity to adequately perform the reviews of the early payment defaults. As a result, Nations could not ensure the accuracy, validity, and completeness of its loan underwriting activities. Further, it may not be able to identify and correct potential deficiencies in a timely manner, potentially resulting in an increased risk to FHA's Mutual Mortgage Insurance Fund.

Nations' Quality Control Plan and Routine Reviews Complied With HUD Requirements

Our assessment of Nations' internal controls included reviewing its quality control plan and related review results. Nations' written quality control plan was generally adequate and complied with HUD requirements. Additionally, its contractor, Mortgage Compliance Advisors, LLC, completed routine quality control reviews as required,⁶ and Nations resolved reported quality control findings accordingly.⁷

Nations Did Not Adequately Document Reviews of Early Payment Defaults

Nations did not adequately document its quality control reviews of early payment defaulted loans. Nations' documentation revealed issues with its quality control reviews of early payment defaults. It did not adequately document the results of its reviews or what the reviews entailed. Additionally, the documentation did not disclose who performed the quality control reviews or the dates on which the reviews were performed. Without identifying who performed the reviews, for instance, Nations could not provide assurance that the quality control reviews were not performed by individuals who were also part of the loan origination and

⁶ HUD Handbook 4060.1, REV-2, paragraph 7-6(A)

⁷ HUD Handbook 4060.1, REV-2, paragraph 7-3(I)

underwriting activities in accordance with HUD requirements.⁸ HUD requires a lender to maintain the quality control report and follow-up plus procedural information, including who performed the review, for a 2-year period.⁹ However, Nations lacked adequate documentation to support the quality control reviews of early payment defaults.

Nations Did Not Perform Timely Quality Control Reviews

Nations did not perform quality control reviews for early payment defaults in a timely manner. HUD requires lenders to perform reviews of early payment defaults within 45 days from the end of the month the loan is reported as 60 days past due.¹⁰ Of the 31 early payment defaulted loans identified, 28 had been in default more than 3 months before the quality control reviews were performed. Nations performed quality control reviews for 15 of the 31 loans (48 percent) 10 to 21 months after default. For instance, a streamline refinance loan, case number 052-5489577, went into early payment default after the first three mortgage payments, and Nations identified the loan as an early payment default when the loan had been in default for 19 months. Nations was unable to explain the untimely review.

Nations Did Not Maintain Evidence of Follow-up or Corrective Actions Taken

Nations did not maintain evidence of follow-up or corrective actions taken based on the results of the quality control reviews performed for early payment defaulted loans. One overriding goal of quality control is to ensure swift and appropriate corrective action.¹¹ HUD requires management to take prompt action to deal appropriately with any material findings, and the final report or addendum must identify actions being taken, their completion timetable, and any planned follow-up activities.¹² Further, a lender must retain the quality control review report and follow-up documentation for a 2-year period. However, Nations' quality control documentation did not show that swift and appropriate corrective actions were taken by management based on the reviews performed.

Conclusion

⁸ HUD Handbook 4060.1, REV-2, paragraph 7-3(B)

⁹ HUD Handbook 4060.1, REV-2, paragraph 7-3(K)

¹⁰ Mortgagee Letter 2011-02, effective January 5, 2011. Before this mortgagee letter, HUD did not have a specified timeframe for the performance of quality control reviews for early payment defaults.

¹¹ HUD Handbook 4060.1, REV-2, paragraph 7-2

¹² HUD Handbook 4060.1, REV-2, paragraph 7-3(I)

Although its written quality control plan was generally adequate and routine quality control reviews were completed in accordance with HUD's requirements, Nations performed deficient quality control reviews for its early payment defaulted loans. The problems occurred because Nations lacked the capacity to adequately perform the reviews of the early payment defaults. Nations acknowledged that its staff lacked the capability to perform the reviews. Therefore, as a result of our audit, it began transferring the performance of the quality control reviews for early payment defaults to its contractor, Mortgage Compliance Advisors, LLC, which already performed its routine quality control reviews. Nations believed that the contractor was better equipped to perform the reviews.

As a result of the conditions identified above, Nations could not ensure the accuracy, validity, and completeness of its loan underwriting activities. Further, it may not be able to identify and correct potential deficiencies in a timely manner, potentially resulting in an increased risk to FHA's Mutual Mortgage Insurance Fund. In addition, Nations' quality control program for early payment defaults did not adequately address the basic goals set forth in HUD requirements.¹³

Recommendations

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

- 1A. Implement an adequate quality control program that complies with HUD's requirements for early payment defaults, including Mortgagee Letter 2011-02, which addresses timely reviews of early payment defaults.
- 1B. Amend its quality control plan to include the requirements for timely reviews of early payment defaults.

¹³ HUD Handbook 4060.1, REV-2, paragraph 7-2

SCOPE AND METHODOLOGY

We performed our audit work from October 2011 through February 2012 at our offices located in Chicago, IL, and Columbus, OH. The audit covered the period October 1, 2009, through September 30, 2011, and was expanded as necessary.

To accomplish our objective, we reviewed applicable HUD handbooks, regulations, mortgagee letters, and other reports and policies related to the FHA mortgage insurance program. Further, we reviewed FHA case binders and Nations' quality control plans, electronic loan files, and quality control review documentation. We interviewed Nations' employees concerning the lender's underwriting and quality control activities.

Using HUD's data maintained in its Single Family Data Warehouse system, we identified 1,647 loans originated by Nations during the period October 1, 2009, through September 30, 2011. Of these loans, 69 were identified as being delinquent or in claim. Of the 69 loans, 50 were originated and sponsored by Nations. For the survey, we selected and reviewed 10 of the 50 loans to determine whether they were underwritten in compliance with HUD's requirements. The 10 loans were comprised of 8 streamline refinances and 2 conventional to FHA refinances.

We reviewed the quality control reports and Nations' responses addressing the quality control findings for a 24-month period¹⁴ for compliance with HUD requirements and Nations' quality control plan. The third-party contractor, Mortgage Compliance Advisors, LLC, performed 257 routine quality control reviews during the 24 months, which were comprised of 162 FHA case file reviews and 95 U.S. Department of Veterans Affairs and conventional loans. For early payment defaults, we reviewed Nations' documentation on quality control reviews it performed for 31 FHA-insured loans during our audit period.

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 Nations' 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. This testing consisted of comparing data in the two HUD systems, checking Single Family Data Warehouse data for duplicates, and reconciling loan information to source documents. Our audit results were based on our review of electronic and supporting hardcopy documentation maintained by Nations.

We conducted our 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.

¹⁴ October 1, 2009, through September 30, 2011

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:

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Compliance with 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 Deficiency

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

- Nations' quality control reviews of early payment defaulted loans were deficient.

APPENDIXES

Appendix A

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Comment 1



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RE: Nations Lending Corporation

RESPONSE TO DISCUSSION DRAFT AUDIT REPORT

Dear United States Department of HUD-Office of Inspector General or agents thereof:

Nations Lending Corporation (NLC) has reviewed the findings and recommendations set forth in the Discussion Draft Audit Report (report) conducted by the Office of Inspector General. NLC has made internal adjustments in regards to the deficiency cited within the report related to quality control review of loans associated with early payment default (EPD). NLC has taken action as follows:

1. Amended NLC's QC plan to include review of early payment defaults.
2. Implemented an adequate quality control plan that complies with HUD's requirements for early payment defaults.
3. NLC has outsourced quality control reviews to a third party.
4. Management will monitor quality control plan reviews for early payment defaults to ensure proper documentation is maintained and corrective action requirements have been met.
5. Management will monitor accuracy, validity and completeness of loan underwriting activities through proper execution of protocols within the quality control plan.

NLC is committed to operating in accordance with HUD requirements and to reducing future risk to FHA's Mutual Mortgage Insurance Fund.

Sincerely,

Jeremy E. Sopko
CEO

OIG Evaluation of Auditee Comments

Comment 1 We commend Nations' efforts to improve its quality control program concerning early payment defaults. Nations did not provide any documentation to support the actions already taken to address the cited finding. Therefore, HUD will determine whether the improvements to Nations' quality control program meet HUD's requirements for early payment defaults.