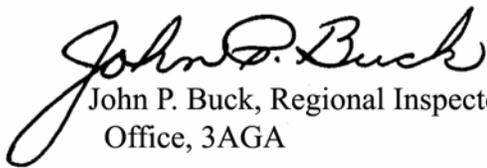


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| Issue Date July 26, 2007 |
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| Audit Report Number 2007-PH-1010 |
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TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing Commissioner, H

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

SUBJECT: Countrywide Home Loans, 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 Countrywide Home Loans (branch office), a nonsupervised 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 10 loans we selected for review¹ were not originated in accordance with HUD requirements. The branch office did not properly verify the borrowers' assets for the two loans originally valued at more than \$254,000. 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.

What We Recommend

We recommend HUD's assistant secretary for housing – federal housing commissioner require Countrywide Home Loans to

- Indemnify \$256,534² for two loans, which it issued contrary to HUD's loan origination requirements; and
- Develop internal procedures to more closely monitor its underwriting process.

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 June 20, 2007. We discussed the report with the branch office during the audit and at an exit conference on July 2, 2007. We requested a written response by July 12, 2007. The branch office provided written comments to our draft report on July 16, 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 Originally valued at more than \$1.2 million.

² This amount is the unpaid principal balance \$251,599 plus a partial claim of \$4,935 paid. The projected loss to HUD is \$74,395, 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. The 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.

Countrywide Home Loans is a direct endorsement lender for FHA loans. Countrywide Home Loans' corporate office is located in Calabasas, California. Countrywide Home Loans' Plymouth Meeting, Pennsylvania, branch office issued 48 FHA loans between December 2004 and November 2006 that defaulted within the first two years. Of the 48 loans, valued at more than \$4.9 million, 38, valued at approximately \$3.8 million, defaulted after 12 or fewer payments. We reviewed 10 of the 38 loans valued at approximately \$1.2 million.

Our objective was to determine whether Countrywide Home Loans' 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 but Did Not Properly Verify Borrowers' Assets for Two Loans

The branch office generally complied with HUD requirements in its origination and quality control review of FHA loans; however, it did not verify borrowers' assets in accordance with HUD requirements for two of 10 loans reviewed, originally valued at more than \$1.2 million. The deficiencies occurred because the branch office did not exercise due diligence in the underwriting of the two loans, causing an unnecessary increased risk to the FHA insurance fund. Therefore, Countrywide Home Loans should indemnify \$256,534³ for the two defaulted loans.

The Branch Office Did Not Properly Verify Borrowers' Funds to Close

For one of the sample cases reviewed, the borrower's earnest money exceeded 2 percent of the sales price, and the source of funds was not adequately verified. The borrower did not adequately document the accumulation of the funds from a private savings club. In addition, the borrower's bank accounts had unexplained large deposits. For another case, the borrowers' bank accounts had unexplained large deposits, without which the borrower would have been unable to support the earnest money deposit.

HUD requirements⁴ state that if the amount of the earnest money deposit exceeds 2 percent of the sales price or 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. HUD also 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. 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. Further, HUD requirements⁶ state that if a homebuyer claims that the cash to close an FHA-insured mortgage is from savings held with a private savings club, the borrower must be able to adequately document the accumulation of those assets with the club. While such clubs are

³ See footnote 2.

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

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

⁶ HUD Handbook 4155.1, REV-5, paragraph 2-10(R).

not supervised banking institutions, the clubs must—at a minimum—have account ledgers, receipts from the club, verification from the club treasurer, and identification of the club so that the lender can verify the information provided. The underwriter must be able to determine that it was reasonable for the borrower to have saved the money claimed and that there is no evidence that these funds were borrowed with an expectation of repayment.

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 verify borrowers' assets for two 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, Countrywide Home Loans should indemnify \$256,534⁷ for the two defaulted loans (see appendixes C and D for more detail).

Recommendations

We recommend that HUD's assistant secretary for housing – federal housing commissioner require Countrywide Home Loans to

- 1A. Indemnify \$256,534⁸ for two loans, which it issued contrary to HUD's loan origination requirements.
- 1B. Develop internal procedures to more closely monitor its underwriting process.

⁷ See footnote 2.

⁸ See footnote 2.

SCOPE AND METHODOLOGY

We targeted lenders with high default rates and selected Countrywide Home Loans' Plymouth Meeting, Pennsylvania, branch office (branch office) because its percentage of defaults by two years was 3.75 percent compared with the Pennsylvania state average of 3.68 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 48 loans, valued at more than \$4.9 million that defaulted within the first two years. Of the 48 loans, 38, valued at approximately \$3.8 million, defaulted after 12 or fewer payments. We sampled 10 loans with four or fewer payments for our survey review. The 10 loans were valued at approximately \$1.2 million. 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 10 sample loans;
- Examined records and related documents of Countrywide Home Loans and its Plymouth Meeting, Pennsylvania, branch office; and
- Conducted interviews with officials and employees of Countrywide Home Loans 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 December 2004 through November 2006. When applicable, the review period was expanded to include current data through March 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 | Unsupported costs 1/ | Funds to be put to better use 2/ |
|--------------------------|-------------------------|-------------------------------------|
| 1A | | \$74,395 |

- 1/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.
- 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).

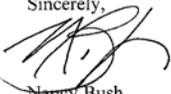
Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Comment 1

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| | <div data-bbox="1039 623 1313 766"><p>31303 AGOURA ROAD MS: WJAR-58 WESTLAKE VILLAGE, CA 91363</p></div> <div data-bbox="544 711 816 848"><p>7/16/07 Jennie A. Swager, Auditor U.S. Department of HUD/OIG 100 Penn Square East, Suite 1005 Philadelphia, PA 19107</p></div> <div data-bbox="544 888 1219 936"><p>Re: Preliminary Audit Survey of Countrywide Home Loans – Plymouth Meeting, PA ROC 54</p></div> <div data-bbox="544 957 695 982"><p>Dear Ms. Swager:</p></div> <div data-bbox="544 1001 1240 1073"><p>Thank you for providing Countrywide Home Loans the opportunity to respond to the preliminary findings from the audit conducted at the Plymouth Meeting, PA branch and outlined in your letter received on May 8, 2007.</p></div> <div data-bbox="544 1092 1239 1184"><p>In our efforts to promote consistency and ensure all participants adhere to agency guidelines and requirements, we routinely share all deficiencies and audit findings with the originating branch and Division personnel to ensure all policies and regulations are being met.</p></div> <div data-bbox="544 1201 1219 1270"><p>We have completed our review and provide the following response to address the findings. If you should have any questions, please feel free to contact me at 818-874-8292.</p></div> <div data-bbox="544 1291 751 1451"><p>Sincerely,  Nancy Bush First Vice President, Credit Risk Management</p></div> <div data-bbox="544 1470 1000 1495"><p>cc: Cindy Simantel, EVP Quality Control/Investor Audit</p></div> <div data-bbox="544 1516 779 1539"><p>Attachment: Attachment 'A'</p></div> |
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ATTACHMENT A

Comment 2

Case #441-7682281 CHL #108340775 – Noland: We generally agree with the preliminary findings. Source of funds from a Susu Fund was not properly documented.

Comment 3

Case #441-7737493 CHL #122364680 - Bolding: Assets unsupported.
We disagree with the findings. Mr. Bolding’s earnings are automatically deposited in to the North Fork Bank account and are clearly identified as payroll deposits from his employer Metrotech. Mrs.Bolding’s earning are not automatically deposited, however, her net earnings average approximately \$1300 every two weeks. It is reasonable to assume the other deposits shown on the bank statement are from Mrs. Bolding’s earnings.

Comment 4

Case 441-7787641, CHL #134726556 – Delorso: Borrower’s investment was not met.
We disagree with the findings: Borrower paid \$454.75 in closing costs as indicated on the MCAW, and a total of 229.29 in prepaid expenses. The seller paid \$1418.63 in closing costs, \$754.63 in prepaid expenses, and \$204.63 for the discount points for a total credit of \$2377.89. See below for breakdown of calculations.

Furthermore, it was verified that the borrower had \$2248.34 in M&T Bank which was more than sufficient to cover the \$454.75 in closing costs and the \$1237.25 required for down payment for the total 3% statutory investment requirement of \$1650. However, because there were aggregate adjustments from the seller shown on the HUD-1 should in no way penalize the borrower by not meeting his required investment only because he did not need to bring in this amount to closing.

| Closing Costs | | Prepays | |
|----------------------|-----------------|--------------------|----------------|
| Appraisal | 230.00 | Interest | 167.52 |
| Appraisal POC | 335.00 | Hazard Ins POC | 461.04 |
| Credit Report POC | 35.00 | Hazard Ins | 153.68 |
| Flood Check | 26.00 | City Property Tax | 229.62 |
| Commitment Fee | 100.00 | School Tax | 42.06 |
| Notary | 15.00 | Total Prepays | <u>1053.92</u> |
| Title | 529.88 | | |
| Endorsement | 150.00 | | |
| Closing Service | 35.00 | | |
| Recording | 142.50 | | |
| City/County Tax | | | |
| Stamp | 137.50 | | |
| State Tax Stamp | 137.50 | | |
| Total Closing Costs | <u>1,873.38</u> | | |
| <hr/> | | <hr/> | |
| Seller Paid CC | 1,418.63 | Seller Paid PPDS | 754.63 |
| Borrower Paid CC | 454.75 | Borrower Paid PPDS | 299.29 |
| Total CC | 1,873.38 | Total PPDS | 1053.92 |

| Total Amount Seller Paid | | Total Amount Borrower Paid | |
|--------------------------|----------|----------------------------|--------|
| Seller Paid CC | 1,418.63 | Borrower Paid CC | 454.75 |
| Seller Paid Prepays | 754.63 | Borrower Paid | |
| Seller Paid Discount | 204.63 | PPDS | 299.29 |
| Seller Credit | 2,377.89 | Borrower Paid | 754.04 |

Comment 5

Case #441-7737493, CHL #122364680 - Ineligible commitment fee of \$150.00
 We disagree with the findings; signed Lock Agreement is in the file. Per Mortgagee Letter 2006-04 dated 1-27-2006, "Mortgagees may charge and collect from mortgagors those customary and reasonable costs necessary to close the mortgage."

Comment 6

Case #441-7787641, CHL #134726556 - Ineligible commitment fee of \$100.00
 We disagree with the findings; signed Lock Agreement is in the file. Per Mortgagee Letter 2006-04 dated 1-27-2006, "Mortgagees may charge and collect from mortgagors those customary and reasonable costs necessary to close the mortgage."

Comment 7

Case #441-7813321, CHL #139133173 - Ineligible commitment fee of \$100.00
 We disagree with the findings. The borrower received a \$600.00 Lender Credit at closing as evidence on line 808 of the HUD-1 closing statement. This was to offset a portion of the commitment, appraisal and credit report fees. Per Mortgagee Letter 2006-04 dated 1-27-2006, "Mortgagees may charge and collect from mortgagors those customary and reasonable costs necessary to close the mortgage."

Comment 8

Case #441-7731636, CHL #127727168 - Overcharged credit report fee
 We disagree with the findings. Per Mortgagee Letter 2006-04 dated 1-27-2006, "Mortgagees may charge and collect from mortgagors those customary and reasonable costs necessary to close the mortgage."

Comment 9

Case #441-7696353, CHL #110780865 - Ineligible commitment fee of \$100.00
 We disagree with the findings; signed Lock Agreement is in the file. Per Mortgagee Letter 2006-04 dated 1-27-2006, "Mortgagees may charge and collect from mortgagors those customary and reasonable costs necessary to close the mortgage."

OIG Evaluation of Auditee Comments

- Comment 1** We discussed our preliminary audit findings with Countrywide Home Loans on May 8, 2007. Our preliminary findings included eight deficiencies associated with six loan cases. Countrywide Home Loans provided comments and additional support to address our preliminary findings on June 4, 2007. Based on Countrywide Home Loans' comments and additional support, we eliminated six of the eight deficiencies reported in our preliminary findings. As a result, this report only includes two deficiencies associated with two loan cases. We provided a draft of this report to Countrywide Home Loans on June 20, 2007, and discussed the deficiencies reported with Countrywide Home Loans officials during an exit conference on July 2, 2007. We requested a written response by July 12, 2007. Countrywide Home Loans chose to address the deficiencies discussed in this report by resubmitting its comments to our preliminary findings. Thus, Comments 4 through 9 in Countrywide Home Loans' response are not applicable to the issues discussed in this report.
- Comment 2** Countrywide Home Loans agreed with our assessment that the source of funds was not properly documented for loan case number 441-7682281.
- Comment 3** Our audit conclusions are based on sufficient, appropriate evidence. Countrywide Home Loans did not provide sufficient, appropriate documentation to show that the borrowers' assets were properly supported for loan case number 441-7737493.
- Comments 4 - 9** As stated above, the deficiencies noted with these loan cases were previously resolved, and were therefore not included in this report.

Appendix C

SCHEDULE OF CASE FILE DISCREPANCIES

| Case number | Mortgage amount | Unpaid principal balance | Claim paid | Estimated loss* | Unsupported assets |
|---------------|------------------|--------------------------|----------------|-----------------|--------------------|
| 441-7682281 | \$95,993 | \$94,238 | \$4,935 | \$28,760 | X |
| 441-7737493 | \$158,746 | \$157,361 | | \$45,635 | X |
| Totals | \$254,739 | \$251,599 | \$4,935 | \$74,395 | 2 |

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

Appendix D

NARRATIVE CASE PRESENTATIONS

Case number: 441-7682281

Mortgage amount: \$95,993

Date of loan closing: June 23, 2005

Status: Delinquent

Payments before first default reported: One

Unpaid principal balance: \$94,238

Partial claim paid: \$4,935

Summary:

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

Pertinent Details:

If the amount of the earnest money deposit exceeds 2 percent of the sales price or 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 (HUD Handbook 4155.1, REV-5, paragraph 2-10(A)). 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 borrower's earnest money exceeded 2 percent of the sales price, and the source of funds was not adequately verified. The borrower did not adequately document the accumulation of the funds from a private savings club. In addition, the borrower's bank accounts had unexplained large deposits.

Case number: 441-7737493

Mortgage amount: \$158,746

Date of loan closing: January 10, 2006

Status: Special forbearance

Payments before first default reported: One

Unpaid principal balance: \$157,361

Summary:

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

Pertinent Details:

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 borrower's bank accounts had unexplained large deposits, without which the borrower would have been unable to support the earnest money deposit.