Issue Date July 25, 2008
Audit Report Number 2008-AT-1010

TO: Brian D. Montgomery, Assistant Secretary for Housing-Federal Housing Commissioner (H)

James D. McKay

FROM: James D. McKay, Regional Inspector General for Audit, 4AGA

SUBJECT: Meridian Lending, Inc., Monroe, Georgia, Did Not Follow HUD Requirements in Originating Two Insured Loans

HIGHLIGHTS

What We Audited and Why

We audited Meridian Lending, Inc. (Meridian), a Federal Housing Administration (FHA)-approved direct endorsement lender, to determine whether it followed the U.S. Department of Housing and Urban Development's (HUD) requirements for (1) borrower eligibility and creditworthiness and property eligibility when underwriting loans and (2) implementing a quality control program. We selected this lender because of its high default rates.

What We Found

Meridian did not follow HUD requirements in originating two of the eight FHA-insured loans reviewed. As a result, Meridian placed HUD's insurance fund at risk for as much as $271,750.

In addition, Meridian did not review its early defaulting loans in a timely manner and did not review all early defaulting loans. This condition occurred because

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Meridian incorrectly pulled its early defaults report data from HUD's Neighborhood Watch system. It pulled only current defaults, instead of pulling all defaults to ensure that it captured all of the early defaults when extracting the data from the system. As a result, the lender adversely impacted the goals of HUD's quality control program, which is designed to protect the lender and HUD from unacceptable risk.

What We Recommend

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner require Meridian to indemnify HUD for the potential loss on the loan with a significant deficiency and reimburse HUD for the claim loss on the other loan. We also recommend that the Assistant Secretary for Housing ensure that Meridian conducts its quality control reviews in a timely manner and reviews all early defaulting loans as required by HUD regulations.

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 discussed our review results with Meridian and HUD officials during the audit. We provided a copy of the draft report to Meridian on June 30, 2008, for its comments and discussed the report with Meridian officials at the exit conference on July 3, 2008. Meridian provided written comments on July 3, 2008. Meridian generally agreed with our findings. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

Meridian Lending, Inc. (Meridian), is a nonsupervised direct endorsement lender operating from its home office in Monroe, Georgia. The U.S. Department of Housing and Urban Development (HUD) Federal Housing Administration (FHA) approved Meridian as a nonsupervised mortgage company in 2002.

Meridian originated 273 loans with original mortgage amounts totaling more than $37 million. Twenty-one of the loans defaulted within the first year of closing. Of the 21 loans, 17 defaulted within the first six payments. The amount of the defaulted loans totaled more than $3.4 million. According to data from HUD's Neighborhood Watch system, more than half (seven) of the 17 early defaults were due to curtailment of income. The chart below shows the default reasons and number of payments before default for the eight files reviewed.

Loan number	Reason for default	Payments before first 90-day default reported
1	Excessive obligations	1
2	Excessive obligations	1
3	Marital difficulties	2
4	Curtailment of income	3
5	Illness of borrower's family member	3
6	Curtailment of income	3
7	Excessive obligations	6
8	Unable to contact borrower	n/a

The objectives of the audit were to determine whether the lender followed HUD requirements for (1) borrower eligibility and creditworthiness and property eligibility when underwriting loans and (2) implementing a quality control program.

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RESULTS OF AUDIT

Finding 1: Meridian Did Not Follow HUD Requirements in Originating Two Insured Loans

Meridian did not follow HUD requirements in originating two of the eight FHA-insured loans reviewed. As a result, it placed HUD's insurance fund at risk for as much as $271,750. Our review did not disclose additional deficiencies in Meridian's underwriting process or errors in the files reviewed.

One Loan Had Underwriting Deficiencies

Meridian incorrectly used a boarder's wages as a compensating factor for approving a loan with a mortgage amount of $130,050. HUD requirements do not allow a boarder's wages to be used as a compensating factor; only a boarder's rental income, if adequately documented, can be used. HUD Handbook 4155.1, REV-5, paragraph 2-7M, provides that a boarder's rental income can be used as a compensating factor only if there is adequate documentation provided to the lender. Meridian should not have used the boarder's wages; the only income that could have been used was the boarder's rental income. Meridian did not have adequate documentation to include the boarder's income as a compensating factor. This loan defaulted within the first six payments due to excessive obligations. Also, the loan did not undergo a quality control review as required by HUD Handbook 4060.1, paragraph 7-6D. The loan amount was $130,050, and HUD should seek an indemnification agreement from the lender.

A Second Deed Was Executed the Day of Closing

Meridian originated a loan with a mortgage of $141,700, in which a second deed was executed the day of closing. On the day of loan closing, the borrower's spouse took ownership interest in the FHA-insured property without Meridian's consent or consideration of the spouse's creditworthiness during underwriting and without signing the mortgage note security instruments executed at loan closing. HUD Handbook 4155.1, REV-5, paragraph 2-2D, does not permit an individual to take an ownership interest in the property at settlement without signing the mortgage note and all security instruments. Persons taking ownership interest should be treated as

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coborrowers, and the lender should have considered the spouse's income, assets, liabilities, and credit history.

This condition occurred because the lender's closing process did not include steps to ensure that loans were closed as underwritten. Because the spouse took ownership at closing, she should have been treated as a coborrower. The lender should have considered her creditworthiness during the underwriting process. The loan defaulted and was submitted for claim to HUD. HUD acquired the property, and it was resold. HUD incurred a loss of $34,172 on the resale.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner require Meridian to

1A. Indemnify HUD $50,720 for the insured loan originated at $130,050, which was contrary to HUD requirements.

1B. Reimburse HUD $34,172 for the actual loss HUD incurred on the claim from the loan that HUD sold.

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Finding 2: Meridian Did Not Fully Comply with HUD Quality Control Requirements.

Meridian did not review its early defaulting loans in a timely manner and did not review all early defaulting loans. This condition occurred because Meridian incorrectly pulled its early defaults report data from HUD's Neighborhood Watch system. It pulled only current defaults, instead of pulling all defaults to ensure that it captured all of the early defaults when extracting the data from the system. As a result, the lender adversely impacted the goals of HUD's quality control program, which was designed to protect the lender and HUD from unacceptable risk.

All Early Defaults Were Not Reviewed

Lenders closing 15 or fewer loans monthly are required to perform quality control reviews on a quarterly basis, and the review must include all loans going into default within the first six payments. However, Meridian only had one quality control review of its early defaults from April 2007 through May 2008. The review covered early defaults from June 2007 through February 2008 and included 11 of the 17 early defaults. The quality control review did not disclose significant deficiencies.

Meridian incorrectly pulled its early defaults report data from the Neighborhood Watch data system. It pulled only current defaults, instead of pulling all defaults to ensure that it captured all of the early defaults when extracting the data from the system. In addition, it did not ensure that its early defaults were reviewed in a timely manner.

Meridian adversely impacted the goals of HUD's quality control program to ensure compliance with HUD's and the lender's own origination or servicing requirements throughout its operations, designed to protect the lender and HUD from unacceptable risk. Quality control is intended to guard against errors, omissions, and fraud. Untimely quality control reviews do not ensure swift and appropriate corrective action.

During the audit, the lender took corrective action to identify all early default loans and to review the early default loans that had not been reviewed.

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Recommendations

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

2A. Ensure that Meridian conducts its quality control reviews in a timely manner and that it reviews all early defaulting loans as required by HUD regulations.

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SCOPE AND METHODOLOGY

Meridian originated 273 FHA-insured loans with beginning amortization dates from March 1, 2006, through February 29, 2008. Twenty-one of the loans defaulted within the first year of closing. Of the 21 loans, 17 defaulted within the first six payments. We reviewed eight of the defaulted loans for loan origination deficiencies. We selected the eight loans based on their reasons for default, front and back ratios, and the number of payments before default.

To accomplish the audit objectives, we

- Obtained an understanding of applicable laws and regulations that related to single-family requirements,
- Reviewed Meridian's independent public accountant annual financial audits,
- Reviewed Meridian's loan case files,
- Reviewed Meridian's quality control plan and quality control reviews,
- Reviewed Meridian's management controls over originating FHA-insured loans,
- Interviewed Meridian's staff to obtain information regarding its policies and procedures, and
- Interviewed program staff of HUD's Quality Assurance and Processing and Underwriting Divisions.

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

We classified $50,720 as funds to be put to better use. This is 39 percent of the $130,050 original mortgage amount for the loan that did not meet HUD requirements. We used 39 percent because HUD has determined that 39 percent is the average loss on indemnified loans.

Our audit generally covered the period March 1, 2006, through February 29, 2008. We performed work at the Home Ownership Center in Atlanta, Georgia, and at Meridian's home office located in Monroe, Georgia. We performed the review from April to June 2008.

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

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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 implemented to reasonably ensure that the loan origination process complies with HUD program requirements.

- Quality control plan - Policies and procedures that management has implemented 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.

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Significant Weaknesses

Based on our review, we believe that the following items are significant weaknesses:

- Meridian did not follow HUD requirements in originating two insured loans (see finding 1).

- Meridian did not fully comply with HUD quality control requirements (see finding 2).

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APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A		$50,720
1B	$34,172	
Total	$34,172	$50,720

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 policies 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 a loan 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 FHA, on average, loses 39 percent of the claim paid for each property.

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Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	Auditee Comments

ALL SOURCE MORTGAGE

Comment 1

1A-Borrower had been renting for 3 years paying $1250 per month satisfactorily and the house payment on the home purchased lowered from her current housing by over $300 per month.
Borrower had been employee by Sams/Walmart (technically one in the same) for 3 years.
Borrower had seven outstanding small medical collections which were 2 to 6 years old, all others were paid.
Borrower made a 5% down payment from her own funds with $14,000 left over for reserves which was 15 months of house payments.
The boarder whose total income went into the household and both were on the checking account with the same address and had been together for over 3 years. They also had children together.
Borrower is no longer on the Neighborhood Watch.

Comment 2

1B-We underwrote and closed this loan per HUD guidelines. It was without our knowledge or consent that his wife was added to the Deed after closing. The closing attorney closed the loan per our instructions. Directly after our closing the attorney executed another deed giving half ownership to his new wife with the right of survivorship. The following factors allowed us to underwrite and close this loan and feel as though it was an excellent file and well within the current guidelines:
1-Ratios were in line per FHA Guidelines 29/40%
2-Borrower invested his own down payment from a Retirement account withdrawal
3-Borrower paid off all debt except for his car payment at closing from the funds withdrawn from his retirement account
4-Borrower had over 6 years employment with the Atlanta Penitentiary
5-Borrower had been renting at the same address for 16 years paying $800 per month satisfactorily and the proposed housing was only a minimal increase

Comment 3

2A-All defaults were pulled from current Neighborhood Watch and QC's were ordered on each. Five loans were missing because there was another early default transaction report that we did not pull. We do however QC

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defaulted loans and are now aware of the other early default report and will QC accordingly.

Meridian does everything possible to have controls and procedures to prevent claims and defaults. Some procedures go above and beyond HUD guidelines, such as 4506T verifications to ensure that all information furnished to us is correct and salaries, etc used to qualify are verified with the IRS.

Respectfully,

Sandra J. Frady
President/CEO

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OIG Evaluation of Auditee Comments

Comment 1 Meridian Lending stated that the boarder's total income went into the household, and they lived together for three years. However, Meridian did not properly use the boarder's rental income as a compensating factor for this loan. Meridian used the boarder's wages as additional income for a compensating factor. HUD requirements state that only a boarder's rental income, if adequately documented, could be used as a compensating factor. Meridian did not follow HUD requirements when using compensating factors in underwriting the loan. Neighborhood Watch shows that as of July 7, 2008, the loan was still in default and was three months delinquent.

Comment 2 Although all of the factors used to underwrite the loan were appropriate, a second deed was executed on the day of closing, giving the borrower's spouse ownership interest without being a part of the underwriting process. It is the lender's responsibility to ensure that the loan closed according to the closing instructions. Meridian Lending did not ensure that this loan closed according to the closing instructions.

Comment 3 Meridian Lending acknowledged that it did not ensure that all early default loans underwent a quality control review. During the audit, the lender took corrective action to identify all early default loans and to review the early default loans that had not been reviewed.

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