Issue Date July 28, 2009	
Audit Report Number 2009-PH-1010	

TO: David H. Stevens, Assistant Secretary for Housing – Federal Housing Commissioner, H

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

SUBJECT: J.P. Morgan Chase Bank, Newark, Delaware, Generally Complied with HUD's Origination and Quality Control Requirements for FHA-Insured Single-Family Loans

HIGHLIGHTS

What We Audited and Why

We audited the Newark, Delaware, branch office (branch office) of J.P. Morgan Chase bank (J.P. Morgan Chase), 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 average default rate. Our objective was to determine whether J.P. Morgan Chase complied with U.S. Department of Housing and Urban Development (HUD) requirements in the origination and quality control review of FHA-insured single-family loans.

What We Found

J.P. Morgan Chase generally complied with HUD requirements in the origination and quality control review of FHA-insured single-family loans. However, a review of eight sample loans valued at approximately $1.3 million showed that its branch office did not underwrite one of the loans, originally valued at more than

$157,000, in accordance with HUD requirements. The branch office approved the loan based on incorrect qualifying ratios.

In addition, J.P. Morgan Chase did not fully implement quality control procedures as required for one improperly underwritten loan out of five loans it reviewed[1] as part of its quality control process. These deficiencies occurred because the branch office did not exercise due care in the underwriting of the deficient loans and J.P. Morgan Chase did not always implement quality control procedures as required. As a result, the FHA insurance fund was exposed to an unnecessarily increased risk.

What We Recommend

We recommend that HUD's Assistant Secretary for Housing – Federal Housing Commissioner require J.P. Morgan Chase to indemnify HUD $193,949 [2] for one loan it issued contrary to HUD's loan origination requirements; reimburse $26,352 for a loss from a claim incurred by HUD on another improperly underwritten loan; and fully enforce its policies, procedures, and controls to ensure that its staff consistently follows HUD 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 J.P. Morgan Chase on June 18, 2009. We discussed the audit results with J.P. Morgan Chase during the audit and at an exit conference on June 23, 2009. J.P. Morgan Chase provided written comments to our draft report on July 7, 2009. J.P. Morgan Chase generally agreed with our results pertaining to its loan origination activity but objected to our conclusions on its quality control plan and implementation of quality control procedures. The complete text of the response, along with our evaluation of that response, can be found in appendix B of this report.

---

[1] This loan was originally valued at more than $197,000.
[2] This amount is the unpaid principal balance for the loan. The projected loss to HUD is $81,459 based on HUD's average insurance fund loss rate of 42 percent.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVE

The U.S. Department of Housing and Urban Development's (HUD) strategic plan states that 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 and multifamily homes including manufactured homes and hospitals. It is the largest insurer of mortgages in the world, insuring more than 34 million properties since its inception in 1934. FHA mortgage insurance provides lenders with protection against losses as the result of homeowners defaulting on their mortgage loans. The lenders bear less risk because FHA will pay a claim to the lender in the event of a homeowner's default. Loans must meet certain requirements established by FHA to qualify for insurance. As of February 2009, FHA's market share of single-family insured mortgages was 68 percent.

HUD's direct endorsement program authorizes approved lenders to underwrite loans without HUD's prior review and approval. 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 who abuse the direct endorsement program.

J.P. Morgan Chase is a direct endorsement lender for FHA loans. Its corporate office is located in Iselin, New Jersey, and its quality control reviews are performed internally at its office locations in Columbus, Ohio and Jacksonville, Florida. Its Newark, Delaware, branch office (branch office) originated 36 FHA loans valued at approximately $5.8 million from July 2006 through June 2008 that defaulted within the first two years. We sampled and reviewed case files for eight of the loans valued at approximately $1.3 million.

Our objective was to determine whether J.P. Morgan Chase complied with HUD requirements in the origination and quality control review of FHA-insured single-family loans.

RESULTS OF AUDIT

Finding: J.P. Morgan Chase Generally Complied with HUD's Origination and Quality Control Requirements for FHA-Insured Single-Family Loans

J.P. Morgan Chase generally complied with HUD requirements in the origination and quality control review of FHA loans. However, its branch office did not originate one of eight loans reviewed in accordance with HUD requirements. The branch office qualified the borrower based on incorrect ratios. In addition, J.P. Morgan Chase did not refer to HUD significant underwriting deficiencies related to one of five loans it reviewed as part of its quality control process. These deficiencies occurred because the branch office did not exercise due care in underwriting the deficient loans and J.P. Morgan Chase did not always implement quality control procedures as required. As a result, the FHA insurance fund was exposed to an unnecessarily increased risk and HUD incurred a loss from a claim paid in the amount of $26,352. J.P. Morgan Chase should indemnify HUD $193,949[3] for one loan, and reimburse HUD for the loss it incurred on the other loan.

The Branch Office Incorrectly Calculated Qualifying Ratios

According to HUD requirements,[4] lenders are required to use ratios to determine whether a borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. Lenders are required to compute two ratios: the mortgage payment expense to effective income (front ratio), which should not exceed 31 percent, and the total fixed payment to effective income (back ratio), which should not exceed 43 percent. HUD[5] also requires lenders to include the monthly housing expense and all other additional recurring charges extending 10 months or more in computing a borrower's debt-to-income ratios. Recurring charges include but are not limited to installment accounts. Debts lasting less than 10 months must also be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing.

In one case (case number 071-1021875), the branch office qualified a borrower based on incorrect ratios because it erroneously overstated the borrower's

[3] See footnote 2.
[4] HUD Handbook 4155.1, REV-5, paragraph 2-12, and HUD Mortgagee Letter 2005-16
[5] HUD Handbook 4155.1, REV-5, paragraph 2-11A

effective monthly income and did not consider two debts that were listed on the borrower's credit report. As a result, the loan was approved based on incorrect debt-to-income ratios. If the branch office had used the correct income and debt amounts, the borrower would not have qualified for the loan because the mortgage payment expense-to-income ratio would have been 36.85 percent, which exceeds the 31 percent allowed by HUD, and the total fixed payment-to-income ratio would have been almost 64 percent compared with HUD's 43 percent limit. HUD paid a claim that resulted in a loss of $26,352[6] for this loan.

J.P. Morgan Chase Needs to Update its Quality Control Plan

According to HUD requirements,[7] approved lenders must have and maintain a quality control plan for the origination and servicing of insured mortgages. The quality control plan must be a prescribed function of the lender's operations and assure that the lender maintains compliance with HUD requirements and its own policies and procedures. Further, HUD requirements[8] indicate the specific minimum elements that must be included in a lender's quality control plan.

J.P. Morgan Chase's quality control plan did not include all the elements required by HUD. The quality control plan did not address key elements to determine whether

- Loan documents requiring signature (other than blanket verification releases) were signed by the borrower or employee(s) of the lender only after completion and that all corrections were initialed by the borrower or employee(s) of the lender;
- All required loan processing, underwriting, and legal documents were included in loan files;
- The seller acquired the property at the time of or soon before closing, indicating a possible property "flip";
- The borrower transferred the property at the time of closing or soon after closing, indicating the possible use of a "straw buyer" in the transaction; and
- All items requiring documentation had been properly evidenced and retained in the file.

J.P. Morgan Chase stated that its quality control reviews addressed the elements noted above and provided us examples of its checklists which included these elements. However to ensure that these elements are consistently addressed and

[6] HUD paid a claim for preforeclosure sale loss mitigation on July 15, 2007.
[7] HUD Handbook 4060.1, REV-2, paragraph 7-1
[8] HUD Handbook 4060.1, REV-2, paragraph 7-7

that HUD is fully protected from unacceptable risk and guarded against errors, omissions, and fraud, J.P. Morgan Chase should update its quality control plan to reflect the minimum elements required by HUD. One way it can accomplish this would be to incorporate its comprehensive checklists directly into its quality control plan.

J.P. Morgan Chase Did Not Always Implement Its Quality Control Plan as Required

HUD requirements[9] state that quality control review findings must be reported to lenders' senior management within a month of completion of the initial report and that management must take prompt action to deal appropriately with material findings. The final report or an addendum must identify actions being taken with regard to findings, the timetable for their completion, and planned follow-up activities. HUD requirements[10] also state that findings discovered during quality control reviews should be reported to HUD within 60 days of the initial discovery.

J.P. Morgan Chase did not implement quality control procedures as required for one (case number 071-1054663) of five loans reviewed to test the implementation of its quality control plan. This loan is currently in delinquent status and was not one of the eight sample loans reviewed. There were significant underwriting deficiencies noted in relation to the loan including income and debt ratios in excess of HUD requirements without compensating factors, a credit report indicating late payments on 16 separate accounts over an 18-month period, and year-to-date earnings that did not support the income used to qualify the borrower. J.P. Morgan Chase reprimanded the responsible underwriter but did not report the findings to HUD within 60 days of discovery. HUD paid a partial claim of $8,051[11] for this loan.

J.P. Morgan Chase's quality assurance staff also reviewed the case in which we determined that the qualifying ratios were incorrect but failed to identify the issue.

J.P. Morgan Chase Did Not Always Exercise Due Care and Follow Required Procedures

The loan origination deficiencies noted occurred because branch office staff did not exercise due care in the underwriting of the loans. The quality control issues

[9] HUD Handbook 4060.1, REV-2, paragraph 7-3I
[10] HUD Handbook 4060.1, REV-2, paragraph 7-3J
[11] HUD paid a partial claim for loss mitigation.

occurred because J.P. Morgan Chase did not always implement quality control procedures as required. According to HUD requirements,[12] one of the goals of quality control is to ensure compliance with FHA's and the lender's own origination or servicing requirements throughout its operations. Also, J.P. Morgan Chase's quality control plan for early payment defaults indicates that part of its quality control review process includes a detailed review for accuracy and validity of documentation for each loan, as well as a re-underwriting of the loan for credit risk factors.

It is important for J.P. Morgan Chase to ensure that its staff exercises due care in underwriting FHA loans. It must also update and implement its quality control plan in accordance with HUD requirements so that it can accurately assess its origination and servicing processes and take appropriate measures as needed to prevent instances of noncompliance with HUD's and its own requirements.

Conclusion

J.P. Morgan Chase generally complied with HUD requirements in its origination and quality control review of FHA loans. However its branch office did not comply with HUD requirements in originating one of eight loans reviewed. In addition, J.P. Morgan Chase did not always implement quality control procedures as required. These deficiencies occurred because the branch office did not always exercise due care in underwriting and J.P. Morgan Chase did not always implement quality control procedures as required. As a result, the FHA insurance fund was exposed to an unnecessarily increased risk and HUD incurred a loss from a claim paid in the amount of $26,352 on one loan. Therefore, J.P. Morgan Chase should indemnify HUD $193,949 [13] and reimburse HUD for the loss it incurred (see appendixes C and D for more detail).

Recommendations

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner require J.P. Morgan Chase to

1A. Indemnify HUD $193,949 for one loan which it issued contrary to HUD's loan origination requirements.

[12] HUD Handbook 4060.1, REV-2, paragraph 7-2
[13] See footnote 2.

1B. Reimburse HUD $26,352 for the loss incurred from a claim paid on one loan which it issued contrary to HUD requirements.[14]

1C. Update its quality control plan to reflect the minimum elements required by HUD.

1D. Enforce its policies, procedures, and controls to ensure that its staff consistently follows HUD's and its own requirements in the underwriting and quality control review of FHA loans.

[14] Case number 071-1021875

SCOPE AND METHODOLOGY

We reviewed lenders with high default rates and selected the Newark, Delaware, branch of J.P. Morgan Chase because its percentage of defaults within two years was 5.9 percent, compared with the Delaware state average of 4.6 percent.

We ran queries in HUD's Neighborhood Watch system to identify the number of defaulted loans within the first two years and the payments made against those loans for the branch office. 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 two-year origination period and is updated on a monthly basis. The information on defaulted loans includes current defaults, and defaults within the first and first two years of endorsement. HUD requires lenders to use the Neighborhood Watch system to monitor and evaluate their performance.

The branch office issued 36 FHA loans, valued at approximately $5.8 million, that defaulted within the first two years. After eliminating loans that were refinanced and terminated and loans with more than 12 payments before default, 24 defaulted loans remained. The 24 loans, valued at more than $3.8 million defaulted after 12 payments or fewer. We sampled and reviewed case files for 8 of the 24 loans valued at approximately $1.3 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,
- Examined records and related documents for J.P. Morgan Chase,
- Reviewed case files for eight sample loans,
- Reviewed J.P. Morgan Chase's quality control plan and its implementation of the plan, and
- Conducted interviews with officials and employees of J.P. Morgan Chase and employees of HUD's Quality Assurance Division.

We reviewed J.P. Morgan Chase's implementation of its quality control plan by reviewing the results of its quality control reviews of five early payment default (EPD) loans in its Quality Assurance report dated December 4, 2008. One of the loans was included in the eight sample cases we reviewed.

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 covered the period July 2006 through June 2008.

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 objective. 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 an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved:

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They 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 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's 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

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

- J.P. Morgan Chase did not always operate in accordance with HUD requirements as they relate to loan issuance or origination.

- J.P. Morgan Chase did not always implement quality control procedures in accordance with HUD requirements.

APPENDIXES

Appendix A

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

Recommendation number	Ineligible costs1/	Funds to be put to better use 2/
1A		$81,459
1B	$26,352	

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. These amounts include 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 that 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 FHA, on average, loses 42 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**

JPMorganChase

JP Morgan Chase Bank, N.A
Retail Financial Services
Mortgage Banking
3415 Vision Dr.
Columbus, Ohio 43219

Deborah T. Whitt
Vice President
Phone: (614) 422-5910
Fax: (614) 422-7346

Date: July 7, 2009

John P. Buck
Regional Inspector General for Audit, Philadelphia Region, 3AGA,
Office of Inspector General
U.S. Department of Housing and Urban Development
Wanamaker Bldg, Suite 1005
100 Penn Square E.
Philadelphia, PA 19107-3380

Re: J.P Morgan Chase Bank, N.A.
HUD OIG Draft -Newark, Delaware Audit Report

Dear Mr. Buck:

JP Morgan Chase Bank, N.A ("Chase" or "Company") is in receipt of a draft audit report ("Report") from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of Inspector General ("OIG"). The report is based on a review of the Newark, Delaware, branch office ("branch office") of JP Morgan Chase Bank, N.A. The OIG performed its review over eight months, between October 16, 2008, and June 23, 2009, and the audit covered loans originated between July 2006, and June 2008. The Report states that the purpose of the OIG audit was to determine whether JP Morgan Chase complied with U.S. Department of Housing and Urban Development (HUD) requirements in the origination and quality control review of the FHA-insured single family loans.

The report contains findings that: i) the branch incorrectly calculated the qualifying ratios, and, therefore, the borrower's debt-to-income ratio exceeded the allowed limits on one loan (the "Qualifying Ratio Loan"); ii) Chase did not report one quality control finding to HUD which the OIG viewed as reportable (the "Unreported Loan"); and iii) based on the two identified loan findings, Chase did not always implement the Quality Control (QC) plan as required.

In response, Chase advises that:

Comment 1

As to the Qualifying Ratio Loan - The identified deficiencies were attributed to individual underwriter error, and the subject underwriter is no longer employed by Chase. Further, the loan was approved in 2006, and since origination of this loan, Chase has implemented numerous enhanced controls in the underwriting environment, including pre-funding reviews, increased focus on FHA training, restricted manual underwriting privileges, and enhanced individual underwriting performance monitoring.

Comment 2

As to the Unreported Loan – Chase's QC processes and procedures require the reporting of findings to HUD via data entry into the Neighborhood Watch Early Warning System in accordance with HUD ML 2005-26. Chase QC clearly took corrective action on the Unreported Loan pursuant to QC procedures, as evidenced by the reprimand signed by the subject underwriter. The decision that this loan was not reportable under HUD ML 2005-26 is being questioned by OIG, but is not indicative of program deficiency.

Comment 3

Chase maintains a quality control plan that is designed to, and does in fact comply with HUD requirements. Pursuant to the plan, which was submitted to HUD prior to implementation, Chase's Quality Assurance Department reviewed well over 8,000 FHA loans during the past year. In addition, 168 FHA specific reports and 143 on-site branch audits were performed last year. Further, 12,000 transactions are reviewed for compliance annually following HUD's servicing requirements. The Chase QC plan, policies and procedures are compared to HUD Handbook 4060.1, REV-2 and to applicable mortgagee letters to remain compliant with HUD requirements. In addition, Chase's Retail compare ratio of 58% (42% better than the Industry Average) serves as some indication of the effectiveness of the plan. The Newark DE branch national compare ratio is at 98%, by HOC 96% and the state ratio is 93%. Therefore, even the Newark DE compare ratios are not supportive of a noncompliant plan.

Comment 3

OIG's report notes that Chase could achieve plan compliance by merely including information contained in Chase's plan detail within the body of the plan description. Chase will investigate methods to implement the suggested changes. Chase however maintains that though such a change will serve to clarify compliance, the current plan is in fact compliant with HUD requirements.

Comment 3

Finally, Chase generally objects to the report findings to the extent that they imply that Chase does not maintain policies that meet HUDs requirements as set forth in Handbook 4060.1, REV-2 and subsequent mortgagee letters. Chase routinely performs frequent quality checks prior to funding and post funding to ensure compliance with HUD's requirements, and Chase's high standards are evidenced by its retail national compare ratio, which is 42% better than the national average.

Comment 4

We hope that the OIG will further consider this response and the supporting documentation (which is being separately provided in confidence). Thank you for your consideration.

Sincerely,

Deborah T. Whitt

Enclosures

OIG Evaluation of Auditee Comments

Comment 1 Despite the fact that the subject underwriter is no longer employed with the company, J.P. Morgan Chase still needs to enforce its policies, procedures, and controls to ensure that its staff consistently follows HUD's and its own requirements.

Comment 2 According to HUD requirements, quality control review findings must be reported to lenders' senior management within a month of completion of the initial report and management must take prompt action to deal appropriately with material findings. The final report or an addendum must identify actions being taken with regard to findings, the timetable for their completion, and planned follow-up activities. Although J.P. Morgan Chase provided documentation indicating that it reprimanded the underwriter of the deficient loan, it did not provide any evidence to show the action(s) taken or being taken to address the findings pertaining to the deficient loan, a timetable for the completion of the action(s), and any planned follow-up activities.

Also, HUD requires mortgagees to immediately report serious violations and report other findings within 60 days of the initial discovery. The loan in question had significant underwriting deficiencies that warrant a request that HUD be indemnified. However J.P. Morgan Chase did not report the deficiencies to HUD as required. This is evidence of an instance in which required quality control procedures were not fully implemented.

Comment 3 The overall conclusion of our report is that J.P. Morgan Chase generally complied with HUD requirements in the origination and quality control review of FHA-insured loans. However, we reviewed J.P. Morgan Chase's quality control plan for 19 specific elements required by HUD and five were missing. As discussed in the report, J.P. Morgan Chase provided separate checklists which reflected the required missing elements. In a discussion with a J.P. Morgan Chase manager during the audit, the manager agreed that the missing elements should be incorporated into the plan. We maintain that J.P. Morgan Chase should update its quality control plan so that it reflects all the minimum elements required by HUD to ensure that they are consistently addressed.

Comment 4 We reviewed the referenced documentation which J.P. Morgan Chase had previously provided, and made revisions as appropriate to our initial draft report. We have again reviewed the submitted documentation along with J.P. Morgan Chase's response and determined that no further changes to the report are warranted.

Appendix C

SCHEDULE OF CASE FILE DISCREPANCIES

Case number	Mortgage amount	Unpaid principal balance	42% loss rate*	Claim paid**	High qualifying ratios	Income not supported	Poor credit	Quality control plan not followed
071-1021875	$157,256	$155,319		$26,352	X			
071-1054663	$197,113	$193,949	$81,459		X	X	X	X
Totals	$354,369	$349,268	$81,459	$26,352				

* This amount was calculated by taking 42 percent of the unpaid principal balance for the loans. On average, HUD loses 42 percent of the claim amount paid.

** This amount represents a claim paid by HUD in June 2007 for the related property. A preforeclosure sale was completed in May 2007 for the home in case number 071-1021875. The home sale price of $150,000 was less than the unpaid principal balance.

Note: The issues related to the second case (071-1054663) were identified by J.P. Morgan Chase during its quality control review of the loan. This loan was reviewed as part of our assessment of J.P. Morgan Chase's quality control process, and was not one of the eight sample loans reviewed.

Appendix D

NARRATIVE CASE PRESENTATIONS

Case number: 071-1021875

Mortgage amount: $157,256

Date of loan closing: July 24, 2006

Status: Preforeclosure sale completed

Payments before first default reported: One

Unpaid principal balance: $155,319

Summary:

The branch office incorrectly calculated qualifying ratios, and, therefore, the borrower's debt-to-income ratios exceeded the allowed limits.

Pertinent Details:

HUD Handbook 4155.1, REV-5, paragraph 2-11A, requires lenders to include the monthly housing expense and all other additional recurring charges extending 10 months or more in computing a borrower's debt-to-income ratios. Recurring charges include but are not limited to installment accounts. Debts lasting less than 10 months must also be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing. Paragraph 2-12 states that ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. The lender must compute two ratios: mortgage payment expense to effective income should not exceed 29 percent, and total fixed payment to effective income should not exceed 41 percent. Mortgagee Letter 2005-16 increased the qualifying ratios to 31 and 43 percent, respectively, for manually underwritten mortgages for which the direct endorsement underwriter must make the credit decision.

The branch qualified a borrower based on incorrect ratios because it erroneously overstated the borrower's effective monthly income and did not consider two debts that were on the borrower's credit report. As a result, the loan was approved based on incorrect debt-to-income ratios. If the lender had used the correct income and debt amounts, the borrower would not have qualified for the loan because the mortgage payment expense-to-income ratio would have been 36.85 percent, which exceeds the 31 percent allowed by HUD, and the total fixed payment-to-income ratio would have been almost 64 percent compared with HUD's 43 percent limit. A preforeclosure sale was completed in May 2007 for the home in this case. The home was sold for $150,000. HUD paid a claim for preforeclosure sale loss mitigation in July 2007.

Case number: 071-1054663

Mortgage amount: $197,113

Date of loan closing: October 31, 2007

Status: Delinquent

Payments before first default reported: Four

Unpaid principal balance: $193,949

Summary:

J.P. Morgan Chase did not report quality control findings to HUD as required. Quality control findings for the subject loan included issues with qualifying ratios, supportability of income, and the borrower's creditworthiness.

Pertinent Details:

HUD Handbook 4060.1, REV-2, paragraph 7-3I, requires lenders to take prompt action to deal appropriately with material quality control review findings. The final quality control review report or an addendum must identify actions being taken with regard to findings, the timetable for their completion, and planned follow-up activities. Paragraph 7-3J states that findings discovered during quality control reviews should be reported to HUD within 60 days of the initial discovery.

J.P. Morgan Chase did not implement quality control procedures as required for the subject loan. Its quality control review of the loan revealed significant underwriting deficiencies including income and debt ratios in excess of HUD's allowed limits without compensating factors, year-to-date earnings that did not support the income used to qualify the borrower, and a credit report indicating late payments on 16 separate accounts within 18 months of closing. J.P. Morgan Chase had identified these issues as of December 2008 but did not report them to HUD as required. HUD paid a partial claim of $8,051 for loss mitigation on this loan.