Issue Date June 4, 2010	
Audit Report Number 2010-KC-1005	

TO: Vicki Bott, Deputy Assistant Secretary for Single Family Housing , HU

//**signed**//

FROM: Ronald J. Hosking, Regional Inspector General for Audit, Kansas City Region, 7AGA

SUBJECT: National Bank of Kansas City, Overland Park, KS, Did Not Follow HUD's Underwriting and Quality Control Requirements

HIGHLIGHTS

What We Audited and Why

We audited National Bank of Kansas City (National Bank) because its 2-year default ratio for sponsored loans was more than three times (339 percent) the sponsored average for the 2 years ending September 30, 2009. We reviewed 16 Federal Housing Administration (FHA) loans underwritten by National Bank and National Bank's quality control program.

Our audit objectives were to determine whether National Bank followed FHA requirements for (1) borrower eligibility and creditworthiness and property eligibility when underwriting loans and (2) implementing a quality control program.

What We Found

National Bank did not follow the U.S. Department of Housing and Urban Development's (HUD) requirements regarding income, liability, and asset determination in 4 of the 16 defaulted loans reviewed. These loans had material underwriting deficiencies that affected the insurability of the loans. National Bank also did not comply with HUD's quality control requirements. Specifically, its plan lacked elements required by HUD, and it did not ensure that its quality control reviews met HUD requirements.

What We Recommend

We recommend that the Deputy Assistant Secretary for Single Family Housing – Federal Housing Commissioner require National Bank to indemnify HUD for two actively insured loans with unpaid principal balances totaling more than $385,600 and future losses on two loans with unpaid principal balances totaling more than $280,800. Also, we recommend that HUD verify that National Bank provides its underwriters with additional training on its new procedures and properly performs its quality control function.

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 the draft report to National Bank on May 6, 2010 and requested a response by May 21, 2010. It provided written comments on May 20, 2010.

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

National Bank of Kansas City (National Bank) is a supervised direct endorsement lender based in Overland Park, KS. There are two types of approved direct endorsement mortgagees-supervised and nonsupervised. A supervised mortgagee is an FHA-approved financial institution that is a member of the Federal Reserve System or an institution whose accounts are insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration. 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. National Bank received approval from the Federal Housing Administration (FHA) on February 18, 1992. It previously had branch offices in Springfield, MO; Topeka, KS; and Tempe, AZ. However, these branches ceased operations in September 2008 since National Bank wanted to centralize their loan operations in one location.

From October 1, 2007, through September 30, 2009, National Bank originated 320 sponsored loans and 1,372 retail loans. For National Bank's sponsored loans, outside brokers often gathered the borrower's loan information and provided it to National Bank for loan underwriting. These loans were later sold to National Bank's investment partners. For the retail loans, all loan origination processes are handled exclusively by National Bank employees. The compare ratio for National Bank's sponsored loans that defaulted within the first 2 years was 337 percent. However, the compare ratio for National Bank's retail loans that defaulted within the first 2 years was only 51 percent. The compare ratio is a comparison of the lender's default rates with other lenders in a geographic area as defined by the U. S. Department of Housing and Urban Development (HUD).

National Bank had two separate divisions originating its sponsored and retail loans. During 2007, National Bank opened a wholesale (sponsored) business lending unit, New Vision Residential Lending. However, it decided to terminate the business activities of New Vision Residential Lending in February 2008. The mortgage division responsible for originating retail loans is still in business.

Our audit objectives were to determine whether National Bank followed FHA requirements for (1) borrower eligibility and creditworthiness and property eligibility when underwriting loans and (2) implementing a quality control program.

RESULTS OF AUDIT

Finding 1: National Bank Did Not Follow HUD's Underwriting Requirements for Four FHA Loans

National Bank did not follow HUD's underwriting requirements while underwriting four FHA loans. This condition occurred because National Bank did not have adequate procedures and policies in place. As a result, the lender placed the insurance fund at unnecessary risk for more than $671,550 in mortgages.

Underwriting Did Not Meet HUD Standards

National Bank did not follow HUD's underwriting requirements for 4 of the 16 loans reviewed. We found five material deficiencies in the four loans. The following table summarizes the material deficiencies identified.

Material deficiency	Number of loans
Income	3
Liabilities	1
Assets	1

Appendix C, criterion 16-23, contains the criteria applicable to the material deficiencies. Appendix D contains a schedule of the material deficiencies, mortgage amounts, and the unpaid principal balances identified in each of the four loans. Appendix E contains detailed narratives for each of the loans.

Income

National Bank did not properly evaluate the income amount for three of the four loans. Lenders may not use income in evaluating the borrower's loan that it cannot verify, is not stable, or will not continue.

For example, in FHA case number 441-8260266, National Bank overstated the borrower's total monthly income by $1,103. First, the lender estimated the borrower's base monthly income as $2,047. However, the borrower's base monthly income was $1,560 in 2008, $2,698 in 2007, and $3,036 in 2006. The borrower's average monthly base income decreased approximately $1,138 from 2007 to 2008 and $338 from 2006 to 2007. The lender did not establish a stable income trend supporting the borrower's rate of pay at the time of the loan closing. Also, there was nothing in the loan file to indicate whether the borrower's position was seasonal. The borrower's base monthly employment income should only have been calculated as $1,560, $487 less than that used by the lender.

Also, the lender determined that the borrower should include $616 in unemployment compensation as monthly income. It based this amount on the borrower's having received unemployment compensation in 2007 and 2006. However, there was nothing in the loan file to indicate that the borrower received this type of compensation in 2008 and no documentation to show reasonable assurance of its continuance. Since the $616 in unemployment compensation should have not been included as income and the borrower's base monthly income should have been $487 less, the borrower's monthly income was overstated by $1,103.

Liabilities

National Bank understated the borrower's liabilities for one loan. In this case, the lender did not include a recurring monthly payment of $398. HUD requires lenders to consider all recurring obligations, contingent liabilities, and projected obligations that meet HUD's specific stipulations when evaluating a loan application.

Assets

National Bank did not properly verify the assets used to close one loan. The HUD-1 settlement statement showed that the borrower paid $7,631in closing costs. The verification of deposit showed a savings account balance of $17,511. However, the savings account statement listed large deposits of $1,000, $11,077, and $1,600 with no explanations for the source of those funds.

HUD states that 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.

Adequate Underwriting Procedures Were Not in Place

National Bank did not have adequate procedures in place. Although it used an FHA loan approval checklist and income calculations worksheet, it did not provide adequate guidance concerning income trend analysis and asset verification to its underwriters.

During our review, National Bank showed us that it recently took several actions to improve its asset verification process. First, it added a step in its loan approval checklist to remind underwriters to verify large deposits. Second, it now requires its underwriters to document the source of any deposit over $1,000.

All of the loans that we questioned due to material deficiencies closed before the above actions took place. Although these actions were noteworthy, additional training on these new procedures would improve National Bank's underwriting process.

Loans Placed the FHA Insurance Fund at Unnecessary Risk of Loss

National Bank placed the FHA insurance fund at an increased risk of loss on four loans with original mortgage amounts totaling more than $671,550. Two loans were in claims, and two were still active.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing require National Bank to

1A. Indemnify HUD for two actively insured retail loans with unpaid principal balances of $385,693. The projected loss is $231,416 based on the FHA insurance fund average loss rate of 60 percent for fiscal year 2009.

1B. Indemnify HUD for future losses on two sponsored loans with unpaid principal balances totaling $280,839 for which HUD had not sold the property. The projected loss is $168,503 based on the FHA insurance fund average loss rate of 60 percent for fiscal year 2009.

1C. Adequately train its underwriters on its new procedures.

Finding 2: National Bank Did Not Comply With HUD's Quality Control Requirements

National Bank did not comply with HUD's quality control requirements. This noncompliance occurred because National Bank did not properly interpret HUD's quality control requirements. As a result, the FHA insurance fund was placed at an increased risk of loss.

Quality Control Plan Was Incomplete and Quality Control Reviews Were Not Adequate

National Bank did not comply with HUD's quality control requirements. Specifically, its plan lacked elements required by HUD, and it did not ensure that its quality control reviews met HUD requirements.

National Bank's quality control plan lacked 14 required elements. For example, the plan did not address the requirement that quality control reviews be completed within 90 days of closing; verify the identity of the loan applicant; include documented onsite reviews of branch offices; or identify patterns of early defaults by location, program, loan characteristic, loan correspondent, or sponsor. Appendix F contains the details of the 14 missing elements.

In addition, National Bank did not ensure that its quality control reviews met HUD requirements. Specifically, it did not

- Ensure that the quality control reviews included all early defaults.
- Properly document onsite quality control reviews of branch offices.
- Conduct onsite quality control reviews of the Topeka, KS, and Springfield, MO, branch offices in 2007.
- Semiannually check its employees against the limited denial of participation/General Services Administration list.

Appendix C, criterion 1-15, contains HUD's specific quality control criteria.

National Bank Did Not Properly Interpret HUD's Quality Control Requirements

National Bank did not properly interpret HUD's quality control requirements. For example, it stated that it knew about the requirement to conduct the early payment default reviews and branch reviews but it did not know it had to document them.

As a result of our review, National Bank revised its quality control plan and added the 14 missing elements. In addition, it developed new procedures to ensure that employees are checked semiannually against the limited denial of participation/General Services Administration list.

There Was an Increased Risk to the FHA Insurance Fund

Without a properly implemented quality control program, the FHA insurance fund is placed at an increased risk of loss. Specifically, the lender is unable to ensure the accuracy, validity, and completeness of its loan origination operations. In addition, it may not identify potential deficiencies and make needed corrections in a timely manner.

Recommendation

We recommend that the Deputy Assistant Secretary for Single Family Housing

2A. Perform a review of National Bank's quality control function in 6 months to ensure that it complies with HUD's requirements.

SCOPE AND METHODOLOGY

We performed our audit work from November 2009 through March 2010 at National Bank's office at 10700 Nall Avenue, Overland Park, KS. Our audit period was October 1, 2007, through September 30, 2009.

To accomplish our objectives, we reviewed HUD's and National Bank's underwriting policies and procedures. We interviewed National Bank's management and staff. Also, we reviewed HUD and National Bank loan files. In addition, we reviewed National Bank's quality control plan and quality control reviews.

National Bank had 111 defaults with a beginning amortization date between October 1, 2007, and September 30, 2009. Of these, 74 were sponsored loans, and 37 were retail loans. Of the 74 sponsored loans, 1 had been terminated and no longer had FHA insurance. Of the 73 remaining sponsored loans, 7 had gone to claims, and 66 were still active. At the beginning of our review, we reviewed all seven sponsored loans in claims status with mortgage amounts totaling $972,735. Next, we selected a sample of nine retail loans. We selected the only two loans in claims status as of November 10, 2009. Next, we selected the only seven active loans that had five or fewer payments made before the first 90-day default and were in default as of November 10, 2009. The total mortgage amount of the nine retail loans was nearly $1.5 million.

When identifying underwriting deficiencies, we assessed whether the deficiencies were material and should have caused the lender to disapprove the loan. We considered deficiencies that affected the approval and insurability of the loans as significant and recommended that HUD take appropriate action on these loans.

We relied on computer-processed data contained in HUD's Single Family Data Warehouse and Neighborhood Watch systems. During the audit, we assessed the reliability of the data and found the data to be adequate. Therefore, we concluded that the data were sufficiently reliable to be used in meeting our objectives.

We assigned a value to the potential savings to HUD if it implements our recommendations to require National Bank to indemnify loans with material deficiencies. For those loans for which HUD had not yet incurred a loss, we applied FHA's loss experience of 60 percent for fiscal year 2009 as provided by HUD. The amount reflects that, upon sale of the mortgaged property, FHA's average loss experience is about 60 percent of the unpaid principal balance based upon statistics provided by HUD.

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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following controls 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:

- Controls to ensure that FHA loans meet HUD underwriting requirements.
- Controls to ensure that the lender implements a quality control program that complies with HUD 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:

- National Bank did not have adequate controls in place to ensure that FHA loans met HUD underwriting requirements (see finding 1).
- National Bank did not have adequate controls in place to ensure that its quality control program met HUD requirements (see finding 2).

APPENDIXES

Appendix A

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

Recommendation number	Funds to be put to better use 1/
1A	$231,416
1B	$168,503

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, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified.

Implementation of our recommendations to require National Bank to indemnify HUD for materially deficient loans will reduce the risk of loss to the FHA insurance fund. The amount above reflects that, upon sale of the mortgaged property, FHA's average loss experience is about 60 percent of the unpaid principal balance based upon statistics provided by HUD. [$385,693 X .60=$231,416 and $280,839 X .60=$168,503]

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

NATIONAL BANK
OF KANSAS CITY
MORTGAGE DIVISION

May 19, 2010

Ronald J. Hosking
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Region VII Office of Audit
400 State Avenue
Gateway Tower II – 5th Floor
Kansas City, KS 66101

Dear Mr. Hosking,

With regards to our recent audit we have written comments (attached) for three of the four loans recommended for indemnification and ask that further consideration be given to these.

Comment 1

Our underwriting procedures have been updated since the time these loans were underwritten. Two relevant enhancements to the procedures were the creation of an Income Sheet retained in the file to show how the underwriter calculated the income and the addition of an Approval Stip that states verified assets. The Underwriting manager holds a regularly scheduled training meeting each month with all the underwriters to train on new items and refresh on old issues.

As a result of this audit National Bank of Kansas City has revised its quality control program to include any missing elements. New procedures have also been developed to ensure that employees are checked semi-annually against the limited denial of participation/General Services Administration list. Early Payment Default reviews (EPD) is being documented as they occur by Risk Management Team.

Documentation has also been put into use to show that we are properly performing our quality control function.

Sincerely,

Todd D Geiman

Todd Geiman
Executive Vice President

Ref to OIG Evaluation	Auditee Comments
	Auditee Comments Comment 1 Appendix E - case #251-3405672 – Issue unverified assets. Although it is our normal practice to document large deposits it appears that in this case an exception was made due to the VOD showing a 2 month average balance of $17,004 with a current balance of $17,511. The large deposit of $11,077 was made 41 days prior to the date of the VOD. The account is not a new account and the required cash was $8,896 well below the average balance.
Comment 2	Comment 2 Appendix E – case #292-4824038 – Issue overstatement of income. Issue understated liability Using a more conservative approach in calculating the income supports sufficient income for this loan when compensating factors are considered. 2006 W-2 shows total income of $42,298/12 = $3,533.17 per month. 2007 W-2 shows total income of $44,586/12 = $3,715.50 per month. 2008 pay stub thru 3/1/08 has year-to-date income of $7,884/2 = $3,942 a month. Last 24 months equals (2 x 3658 + 12 x 3715.50 + 10 x 3533.17 = $87,801.70/24 = $3,658.40 per month. Housing ratio is 34.25% (1252.97 / 3658.40) Debt ratio is 45.13% (1650.97 / 3658.40) Compensating factor for debt ratio exceeding 45% is verified assets exceeding $6,000, which is more than the required 2 months amount.
Comment 3	Comment 3 Appendix E – case #291-3603287 – Issue calculation of co-borrower's income. Agree that co-borrower's income was miscalculated. Compensating factors for ratios higher than 31/43 are: • Good rental history with no lates • Borrower has stable employment. • Co-borrower has been back to work for 5 months after maternity leave. • Co-borrower was off work due to a high risk pregnancy from 1/07 to 8/07 per LOE. • All revolving debt paid off.
Comment 4	

OIG Evaluation of Auditee Comments

Comment 1 We commend National Bank for updating their underwriting procedures and taking quick action in correcting their quality control deficiencies.

Comment 2 National Bank did not adequately verify and document the $11,077 deposit so it is unknown whether these funds were from the borrower's savings or a gift. HUD Handbook 4155.1, REV-5, paragraph 2-10 states that if there was a large increase in an account, the lender must obtain a credible explanation on the source of those funds.

Comment 3 National Bank agreed the payment-to-income ratio and total debt-to-income ratios exceeded HUD's maximum ratios of 31 and 43 percent, respectively. The mortgage credit analysis worksheet did not list assets as a compensating factor. HUD Handbook 4155.1, REV-5, paragraph 2-13, states that underwriters must state the compensating factors used to support the loan approval in the remarks section of the underwriting worksheet. Also, those assets were needed to help close on the loan so the borrower actually did not have two months in reserves.

Comment 4 National Bank agreed the coborrower's income was miscalculated. Also, the mortgage credit analysis worksheet did not list any compensating factors. HUD Handbook 4155.1, REV-5, paragraph 2-13, states that underwriters must state the compensating factors used to support the loan approval in the remarks section of the underwriting worksheet.

Appendix C

CRITERIA

Criterion 1

HUD Handbook 4060.1, REV-2, paragraph 7-3, states that there are several basic elements that are required in all quality control programs that apply to both origination and servicing. Paragraph 7-3F states that all aspects of the mortgage operation, including but not limited to all branch offices or sites, FHA-approved loan correspondents, authorized agents, loan officers or originators, processors, underwriters, appraisers, closing personnel, and all FHA loan programs, must be subject to the lender's quality control reviews.

Criterion 2

HUD Handbook 4060.1, REV-2, paragraph 7-6A, states that loans must be reviewed within 90 days from the end of the month in which the loan closed. This requirement is intended to ensure that problems left undetected before closing are identified as early after closing as possible.

Criterion 3

HUD Handbook 4060.1, REV-2, paragraph 7-3G, states that lender offices, including traditional, nontraditional branch, and direct lending offices engaged in origination or servicing of FHA-insured loans, must be reviewed to determine that they are in compliance with HUD's requirements. Paragraph 7-3G(1) states that the review must include but not necessarily be limited to confirmation of the following items:

- Location is properly registered with HUD and the address is current.
- Operations are conducted in a professional, business like environment; if located in a commercial space, the office is properly and clearly identified for any walk-in customers, has adequate office space and equipment, is in a location conducive to mortgage lending, and is separated from any other entity by walls or partitions.
- Servicing office provides toll-free lines or accepts collect calls from borrowers.
- Personnel at the office are trained and have access to relevant regulatory guidance.
- Procedures are revised to reflect changes in HUD requirements, and personnel are informed of the changes in HUD requirements.
- Personnel at the office are all employees of the lender.
- Office does not employ or have contract with anyone who is currently under debarment, suspension, or limited denial of participation.

Criterion 4

HUD Handbook 4060.1, REV-2, paragraph 7-3J, states that findings of fraud or other serious violations must be immediately referred in writing (along with any available supporting documentation) to the Director of the Quality Assurance Division in the HUD homeownership center having jurisdiction. If HUD staff is suspected of involvement, OIG should be notified.

Criterion 5
HUD Handbook 4060.1, REV-2, paragraph 7-3L, states that the lender should determine that no one is employed for HUD origination, processing, underwriting, or servicing who is debarred, suspended, subject to a limited denial of participation, or otherwise restricted from participation in HUD/FHA programs. Lenders must check the employee list at least semiannually.

Criterion 6
HUD Handbook 4060.1, REV-2, paragraph 7-3G(2), states that the criteria used by the lender to determine the frequency of onsite reviews must be in writing and available for review by HUD at the corporate office and any branch office that is not being reviewed annually.

Criterion 7
HUD Handbook 4060.1, REV-2, paragraph 7-5A, states that lenders should monitor the application process and must verify the identity of the loan applicant.

Criterion 8
HUD Handbook 4060.1, REV-2, paragraph 7-5C, states that lenders must identify patterns of early defaults by location, program, loan characteristic, loan correspondent, or sponsor. In addition, paragraph 7-6D states that in addition to loans selected for routine quality control reviews, lenders must review all loans going into default within the first six payments. Early payment defaults are loans that become 60 days past due.

Criterion 9
HUD Handbook 4060.1, REV-2, paragraph 7-6G, states that each loan selected for a quality control review must be reviewed to determine whether the seller was the owner of record or was exempt from the owner of record requirement in accordance with HUD regulations.

Criterion 10
HUD Handbook 4060.1, REV-2, paragraph 7-7C, states that the lender should determine whether loan documents requiring signature (other than blanket verification releases) were signed by the borrower or the lender employees only after completion and all corrections were initialed by the borrowers or lender employees.

Criterion 11
HUD Handbook 4060.1, REV-2, paragraph 7-7F, states that the lender should determine whether more than one credit report was ordered and whether all credit reports were submitted with the loan package to HUD/FHA or the direct endorsement underwriter.

Criterion 12
HUD Handbook 4060.1, REV-2, paragraph 7-7G, states that the lender should determine whether outstanding judgments shown on the report were shown on the mortgage credit analysis worksheet and acceptably explained in accompanying documentation.

Criterion 13
HUD Handbook 4060.1, REV-2, paragraph 7-7H, states that the lender should determine whether the loan file contains pertinent documentation of the borrower’s source of funds for the

required investment, the acceptability of that source, and that any obligation to repay the funds is included on the uniform residential loan application.

Criterion 14
HUD Handbook 4060.1, REV-2, paragraph 7-7J, states that the lender should determine whether there are sufficient and documented compensating factors if the debt ratios exceed FHA limits.

Criterion 15
HUD Handbook 4060.1, REV-2, paragraph 7-7P, states that the lender should determine whether the seller acquired the property at the time of closing or soon after closing, indicating the possible use of a straw buyer in the transaction.

Criterion 16
HUD Handbook 4155.1, REV-5, paragraph 2-6, states that the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt. Income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue. This section describes acceptable types of income, procedures for calculating effective income, and requirements for establishing income stability. HUD does not impose a minimum length of time a borrower must have held a position of employment to be eligible. However, the lender must verify the borrower's employment for the most recent 2 full years. To analyze and document the probability of continued employment, lenders must examine the borrower's past employment record, qualifications for the position, previous training and education, and the employer's confirmation of continued employment.

Criterion 17
HUD Handbook 4155.1, REV-5, paragraph 2-11A, states that the borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other recurring charges extending 10 months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts, alimony, etc. Debts lasting less than 10 months must 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, especially if the borrower will have limited or no cash assets after loan closing.

Criterion 18
Mortgagee Letter 2005-16 states that for manually underwritten mortgages in which the direct endorsement underwriter makes the credit decision, the qualifying ratios are raised to 31 percent and 43 percent. This change will allow a larger number of deserving families to purchase their first home while not increasing their risk of default. As always, if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval.

Criterion 19
HUD Handbook 4155.1, REV-5, paragraph 2-13, lists various compensating factors that may be used in justifying approval of loans with excessive qualifying ratios. Underwriters must state the

compensating factors used to support loan approval in the remarks section of the underwriting worksheet.

Criterion 20

HUD Handbook 4155.1, REV-5, paragraph 2-10, states that all funds for the borrower's investment in the property must be verified and documented. In addition, paragraph 2-10A states that if the amount of 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. Paragraph 2-10B adds that a verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there was 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.

Criterion 21

Direct Underwriting Findings states that if the amount of the earnest money deposit or other large deposits exceed 2 percent of the sales prices or appears excessive based on the borrower's history of accumulating savings, the lender must verify the deposit amount and source of funds according to FHA guidelines. The lender must also determine that any recent debts were not incurred for any part of the cash investment on the property being purchased.

Criterion 22

HUD Handbook 4155.1, REV-5, paragraph 2-7L, states that income received from government assistance programs is acceptable, subject to documentation from the paying agency, provided the income is expected to continue at least 3 years. If the income is not expected to be received for at least 3 years, such income may be considered a compensating factor. (Unemployment income must be documented for 2 years. Reasonable assurance of its continuance is also required. The requirement may apply to individuals employed on a seasonal basis, such as farm workers, resort employees, etc.)

Criterion 23

Direct Underwriting Findings states that employment received under a welfare program, unemployment income, workmen's compensation, payments for foster children, etc., are acceptable subject to documentation from the paying agency provided the income is expected to continue at least 3 years. If not expected to last at least 3 years, such income may be considered a compensating factor. Unemployment income requires a 2-year documentation of receipt and reasonable assurance of its continuance.

Appendix D

SCHEDULE OF SIGNIFICANT UNDERWRITING DEFICIENCIES

FHA case number	Loan type	Insurance status	Mortgage amount	Unpaid principal balance	Potential loss on active/ claims loans*	Income	Assets	Liabilities	Total number of material deficiencies
251-3405672	Retail	Active	$219,800	$218,308	$130,985		X		1
441-8260266	Retail	Active	$169,505	$167,385	$100,431	X			1
Subtotals			**$389,305**	**$385,693**	**$231,416**				
292-4824038	Sponsored	Claims-not sold	$134,883	$134,473	$80,684	X		X	2
291-3603287	Sponsored	Claims-not sold	$147,364	$146,366	$87,819	X			1
Subtotals			**$282,247**	**$280,839**	**$168,503**				
Totals	2-retail 2-sponsored	2-active 2-claims not sold	**$671,552**	**$666,532**	**$399,919**				

* Estimated future losses are based on HUD's average loss rate of 60 percent of the unpaid principal balance for claims paid from the FHA insurance fund for fiscal year 2009.

Appendix E

CASE STUDIES FOR FOUR QUESTIONED LOANS

Case number: 251-3405672

Insured amount: $219,800

Section of Housing Act: 203(b)

Status upon selection: Defaulted on the 1st payment

Date of loan closing: March 20, 2008

Underwriter type: Automated

Assets

The lender did not verify the assets used to close the loan. The HUD-1 settlement statement showed that the borrower paid closing costs of $7,630.54. The verification of deposit, dated March 4, 2008, showed a savings account balance of $17,511. The demand deposit (savings account) statement showed a balance of $20,102.46 as of February 11, 2008, and the earliest balance listed was $5,567.39 as of January 14, 2008. The demand deposit statement showed several large deposits with no explanations. On January 4, 2008, it listed a deposit of $1,000. On January 22, 2008, it listed a deposit of $11,077.29. On February 4, 2008, it listed a deposit of $1,600.

HUD Requirements – Appendix C

HUD Handbook 4155.1, REV-5, paragraph 2-10B (criterion 20)
Direct Underwriter Findings (criterion 21)

Case number: 441-8260266

Insured amount: $169,505

Section of Housing Act: 203(b)

Status upon selection: Defaulted on the 6th payment

Date of loan closing: June 28, 2008

Underwriter type: Automated

Income

National Bank overstated the borrower's income by $1,103. Also, it did not establish a stable income trend supporting the borrower's rate of pay at the time of the loan closing. The lender estimated the borrower's base employment income as $2,047. According to the borrower's verification of employment, the borrower began his present job on July 10, 2006, which equated to 6.32 months. According to the borrower's 2006 Internal Revenue Service Form W-2 (W-2), he earned $19,188 in 6.32 months. The 2007 W-2 indicated that the borrower earned $32,372. As of June 1, 2008, the borrower had earned $7,799.42 in year-to-date income.

The borrower's average monthly income decreased approximately $1,138 from 2007 to 2008 ($2,698-$1,560) and $338 ($3,036-$2,698) from 2006 to 2007. There was nothing in the loan file to indicate whether the borrower's position was seasonal and/or any gaps in employment spanning 1 month or more. As a result, the borrower's income should have been calculated as $1,560. The difference between our calculation and the lender's calculation of base employment income was $487 ($2,047-$1,560). The lender correctly calculated the co-borrower's monthly income as $2,183.

Also, the lender determined that the borrower had monthly unemployment income of $616 based on the borrower's unemployment compensation amounts received in 2007 and 2006 ($5,784 + $8,991/24 months). However, there was nothing in the loan file to indicate whether the borrower received unemployment compensation in 2008 and no documentation to show reasonable assurance of its continuance. As a result, the $616 in unemployment compensation should not have been included in the borrower's total monthly income. Overall, the lender overstated the borrower's income by $1,103 ($487 +$616). This amount would have decreased the overall monthly income to $3,743 ($1,560 + $2,183). The $1,103 decrease in income would have increased the income ratios from 28.76 and 51.35 percent to 37.22 and 66.48 percent, respectively.

HUD Requirements – Appendix C
HUD Handbook 4155.1, REV-5, paragraph 2-6 (criterion 16)
HUD Handbook 4155.1, REV-5, paragraph 2-7 L (criterion 22)
Direct Underwriter Findings (criterion 23)

Case number: 292-4824038

Insured amount: $134,883

Section of Housing Act: 203(b)

Status upon selection: Defaulted on the 5th payment

Date of loan closing: March 10, 2008

Underwriter type: Manual

Income
The lender overstated the borrower's monthly income by $338 per month. We reviewed the borrower's verification of employment, recent pay stubs, and other income documentation and determined that the borrower's year-to-date income (pay period ending March 1, 2008) was $7,885. The borrower's three most recent pay stubs were for pay periods ending February 10, February 23, and March 1, 2008. There was no paycheck for the pay period ending February 17, 2008, and based on year-to-date amounts, it appears that the borrower did not have a paycheck for this pay period. The borrower's income significantly varied from one paycheck to another ($754, $732, and $1,040 regular pay per paycheck for periods indicated above), and yet the underwriter used only the 2 most recent months of income to calculate monthly income as opposed to using the past 2 years (24 months). We also noted that the underwriter provided no explanation for using 2 months of income as opposed to a 24-month period, yet the borrower had provided W-2s for the past 3 years. Although there was sufficient documentation in the file

showing that the borrower had been a truck driver for the past 2.5 years and the borrower's income increased from $40,872.40 in 2006 to $44,586.03 in 2007, the pay stubs and verification of employment did not show the number of hours worked or the basis of compensation. Therefore, the underwriter's calculation of the borrower's monthly income at $3,943.50 based on 2 months of income was incorrect, and the amount used to qualify was not adequately supported. We calculated the borrower's monthly income as $3605.46.

HUD Requirements – Appendix C
HUD Handbook 4155.1, REV-5, paragraph 2-6 (criterion 16)

Liabilities
The lender understated the borrower's monthly liabilities by $398. We initially reviewed the borrower's uniform residential loan application, mortgage credit analysis worksheet, and credit report for any differences. We noticed that the borrower reported a recurring monthly obligation of $398 on the uniform residential loan application, which the loan underwriter did not include in tabulating the loan qualifying ratios. According to the uniform residential loan application, the recurring monthly obligation had an outstanding unpaid balance of $10,431. We reviewed the borrower's credit report for information evidencing the existence of this obligation but found no information indicating its existence. There was no explanation in the loan file to determine whether this liability was entered in error or even existed.

We recalculated the ratios using the recomputed income of $3,605.46 and underreported liabilities of $398. The borrower's revised mortgage payment-to-income ratio was 34.75 percent, and the total debt-to-income ratio was 45.79 percent. These ratios are above HUD's maximum ratios of 31 and 43 percent, respectively.

HUD Requirements – Appendix C
HUD Handbook 4155.1, REV-5, paragraph 2-11A (criterion 17)(
Mortgagee Letter 2005-16 (criterion 18)

Case number: 291-3603287

Insured amount: $147,364

Section of Housing Act: 203(b)

Status upon selection: Defaulted on the 6th payment

Date of loan closing: January 11, 2008

Underwriter type: Manual

Income
The lender did not accurately calculate the coborrower's income as it initially calculated the income as $833.11. The coborrower's work history was sporadic for the 3 years preceding the FHA loan closing. The coborrower had six jobs in 2005, four in 2006, and one indicated in 2007. We decided to use the 2006 W-2 income and the 2007 income to meet the FHA 2-year requirement. If we add the coborrower's 2006 income ($6,990.10) and the 2007 income

($3,124.19) as of November 11, 2007 (10.77 months=10 months and 23 days/30 days), we calculate a total income of $10,114.29. If we divide this total income by 22.77 months ($10,114.29/22.77), the monthly income would average $444.19. When we added the borrower's income $2,495.53 ($2,166.63 + $328.90) with the coborrower's income ($444.19), the revised total income was $2,939.72.

We recalculated the ratios using the recomputed income of $2,939.72. The borrower's revised mortgage payment-to-income ratio was 40.56 percent, and the revised total debt-to-income ratio was 51.75 percent. These ratios are well above HUD's maximum ratios of 31 and 43 percent, respectively. We also noted that the mortgage credit analysis worksheet did not list compensating factors.

HUD Requirements – Appendix C

HUD Handbook 4155.1, REV-5, paragraph 2-6 (criterion 16)
HUD Handbook 4155.1, REV-5, paragraph 2-13 (criterion 19))Mortgagee Letter 2005-16 (criterion 18)

Appendix F

QUALITY CONTROL PLAN
MISSING ELEMENTS

National Bank's quality control plan did not contain the following 14 required elements per HUD Handbook 4060.1, REV-2. The plan did not require the lender to

- Address the requirement that quality control reviews should be performed within 90 days of closing.

- Review certain items at the branch offices, including whether the office provided toll-free lines or accepted collect calls from borrowers and whether personnel were employees of the lender or contract employees performing functions that FHA allows to be outsourced.

- Immediately refer findings of fraud or other serious violations in writing (along with available documentation) to HUD or to refer HUD staff suspected of involvement to OIG.

- Determine that no one is employed for HUD origination, processing, underwriting, or servicing who is debarred, suspended, subject to a limited denial of participation, or otherwise restricted from participation in the HUD/FHA programs. Lenders must check the employee list at least semiannually.

- Determine that the frequency of onsite reviews must be in writing and available for review by HUD at the corporate office or any branch office that is not reviewed annually.

- Verify the identity of the loan applicant.

- Identify patterns of early defaults by location, program, loan characteristic, loan correspondent, or sponsor.

- Verify that the seller was the owner of record or was exempt from the owner of record requirements.

- Determine whether loan documents, requiring signature, were signed by the borrower or employees of the lender only after completion and that all corrections were initialed by the borrower and/or employees of the lender, as appropriate.

- Determine whether the seller acquired the property at the time of closing or shortly before the closing, indicating a possible property flip. .

- Determine whether more than one credit report was ordered and ensure that all credit reports are submitted.

- Determine whether outstanding judgments shown on the credit report were shown on the mortgage credit analysis worksheet and explained in accompanying documentation.

- Determine whether the loan file contains pertinent documentation of the borrower's source of funds for the required investment, the acceptability of that source, and that any obligation to repay the funds is included on the form HUD 92900.

- Determine whether there are sufficient and documented compensating factors if the debt ratios exceed FHA limits.