Issue Date April 11, 2007
Audit Report Number 2007-SE-1002

TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing Commissioner, H

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region X, 0AGA

SUBJECT: The Renton, Washington, Branch of Countrywide Home Loans Inc. Did Not Comply with HUD Guidelines in Underwriting Five Federal Housing Administration-Insured Loans

HIGHLIGHTS

What We Audited and Why

We completed an audit of single-family loan origination at the Renton, Washington, branch of Countrywide Home Loans Inc. (Renton branch) to determine whether it originated Federal Housing Administration-insured loans in accordance with U.S. Department of Housing and Urban Development (HUD) requirements.

What We Found

Countrywide's Renton branch did not comply with HUD requirements in underwriting five Federal Housing Administration-insured loans.

What We Recommend

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner require Countrywide to correct the deficiencies or indemnify HUD for the five loans with original insured amounts totaling $740,007.

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 our discussion draft report to Countrywide on March 19, 2007, and held an exit conference on March 29, 2007. Countrywide generally agreed with our report 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

The U.S. Department of Housing and Urban Development (HUD) authorized Countrywide Home Loans Inc. (Countrywide) as a nonsupervised lender in 1969. Its corporate office is in Calabasas, California. As of November 2006, Countrywide had 470 active offices and sponsored 2,442 active Federal Housing Administration-approved loan correspondents.

HUD authorized Countrywide's Renton, Washington, branch in May 2002. During our audit period of August 1, 2003, to July 31, 2006, the Renton branch originated more than 850 single-family loans totaling more than $123 million. We reviewed 22 of the loans originated during this period.

Our objective was to determine whether the Renton, Washington, branch of Countrywide originated Federal Housing Administration-insured loans in accordance with HUD requirements.

RESULTS OF AUDIT

Finding 1: Countrywide's Renton Branch Did Not Follow HUD Underwriting Requirements for Five Federal Housing Administration-Insured Loans

Countrywide's Renton branch did not comply with HUD requirements in originating five Federal Housing Administration-insured loans. The lender failed to establish that the borrowers had the ability and willingness to repay the mortgage debt or that the insured property was sufficient collateral for the loan. As a result, the Renton branch exposed the Federal Housing Administration insurance fund to an unnecessary risk totaling $740,007, the total insured amount for the five loans.

HUD Underwriting Requirements

HUD Handbook 4155.1, REV-5, Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Family Properties, contains HUD's requirements for mortgage credit analysis for Federal Housing Administration-insured loans. For each loan, lenders must analyze whether the borrower has the ability and willingness to pay the mortgage and whether the insured property is sufficient collateral. This decision must be based on sound underwriting principles and must be supported by sufficient documentation. HUD expects lenders to exercise sound judgment and due diligence in underwriting loans because simply establishing that a loan meets minimum standards does not necessarily constitute prudent underwriting.

Countrywide Did Not Document Compensating Factors

Paragraph 2-12 of the handbook requires lenders to calculate the borrower's mortgage payment-to-effective income ratio and the borrower's total fixed payment-to-effective income ratio. Lenders use these qualifying ratios to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. HUD limits these qualifying ratios to 29 percent and 41 percent, respectively, but allows higher ratios if the lender documents one or more of the compensating factors listed in Section 2-13 of the handbook. In April 2005, HUD raised these limits to 31 percent and 43 percent, respectively. The Renton branch failed to document compensating factors for a loan in which the borrower had excessive payment-to-income ratios.

Federal Housing Administration-Insured Loan #561-8192256

For Federal Housing Administration-insured loan #561-8192256, the borrower's mortgage payment-to-effective income ratio of 35.13 percent exceeded HUD's limit of 31 percent, the limit after HUD raised the ratio limits in April 2005. However, the Renton branch did not document the acceptable compensating factors necessary to justify loan approval.

Paragraphs 2-11 and 2-12 of the handbook allow lenders to exclude recurring charges of nine months or less unless those recurring charges affect the borrower's ability to make the mortgage payment during the months immediately after loan closing. Since the borrower's $248 monthly car payment had less than six months remaining to pay after closing, the Renton branch excluded it from the borrower's total fixed payment-to-effective income ratio calculation. However, the $248 per month would have increased the borrower's total fixed payment-to-effective income ratio from 40.37 percent to 50.14 percent, significantly affecting the borrower's ability to make mortgage payments in the months after closing.

Further, the Renton branch did not include the borrower's $113-per-month loss on a mobile home rental as a recurring obligation. The cumulative effect of the car payment and the rental loss increased the borrower's total fixed payment-to-effective income ratio from 40.37 percent to more than 54.59 percent. These additional obligations are especially significant since the mortgage increased the borrower's housing expense by $1,025 per month.

This loan defaulted after five payments and was three months delinquent as of March 2007.

Countrywide Did Not Use Sound Underwriting Judgment

The handbook states in section 2-3 that past credit performance is the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions. A borrower who has made payments on previous and current obligations in a timely manner represents reduced risk. The handbook adds that underwriting requires careful analysis of the many aspects of the mortgage and simply establishing that a loan transaction meets minimal standards does not necessarily constitute prudent underwriting. Lenders must analyze the probability that the borrower will be able to pay the mortgage. The Renton branch did not use sound underwriting judgment when it approved a loan for borrowers with a problematic credit history.

Federal Housing Administration-Insured Loan #561-8115572

For Federal Housing Administration-insured loan #561-8115572, the borrowers' credit report showed a total of 47 30-day late payments, 10 60-day late payments, and nine 90-

day late payments. While the vast majority of these were greater than two years before closing, the borrowers had six delinquencies within 16 months of the loan closing in January 2005. The credit reports also showed four collections with current balances and two satisfied judgments, one of which was satisfied in December 2004, the month before closing.

The loan file contained correspondence signed by the borrower, dated August 2004, saying that the borrowers "have gotten our payment and credit issues cleared up" and they "have always paid our rent on time and understand the importance of making our house payments." However, the borrowers missed a payment on a repayment agreement to a collection agent in November 2004 and missed three rent payments, the most recent of which was in December 2004. Further, the borrowers' bank statement showed two overdraft charges in July 2004. The handbook states that a period of financial difficulty does not necessarily make the risk unacceptable if the borrowers maintained a good payment record for a considerable period after the difficulty. This loan defaulted after five payments and was seven months delinquent as of March 2007. Countrywide has started foreclosure, and the borrowers are in Chapter 13 bankruptcy.

Countrywide Did Not Adequately Analyze Self-Employed Borrowers' Incomes

For self-employed borrowers, section 2-9 of the handbook requires the lender to establish the borrower's earnings trend over the previous two years and to analyze the business's financial strength to determine whether the business can be expected to generate sufficient income for the borrower's needs. To that end, lenders must obtain individual tax returns, business tax returns for "S" corporations, year-to-date profit and loss statements, and business credit reports for "S" corporations. For two loans, the Renton branch failed to obtain and analyze information to support the self-employed income claimed by the borrowers.

Federal Housing Administration-Insured Loan #561-8061603

For Federal Housing Administration-insured loan #561-8061603, the Renton branch did not obtain the required business credit report needed to adequately analyze the factors affecting the borrower's income. The Renton branch listed three income sources for the borrower: an "S" corporation day care facility providing more than 60 percent of the total income, a sole proprietorship day care facility, and a pension. Although correspondence in the loan file showed the "S" corporation owed more than $9,300 to the local telephone company, the Renton branch did not obtain the required credit report for the business. Therefore, it did not know whether the "S" corporation had other credit issues or other overdue bills that might have adversely affected its ability to stay in business. Washington secretary of state records showed that both of the borrower's businesses had terminated.

The first default on this loan occurred on the 13th loan payment and this loan has been delinquent 90 days or more.

Federal Housing Administration-Insured Loan #561-7940482

For Federal Housing Administration-insured loan #561-7940482, the Renton branch did not obtain the required year-to-date profit and loss statement or balance sheet for this self-employed borrower, whose only source of income was a consulting company. The Renton branch used the borrower's tax returns to compute the borrower's income, but without the year-to-date financial information, there is no reasonable assurance that the borrower's income was stable or increasing as required. The year-to-date profit and loss statement and balance sheet serve the same purpose as the verification of employment, showing that the borrower has a stable and current income source. The loan closed in October 2006, a considerable time after the tax return was prepared. The first default on this loan occurred on the 11th loan payment. This loan was reinstated by the mortgagor in January 2007 and is again delinquent as of March 2007.

Countrywide Did Not Protect HUD's Financial Interest in the Insured Property

Section 8-1 of HUD Handbook 4150.2, Valuation Analysis for One-to-Four Unit Dwellings, requires a licensed professional engineer to certify that a manufactured home is erected on and attached to a foundation in accordance with HUD's Permanent Foundation Guide for Manufactured Housing. The Renton branch did not follow this requirement and, thus, did not protect HUD's financial interest when it approved a loan for a manufactured home.

Federal Housing Administration-Insured Loan #562-1916612

For Federal Housing Administration-insured loan #562-1916612, the Renton branch did not obtain a licensed professional engineer's certification that the manufactured home complied with HUD's Permanent Foundation Guide for Manufactured Housing. This certification assures that the insured manufactured home meets the support and anchorage requirements necessary to minimize damage during high winds or earthquakes, thus protecting the value of the HUD's collateral for the mortgage.

Conclusion

Approval of the above unqualified loans occurred because the Renton branch did not follow HUD underwriting requirements. The Renton branch approved five Federal Housing Administration-insured loans without (1) documenting adequate compensating factors for qualifying ratios that exceeded HUD limits, (2) analyzing the borrower's ability to repay the mortgage obligation, (3) obtaining documentation needed to analyze the incomes of self-employed borrowers, or (4) protecting HUD's financial interest in the insured property.

These deficiencies caused unnecessary risk to the Federal Housing Administration insurance fund totaling $740,007, the total insured amount for the five loans. In addition, the deficiencies increased the risk of borrowers' defaulting on the Federal Housing Administration-insured loans.

Recommendations

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner require Countrywide to

1A. Correct the deficiencies or indemnify HUD for the five loans with original insured amounts totaling $740,007. The projected loss is $207,947, 29 percent of the total unpaid balance on the five loans (see appendix C).

SCOPE AND METHODOLOGY

The audit period covered August 1, 2003, through July 31, 2006. We performed our audit work from September 2006 through February 2007.

To accomplish our objective, we reviewed Federal Housing Administration-insured loan case files and Countrywide's quality control plan and interviewed lender personnel and selected borrowers.

We selected the Renton, Washington, branch of Countrywide because the branch's default rate for Federal Housing Administration-insured loans originated in Washnigton State was 143 percent of the average default rate for all Federal Housing Administration-insured loans originated by all lenders in Washington State over the past two years. We reviewed all 22 active Federal Housing Administration-insured purchase loans originated by Countrywide's Renton branch that were amortized and went into default status during the audit period.

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

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal controls were relevant to our audit objectives:

- Safeguarding the Federal Housing Administration insurance fund from unnecessary risk.
- Originating and processing Federal Housing Administration-insured loans in accordance 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 the following items are significant weaknesses:

- The Renton branch exposed the Federal Housing Administration insurance fund to unnecessary risk.
- The Renton branch did not underwrite Federal Housing Administration-insured loans in accordance with HUD requirements.

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	$207,947

1/ 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. Implementation of our recommendation to indemnify loans that were not originated in accordance with HUD requirements will reduce the risk of loss to the Federal Housing Administration insurance fund. The above amounts reflect HUD statistics that show an average Federal Housing Administration loss of 29 percent of the unpaid loan amount for each property (see appendix C).

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	**Auditee Comments**

Countrywide HOME LOANS
31303 Agoura Road
Westlake Village, CA 91363

4/4/2007

Ms. Joan S. Hobbs
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
611 W 6th St
Suite 1160
Los Angeles, CA 90017-3101

Re: The Renton, Washington Branch of Countrywide Home Loans Inc Audit Report.

Dear Ms. Hobbs:

Thank you for providing Countrywide Home Loans the opportunity to respond to the findings from the audit conducted at the Renton, Washington Branch review outlined in your letter dated March 19, 2007.

In our efforts to promote consistency and ensure all participants adhere to agency guidelines and requirements, we routinely share all deficiencies and audit findings with the originating Branch and/or Division personnel to ensure all policies and regulations are being met.

Comment 1

We have completed our review of the six loans discussed in the report and generally agree with the preliminary findings. The six loans in question will be presented for discussion at our monthly LERC (Loss Exposure Review Committee) meeting to be held on April 20th where the request for Indemnification will be brought for Senior Management approval.

If you should have any questions please feel free to contact me at (818) 707-5426.

Sincerely,
Raul Matilla Jr
Vice President, Investor Due Diligence
Raul Matilla Jr

Cc Nancy Bush, FVP Quality Control/Investor Audit

OIG Evaluation of Auditee Comments

Comment 1 The discussion draft report included 6 loans. Information as of March 31, 2007 shows 1 of the 6 loans terminated. We deleted that loan from the final report and adjusted the amounts in the appendixes.

Appendix C

SCHEDULE OF DEFICIENCIES

Federal Housing Administration-insured loan	Loan principal amount	Unpaid loan balance (1)	Estimated loss (2)	A	B	C	D	E
561-8192256	$ 110,761	$ 109,213	$ 31,672	x	x			
561-8115572	$ 186,966	$ 183,595	$ 53,243			x		
561-8061603	$ 202,051	$ 194,387	$ 56,372				x	
561-7940482	$ 166,388	$ 159,203	$ 46,169				x	
562-1916612	$ 73,841	$ 70,659	$ 20,491					x
Total	$ 740,007	$ 717,057	$ 207,947					

Legend

A The Renton branch did not document compensating factors.
B The Renton branch did not include all of the borrower's obligations.
C The Renton branch did not critically analyze credit information.
D The Renton branch did not adequately analyze self-employed borrowers' incomes.
E The Renton branch did not protect HUD's financial interest.

(1) Amount as shown in Neighborhood Watch as of March 2007
(2) Unpaid principal balance multiplied by 29 percent