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| Issue Date          | September 3, 2008 |
| Audit Report Number | 2008-KC-1005      |

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

FROM: *//signed//*  
Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: James B. Nutter Did Not Meet HUD’s or Its Own Quality Control Requirements Regarding the Number of Loans to Review

## **HIGHLIGHTS**

### **What We Audited and Why**

We reviewed James B. Nutter and Company’s (J.B. Nutter) quality control program. Our objective was to determine whether J.B. Nutter followed U.S. Department of Housing and Urban Development (HUD) quality control requirements for home equity conversion mortgages insured by the Federal Housing Administration (FHA).

We audited J.B. Nutter because it is a large volume lender of FHA-insured home equity conversion mortgages. From January 2004 through March 2008, J.B. Nutter originated or sponsored 11,453 home equity conversion mortgages valued at more than \$2.27 million.

### **What We Found**

For six months in 2007 and 2008, J.B. Nutter did not meet HUD’s or its own quality control requirements regarding the number of loans to review. We also identified minor exceptions with the lender’s documentation of payment of hazard

insurance and property taxes, and communicated the minor exceptions to HUD in a separate management letter.

### **What We Recommend**

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner ensure that J.B. Nutter follows HUD requirements regarding the minimum number of endorsed loans to be reviewed for quality control purposes.

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**

J.B. Nutter generally agreed with our audit conclusions. We provided the draft report to J.B. Nutter on August 13, 2008, and requested a response by August 27, 2008. It provided written comments on August 22, 2008.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix A of this report.

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## **BACKGROUND AND OBJECTIVES**

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James B. Nutter and Company (J.B. Nutter) is a nonsupervised lender based in Kansas City, Missouri. J.B. Nutter was incorporated in 1955 and became an approved lender for the Federal Housing Administration (FHA) in 1957.

The Housing and Community Development Act of 1987 established a federal mortgage insurance program to insure home equity conversion mortgage loans. A home equity conversion mortgage, also known as a reverse mortgage, is a special type of home loan that lets borrowers 62 years of age or older convert a portion of the equity in their home into cash. Unlike a traditional home equity loan or second mortgage, the loans do not have to be repaid until the borrowers no longer use the home as their principal residence. FHA insures home equity conversion mortgages to protect lenders against a loss if amounts withdrawn exceed the equity when the property is sold.

From January 2004 through March 2008, J.B. Nutter originated or sponsored 19,675 FHA loans, of which 11,453 were home equity conversion mortgages. Loan correspondents originated and J.B. Nutter sponsored most of these mortgages. J.B. Nutter currently sponsors more than 600 loan correspondents nationwide. It was also the first lender in the nation to close an FHA reverse mortgage.

Our objective was to determine whether the J.B. Nutter followed HUD quality control requirements for home equity conversion mortgages.

## RESULTS OF AUDIT

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### Finding: J.B. Nutter Did Not Meet HUD's or Its Own Quality Control Requirements Regarding the Number of Loans to Review

For six months in 2007 and 2008, J.B. Nutter did not meet HUD's or its own quality control requirements when it provided fewer FHA loans for review to its contractors than required. This occurred because J.B. Nutter's quality control manager was not satisfied with the initial contractor's performance. While J.B. Nutter sought out another contractor with home equity conversion mortgage experience, it chose to provide a limited number of loans for quality control review and to avoid paying review costs for poor service. As a result, J.B. Nutter could not ensure the accuracy, validity, and completeness of its loan originations.

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#### **The Quality Control Process Did Not Meet HUD or J.B. Nutter Standards**

J.B. Nutter did not provide the required number of loans to its quality control contractors for review. HUD Handbook 4060.1, REV-2, states that a lender who originates and/or underwrites 3,500 or fewer FHA loans per year must review 10 percent of the FHA loans it originates. A lender who originates more than 3,500 FHA loans per year may review 10 percent of its loans or a statistical random sampling that provides a 95 percent confidence level with 2 percent precision.

J.B. Nutter chose the 10 percent option and selected the samples to provide to its quality control contractors. However, it did not provide its contractors with the required number of total FHA or home equity conversion mortgages for review.

Our audit concentrated on home equity conversion mortgages, and, therefore, the following chart illustrates the percentage of home equity conversion mortgages that J.B. Nutter's contractors evaluated during the six months that we reviewed. For the five months reviewed under the initial contractor (four months in 2007 and January 2008), J.B. Nutter provided only 1 to 2 percent of the loans required for review. For the month reviewed under the new contractor (February 2008), J.B. Nutter provided a larger sample of about 8 percent but still did not provide the required 10 percent of loans for review.

| Endorsed month | Number of FHA loans endorsed* (excluding streamline refinances) | Number of HECM** loans endorsed | Number of HECM loans reviewed | Percentage of HECMs reviewed vs. HECMs endorsed | Percentage of HECMs reviewed vs. all FHA loans endorsed |
|----------------|---|---------------------------------|-------------------------------|---|---|
| February 2008  | 1,437   | 1,420                           | 113                           | 7.96%   | 7.86%   |
| January 2008   | 1,560   | 1,552                           | 25                            | 1.61%   | 1.60%   |
| December 2007  | 823   | 808                             | 16                            | 1.98%   | 1.94%   |
| June 2007      | 525   | 504                             | 8                             | 1.59%   | 1.52%   |
| May 2007       | 606   | 597                             | 10                            | 1.68%   | 1.65%   |
| April 2007     | 617   | 601                             | 7                             | 1.16%   | 1.13%   |

\* Number of loans based on data in HUD's Single Family Data Warehouse system

\*\* Home equity conversion mortgage (HECM)

As the chart shows, home equity conversion mortgages made up the vast majority of J.B. Nutter's FHA portfolio. Therefore, even if the initial contractor had reviewed all of the other types of FHA loans, it would not have met the 10 percent requirement. For the February 2008 review, the contractor reviewed three FHA loans in addition to the home equity conversion mortgages, attaining 8.1 percent of FHA loans. While J.B. Nutter significantly improved its number of reviewed loans, it was not sufficient to reach the 10 percent requirement.

### Managers Were Aware of Requirements but Chose to Limit the Number of Loans Provided for Review

J.B. Nutter's quality control manager was aware of HUD's and J.B. Nutter's loan review requirements. However, due to the poor performance of the initial contractor, the manager decided to limit the number of loans provided for quality control reviews. This allowed J.B. Nutter to avoid paying review costs for poor service until the contractor improved its services or J.B. Nutter was able to hire a contractor with more experience in reviewing home equity conversion mortgages.

### The Lender Could Not Ensure that FHA Loans Submitted for Insurance Were Acceptable

Without an adequate quality control program, J.B. Nutter could not ensure that it

- Complied with HUD requirements when originating loans;
- Protected itself and HUD from unacceptable risk; and
- Guarded against errors, omissions, and fraud.

As a result, HUD lacked assurance that J.B. Nutter identified and corrected potential deficiencies in its loan origination process before submitting loans for FHA insurance.

### **Recommendation**

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

- 1A. Ensure that J.B. Nutter follows HUD requirements regarding the minimum number of endorsed loans to be reviewed for quality control purposes.

## SCOPE AND METHODOLOGY

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To accomplish our objectives, we reviewed J.B. Nutter's quality control plan and quality control reports. We interviewed J.B. Nutter management and HUD staff. We also reviewed HUD's and J.B. Nutter's underwriting policies and procedures and J.B. Nutter's loan servicing procedures and documentation.

Our audit period was January 1, 2004, through March 31, 2008. During that time, JB Nutter originated or sponsored 19,675 FHA-insured loans. Of those loans, 11,453 were home equity conversion mortgages valued at more than \$2.27 million. We reviewed the HUD and J.B. Nutter loan files for 15 home equity conversion mortgages. Four of the loans had been FHA insured for more than one year. We reviewed the servicing documentation for these four loans, including servicing notes and proof of payment documentation for hazard insurance and property taxes.

We relied on computer-processed data contained in HUD's Single Family Data Warehouse system solely to select a sample of loans for review. Based on previous experience, assessments, and testing of the data, we concluded that the data were sufficiently reliable to the extent used for sample selection.

We performed audit work from May through July 2008 at J.B. Nutter's main office at 4153 Broadway, Kansas City, Missouri. We conducted our 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

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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.

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## Relevant Internal Controls

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

- Controls to ensure that J.B. Nutter had implemented its quality control plan and adequately monitored its quality control contractor for compliance.

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 Weakness

Based on our review, we believe the following item is a significant weakness:

- J.B. Nutter did not have adequate controls to ensure that it fully implemented its quality control plan and met HUD requirements.

## OTHER MATTERS

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During the audit, we became aware of an issue that HUD needs to be aware of regarding lender documentation of proof of payment for property hazard insurance and taxes when the borrower elects to pay these expenses personally. HUD allows home equity conversion mortgage borrowers to pay these required homeowner expenses personally or through escrow accounts with their lender. When borrowers elect to pay the expenses personally, HUD requires lenders to obtain proof of payment on an annual basis to show that the property is actively insured with hazard insurance and that property taxes have been paid.

We determined that J.B. Nutter frequently relied on insurance declaration pages from insurance companies as proof of payment in lieu of receipts or similar documentation proving that the borrower had paid the premiums and was actively insured. According to several insurance companies, an insurance declaration page generally serves to describe the offered coverages and associated costs, not to provide assurance that premiums are paid and the insurance is current. Similarly, J.B. Nutter relied on staff data entries/notations to its computerized servicing system indicating that borrowers had paid their property taxes. Its staff frequently used government Web sites to confirm property tax payments; however, the staff notations were not supported by receipts or similar documentation proving that the borrower had paid his or her property taxes.

For J.B. Nutter, this was not a reportable issue that required HUD to take action. However, we recommend that HUD include this area of concern in its future monitoring of FHA-approved lenders.

# APPENDIXES

## Appendix A

### AUDITEE COMMENTS AND OIG'S EVALUATION

#### Ref to OIG Evaluation

#### Auditee Comments

#### JAMES B. NUTTER & COMPANY *Mortgage Bankers*

[816] 531-2345

WESTPORT/PLAZA OFFICE  
4153 BROADWAY  
P.O. BOX 10346  
KANSAS CITY, MISSOURI 64171-9936

August 20, 2008

TO: Kim Randall, Assistant Regional Inspector General,  
HUD Office of Inspector General, Office of Audit

FROM: George B. Lopez, Vice President, James B. Nutter &  
Company

SUBJECT: Auditee's Response – OIG Audit Report

Dear Ms. Randall:

James B. Nutter & Company welcomes the opportunity to respond to the IG Audit Report.

Since 1957, James B. Nutter & Company has originated and serviced FHA mortgage loans in 50 states, the District of Columbia and the Commonwealth of Puerto Rico. Our rigorous underwriting and ethical lending practices have allowed us to increase the quantity of our production without compromising the quality. Our delinquency and foreclosure rates stand as proof positive of this fact—both rates are about one-third to one-half the national average. In addition, James B. Nutter did not engage in the collection of “junk fees” or participate in any subprime lending practices.

In 1989, we closed the first FHA HECM Reverse Mortgage in the nation. Currently, we service over 20,000 senior clients in 50 states, the District of Columbia and the Commonwealth of Puerto Rico.

With respect to the findings of the IG Audit Team, we wish to note the following:

First, James B. Nutter is currently in QC compliance. Since February 2008, James B. Nutter has been utilizing a new QC contractor that has extensive experience with the reverse mortgage product and is providing the requisite number of loans for quality control review.

(cont.)

**Comment 1**

**JAMES B. NUTTER & COMPANY** *Mortgage Bankers*

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The following chart illustrates this point:

James B. Nutter & Company  
HECM QC Submissions  
March-July 2008

| <u>Closing month</u> | <u>Number of HECMs closed</u> | <u>Number of HECMs reviewed</u> | <u>% of HECMs reviewed vs. HECMs closed</u> |
|----------------------|-------------------------------|---------------------------------|---|
| February 2008        | 1,168                         | 113                             | 9.67%                                       |
| March 2008           | 1,193                         | 118                             | 9.89%                                       |
| April 2008           | 1,400                         | 151                             | 10.79%                                      |
| May 2008             | 1,404                         | 134                             | 9.54%                                       |
| June 2008            | 1,324                         | 143                             | 10.80%                                      |
| July 2008*           | 1,480                         | 162                             | 10.95%                                      |
| <b>TOTALS</b>        | <b>7,969</b>                  | <b>821</b>                      | <b>10.30%</b>                               |

\*At the time of this audit, HUD numbers were unavailable for July 2008.

Second, James B. Nutter switched QC contractors because of core competency issues and not cost issues. As you know, a common problem in the reverse mortgage industry is finding vendors that have basic expertise with the reverse mortgage product. James B. Nutter & Company initially directed the QC contractor that we used in our forward mortgage business to handle the QC for our reverse mortgage business. When this contractor was found to be providing an unacceptable level of QC service, our Quality Control Manager switched to a contractor (QCPS) who we feel is the leading provider in the industry. Cost had nothing to do with our decision. In fact, a comparison of the two vendors indicates that each vendor's price per file is within \$5 of the other.

Third, the temporary reduction in QC submissions was brief. As explained above, for over 50 years, James B. Nutter & Company has met or exceeded the highest standards of FIIA lending, including QC reporting. In 1995, we were selected as one of the first 10 lenders in the nation to  
(cont.)

Comment 2

Comment 3

Ref to OIG Evaluation

Auditee Comments

**JAMES B. NUTTER & COMPANY** *Mortgage Bankers*

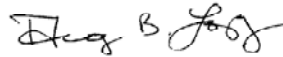
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sign HUD's Fair Lending/Best Practices Agreement. It's important that those parties who review this report know that for over 50 years, James B. Nutter & Company has been and will continue to perform the necessary quality control to comply with HUD guidelines.

We appreciate the hard work and diligence of the OIG's office in preparing this report. If you have any questions, please do not hesitate to contact me at (816) 531-2345.

Sincerely,



George B. Lopez  
Vice President

Cc: James B. Nutter, Sr., Chairman  
James B. Nutter, Jr., President  
Len Kuklenski, CFO

**JAMES B. NUTTER & COMPANY** *Mortgage Bankers*

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Exhibit A

James B. Nutter & Company  
March-July 2008  
HECM QC Submissions

**Comment 2**

| <u>Closing month</u> | <u>Number of<br/>HECMs<br/>closed</u> | <u>Number of<br/>HECMs<br/>reviewed</u> | <u>% of HECMs<br/>reviewed vs.<br/>HECMs closed</u> |
|----------------------|---------------------------------------|---|---|
| February 2008        | 1,168                                 | 113                                     | 9.67%   |
| March 2008           | 1,193                                 | 118                                     | 9.89%   |
| April 2008           | 1,400                                 | 151                                     | 10.79%  |
| May 2008             | 1,404                                 | 134                                     | 9.54%   |
| June 2008            | 1,324                                 | 143                                     | 10.80%  |
| July 2008*           | 1,480                                 | 162                                     | 10.95%  |
| <b>TOTALS</b>        | <b>7,969</b>                          | <b>821</b>                              | <b>10.30%</b>                                       |

\*HUD numbers were unavailable for July 2008 at the time of this audit.

**OIG Evaluation of Auditee Comments**

**Comment 1** We commend J.B. Nutter for taking steps to improve its quality control program to ensure that it receives a useful and acceptable quality control service and meets HUD’s requirements on FHA loans. Ongoing compliance with HUD’s quality control requirements should help ensure that J.B. Nutter submits FHA loans for insurance that meet HUD’s standards.

**Comment 2** The draft report provided to J.B. Nutter for a response addressed J.B.Nutter’s compliance with HUD’s 10 percent quality control requirement based on the number of FHA loans closed in each of six months reviewed. Due to subsequent comments that we received from HUD, we changed the final report to reflect J.B. Nutter’s performance based solely on endorsed loans. This change did not affect the overall finding that J.B. Nutter did not comply with HUD’s quality control requirements regarding the number of loans reviewed.

In addition, J.B. Nutter’s response to the draft report addressed its more recent performance using the number of loans closed, based on information in HUD’s data systems that we provided to J.B. Nutter. Due to HUD’s comments on the draft report, we recomputed J.B. Nutter’s more recent performance on the number of loans reviewed, using the number of endorsed loans. The new data showed that J.B. Nutter has generally improved its compliance with HUD’s 10 percent quality control requirement in recent months, as demonstrated in the following chart.

| <b>Endorsed month</b> | <b>Number of HECMs endorsed</b> | <b>Number of HECMs reviewed</b> | <b>Percentage of HECMs reviewed vs. HECMs endorsed</b> |
|-----------------------|---------------------------------|---------------------------------|--|
| <b>February 2008</b>  | 1,420                           | 113                             | 7.96%  |
| <b>March 2008</b>     | 1,355                           | 118                             | 8.71%  |
| <b>April 2008</b>     | 1,369                           | 151                             | 11.00%   |
| <b>May 2008</b>       | 992                             | 134                             | 13.50%   |
| <b>June 2008</b>      | 1,541                           | 143                             | 9.28%  |
| <b>July 2008</b>      | 1,485                           | 162                             | 10.91%   |

**Comment 3** We understand that J.B. Nutter limited the number of reviewed loans as part of its efforts to mitigate the poor service that it was receiving from the initial contractor. Our comments regarding the cost savings were intended to explain that J.B. Nutter recognized that it was receiving poor service and not getting what it paid for in quality control reviews. Therefore, limiting the number of loans reviewed (and paid for) during the period in question was a business decision that J.B. Nutter management made to keep the company from paying for poor service, not as a means to save costs in general.