Issue Date July 8, 2009	
Audit Report Number 2009-KC-1007	

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

//**signed**//

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

SUBJECT: Midwest Mortgage Capital Did Not Adequately Underwrite Seven Loans and Inadequately Performed Quality Control Reviews

HIGHLIGHTS

What We Audited and Why

We reviewed 29 Federal Housing Administration (FHA) loans underwritten by Midwest Mortgage Capital (Midwest) of St. Louis, Missouri. Our audit objectives were to determine whether Midwest followed U.S. Department of Housing and Urban Development (HUD) requirements for underwriting loans and performing its quality control function for single-family production.

We audited Midwest due to its above-average default rate. During the two-year period ending December 2008, Midwest underwrote more than 860 FHA loans, and 63 of them defaulted.

What We Found

Midwest did not properly underwrite 7 of the 29 defaulted loans reviewed. These loans had material underwriting deficiencies that affected the insurability of the loans. In addition, Midwest's quality control reviews were inadequate and did not meet HUD's requirements.

What We Recommend

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner require Midwest to indemnify HUD against future losses for seven loans with unpaid principal balances totaling more than $1 million.

Further, we recommend that HUD verify that Midwest

- Provides its underwriters with additional training on FHA requirements 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 Midwest on June 17, 2009, and requested a response by July 1, 2009. Midwest provided written comments on July 1, 2009, and agreed with the majority of our audit 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.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVES

Midwest Mortgage Capital (Midwest) is a nonsupervised direct endorsement lender based in St. Louis, Missouri. Midwest received approval from the Federal Housing Administration (FHA) in November of 2001 and currently operates two branch offices in Illinois.

FHA's mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to approve mortgages for otherwise creditworthy borrowers and projects that might not be able to meet conventional underwriting requirements by protecting the lender against default. The direct endorsement program simplifies the process for obtaining FHA mortgage insurance by allowing lenders to underwrite and close the mortgage loan without prior U.S. Department of Housing and Urban Development (HUD) review or approval. Lenders are responsible for complying with all applicable HUD regulations and are required to evaluate the borrower's ability and willingness to repay the mortgage debt. Lenders are protected against default by FHA's Mutual Mortgage Insurance Fund, which is sustained by borrower premiums. FHA mortgages had a market share of 13 percent in February 2009.

From January 2007 through December 2008, HUD's Neighborhood Watch system revealed that Midwest approved 867 FHA loans. During this same period, 63 of the loans (7.27 percent) were at least 90 days delinquent. The national average default rate was 5.23 percent.

Our audit objectives were to determine whether Midwest followed HUD requirements for underwriting loans and performing its quality control function for single-family production.

RESULTS OF AUDIT

Finding 1: Midwest Did Not Adequately Underwrite Seven FHA Loans

Midwest did not adequately underwrite 7 of 29 loans reviewed. This condition occurred because the underwriter was not sufficiently aware of HUD underwriting requirements. As a result, the lender placed the FHA insurance fund at an increased risk of loss on seven loans with original mortgage amounts totaling more than $1.1 million.

Underwriting Did Not Meet HUD Standards

Midwest did not adequately underwrite 7 of 29 loans reviewed. The following table summarizes the material deficiencies identified.

Area of noncompliance	# of loans
Credit history/liabilities	5
Income	1
Quality ratios and compensating factors	1

Appendix C contains a schedule of the material deficiencies identified in each of the seven loans. Appendix D contains detailed narratives for each of the loans.

<u>Credit History/Liabilities</u>
Midwest did not properly document the credit history and/or liabilities of borrowers for five loans. Specifically, the lender failed to obtain explanations for derogatory credit, verify the payment of outstanding judgments, adequately verify child support obligations, or follow up on credit report inquiries. In addition, the lender refinanced a loan when the prior month's payment was outstanding.

For example, in case # 292-4993498, Midwest failed to document the acceptance of a tax repayment plan by the Internal Revenue Service (IRS) or document the terms of the repayment plan. Additionally, Midwest failed to document the reason for the tax liability.

<u>Income</u>
Midwest did not properly evaluate the income used to compute qualifying ratios for one loan. In this case, the lender overstated the borrower's overtime income. When recalculating the overtime income, the borrower's total debt -to-income ratio grossly exceeds HUD's limit of 43 percent. This ratio is the total of the mortgage payment and all recurring charges divided by the monthly income.

Qualifying Ratios and Compensating Factors
Midwest did not provide compensating factors for underwriting a loan when the borrower's total debt-to-income ratio was 51.1 percent and the borrower did not have a large amount of assets in reserve or a high income level.

The Underwriter Was Not Sufficiently Aware of HUD Underwriting Requirements

The underwriter did not fully understand HUD's documentation requirements for loan approval. For example, the underwriter did not understand that he needed to verify the acceptance of the installment agreement by the IRS.

Midwest indicated that it intended to provide its staff with more training. In addition, the underwriter developed a checklist to better document the loan file and remind him of key items to review before approving the loan.

Loans Placed the FHA Insurance Fund at an Increased Risk of Loss

Midwest placed the FHA insurance fund at an increased risk of loss on seven loans with original mortgage amounts totaling more than $1.1 million and more than $478,000 in potential losses. One of these loans was in claim, four were in foreclosure, one was in default, and one was in forbearance.

Recommendations

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

1A. Indemnify HUD for seven loans with unpaid principal balances totaling $1,140,282. The projected loss is $478,918 based on the FHA insurance fund average loss rate of 42 percent for fiscal year 2009. Appendix E lists the seven loans with material underwriting deficiencies.

1B. Provide its underwriters with additional training, as approved by HUD, that address the deficiencies identified in this finding.

Finding 2: Midwest's Quality Control Reviews Were Not Adequate

Midwest's quality control reviews were not adequate. This condition occurred because the lender did not assign sufficient and knowledgeable staff to the quality control function. As a result, Midwest was unable to ensure the accuracy, validity, and completeness of its loan origination operations, resulting in an increased risk to the FHA insurance fund.

The Quality Control Process Did Not Meet HUD Standards

Midwest's quality control reviews were inadequate and did not meet HUD requirements. Specifically, Midwest did not

- Perform thorough quality control reviews.
- Always review 10 percent of loans closed on a monthly basis.
- Always properly reverify the borrowers' employment status, income, and assets or obtain new credit reports.
- Document branch site reviews.
- Semiannually check its employees against the limited denial of participation/General Services Administration list.

Quality Control Reviews Not Thorough

HUD requires that each loan selected for a quality control review be reviewed for compliance with HUD underwriting requirements, sufficiency of documentation, and the soundness of underwriting judgments. Midwest's quality control reviews were not thorough and did not provide sufficient detail regarding the documents examined and the result of the review. The reviewer's notes on the quality control reports primarily concerned differences between the initial and final applications and did not analyze the merits of the transaction or draw a conclusion about the overall loan quality.

10 Percent of Loans Closed on a Monthly Basis Not Reviewed

HUD requires lenders to perform quality control reviews on 10 percent of the loans that close in any particular month. Midwest did not always perform quality control reviews on 10 percent of the loans that closed on a monthly basis. During 2007 and 2008, Midwest closed 1,007 loans and, therefore, should have reviewed at least 101 loans. Instead, it reviewed 88 loans. The following table shows the months in which Midwest performed fewer reviews than required.

Closing month	# of loans closed	# of required reviews	# reviewed
February 2007	19	2	1
March 2007	16	2	1
April 2007	28	3	2
May 2007	32	3	2
June 2007	32	3	2
July 2007	25	3	2
September 2007	35	4	2
October 2007	36	4	3
December 2007	50	5	4
January 2008	61	6	4
March 2008	55	6	4
May 2008	55	6	5
June 2008	38	4	3
November 2008	41	4	3

Borrowers' Employment Status, Income, and Assets Not Always Reverified and New Credit Reports Not Always Obtained

HUD requires Midwest to reverify the employment status, income, assets, and credit report of the borrowers selected for quality control reviews. During the postclosing quality control process, Midwest did not always properly reverify the borrowers' employment status, income, and assets or obtain new credit reports. Frequently, Midwest would perform a telephone reverification of employment status but could not show whether it attempted a written reverification of the borrower's income amount.

Branch Reviews Not Documented

HUD requires lenders to periodically review their branch offices for 10 required elements. Midwest's president performed these reviews for its two branches but was unable to document that he had performed the reviews or that the reviews covered the required elements.

Employee List Not Checked Semiannually

HUD requires lenders to determine that employees involved in FHA transactions are checked against restricted participation lists at least semiannually. Midwest only performed this check on an annual basis. Midwest also checked some employees, such as loan officers, throughout the year, but it did not ensure that all employees received a second check against the list.

See appendix F for HUD's specific quality control requirements.

Midwest Did Not Assign Adequate Quality Control Staff

Midwest did not assign sufficient and knowledgeable staff to the quality control function.

Midwest did not have dedicated quality control staff as loan volumes increased. The vice president handled both the monthly and the early payment default quality control reviews until mid-2008. At that time, another staff member was assigned the task of conducting monthly quality control reviews on closed loans, while the vice president continued to review the early payment default loans. Both of these individuals had duties in addition to quality control. During this time, Midwest's FHA loan volume increased from a monthly average of 29 loans in 2007 to 55 loans in 2008.

Quality control reviews were performed by staff who were not fully aware of HUD's quality control requirements. For example, staff were not aware that reverse mortgages should be counted when conducting monthly quality control reviews. In addition, contrary to HUD's stated requirements, Midwest did not believe that it was necessary to document the branch office reviews. Staff had not received adequate training on FHA requirements.

In response to our audit, Midwest hired a compliance officer with more than 10 years of experience in various aspects of the mortgage industry including handling FHA loans. This individual will be dedicated exclusively to quality control.

Midwest Was Unable to Ensure Proper Loan Originations

As a result of the conditions described above, Midwest was unable to ensure the accuracy, validity, and completeness of its loan origination operations, resulting in an increased risk to the FHA insurance fund.

In addition, HUD lacked assurance that Midwest consistently 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

2A. Perform a review of Midwest's quality control function in six months to ensure it complies with HUD requirements (including that it has reviewed 10 percent of the closed loans) and minimizes the risk to HUD's FHA insurance fund.

SCOPE AND METHODOLOGY

To accomplish our objectives, we

- Reviewed HUD's and Midwest's policies and procedures,
- Interviewed Midwest's staff,
- Reviewed HUD and Midwest loan files,
- Reviewed quality control reports, and
- Obtained reverifications as appropriate.

From January 2007 through December 2008, Midwest approved more than 860 FHA loans, valued at more than $121 million. To select our underwriting review sample of 29 loans, we selected all 32 loans that had defaulted within the first six payments as of December 31, 2008, that were active and not streamline refinances. We excluded three loans that were reviewed by HUD's processing and underwriting division.

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

When reviewing the 29 quality control reviews that Midwest performed on our sample loans, we determined whether Midwest obtained new credit reports when required; properly reverified employment, income, and funds needed to close; and addressed the required review elements in its review files. We also obtained all 88 quality control reviews performed by Midwest on 10 percent of monthly loans closed during the audit period. We determined whether there was documentation for each of these 88 loans. Two of the quality control reviews were included in both samples.

We relied on computer-processed data contained in HUD's Neighborhood Watch system and provided by Midwest. During the audit, we assessed the reliability of the data and found the data to be adequate. We also performed sufficient tests of the data, and based on the assessments and testing, 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 Midwest to indemnify loans with material deficiencies. For those loans for which HUD had not yet incurred a loss, we applied FHA's average loss experience for fiscal year 2009 provided by HUD.

We performed audit work from January through May 2009 at Midwest's office at 1227 Fern Ridge Parkway, Suite 200, St. Louis, Missouri.

We performed our review 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's quality control program for single-family production meets 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:

- Midwest did not have adequate controls in place to ensure that FHA loans met HUD underwriting requirements (see finding 1).
- Midwest 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	$478,918

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. 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 Midwest 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 42 percent of the unpaid principal balance based upon statistics provided by HUD. [$1,140,281 x .42 = $478,918]

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

MIDWEST MORTGAGE CAPITAL

1227 Fern Ridge Parkway | Suite 200 | St. Louis, MO 63141
ph: 314.787.2900 | fax: 314.317.8908 | 1.800.803.9910

July 1, 2009

Mr. Ronald J. Hosking
Regional Inspector General for Audit
Office of Inspector General
Region VII office of Audit
Gateway Tower II-5th Floor
400 State Avenue
Kansas City, KS 66101-2406

Dear Mr. Hosking:

Please accept this written response to the audit report dated June 17, 2009. We take these matters very seriously and as a result of your audit we have thoroughly evaluated our internal controls and have adopted a number of changes to our procedures. These changes will ensure that our quality control procedures are in compliance with HUD requirements as well as improve the quality of the loans that we originate.

QUALITY CONTROL

Comment 1

After examining our shortcomings we have made the following changes to our QC procedures.

- We have hired a Compliance Manager with over 10 years of experience in quality control and compliance. The primary responsibilities of this role will be to effectively administer our quality control plan, protect our firm against fraud, and ensure that our staff is aware of the latest in HUD, legal, and investor requirements.
- We have formalized our file review process to include a written paper trail of all audit functions.
    - Compliance Manager will pull a full 10% sample of originations including Reverse Mortgage transactions.
    - Written re-verifications of employment, income, assets, and credit are preformed on all reviews as required by HUD.
    - Compliance Manager will review all early payment default loans.
    - Any exceptions will be noted in writing and given to the underwriter for response.
    - A committee meeting will be held monthly to review the responses and make a written determination as to the conclusions.

www.midwestmortgagecapital.com

Ref to OIG Evaluation	Auditee Comments

- Detailed minutes will be taken in these meetings which include meeting attendees, actions taken, and the ultimate disposition of the findings. Any critical findings will be reported to HUD.

- We have devised a checklist that will be used to document each branch review on all future site visits.
- All employees will be checked against the LDP/GSA databases in June and December. We will continue our policy to check all parties involved in the origination of the loan on each individual transaction.
- We have begun utilizing multiple fraud prevention tools and public record searches to mitigate risk at the initial quality control phase. These tools will be used to uncover any of the following:
  - Borrower irregularities
  - Property and valuation irregularities
  - Employment and income irregularities including re-verification of income through the IRS
  - Social security number verification
  - Seller and lease abnormalities
  - Common fraud schemes such as identity of interest transactions, straw buyers, rental property and the like
- We are expanding our activity of reviewing the common characteristics of defaulting loans and mapping corollaries with the goal of adjusting our underwriting standards with a focus on performing loans.

Comment 2

UNDERWRITING

In addition to changes in our QC procedures we have studied in detail all the exceptions brought forth by the auditors. We have made several changes in our underwriting processes that should prevent future underwriting oversights.

- We have created an underwriting checklist that will serve as an organizational tool and reminder to ensure that all guidelines are met.
- We are including in our files a worksheet that outlines the exact method used to calculate income for all borrowers. This will ensure accuracy and give a better paper trail for internal use, as well as for compliance and regulatory purposes.
- We have increased our training budget and will provide additional training for underwriting personnel as well as processors and loan officers.

Of the 7 files identified as placing the insurance fund at an increased risk of loss we have no issue with the auditor's findings on the following five files.

1. 292-4993498
2. 132-1919870
3. 481-2681900
4. 292-5056597
5. 292-4763517

Ref to OIG Evaluation	Auditee Comments

In the following two files we respectfully disagree with the auditors conclusions and offer the following in our defense.

Comment 3

1. 292-4800077

In speaking with two different attorneys, Mr. David Waltrip, LLC of Clayton, MO and Ms Barbara Graham, Law Offices of Barbara Graham, of Clayton, MO, the underwriter was told that in the State of Missouri if the divorce decree is silent as to whether or not the parent is to continue to pay child support past the age of 18, there is not a requirement to continue paying beyond that age. In the state of Missouri a child's emancipation is 18 years of age.

The underwriter has also been informed that the divorce decree must explicitly state that the parent is to continue to pay child support due to the child being currently enrolled in school. If requested, it must be in writing and then the child support obligation ends at the earlier of the child's graduation or the age of 22. In this case the divorce decree made no mention of any child support benefits after the age of 18.

Additionally this scenario was reviewed with a Senior Underwriter at the Denver Home Ownership Center at HUD, Mr. Mark Balun, Reference # 480646-241925494. Mr Balun stated that in his opinion if that the children were already 18 years of age, and if there were no indications of any delinquent or outstanding payments via the title or the credit report, no further action would be necessary.

The Underwriter also contacted the Missouri Department of Social Services for the state of Missouri at 1-800-859-7999 and spoke with Ms Kim Tripp. She stated that a case being open does not necessarily indicate that there is any child support due. She further stated that most people have no idea that once ones child support obligation ends, they can contact the Division of Family Services and request that their case be officially closed.

Furthermore we have attached an attorney's opinion letter from the law offices of Barbara Graham that further explains Missouri law as it pertains to this case.

Please note that MMC did not consider any child support obligation against the borrower because the divorce decree and parenting plan obtained were silent as to our borrower's obligation if any beyond the children's age of 18. At the time of closing, both children were past the age of 18. The oldest child was born 7/13/1983 (24 years old) and the youngest child was born 8/28/1988 (19 years old). Their birth dates can also be found on Page 1 of 11 of the Parenting Plan.

With respect to the releasing of the judgment for payment of child support, the divorce decree and parenting plan are fulfilled. This alleviates any further obligation of the borrower. The releasing of the judgment is merely a formality and not widely practiced.

Ref to OIG Evaluation **Auditee Comments**

In our borrower's case there was no indication of past child support due, title did not show any liens against our borrower, nor did the credit report pulled on a post closing quality control review show any evidence of child support obligations.

2. 132-2034608

Comment 4

Through our review of the HUD handbook 4155 and in speaking with several HUD Underwriters over the past years, it is our understanding that HUD typically prefers to see a borrower that is being qualified with overtime have at least a two year history. Per 4155.1 4.D.2.b "*Periods of overtime and bonus income less than two years may be acceptable, provided the lender can justify and document in writing the reason for using the income for qualifying purposes*" In our discussions with various HOCS, part of the logic is to make reasonably sure that the borrower has the mental and physical ability to handle more than a normal 40 hour per week work load. In this particular case this test had been met.

In terms of our income calculation we were provided with two separate memorandums from the borrower's employer. Operations Memorandum #08-18 states that the borrower is eligible to continue to work overtime, and a second letter from his Deputy Chief stating the amount of overtime allotted for our borrower to work was unlimited.

The underwriter is aware of the formula that HUD prescribes in calculating overtime. However in many conversations with HUD, including the most recent conversation with an underwriter named Pablina on June 19th at the Denver HOC, HUD does allow an underwriters discretion in varying from their guidelines as long as there is a sound basis. She further stated that based on the borrower's employment situation, the averaging of the overtime income could be waived at the discretion of the underwriter.

On this particular file the borrower's overtime had been increasing ***exponentially*** from 2006 where his overtime was $5866. In 2007 the overtime worked had more than doubled to $12,233 for the year. At the time of the underwriting of the file, the borrower's overtime thru Feb. of 2008 had already averaged $3,088 per month. The underwriter did not feel it appropriate to qualify the borrower with this monthly amount. However, there were changing circumstances regarding his overtime. The underwriter felt it reasonable in his judgment to allow the borrower 2.5 hours per day in overtime, a figure significantly less than his current situation. When calculating 2.5 hours per day (12.5 hours per week) at $31.75 per hour (based upon the borrower's paystub) the calculation equates to $405.00 per week or $1755.91 per month.

Again the Underwriter felt the borrower had the mental and physical ability to work the overtime and he felt the approach used was conservative based on recent changing events in the borrower's employment.

In closing, we hope that you can see that we take these matters very seriously and have made significant changes in our internal controls and procedures. We hope that after

Ref to OIG Evaluation **Auditee Comments**

examining the two cases above you will see that our underwriting decisions were based in sound logic and factual information. Should you have any additional questions we welcome the opportunity to discuss this matter either verbally or via written correspondence.

Sincerely,

Jerry M. Frost
President

Ref to OIG Evaluation **Auditee Comments**

06/29/2009 12:09 3147257548 LAW_OFFICES PAGE 01/01

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June 26, 2009

Robert L. Seigel
Director of Underwriting
Midwest Mortgage Capital, LLC
1227 Fern Ridge Parkway, Ste 200
St. Louis, MO 63141

Re: Child Support Law/Emancipation in Missouri

Dear Bob:

In Missouri, there a presumption, under 452.340 RSMo, that a parent's obligation to pay child support terminates when a child dies, marries, enters active military duty, becomes self supporting, or reaches age 18. At that point a child is considered to be emancipated if the Judgment of Dissolution does not specify otherwise.

Many parents paying child support are not aware that they can file an affidavit when their child support obligation ends, but they cease their child support payments nonetheless. In this situation, the child support judgment is still out there, but upon a showing of proof to the court of when the child was actually emancipated, the judge, and also the state, will retroactively terminate the judgment, therefore wiping the judgment off from the parent's record.

Sincerely,

Barbara L. Graham
Attorney at Law

OIG Evaluation of Auditee Comments

Comment 1 Midwest's written response along with its verbal response at the exit conference indicates agreement with the quality control finding and recommendations. The planned and already executed actions on the part of Midwest should resolve the issues that we identified.

Comment 2 The planned action by Midwest should help in identifying and reducing the occurrences of the violations.

Comment 3 Based on the phone call made by the OIG to the Missouri Department of Child Support Enforcement, the child support order was still in effect and the borrower was required to make payments. Midwest should have ensured that the borrower had no outstanding child support liability.

Comment 4 We disagree with Midwest's assertion that its overtime calculation was reasonable. As stated in our finding, the average over the previous two years (25.76 months) was $912. Even using a shorter one year period (13.76 months from January 2007 through February 22, 2008), the borrower only averaged $1,282, far less than the $1,760 computed by Midwest using its method. Midwest should have used a more conservative method to calculate the borrower’s overtime income.

Appendix C

SCHEDULE OF SIGNIFICANT UNDERWRITING DEFICIENCIES

#	Case number	Closing Date	Underwriter type	Original mortgage amount	Credit history/liabilities	Income	Qualifying ratios and compensating factors
1	292-4993498	July 31, 2008	Manual	$285,468	x		
2	132-2034608	Mar. 21, 2008	Manual	$194,296		x	
3	292-4763517	June 21, 2007	Automated	$144,637			x
4	132-1919870	Dec. 18, 2006	Manual	$142,980	x		
5	481-2681900	Feb. 12, 2008	Manual	$139,816	x		
6	292-5056597	Aug. 18, 2008	Automated	$135,045	x		
7	292-4800077	Jan. 24, 2008	Manual	$112,817	x		
		Total		$1,155,059			

Appendix D

CASE NARRATIVES

Case number: 292-4993498
Closing date: July 31, 2008
Underwriter type: Manual
Original mortgage amount: $285,468
Loan status as of April 30, 2009: Active (in foreclosure)
Unpaid balance: $283,415

Credit History/Liabilities
The borrower had a delinquent federal tax debt owed to the IRS for underreported income from 2006 and 2007. The borrower owed a total of $50,925. The file contained an IRS Form 433-D, Installment Agreement, which stated that the borrower agreed to make payments of $560 monthly, starting August 1, 2008. The IRS stamped the form as received on July 23, 2008, but there was no indication that it accepted the repayment plan as the form was not signed by an IRS official. It is unclear how the repayment plan amount was calculated since the two previous tax returns showed a tax-owed amount of $50,925, not $33,763 as stated on the Installment Agreement. In addition, the borrower did not provide documentation to show that he had already paid $17,162 ($50,925 - $33,763). The underwriter failed to explain the repayment plan terms and failed to document the acceptance of the plan by the IRS. Midwest did not document the reason why the borrower did not pay his federal taxes for 2006 and 2007. Additionally, the borrower did not provide an explanation for the delinquent federal taxes.

Criteria
HUD Handbook 4155.1, REV-5, paragraph 2-3, states that major indications of derogatory credit (including judgments, collections, and any other recent credit problems) require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file. It also states that when delinquent accounts are revealed, the lender must document its analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including delayed mail delivery or disputes with creditors.

HUD Handbook 4155.1, REV-5, paragraph 2-5B, states that if a borrower is presently delinquent on any federal debt, the borrower is not eligible until the delinquent account is brought current, paid, or otherwise satisfied or a satisfactory repayment plan is made between the borrower and the federal agency owed and is verified in writing.

Case number: 132-2034608
Closing date: March 21, 2008
Underwriter type: Manual
Original mortgage amount: $194,296
Loan status as of April 30, 2009: Active (in foreclosure)

Unpaid balance: $192,099

Income/Employment
The underwriting worksheet, dated March 11, 2008, reported $3,602 base income and $1,760 overtime income. A verification of employment from the borrower's employer, dated February 29, 2008, revealed overtime income of $5,867 for 2006, $12,234 for 2007, and $5,405 through February 22, 2008. The verification of employment and a letter from the borrower's employer indicated that overtime was likely to continue and that unlimited overtime was available to the borrower. The lender provided notes on its calculation of overtime income. The notes revealed that the lender used the hourly overtime rate of $31.17 and a weekly average of 13 hours of overtime to calculate $1,756 of monthly overtime income. Our calculation consisted of dividing the total amount of overtime received by the 25.76 covered months. This calculation produces average monthly overtime income of $912. This calculation is significantly less than the overtime income used on the underwriting worksheet. The overtime income calculation used by the underwriter was influenced heavily by the borrower's overtime in the first 1.76 months of 2008, which was not necessarily indicative of a sustainable amount of overtime.

Criteria
HUD Handbook 4155.1, REV 5, paragraph 2-7A, states that overtime income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of the overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. An earnings trend also must be established and documented for overtime and bonus income.

Ratios and Compensating Factors
The recomputed income for the borrower would be $4,514 ($3,602 base + $912 overtime). Using the recomputed income, the borrower's mortgage payment-to-income ratio would be 36.25 percent, and the total debt-to-income ratio would be 58.78 percent, well above the maximum ratios of 31 percent and 43 percent, respectively.

Criteria
HUD Mortgagee Letter 2005-16 states that the borrower's qualifying ratios are currently limited to 31 percent (payment-to-income ratio) and 43 percent (debt-to-income ratio). If either or both ratios are exceeded on a manually underwritten loan, the lender must describe the compensating factors used to justify loan approval.

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.

Case number: 292-4763517
Closing date: June 21, 2007
Underwriter type: Automated

Original mortgage amount: $144,637
Loan status as of April 30, 2009: Claim (loss not yet determined)
Unpaid balance: $142,130

Ratios and Compensating Factors
Midwest failed to document adequate compensating factors when it underwrote this loan. The loan was initially processed through the automated underwriting system. However, all liabilities were not considered by the automated underwriting system. Midwest excluded three revolving accounts from the automated underwriting report, which were listed on the April 9, 2007, credit report. The three excluded accounts equal an additional $147 in monthly liabilities for the borrower. At closing, the underwriter converted the loan from a cash-out refinance to a rate and term refinance. He overrode the automated underwriting system, and the loan became a manually underwritten loan. While the additional $147 in liabilities was included on the underwriting worksheet, the underwriter failed to document compensating factors for underwriting the loan as the borrower's fixed expense-to-income ratio was 51.1 percent. The borrower was under a temporary hardship forbearance on his student loans from August 17, 2007, to August 16, 2008, and did not have a large amount of assets in reserve or a high income level.

Criteria

HUD Mortgagee Letter 2005-16 states that the borrower's qualifying ratios are currently limited to 31 percent (payment-to-income ratio) and 43 percent (debt-to-income ratio). If either or both ratios are exceeded on a manually underwritten loan, the lender must describe the compensating factors used to justify loan approval.

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.

Case number: 132-1919870
Closing date: December 18, 2006
Underwriter type: Manual
Original mortgage amount: $142,980
Loan status as of April 30, 2009: Active (in default)
Unpaid balance: $139,258

Credit History/Liabilities
The borrower and his spouse had an outstanding judgment in the amount of $2,661. There was no documentation in the file to support the payment of this judgment before loan closing or an agreement with the creditor to make regular and timely payments on the judgment, thus making the mortgage ineligible for FHA insurance endorsement.

The borrower had five collections listed, which occurred after the discharge of his Chapter 7 bankruptcy in November 2002. The borrower did not explain in writing all collections and judgments. While the loan file contained multiple letters of explanation, the letters did not specifically address the collections and judgments listed on the credit report.

Overall, the borrower had acquired several collections accounts since bankruptcy and had been unable to pay his student loans due to his current financial situation. Therefore, the borrower had not demonstrated a documented ability to responsibly manage his financial affairs.

Criteria

HUD Handbook 4155.1, REV-5, paragraph 2-3 C, requires that court-ordered judgments be paid off before the mortgage loan is eligible for FHA insurance endorsement. FHA does not require that collection accounts be paid off as a condition of mortgage approval. Collections and judgments indicate a borrower’s regard for credit obligations and must be considered in the analysis of creditworthiness with the lender, documenting its reasons for approving a mortgage when the borrower has collection accounts or judgments. The borrower must explain in writing all collections and judgments.

HUD Handbook 4155.1, REV-5, paragraph 2-3 E, states that a Chapter 7 bankruptcy (liquidation) does not disqualify a borrower from obtaining an FHA-insured mortgage if at least two years have elapsed since the date of the discharge of the bankruptcy. Additionally, the borrower must have reestablished good credit or chosen not to incur new credit obligations. The borrower also must have demonstrated a documented ability to responsibly manage his or her financial affairs.

Other

The underwriter failed to consider the income, debts, and credit history of a purchasing spouse. According to the application and underwriting worksheet, there was only one borrower on this loan, and the spouse was supposed to be nonpurchasing. However, based on the loan file documentation, both the borrower and his spouse were purchasing borrowers. In addition to signing the mortgage note, the borrower’s spouse signed the purchase agreement, counteroffer, amendment to the contract, and settlement statement as a coborrower. Further, she was listed on the title insurance commitment and the warranty deed from the sellers. Based on these documents, the underwriter should have considered the income, debts, and credit history of both the borrower and his spouse when approving this loan.

Criteria

HUD Handbook 4155.1, REV-5, paragraph 2-2A, states, “Borrowers and Co-borrowers take title to the property and are obligated on the mortgage note and must also sign the security instrument. The co-borrower’s income, assets, liabilities, and credit history are considered in determining creditworthiness.”

HUD Handbook 4155.1, REV-5, paragraph 2-2D, states, “If required by state law in order to perfect a valid and enforceable first lien, the non-purchasing spouse may be required to sign either the security instrument or documentation evidencing that he or she is relinquishing all rights to the property. If the non-purchasing spouse executes the security instrument for such reasons, he or she is not considered a borrower for our purposes and need not sign the loan application. In all other cases, the non-purchasing spouse is not to appear on the security instrument or otherwise take title to the property at loan settlement."

Case number: 481-2681900
Closing date: February 12, 2008
Underwriter type: Manual
Original mortgage amount: $139,816
Loan status as of April 30, 2009: Active (special forbearance)
Unpaid balance: $137,803

Credit History/Liabilities
The borrower had child support payments garnished from his weekly wages, which Midwest did not consider when underwriting his loan. Child support payments were deducted in an amount of $201 weekly or $869 monthly from his employment income. Midwest did not list child support payments on the liability section of the borrower's loan application, dated February 7, 2008. Adding the monthly child support liability to the amount of total installment debt listed on the underwriting worksheet brings the total monthly debt payment to $1,436.

Further, the loan file did not contain borrower explanations for all inquiries shown on the credit report in the last 90 days. There were eight unexplained inquiries from October 20, 2007, through January 5, 2008. The borrower had an inquiry from a finance company on December 12, 2007, and then opened three accounts with the same company in December 2007, February 2008, and May 2008 for $720, $800, and $800, respectively. The borrower had also opened accounts with the same finance company in November 2006 and September 2007 in the amount of $640 and $720, respectively. This company was in the business of granting payday loans. The borrower was borrowing larger sums of money over time, indicating that he was not able to survive on his employment income, and Midwest should have discovered this fact. Additionally, Midwest should have obtained an explanation for all of the eight inquiries on his credit report.

Criteria
HUD Handbook 4155.5, REV-5, paragraph 2-11A, states, "The borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other additional recurring charges extending ten months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc."

HUD Handbook 4155.5, REV-5, paragraph 2-3B, states that borrowers must explain in writing all inquiries shown on the credit report in the last 90 days.

Ratios and Compensating Factors
Midwest understated the borrower's qualifying ratio. According to the underwriting worksheet, the borrower's qualifying ratios were 30.71 percent and 48.19 percent. Using the recomputed

monthly liability of $1,436, the borrower's mortgage payment-to-income ratio would remain the same, but the total debt-to-income ratio would be 75 percent, well above the maximum ratio of 43 percent.

Criteria
HUD Mortgagee Letter 2005-16 states that the borrower's qualifying ratios are currently limited to 31 percent (payment-to-income ratio) and 43 percent (debt-to-income ratio). If either or both ratios are exceeded on a manually underwritten loan, the lender must describe the compensating factors used to justify loan approval.

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.

Case number: 292-5056597
Closing date: August 18, 2008
Underwriter type: Automated
Original mortgage amount: $135,045
Loan status as of April 30, 2009: Active (in foreclosure)
Unpaid balance: $134,205

Miscellaneous Refinance Issues
Midwest approved the borrower's refinance loan when the prior month's payment was outstanding. The lender was required to document that the borrower made his July 2008 mortgage payment as the new mortgage closed in August 2008. According to the payoff statement, the borrower made his June 2008 mortgage payment but did not make his July 2008 mortgage payment.

Criteria
HUD Handbook 4155.5, REV-5, paragraph 1-10E, states that lenders are not permitted to allow borrowers to "skip" payments. The borrower is either to make the payment when it is due or bring the monthly mortgage payment check to settlement. When the new mortgage amount is calculated, FHA does not permit the inclusion of any mortgage payments "skipped" by the homeowner in the new mortgage amount.

Case number: 292-4800077
Closing date: January 24, 2008
Underwriter type: Manual
Original mortgage amount: $112,817
Loan status as of April 30, 2009: Active (in foreclosure)
Unpaid balance: $111,372

Credit History/Liabilities

The borrower had a child support order against him, which the underwriter failed to consider when underwriting this loan. The borrower was required to make monthly payments of $290 based on his divorce decree signed in November 2005. The Missouri Department of Social Services, Division of Child Support Enforcement, confirmed to us that the child support order was still in effect and had not been satisfied. A review of Missouri court records also revealed that the child support order had not been satisfied. The underwriter should not have omitted this liability when underwriting this loan.

The borrower's credit report, dated December 11, 2007, listed two inquiries within the past 90 days. The underwriter could not provide an explanation for these inquiries from the borrower.

Criteria

HUD Handbook 4155.5, REV-5, states, "The borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other additional recurring charges extending ten months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc."

HUD Handbook 4155.5, REV-5, paragraph 2-3B, states that borrowers must explain in writing all inquiries shown on the credit report in the last 90 days.

Ratios and Compensating Factors

The underwriter understated the borrower's qualifying ratios and failed to present significant compensating factors to justify approval of this loan. Using the recomputed liabilities, the borrower's total debt-to-income ratio would increase to 63.01 percent. While the underwriting worksheet noted several potential compensating factors, these factors were inadequate.

Criteria

HUD Mortgagee Letter 2005-16 states that the borrower's qualifying ratios are currently limited to 31 percent (payment-to-income ratio) and 43 percent (debt-to-income ratio). If either or both ratios are exceeded on a manually underwritten loan, the lender must describe the compensating factors used to justify loan approval.

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.

Appendix E

SCHEDULE OF LOAN STATUS FOR LOANS WITH SIGNIFICANT UNDERWRITING DEFICIENCIES

Case number	Loan status as of April 30, 2009	Unpaid balance	Payments before first 90-day default reported
292-4993498	Active (in foreclosure)	$ 283,415	0
132-2034608	Active (in foreclosure)	$ 192,099	4
292-4763517	Claim (loss not yet determined)	$ 142,130	1
132-1919870	Active (in default)	$ 139,258	5
481-2681900	Active (special forbearance)	$ 137,803	5
292-5056597	Active (in foreclosure)	$ 134,205	0
292-4800077	Active (in foreclosure)	$ 111,372	2
Total		$1,140,282	

Appendix F

QUALITY CONTROL CRITERIA

HUD Handbook 4060.1, REV-2, paragraph 7-3G, states that a lender's 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. The review must include but not necessarily be limited to confirmation of the following items:

- The office is properly registered with FHA, and the address is current;
- Operations are conducted in a professional, business-like environment;
- If located in 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 (entrances and reception areas may be shared);
- If located in noncommercial space, the office has adequate office space and equipment; it displays a fair housing poster if the public is received; if it is open to receive the public, it is accessible to persons with disabilities, including those with mobility impairments; if it is not open to the public but used occasionally to meet with members of the public, it provides alternate means of accommodation to serve persons with disabilities;
- The servicing office provides toll-free lines or accepts collect calls from borrowers;
- The office is sufficiently staffed with trained personnel;
- Office personnel have access to relevant statutes, regulations, and HUD issuances and handbooks, either in hard copy or electronically;
- Procedures are revised to reflect changes in HUD requirements, and personnel are informed of the changes;
- Personnel at the office are all employees of the lender or contract employees performing functions that FHA allows to be outsourced; and
- The office does not employ or have a contract with anyone currently under debarment or suspension or a limited denial of participation.

HUD Handbook 4060.1, REV-2, paragraph 7-3I, states that review findings must be reported to the lender's senior management within one month of completion of the initial report. Management must take prompt action to deal appropriately with any material findings. The final report or an addendum must identify actions being taken, the timetable for their completion, and any planned follow-up activities.

HUD Handbook 4060.1, REV-2, paragraph 7-3L, states that the lender must 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 periodically check employee lists, at least semiannually.

HUD Handbook 4060.1, REV-2, paragraph 7-6B, states that for lenders closing more than 15 loans monthly, quality control reviews must be conducted at least monthly and must address one month's activity.

HUD Handbook 4060.1, REV-2, paragraph 7-6C, states that because it is not feasible to review all loans originated during a period, the program must require that an appropriate-size sample is selected and evaluated during each review. A lender that originates and/or underwrites 3,500 or fewer FHA loans per year must review 10 percent of the FHA loans it originates.

HUD Handbook 4060.1, REV-2, paragraph 7-6E (1), states that a new credit report must be obtained for each borrower whose loan is included in a quality control review, unless the loan was a streamline refinance or was processed using an FHA-approved automated underwriting system exempted from this requirement.

HUD Handbook 4060.1, REV-2, paragraph 7-6E (2), states that documents contained in the loan file should be checked for sufficiency and subjected to written reverification. If the written reverification is not returned to the lender, a documented attempt must be made to conduct a telephone reverification. If the original information was obtained electronically or involved alternative documents, a written reverification must still be attempted. Examples of items that must be reverified include but are not limited to the borrower's employment or other income, deposits, gift letters, alternate credit sources, and other sources of funds.

HUD Handbook 4060.1, REV-2, paragraph 7-6F, states that each direct endorsement loan selected for a quality control review must be reviewed for compliance with HUD underwriting requirements, sufficiency of documentation, and the soundness of underwriting judgments.