



U.S. Department of Housing and Urban Development  
Office of Inspector General  
Region X Office of Audit  
909 First Avenue Suite 126  
Seattle, WA 98104-1000

MEMORANDUM NO:  
2011-SE-1801

September 30, 2011

MEMORANDUM FOR: Craig T. Clemmensen, Director, Departmental Enforcement Center, CACB

//signed//

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

SUBJECT: Pierce Commercial Bank, Tacoma, WA, Did Not Properly Underwrite a Selection of FHA Loans

### **INTRODUCTION**

We reviewed 46 Federal Housing Administration (FHA) loans that Pierce Commercial Bank underwrote as an FHA direct endorsement lender. Pierce was a supervised FHA direct endorsement lender located in Tacoma, WA. This case was referred to us by the Office of Inspector General's (OIG) Office of Investigation. Our review objective was to determine whether Pierce underwrote 46 loans in accordance with FHA requirements.

For each recommendation without a management decision, please respond and provide status reports in accordance with U.S. Department of Housing and Urban Development (HUD) Handbook 2000.06, REV -3. Please furnish us copies of any correspondence or directives issued because of the review.

We did not provide a discussion draft memorandum report to Pierce due to ongoing investigations and the bank's subsequent closure.

### **METHODOLOGY AND SCOPE**

Our review of Pierce was limited to reviewing official FHA loan files submitted by Pierce to support FHA's insurance endorsement. Since this case was referred to us by the Office of Inspector General's (OIG) Office of Investigation, we were not able to interview Pierce management and staff due to ongoing investigations. Our review of this documentation was limited

to our stated objective and should not be considered a detailed analysis of the lender's internal controls or operations.

Pierce originated 1,912 FHA-insured loans between 2006 and 2009, primarily in Washington State, totaling more than \$475.8 million. Of the 145 files obtained, we selected 46 loans with an original mortgage value of more than \$11.9 million that included 44 finalized and an additional 2 in-process claims. All 25 loans cited in our examples, originally valued at more than \$6.6 million, have been foreclosed upon and are in claim status. The loans obtained and reviewed included both purchase and refinance transactions. Our selection of loans was not intended to be representative, and additional loans fit our selection criteria. We limited our review to those files released by OIG's Office of Investigation and the FBI.

The Office of Investigation interviewed borrowers, many of whom confirmed that some documents included in their loan files were not accurate or authentic. At the request of the Criminal Division Assistant U.S. Attorney, we did not contact borrowers associated with the potential criminal case.

## **BACKGROUND**

HUD's One- to Four-Family Mortgage Insurance program encourages lending to potential homeowners by insuring qualifying mortgages against loss. To qualify for mortgage insurance, borrowers must satisfy cash investment, mortgage payment, and credit requirements.

FHA uses form HUD-92900A as the primary document to assign mortgage insurance to a mortgage transaction. The borrower signs form HUD-92900A as an addendum to the uniform residential loan application. In addition, the underwriter completes the lender portion of the document and signs it to attest to the accuracy of the information.

When a loan is manually underwritten, the underwriter certifies that the lender used due diligence and reviewed all associated documents during the underwriting of the loan. When a loan is electronically underwritten, the underwriter certifies to the integrity of the data entered by the lender, which is used by FHA systems to determine the quality of the loan.

Under both underwriting options, the lender certifies that a direct endorsement underwriter reviewed the appraisal (if applicable) and further certifies that this mortgage is eligible for HUD mortgage insurance. In all cases, the lender's representative at the time of closing the mortgage is required to certify that he or she has personally reviewed the mortgage loan documents, closing statements, application for insurance endorsement, and all accompanying documents. He or she also makes all certifications required for the mortgage as set forth in HUD Handbook 4000.4.

Pierce Commercial Bank, Tacoma, WA, was closed November 5, 2010, by the Washington Department of Financial Institutions, which appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. To protect the depositors, FDIC entered into a purchase and assumption agreement with Heritage Bank, Olympia, WA, to assume all of Pierce's deposits.

As of September 30, 2010, Pierce had approximately \$221.1 million in total assets and \$193.5 million in total deposits. Heritage Bank will pay FDIC a premium of 1 percent to assume all of Pierce's deposits. In addition to assuming all of the deposits of the failed bank, Heritage Bank agreed to purchase essentially all of the assets. FDIC estimates that the cost to the Deposit Insurance Fund will be \$21.3 million. Compared to other alternatives, Heritage Bank's acquisition was the least costly resolution for FDIC's Deposit Insurance Fund. Interested parties also can visit FDIC's Web site at <http://www.fdic.gov/bank/individual/failed/piercecommercial.html>.

On August 5, 2011, the U.S. Attorney for the Western District of Washington indicted former Pierce Commercial Bank employees, including the Vice President, Underwriter 1, the loan officer, and others related to an investigation of the bank's FHA loan operations.

Our objective was to determine whether Pierce loan files complied with FHA lending requirements. We performed our work from April 2010 through May 2011. We did not conduct our work in accordance with generally accepted government auditing standards because of the ongoing investigation. To meet our objective, it was not necessary to fully comply with the standards, nor did our approach negatively affect our review results.

### **RESULTS OF REVIEW**

Pierce did not properly underwrite at least 25 of the 46 loans reviewed because its underwriters did not follow FHA's requirements in HUD Handbook 4155.1, REV-5. For these 25 loans, the FHA insurance fund suffered an estimated net loss of more than \$3.5 million after reducing the proceeds from property sales from actual claims paid of more than \$6.7 million. Only 1 of our 25 example claims had not been finalized.

The Vice President, Underwriter 1, the loan officer, and others together originated these 25 loans. This loan officer was the Pierce loan officer on 17 of the loans, and Underwriter 1 was the underwriter on 22 of the loans. The Vice President signed all 23 of the notes obtained. We documented a number of deficiencies in the credit approval decisions and loan documentation, demonstrating that the underwriter did not exercise due care in meeting the basic underwriting guidelines.

Pierce's direct endorsement underwriters incorrectly certified that due diligence was used in underwriting the 25 loans since it did not underwrite them in accordance with HUD and FHA regulations. Pierce underwrote each loan, and a Pierce underwriter certified to each application's accuracy. We found at least 1 material underwriting deficiency in each these 25 loans.

We summarized our review of the 25 loans by finding, below, and by case file and finding in appendix A. Individual discussion of case files is available upon request.

Types of findings	Observed
Poor credit history	10
Unsupported income or questionable employment history	14
Excessive debt-to-income ratio	17
Excessive loan-to-value ratio	4
Problem with funds to close	3
Did not qualify as underwritten	5

The attached appendixes provide further detail related to our observations.

- Appendix A: Schedule of Findings
- Appendix B: Schedule of Participants
- Appendix C: Underwriter 1 Observations
- Appendix D: Loan Officer Observations
- Appendix E: Other Individuals

#### Vice President, Pierce Residential Lending

The manager of Pierce's residential lending operation, the Vice President, was responsible for the lending operation and signed the mortgage notes at closing. During the audit period, the lending operation was cited by FHA's Quality Assurance Division in file No. 22458, dated May 28, 2009, for two findings regarding Pierce's operation and nine findings that were case specific.

Pierce failed to adopt, implement, and maintain a quality control plan in compliance with HUD Handbook 4060.1, REV-2, chapter 7. Notably, during the 2 years preceding the Quality Assurance Division's review, Pierce had 92 loans that went into default (60 days past due), but Pierce failed to provide documentation showing that the loans were selected for quality control review (refer to HUD Handbook 4060.1, REV-2, paragraph 7-6D). Our review of 25 more examples of poor underwriting demonstrates that this lapse in quality control and management of underwriting activities was substantial in scope.

#### Underwriter 1

As the lender's representative at the time of closing, Underwriter 1 was required to certify that she had personally reviewed the mortgage loan documents, closing statements, application for insurance endorsement, and all accompanying documents. The certifications also referred to due diligence and the integrity of the data used to qualify the loan. The deficiency examples offered below, from 22 loans for which Underwriter 1 signed the lender's certificate, contradict these certifications.

<b>Types of findings</b>	<b>Observed</b>
Poor credit history	9
Unsupported income or questionable employment history	13
Excessive debt-to-income ratio	15
Excessive loan-to-value ratio	4
Problem with funds to close	2
Did not qualify as underwritten	5

### Loan Officer

The loan officer assisted potential borrowers in completing the initial and final loan application describing the transaction and the borrower's assets, income, and liabilities. The loan officer signed page three of the application. The application provides instructions to the lender and borrower and states that this information is the basis for qualifying the loan. His signature on the application is an acknowledgement of these facts and instructions. The lender certifies on HUD's addendum to the uniform residential loan application.

Of the 17 examples of loan applications signed by the loan officer, 10 contained unsupported income or questionable employment history. One loan's downpayment source was disputed by the borrower. Another loan's description was misrepresented, including a falsified job according to the borrower. Three loans involved financing more than one home as owner occupied without disclosure to HUD, knowing that one would be rented.

We also noted that the loan application's documentation of "other assets" instructed the underwriter to itemize them. However, none of the applications contained a breakdown of assets. On 13 of the 25 loans, the amount was exactly \$45,000. Six loans showed no assets, and one showed \$75,000 in assets without itemization.

### Other Individuals

We noted some examples of poor underwriting by other individuals. We did not review a sufficient quantity of files by these individuals to recommend action against them at this time. However, these examples may warrant attention if additional examples are identified by other audits or investigations.

## **AUDITEE COMMENTS**

We did not provide a discussion draft memorandum report to Pierce due to ongoing investigations and the bank's subsequent closure. After initiation of our review, Pierce performed its own review of files and self-reported a number of underwriting violations. Some of our selected case files contained self-reported violations. The self-reported comments from Pierce for each case file are included in our appendix of findings for Civil Referral 2011-KC-0004-CA, previously provided to the Office of Program Enforcement. Additional electronic data on Pierce's self-report submission are available upon request.

## **RECOMMENDATIONS**

We recommend that HUD's Departmental Enforcement Center

- 1A. Initiate debarment action against the Pierce employees responsible for the material underwriting deficiencies cited in this report and maintain diligent coordination with OIG Offices of Audit and Investigation as well as applicable staff of the U.S. Department of Justice and Office of the United States Attorney to ensure that all related administrative, civil, and criminal cases proceed without being compromised.

**Appendix A****SCHEDULE OF FINDINGS**  
25 selected cases**Pierce Commercial Bank**  
Tacoma, WA

<b>FHA case No.</b>	<b>Poor credit history</b>	<b>Unsupported income or questionable employment history</b>	<b>Excessive debt-to-income ratio</b>	<b>Excessive loan-to-value ratio</b>	<b>Problem with support for funds to close</b>	<b>Did not qualify for insurance as underwritten</b>
561-8401576	X					X
561-8636061			X			
561-8270108		X				X
561-8395940		X				
561-8414419		X	X	X		
561-8442443		X	X			
561-8464480						X
561-8468027	X	X	X			
561-8481312		X	X	X		X
561-8483546	X					
561-8511210	X		X			
561-8526194		X	X	X		
561-8274588	X	X	X		X	
561-8624743		X	X			
561-8583553	X		X			
561-8424265		X	X			
561-8461869			X			X
561-8535404	X		X		X	
561-8496965			X			
561-8773564			X			
561-8488572		X	X			
561-8610143		X				
561-8512114	X	X				
561-8322693	X		X		X	
562-2094647	X	X		X		
<b>Observations:</b>	<b>10</b>	<b>14</b>	<b>17</b>	<b>4</b>	<b>3</b>	<b>5</b>

**Appendix B****SCHEDULE OF PARTICIPANTS**

25 selected cases

Pierce Commercial Bank  
Tacoma, WA

<b>FHA loan no.</b>	<b>Vice President</b>	<b>Underwriter 1</b>	<b>Loan Officer</b>	<b>Underwriter 3</b>	<b>Underwriter 2</b>	<b>Employee 1</b>	<b>Employee 2</b>	<b>Employee 3</b>	<b>Employee 4</b>	<b>Employee 5</b>	<b>Employee 6</b>	<b>Employee 7</b>	<b>Underwriter 4</b>
561-8401576	X	X	X										
561-8636061											X		X
561-8270108	X	X	X										
561-8395940	X	X	X										
561-8414419	X	X	X										
561-8442443	X	X	X										
561-8464480	X	X	X										
561-8468027	X	X	X										
561-8481312	X	X	X										
561-8483546	X	X	X										
561-8511210	X	X	X										
561-8526194	X	X	X										
561-8274588	X	X	X										
561-8624743	X	X	X										
561-8583553	X	X	X										
561-8424265		X	X										
561-8461869	X	X	X										
561-8535404	X			X								X	
561-8496965	X	X			X								
561-8773564	X	X					X						
561-8488572	X	X	X					X					
561-8610143	X			X	X					X			
561-8512114	X	X				X							
561-8322693	X	X				X							
562-2094647	X	X							X				
<b>Observations:</b>	<b>23</b>	<b>22</b>	<b>17</b>	<b>2</b>	<b>2</b>	<b>2</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>1</b>

X indicates which individuals were associated with the origination, underwriting, or closing of the loan.



**Appendix C****SCHEDULE OF DEFICIENCIES:****Underwriter 1  
22 selected cases****Pierce Commercial Bank  
Tacoma, WA**

<b>FHA loan no.</b>	<b>Underwriter 1 deficiencies:</b>
561-8401576	The property did not qualify for insurance as underwritten since the second home was not intended to be owner occupied. Two homes were in financing. Underwriter 1 manually approved this loan despite a history of bad credit including late housing payments.
561-8270108	The property did not qualify for insurance as underwritten since the second home was not intended to be owner occupied. Two homes were in financing. The verification said that employment had been terminated and Underwriter 1 did not further document the borrower's employment.
561-8395940	The continuance of overtime was not supported but was included in the income figure used for automated approval. The verification said that overtime would not continue.
561-8414419	The loan-to-value limit was exceeded due to recent late mortgage payments; the late mortgage payments were rolled into the new mortgage. Underwriter 1 manually approved excessive ratios without compensating factors. The ratios exceeded the FHA guidelines and were calculated using income that was overstated on the application. The net monthly rental income from a vacation house, reported at \$1,639.50, was excessive and reported as false by the owner in an interview with OIG investigators and the FBI.
561-8442443	Underwriter 1 manually approved excessive ratios without compensating factors. The ratios were calculated using income that was improperly inflated by the loan officer. If corrected, the already excessive ratios would have increased.
561-8464480	The property did not qualify for insurance as underwritten. The owner was planning to move and was also discussing the new home's financing with the loan officer. Since the refinanced property was not intended to be owner occupied, it did not qualify for a cash-out refinance.
561-8468027	Underwriter 1 manually approved a loan with poor credit and unpaid collections, which did not demonstrate the willingness to repay debt. The ratios exceeded the FHA guidelines and were calculated using income that was overstated on the application. Compensating factors were inadequate. Income was not properly verified, and the borrower stated in an interview with OIG investigators and the FBI that the support was falsified.

<b>FHA loan no.</b>	<b>Underwriter 1 deficiencies:</b>
561-8481312	Underwriter 1 electronically approved a misrepresented transaction by recording a sale between siblings as a refinance. The loan-to-value limit was exceeded because the house had not been owned for 12 months. Income source and amounts were not authentic and were significantly overstated on the application. The ratios were calculated using the overstated income. If corrected, the ratios would have been excessive.
561-8483546	Underwriter 1 manually approved the loan although the borrower's credit did not indicate the ability or willingness to repay. Not all outstanding consumer debt was current, and compensating factors were inadequate.
561-8511210	Underwriter 1 manually approved the loan although the borrower's credit did not indicate the ability or willingness to repay and the debt-to-income ratios were high. Not all outstanding consumer debt was current, and compensating factors were inadequate.
561-8526194	The loan-to-value limit was exceeded due to recent late mortgage payments that were rolled into the new mortgage. Underwriter 1 manually approved excessive ratios without compensating factors. The ratios were calculated using income that was improperly calculated by the loan officer. If corrected, the already excessive ratios would have increased.
561-8274588	Underwriter 1 manually approved the loan although the borrower's credit did not indicate the ability or willingness to repay. Recent consumer debt showed late payments, including a repossessed car. The loan officer incorrectly calculated the debt-to-income ratios. If corrected, the ratios would have exceeded the FHA guidelines, and there were no compensating factors. The source of the downpayment was not established, and the explanation was disputed by the borrower in an interview with an OIG investigator and the FBI.
561-8624743	Underwriter 1 manually approved excessive ratios without compensating factors. The loan officer calculated ratios using income that he significantly overstated. Both the front- and back-end ratios would have exceeded the benchmark guidelines and would have required compensating factors if the correct income, supported in the case file, had been used for the calculation.
561-8583553	Underwriter 1 manually approved debt-to-income ratios that far exceeded FHA standards, without compensating factors. These borrowers had many accounts in collection, indicating a lack of ability or willingness to pay.
561-8424265	Electronic approval was obtained by Underwriter 1 based on overstated income. Income was not properly verified and was not going to continue. Ratios would have exceeded the FHA guidelines if supportable income levels had been used for the calculation.

<b>FHA loan no.</b>	<b>Underwriter 1 deficiencies:</b>
561-8461869	Electronic approval was obtained by Underwriter 1 based on inaccurate information and should not have been relied upon to approve the loan. The loan was classified as a “no-cash-out refinance” for automated underwriting but paid cash-out of more than \$42,000. The ratios were calculated using a housing payment and monthly debt that was understated.
561-8488572	Underwriter 1 manually approved debt-to-income ratios that far exceeded FHA standards without compensating factors. Primary employment was terminated 2 weeks before closing and the stability of the coborrower’s income was not determined.
561-8496965	Underwriter 1 manually approved debt-to-income ratios that far exceeded FHA standards without compensating factors. Child support income was not stable and was the basis for a bankruptcy 2 years before the loan was approved. Income from the borrower’s parents was not properly documented.
561-8773564	Underwriter 1 manually approved debt-to-income ratios that far exceeded FHA standards without adding compensating factors after the automated underwriting system referred the loan for manual underwriting due to an excessive housing payment-to-income ratio.
561-8512114	Underwriter 1 manually approved the loan although the borrower’s credit did not indicate the ability or willingness to repay. Not all outstanding consumer debt was current, and compensating factors were inadequate. The explanation for bad credit provided no basis to expect change. There was no evidence that child support would continue.
561-8322693	Underwriter 1 manually approved the loan although the borrower’s credit did not indicate the ability or willingness to repay. Not all outstanding consumer debt was current. The front-end ratio was excessive, and compensating factors were inadequate. An inducement to purchase did not reduce the mortgage amount.
562-2094647	The loan-to-value limit was exceeded due to recent late mortgage payments that were rolled into the new mortgage. The borrower’s credit did not indicate the ability or willingness to repay. Income was not properly verified for 2 years, just for 10 months.
<b>Observations:</b>	<b>22 loans as underwriter</b>

**Appendix D****SCHEDULE OF DEFICIENCIES:****Loan Officer  
17 selected cases****Pierce Commercial Bank  
Tacoma, WA**

<b>FHA loan no.</b>	<b>Loan Officer deficiencies:</b>
561-8401576	This borrower had two homes in financing with the loan officer. Therefore, the property did not qualify for insurance as underwritten since this second home was not intended to be owner occupied.
561-8270108	This borrower had two homes in financing with the loan officer. Therefore, the property did not qualify for insurance as underwritten since this second home was not intended to be owner occupied.
561-8395940	The verification said that overtime would not continue. Therefore, although the loan officer included it in the income figure on the application, he could not support the continuance of overtime.
561-8414419	Income was overstated on the application. The net rental income from a vacation house, reported at \$1,639.50, was excessive and reported as false by the owner in an interview with OIG investigators and the FBI.
561-8442443	The loan officer calculated the ratios using income that was improperly inflated. If corrected, the already excessive ratios would have increased.
561-8464480	The owner was moving and was discussing new home financing with the loan officer. Therefore the property did not qualify for insurance as underwritten since this second home was a cash-out refinance and was not intended to be owner occupied. The information on the application was misstated.
561-8468027	The loan officer's documentation of income in the application was not properly verified and was overstated. The borrower stated, in an interview with OIG investigators and the FBI, that the support was falsified.
561-8481312	The loan officer misrepresented a sale between siblings as a refinance. Therefore, the loan-to-value limit was exceeded because the house had not been owned for 12 months. The income source and amounts were not authentic and were significantly overstated on the application. The loan officer calculated the ratios using the overstated income. If corrected, the ratios would have been excessive.
561-8483546	Although he was involved in this loan, the loan officer's actions were not directly linked to the exceptions cited in this example (see this loan in appendix C).

<b>FHA loan no.</b>	<b>Loan Officer deficiencies:</b>
561-8511210	Although he was involved in this loan, the loan officer's actions were not directly linked to the exceptions cited in this example (see this loan in appendix C).
561-8526194	The loan officer calculated the ratios using income that was improperly calculated and Underwriter 1 manually approved the excessive ratios without compensating factors. If corrected, the already excessive ratios would have increased.
561-8274588	The loan officer calculated the debt-to-income ratios using income that was improperly calculated. If corrected, the ratios would have exceeded the FHA guidelines without compensating factors. The source of the downpayment was not established, and the explanation was disputed by the borrower in an interview with OIG investigators and the FBI.
561-8624743	The loan officer significantly overstated income. Income documentation was not properly verified, showed double counting, and may not have been authentic.
561-8583553	Although he was involved in this loan, the loan officer's actions were not directly linked to the exceptions cited in this example (see this loan in appendix C).
561-8424265	The loan officer did not properly verify income, and the income was not expected to continue. Therefore, electronic approval was based on overstated income. Ratios would have exceeded the FHA guidelines if supportable income levels had been used for the calculation.
561-8461869	Although he was involved in this loan, the loan officer's actions were not directly linked to the exceptions cited in this example (see this loan in appendix C).
561-8488572	Primary employment was terminated 2 weeks before closing and the loan officer did not document the stability of the coborrower's income.
<b>Observations:</b>	<b>13 of 17 loans as loan officer</b>

**Appendix E****SCHEDULE OF OTHER PARTICIPANTS****Pierce Commercial Bank  
Tacoma, WA**

<b>FHA loan no.</b>	<b>Deficiencies:</b>
	<b>Underwriter 2</b>
561-8610143	<b>Underwriter 2</b> did not properly document the application for credit by a self-employed borrower. Documentation required to properly evaluate personal and business assets and liabilities was not available, including income, deposits, and credit.
561-8496965	<b>Underwriter 2</b> used child support income that was not stable and was the basis for a bankruptcy 2 years before the loan was approved. Income from parents was not properly documented.
	<b>Underwriter 3</b>
561-8535404	<b>Underwriter 3</b> manually approved debt-to-income ratios that far exceeded FHA standards without compensating factors. The borrower's credit did not indicate the ability or willingness to repay, and bad credit was not explained. <b>Underwriter 3</b> did not verify the gift funds or explain their origin. Prepaid commissions of \$9,909 could have been the source of the downpayment.
561-8610143	<b>Underwriter 3's</b> underwriting did not meet standards for a self-employed borrower and directly impacted the automated underwriting data entries and decision. There was no corresponding self-employment underwriting and credit analysis that should have been performed to consider corporate income, assets, liabilities, and credit. Documentation required to properly underwrite the file was not available, including income, deposits, and credit.
	<b>Underwriter 4</b>
561-8636061	<b>Underwriter 4</b> manually approved excessive ratios without compensating factors.