



Issue Date	July 24, 2008
------------	---------------

Audit Report Number	2008-BO-1007
---------------------	--------------

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

FROM: for John Dvorak, Regional Inspector General for Audit, Boston Region, 1AGA

SUBJECT: Countrywide Bank, Milford and Madison, Connecticut, Did Not Comply with  
Certain HUD Requirements in Administering Its Federal Housing  
Administration Insured Loan Programs

## **HIGHLIGHTS**

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

We audited the Milford, Connecticut, branch office of Countrywide Bank, FSB (Countrywide<sup>1</sup>), which is a supervised national bank approved by the U.S. Department of Housing and Urban Development (HUD) to originate, underwrite, and service Federal Housing Administration (FHA) single-family insured loans. We selected the Milford, Connecticut, branch office largely based on a lender risk analysis, which showed that the loans it originated had a higher default percentage than the Connecticut state average. We expanded the audit to cover the Madison, Connecticut, branch office, which used the same FHA identification number.

Our objectives were to determine whether the lender acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of the FHA-insured single-family mortgages selected for review; and whether its quality control plan as implemented met HUD requirements.

---

<sup>1</sup> “Countrywide Bank, FSB” (Federal Savings Bank) and “Countrywide” used interchangeably throughout this report.

## What We Found

Countrywide did not fully comply with HUD regulations, procedures, and instructions in the origination of FHA-insured single-family mortgages. However, the lender's quality control plan and implementation was adequate.

Specifically, Countrywide allowed some borrowers utilizing secondary financing from an agency acting as an instrumentality of government to incorrectly receive cash back at closing in excess of their total cash deposit totaling \$5,767. This occurred because Countrywide did not follow proper HUD underwriting guidelines, which resulted in the loans being overinsured and a minimal increased risk to the FHA insurance fund. Countrywide also did not properly notify HUD upon the sale and/or transfer of FHA-insured loans. This condition occurred because Countrywide was not fully aware of the HUD requirements regarding mortgage record changes.

## What We Recommend

We recommend that HUD's Assistant Secretary for Housing–Federal Housing Commissioner require Countrywide to (1) pay down the principal by \$5,767 for the five overinsured loans and implement controls to prevent cash back when secondary financing is used; and (2) update their mortgage records in HUD's system to reflect the appropriate mortgage holder and implement procedures to ensure the timely submission of mortgage record changes for future loans assigned or sold.

For each recommendation in the body of the report without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please also furnish us copies of any correspondence or directives issued because of the audit.

## Auditee's Response

We provided Countrywide officials draft finding details throughout the course of the audit. We also provided Countrywide officials with a draft audit report on June 27, 2008, and requested a response by July 22, 2008. We discussed the draft report at an exit conference on July 17, 2008, and received their written comments on July 18, 2008. Countrywide agreed with the facts, conclusions, and recommendations in this report. Countrywide's written response can be found in appendix B of this report.

## TABLE OF CONTENTS

---

Background and Objectives	4
Results of Audit	
Countrywide Did Not Comply With Certain HUD Requirements Concerning the Origination and Servicing of FHA-Insured Loans	6
Scope and Methodology	8
Internal Controls	10
Appendixes	
A. Schedule of Questioned Costs	12
B. Auditee Comments	13
C. Schedule of Loans With Excess Cash Back to Borrowers	14

## BACKGROUND AND OBJECTIVES

---

The National Housing Act, as amended, established the Federal Housing Administration (FHA), an organizational unit within the U.S. Department of Housing and Urban Development (HUD). FHA<sup>2</sup> provides insurance to private lenders against losses on mortgages financing homes. The basic single-family mortgage insurance program is authorized under Title II, Section 203(b) of the National Housing Act and is governed by regulations in 24 CFR [*Code of Federal Regulations*] Part 203. The single-family programs are generally limited to dwellings with one- to four-family units. HUD Handbooks and Mortgagee Letters provide detailed processing instructions, and advise the mortgage industry of major changes to FHA programs and procedures.

There are two types of HUD-approved lenders<sup>3</sup>—supervised and non-supervised. A non-supervised lender is a financial entity that has as its principal activity the lending or investing of funds in real estate mortgages, but it is not a member of the Federal Reserve System or an institution whose accounts are insured. A supervised lender is a financial institution, which is a member of the Federal Reserve System or an institution whose accounts the Federal Deposit Insurance Corporation or the National Credit Union Administration insures. Prior to 2008, the audited branches (Milford and Madison, Connecticut) were part of Countrywide Home Loans, Inc., which was a non-supervised mortgage company. In January 2008, Countrywide integrated its mortgage loan production divisions and certain other mortgage banking operations into Countrywide Bank, FSB, which is a supervised national bank. Countrywide is a nationwide lender and its corporate office is in Calabasas, California. Countrywide is responsible for the loan quality and performance of all its branches<sup>4</sup>.

Based on HUD's data, the Milford and Madison, Connecticut, branch offices originated approximately 661 FHA loans from January 1, 2005, through March 31, 2008. The total original mortgage amount for all loans originated during this period was more than \$124 million.

As of March 31, 2008, the FHA loan default rate for loans that were originated by the Milford and Madison, Connecticut, branch offices and went into default within the first two years of origination was 4.18 percent. The rate for all other lenders that originated loans in Connecticut for the last two years was 3.83. The Milford and Madison, Connecticut, branch offices have consistently had a higher default rate during the early loan repayment period the last several quarters as compared to other lenders that originated loans in Connecticut (see table on the following page).

---

<sup>2</sup> The acronyms HUD and FHA are often used interchangeably.

<sup>3</sup> For ease of reading, we have chosen to use "lender" in lieu of "mortgagee" throughout this report. However, lender is to be interpreted as an FHA-approved mortgagee as described in the regulations, program handbooks, etc.

<sup>4</sup> HUD Handbook 4060.1 REV-2, "FHA Title II Mortgagee Approval Handbook," Chapter 2, Section 2-11.

Comparison of early payment loan default percentages, Milford and Madison, Connecticut, Branch Offices, Countrywide Bank, and Connecticut Lenders

Quarter end date	Loan defaults (%)		Compare ratio (%)*
	Milford and Madison, CT, Branch Offices, Countrywide Bank	Connecticut Lenders	
3/31/2008	4.18	3.83	109
12/31/2007	4.83	3.93	123
9/30/2007	4.23	3.62	117
6/30/2007	4.38	3.49	126
3/31/2007	4.99	3.59	139
12/31/2006	4.57	3.51	130

\* A compare ratio is the percentage of originations that went into default or were claim terminated divided by the percentage of originations that went into default or were claim terminated for the selected geographic area. Compare ratio is the value that reveals the largest discrepancies between the subject's default and claim percentage and the default and claim percentage to which it is being compared.

The audit objectives were to determine whether the lender acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of the FHA-insured single-family mortgages selected for review and whether its quality control plan as implemented met HUD requirements. We also assessed other general aspects of Countrywide's operations as they related to continued lender approval.

## RESULTS OF AUDIT

---

### Countrywide Did Not Comply With Certain HUD Requirements Concerning the Origination and Servicing of FHA-Insured Loans

Countrywide did not comply with certain HUD requirements concerning the origination and processing of FHA-insured loans. Specifically, Countrywide allowed five borrowers to incorrectly receive cash back at closing in excess of their total cash deposit. This occurred because Countrywide did not follow proper HUD underwriting guidelines governing the use of secondary financing from an agency acting as an instrumentality of government. This failure to follow prudent lending practices was not an indication of a pattern of noncompliance, but the five loans were overinsured by \$5,767, representing a minimal increased risk to the FHA insurance fund. Countrywide also did not properly notify HUD upon the sale and/or transfer of FHA-insured loans. This condition occurred because Countrywide was not fully aware of the HUD requirements regarding mortgage record changes.

---

#### **Borrowers Incorrectly Received Cash Back**

Our review of 46 FHA-insured loan origination files identified five instances where the HUD-1 Settlement Statements indicated that the borrowers received cash back at closing in excess of their earnest money deposit or other upfront costs paid outside of closing. The borrowers received downpayment assistance from the Connecticut Housing Finance Authority (CHFA), which is considered an instrumentality of government. Federal, state, and local government agencies, as well as, nonprofit agencies considered instrumentalities of government, may provide secondary financing for the borrower's entire cash investment in the FHA-insured property so long as it does not result in cash back to the borrower.<sup>5</sup> The total cash incorrectly received back by the five borrowers totaled \$5,767 (see appendix C).

Although Countrywide did not follow proper HUD underwriting guidelines, there was no indication of a pattern of noncompliance. Nonetheless, the five loans were overinsured by \$5,767, representing a minimal increased risk to the FHA insurance fund and Countrywide will need to be more vigilant in its underwriting.

---

<sup>5</sup> HUD Handbook 4155.1 REV-5, "Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Family Properties," Chapter 1, Section 5.

## Significant Number of Mortgage Records Not Updated

In November 2003, recognizing the new technology under which the mortgage industry and HUD operates the single-family insurance programs, HUD eliminated the paper mortgage insurance certificate in favor of electronic records maintained by HUD for the purpose of verification of both the ownership and of the insured status of a mortgage. As a result, HUD made several procedural changes that affected the originating lender, the holding lender, and the servicing lender.<sup>6</sup>

HUD determined that it was imperative that the data contained in HUD's Single Family Insurance System regarding a lender's FHA-insured portfolio be accurate.<sup>7</sup> Of key concern is the submission of mortgage record changes and mortgage insurance terminations that update HUD's insurance system. Lenders must notify HUD of a sale of an FHA-insured loan within 15 calendar days.<sup>8</sup> HUD identified that the most common problem was that lenders often did not update the holder of record for each loan as required. As of December 1, 2005, only the existing holder of record is able to provide HUD with mortgage record changes to update a new holder of record, if 90 days have passed after endorsement.<sup>9</sup> In addition, HUD will not pay any claim for insurance benefits for which the information on the claim and HUD's FHA insurance system do not agree.

As of May 29, 2008, Countrywide was listed as the holding lender for 797 active loans of which 751 (94 percent) were over 90 days past endorsement (see table below).

Countrywide Listed as Holding Lender (as of May 29, 2008)		
Days Since Endorsement	Number of FHA Loans	Percent of Total Loans
0 – 30	1	0.13%
31 – 60	26	3.26%
61 – 90	19	2.38%
91 – 120	16	2.01%
121 – 365	165	20.70%
366 – 730	194	24.34%
731 - 1,096	184	23.09%
>1,096	192	24.09%
<b>Totals</b>	<b>797</b>	<b>100.00%</b>

However, Countrywide assigned a high percentage of FHA-insured loans to CHFA at closing. We did not specifically identify which loans Countrywide assigned to CHFA but estimate that Countrywide assigned over 600 loans during our audit period. Therefore, CHFA should be reflected as the holding lender for

<sup>6</sup> Mortgagee Letter 2003-17.

<sup>7</sup> Mortgagee Letters 2003-17, 2004-34, 2005-11, and 2005-42.

<sup>8</sup> Title 24 of the *Code of Federal Regulations*, Part 203.431, "Sale of insured mortgage to approved mortgagee."

<sup>9</sup> Mortgagee Letter 2005-42.

these loans. Countrywide officials acknowledged that they had not been notifying HUD or updating mortgage record upon the sale and/or transfer of FHA-insured loans because they were not aware of the requirements, which are explained in a series of related mortgagee letters.

## Conclusion

Countrywide's oversight of its underwriting overall appeared adequate and errors noted during our file reviews only have a minimal impact on HUD's single-family mortgage insurance program. However, five borrowers incorrectly received cash back at closing, resulting in loans overinsured by \$5,767 and a minimal increased risk to the FHA insurance fund. This occurred because Countrywide did not follow proper HUD underwriting guidelines. In addition, Countrywide did not properly notify HUD upon the sale and/or transfer of FHA-insured loans. This condition occurred because Countrywide was not fully aware of the HUD requirements regarding mortgage record changes. Inaccurate or untimely reporting of mortgage record changes directly affects the payment of claims for insurance benefits. As such, HUD will not pay any claim for insurance benefits for which the information on the claim and HUD's FHA insurance system do not agree. Therefore, it is incumbent upon the lender to ensure that HUD's records accurately reflect both the correct holder and servicer of record.

## Recommendations

We recommend that HUD's Assistant Secretary for Housing—Federal Housing Commissioner require Countrywide to

- 1A. Pay down the principal by \$5,767 for the five overinsured loans. If HUD has subsequently paid a claim on any of these loans, Countrywide should remit this payment to HUD.
- 1B. Implement controls to ensure that when instrumentalities of government provide downpayment assistance or secondary financing for the borrower's cash investment in a FHA-insured property that it does not result in cash back to the borrower.
- 1C. Update their mortgage records in HUD's system to reflect the appropriate mortgage holder.
- 1D. Implement procedures to ensure the timely submission of mortgage record changes for future loans assigned or sold.



## SCOPE AND METHODOLOGY

---

Our audit primarily covered the period of January 1, 2005, through December 31, 2007, and included loans originated and sponsored by the Milford, CT, and Madison, CT branches of Countrywide Bank, FSB. We extended the audit period as necessary through March 31, 2008. We conducted our audit work from February 2008 through June 2008. We primarily carried out our audit work at the Milford, CT, branch office of Countrywide Bank, FSB, and the local HUD Hartford (Connecticut) field office. We focused the audit on the lender's loan origination, underwriting, servicing, and quality control operations.

To achieve our objectives, we identified, obtained, and reviewed relevant rules, regulations, and guidance pertaining to the origination of single-family mortgages, including the *Code of Federal Regulations*, HUD handbooks, Mortgagee Letters, and the *United States Code*. We also obtained and analyzed critical documents from the loan origination files maintained by Countrywide and HUD. We interviewed appropriate lender and HUD officials. In addition, we obtained an understanding of controls significant to the audit objectives and considered whether the lender designed and placed specific control procedures in operation.

We relied on information from HUD's data systems. We reviewed existing information about the data and performed sufficient tests to determine whether the data was reliable. Based on our assessments, we determined that the data was sufficiently reliable for our purposes.

We selected 46 FHA-insured loans that defaulted within the first three years of origination for detailed loan origination analysis. The 46 loans represented 100% of the loans that defaulted out of the 661 loans originated during our audit period of January 1, 2005 through March 31, 2008. The results of our detailed testing only relate to the loans reviewed. This sampling method allowed us to focus on loans that had a greater inherent risk to the FHA insurance fund and/or of noncompliance or abuse.

We also communicated minor issues disclosed during the audit with the auditee and sent a separate letter to HUD program officials.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

# INTERNAL CONTROLS

---

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

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

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

---

## Relevant Internal Controls

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

- Controls over program operations - Policies and procedures that management has implemented to reasonably ensure that the HUD single-family insurance program meets its objectives and that unintended actions do not result.
- Controls over the validity and reliability of data - Policies and procedures that management has implemented to reasonably ensure that valid and reliable data (including computer-processed data) are obtained, maintained, and fairly disclosed in reports and HUD computer systems.
- Controls over compliance with laws and regulations - Policies and procedures that management has implemented to reasonably ensure that the single-family program implementation is consistent with laws, regulations, and provisions of contracts or grant agreements.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

## Significant Weaknesses

Based on our review, we believe the following items are significant weaknesses:

- Controls over compliance with laws and regulations – Countrywide allowed cash back to borrowers with secondary financing from an agency acting as an instrumentality of government.
- Controls over the validity and reliability of data – Countrywide did not update its mortgage records in a timely manner.

## APPENDIXES

---

### Appendix A

#### SCHEDULE OF QUESTIONED COSTS

---

Recommendation number	Ineligible <u>1/</u>
1A	\$5,767

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local polices or regulations.

## Appendix B

### AUDITEE COMMENTS

---



Timothy J. Bannon, ACDA, CGAP  
Senior Auditor

U.S. Department of Housing & Urban Development  
Office of Inspector General  
One Corporate Center, 19th Floor  
20 Church Street  
Hartford, CT 06103

RE: HUDOIG Draft Audit

Mr. Bannon,

We are in receipt of your audit findings that resulted from an on site audit located at 1 New Haven Avenue, Suite 101, Milford, CT. 06460.

We would like to respond to your findings as follows:

**Borrowers Incorrectly Received Cash Bank:**

We have reviewed the five loan files in question and do concur with your findings of overpayment. We will be reducing the principal on these loans by the amounts specified in your draft audit. If any claims have been paid to HUD we will remit any monies due. We believe these types of errors to be isolated and will assure that we address this to our underwriting and closing staff.

**Mortgage Records not updated:**

We understand the importance of the correct information to be listed in HUD's system when a loan is sold. We are working with Connecticut Housing Finance Authority and our loan administration group to assure that this process is done timely upon the sale of the mortgage. We will work with both groups to assure that all outstanding records are changed. We will implement proper procedures to ensure the timely submission of the electronic mortgage record changes for future loans sold.

Sincerely,

Linda Jacopetti  
Executive Vice-President  
Government Lending Compliance  
30920 Russell Ranch Road  
MS: WLRR-11  
Westlake Village, CA. 91362

## Appendix C

### SCHEDULE OF LOANS WITH EXCESS CASH BACK TO BORROWERS

---

#	Lender's Loan #	FHA #	Cash Paid to Borrower at Closing	Earnest Deposit and/or Other Costs Paid Outside of Closing	Excess (Cash Paid to Borrower at Closing Less Earnest Deposit and Other Costs Paid Outside of Closing)
1	100366494	061-2862414	\$4,557.34	\$2,200.00	\$2,357.34
2	102018386	061-2869934	\$2,642.50	\$2,000.00	\$642.50
3	123630311	061-2919271	\$2,830.92	\$2,600.00	\$230.92
4	155413159	061-3008096	\$2,168.67	\$634.00	\$1,534.67
5	138556782	061-3014821	\$1,601.76	\$600.00	\$1,001.76
<b>TOTAL EXCESS CASH BACK:</b>					<b>\$5,767.19</b>