audit report

Issue Date July 31, 2008
Audit Report Number 2008-PH-1011

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

FROM: John P. Buck, Regional Inspector General for Audit, Philadelphia Regional Office, 3AGA

SUBJECT: Wells Fargo Home Mortgage, Newark, Delaware, Did Not Always Comply with HUD Requirements in the Origination of FHA-Insured Single-Family Loans

HIGHLIGHTS

What We Audited and Why

We audited the Newark, Delaware, branch office (branch office) of Wells Fargo Home Mortgage (Wells Fargo), a supervised direct endorsement lender approved to originate Federal Housing Administration (FHA) single-family mortgage loans. The branch office is mainly responsible for underwriting loans for 22 Wells Fargo sales branch offices throughout Pennsylvania, excluding Pittsburgh, as well as two sales offices in Marlton, New Jersey. We selected the branch office because of its relatively high default rate, compared with the average default rate for the state of Pennsylvania. Our objective was to determine whether the branch office complied with U.S. Department of Housing and Urban Development (HUD) requirements in the origination and quality control review of FHA loans.

What We Found

Wells Fargo's branch office did not always comply with HUD requirements in the origination of FHA-insured single-family loans. Four of eight loans we selected for review[1] were not originated in accordance with HUD requirements. Wells Fargo generally complied with HUD requirements in its quality control reviews of FHA loans. The deficiencies we noted with the loan originations occurred because Wells Fargo staff did not exercise due care in the underwriting of the loans. As a result, the FHA insurance fund was exposed to an unnecessarily increased risk.

What We Recommend

We recommend that HUD's Assistant Secretary for Housing – Federal Housing Commissioner require Wells Fargo to indemnify more than $816,000[2] for four loans, which it issued contrary to HUD's loan origination requirements, and enforce its policies, procedures and controls to ensure that its staff consistently follows HUD's requirements.

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 a draft report to Wells Fargo on June 9, 2008. We discussed the report with Wells Fargo during the audit and at an exit conference on June 12, 2008. Following the exit conference, we provided an updated draft to Wells Fargo on June 25, 2008. Wells Fargo provided written comments to our revised draft report on June 30, 2008. In its response it stated it agreed with our findings and provided a list of steps it has taken to address them. The complete text of Wells Fargo's response can be found in appendix B of this report.

[1] The eight loans were originally valued at more than $1.6 million.
[2] This amount is the unpaid principal balance. The projected loss to HUD is $318,596 based on HUD's average insurance fund loss rate of 39 percent.

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BACKGROUND AND OBJECTIVES

The U.S. Department of Housing and Urban Development's (HUD) strategic plan states that its mission is to increase homeownership, support community development, and increase access to affordable housing free from discrimination.

The National Housing Act, as amended, established the Federal Housing Administration (FHA), an organizational unit within HUD. FHA provides insurance for lenders against loss on single-family home mortgages.

HUD's direct endorsement program, authorizes approved lenders to underwrite loans without HUD's prior review and approval. HUD can place lenders on credit watch status or terminate their approval if their rate of defaults and claims exceeds the normal rate for the area. Many sanctions are available for taking actions against lenders or others who abuse the program.

Wells Fargo Home Mortgage (Wells Fargo) is a direct endorsement lender for FHA loans. Its corporate office is located in Des Moines, Iowa.

The Newark, Delaware, branch office (branch office) issued 48 FHA loans valued at approximately $6.6 million that defaulted within the first two years. We sampled and reviewed case files for eight of the loans valued at approximately $1.6 million.

Our objective was to determine whether the branch office complied with HUD requirements in the origination and quality control review of FHA loans.

RESULTS OF AUDIT

Finding: The Branch Office Did Not Always Comply with HUD Requirements in the Origination of FHA-Insured Single-Family Loans

The branch office did not always comply with HUD requirements in the origination of FHA-insured single-family loans. Four of eight loans selected for review were not originated in accordance with HUD requirements. The branch office did not always verify borrowers' rental histories as required. It also approved a borrower with unacceptably high debt ratios and improperly reimbursed a borrower for "sweat equity." These deficiencies occurred because Wells Fargo staff did not exercise due care in underwriting the loans, causing an unnecessarily increased risk to the FHA insurance fund. Therefore, Wells Fargo should indemnify more than $816,000[3] for the four defaulted loans.

The Branch Office Did Not Verify Borrowers' Rental Histories

According to HUD requirements,[4] lenders must obtain borrowers' payment histories of housing obligations through either credit reports, verification directly from the landlords (with no identity of interest with the borrower), or canceled checks covering the most recent 12-month period.

For two of our sample loans, the case files did not include rental histories or verification of monthly rental payments, and the borrowers' credit reports did not include payment histories pertaining to housing obligations. Monthly rental payment amounts were listed on the borrowers' uniform residential loan agreement, and one of the loans was a lease purchase. In the absence of the information discussed, there was no evidence that the branch office determined the borrowers' payment history of housing obligations as required by HUD.

[3] See footnote 2.
[4] HUD Handbook 4155.1, REV-5, paragraph 2-3A.

The Branch Office Improperly Reimbursed the Borrower for "Sweat Equity"

HUD requirements[5] state that labor to be performed by the borrower on the property being rehabilitated may be used to create additional equity in the property ("sweat equity"), but that the borrower cannot receive any cash back for the labor performed. The borrower can only be reimbursed for the cost of any materials that the borrower may have purchased.

One of the sample cases involved a Section 203K rehabilitation loan. The borrower performed the repair work on the property. He provided the branch office a quote/cost estimate prepared by a construction company that was also his employer. The quote reflected a total of $9,998 in rehabilitation costs and showed that the amount included the cost of materials and labor. The total drawn amount for the repairs was $9,998, indicating that the borrower was reimbursed the cost of his labor in violation of HUD requirements.

The Branch Office Overstated the Borrowers' Income and, Therefore, Relied on High Debt-to-Income Ratios

According to HUD requirements,[6] the lender must develop an average of bonus or overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes. HUD requirements[7] also state that ratios should be used to determine whether a borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. Lenders are required to compute two ratios: the mortgage payment expense to effective income, which should not exceed 31 percent, and the total fixed payment to effective income, which should not exceed 43 percent.

In one case, the branch office overstated the borrowers' effective monthly income and, therefore, approved the loan based on incorrect debt-to-income ratios. The branch office included overtime income in the computation of the borrowers' effective income without developing an average of bonus or overtime income for the previous two years or documenting written justification for including the

[5] HUD Mortgagee Letter 94-11, paragraph 17.
[6] HUD Handbook 4155.1, REV-5, paragraph 2.7A.
[7] HUD Handbook 4155.1, REV-5, paragraph 2.12, and HUD Mortgagee Letter 2005-16.

overtime earnings. Without the overtime income, the borrowers would not have qualified for the loan because their mortgage payment expense-to-effective income ratio would have been 39.68 percent, which exceeds the 31 percent allowed by HUD, and their total fixed payment-to-effective income ratio would have been 54.69 percent, compared with HUD's 43 percent limit.

Wells Fargo Staff Did Not Exercise Due Care

The deficiencies noted occurred because branch office staff did not exercise due care in the underwriting of the loans. We discussed the deficiencies with staff at the branch office as well as staff in Wells Fargo's Credit Risk Management Division in Minneapolis, Minnesota. Wells Fargo could not provide justification for the branch office's noncompliance with HUD requirements. Also, although Wells Fargo established a quality control plan and generally performed related reviews in compliance with HUD requirements, for one of the cases in which we determined the borrower's rental history was not verified, Wells Fargo also reviewed that particular loan as part of its quality control process but failed to identify the issue we noted. The quality control review was performed by Wells Fargo's Credit Risk Quality Assurance staff in Minneapolis, Minnesota.

It is important for Wells Fargo to ensure that its staff exercises due care in underwriting FHA loans and also in its quality control review process so that it can correctly assess the performance of its underwriters and take appropriate measures to prevent instances of noncompliance with HUD requirements.

Conclusion

The branch office did not comply with HUD requirements in originating four of eight loans reviewed. It did not always verify borrowers' rental histories. It also approved a borrower with unacceptably high debt ratios and improperly reimbursed a borrower for "sweat equity." These deficiencies occurred because Wells Fargo staff did not exercise due care in underwriting the loans, causing an unnecessarily increased risk to the FHA insurance fund. Therefore, Wells Fargo should indemnify more than $816,000[8] for the four defaulted loans (see appendixes C and D for more detail).

Recommendations

[8] See footnote 2.

We recommend that HUD's Assistant Secretary for Housing – Federal Housing Commissioner require Wells Fargo to

1A. Indemnify $816,912[9] for four loans which it issued contrary to HUD's loan origination requirements.

1B. Enforce its policies, procedures and controls to ensure that its staff consistently follows HUD requirements.

[9] See footnote 2.

SCOPE AND METHODOLOGY

We reviewed lenders with high default rates and selected the Jenkintown, Pennsylvania, branch of Wells Fargo, HUD branch ID number 2299504147, because its percentage of defaults by two years was 3.48 percent, compared with the Pennsylvania state average of 3.31 percent. We later learned that the branch ID actually covers 22 Wells Fargo sales branch offices throughout Pennsylvania (excluding Pittsburgh) as well as two sales offices in Marlton, New Jersey, and that the underwriting for all these offices is performed at Wells Fargo's Newark, Delaware, branch office. As a result, we focused on and performed our review at that branch office.

We ran queries in HUD's Neighborhood Watch system to identify the number of defaulted loans within the first two years and the number of payments made against those loans for the branch office. The branch office issued 48 FHA loans, valued at approximately $6.6 million, that defaulted within the first two years. After eliminating loans that were processed outside the branch office, 25 defaulted loans remained. The 25 loans, valued at more than $3.5 million, defaulted with 12 payments or fewer. We sampled and reviewed case files for eight of the loans valued at approximately $1.6 million. To determine whether the branch office complied with HUD regulations, procedures, and instructions in the origination and quality control review of FHA loans, we performed the following:

- Reviewed applicable HUD handbooks and mortgagee letters,
- Reviewed case files for the eight sample loans,
- Examined records and related documents of Wells Fargo and its branch office, and
- Conducted interviews with officials and employees of Wells Fargo and the branch office and employees of the HUD Quality Assurance Division.

In addition, we relied in part on data maintained by HUD in the Neighborhood Watch system. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data adequately reliable for our purposes.

Our review covered the period November 2005 through October 2007. When applicable, the review period was expanded to include current data through February 2008.

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

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Loan origination process – Policies and procedures that management has in place to reasonably ensure that the loan origination process complies with HUD program requirements.

- Quality control plan – Policies and procedures that management has in place to reasonably ensure implementation of HUD's quality control requirements.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- Wells Fargo did not operate in accordance with HUD requirements as they relate to loan issuance or origination.

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use 1/
1A	$318,596

1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. In this instance, implementation of our recommendation to indemnify loans that were not originated in accordance with HUD requirements will reduce the risk of loss to the FHA insurance fund. The above amount reflects HUD statistics, which show that FHA, on average, loses 39 percent of the claim paid for each property (see appendix C).

Appendix B

AUDITEE COMMENTS

Auditee Comments

WELLS FARGO HOME MORTGAGE

MAC X9903-022
2650 Wells Fargo Way
2nd Floor, West Building
Minneapolis, MN 55467-0001

June 23, 2008

John P. Buck
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Wanamaker Building, Suite 1005
100 Penn Square East
Philadelphia, PA 19107 – 3380

Dear Mr. Buck,

Wells Fargo Home Mortgage (WFHM) is committed to originating Federal Housing Administration (FHA) loans that conform to the Department of Housing and Urban Development's (HUD) origination, underwriting and servicing requirements. As the nation's leading originator of Government National Mortgage Association (GNMA) loans, WFHM values our relationship with HUD and we are committed to improving its origination, underwriting and servicing operations and processes.

We are proud that the quality of WFHM's FHA-insured originations, as measured by the industry standards, ranks above the national industry average. Additionally, WFHM is a high-volume servicer with a Tier 1 ranking, reflecting our success in loss mitigation and the underlying quality of our originations.

We are writing you today in response to the draft report received June 25 from the Office of the Inspector General (OIG) which detailed findings from the review of a sample of WFHM FHA-insured loans originated between November 1, 2005 and October 31, 2007. While we are confident that our overall quality record as an FHA originator and servicer is among the best in the industry, we take seriously the draft findings outlined in the OIG's review and we have initiated processes to address issues in draft finding.

WFHM consistently strives to meet all HUD's guidelines when originating, processing and closing loans. We have a series of quality controls and measures in place to ensure that errors are detected and addressed. We have taken numerous steps to identify opportunities, determine root causes and create action plans to appropriately address the issues nationally and at our local sales and fulfillment centers.

Wells Fargo Home Mortgage
is a division of Wells Fargo Bank, N.A.

Wells Fargo Continuously Reviews and Improves Its Processes and Controls

Wells Fargo continuously implements improvements in its process and controls for FHA originations and underwriting. On a monthly basis, random and targeted samples of FHA originations and loans submitted for endorsement are assessed for adherence to HUD guidelines. These results are reviewed with senior management from our lines of business in an effort to identify opportunities for improvement and root causes of any errors. Established quality benchmarks are monitored on a monthly basis. Branch sites that do not produce loans in conformance to HUD guidelines receive corrective feedback to address the deficiencies. Action plans are implemented and closely monitored for effectiveness and improvement.

Summary of the OIG Draft Audit Report and Our Response

The OIG revised draft audit report was received June 25, 2008 for review and comment. The audit period covered by the report is November 1, 2005 through October 31, 2007.

The background and objectives section of the report states that the audit was focused on the Newark, Delaware branch operation office. The objective was to determine whether the branch office complied with HUD regulations, procedures, and instructions in the origination and quality control review of FHA loans. The claim is that the branch office did not always ensure the borrowers met the minimum requirements including verifying funds to close, and rental histories. Additionally, the branch also approved a borrower with unacceptable high debt ratios and improperly reimbursed a borrower for "sweat equity".

Finding 1: Wells Fargo – Newark Branch Office Did Not Always Comply with HUD Requirements

According to data from HUD's Single Family Data Warehouse as of April, 2007, WFHM is consistently above the national industry average in adhering to prudent lending practices and has maintained this standing for over the past five years. In addition, our Philadelphia HUD Branch ID has historically performed close to or at the industry standards for the same time period.

Because of our commitment to leadership in FHA lending, WFHM has taken steps to improve our originations and underwriting processes and controls and we believe that these changes are providing positive results. WFHM will continue to take action to ensure ongoing improvement in the quality of our FHA originations and underwriting processes.

WFHM also agrees to work with HUD on repairing four of the eight defaulted loans it examined. While we do not believe the findings based on this small sample of defaulted loans are indicative of the overall quality of our FHA originations, the feedback helps strengthen our origination and production capabilities. We take seriously the responsibility of being the nation's No. 1 FHA lender, and will continue to generate high-quality FHA loans through our partnership with HUD.

WFHM's Actions to Strengthen Origination Practices

Nationally and in our Philadelphia office, WFHM has fortified its culture of risk governance by instituting monthly enterprise-wide management assessments of risk controls and immediately addressing areas considered marginal or insufficient. In addition, we have taken specific action toward the enhancement of compliance with HUD requirements, which include:

- Improving controls within our loan origination systems
- Articulating and validating underwriting and closer competencies by the development of Underwriting Quality Scorecard
- Updated FHA training for Sales and Fulfillment staff with comprehensive job aids to address the following:
    - Acceptable compensating factors for manually underwritten loans with ratios exceeding 29/42
    - Income Calculation
    - Asset Verification
    - Credit Requirements, which include reminder for the Verification of Rents (VOR)
    - Minimum Required File Documentation
    - Minimum Investment Requirements
    - Specific Training for 203K programs
- Centralized 203K decisioning sites to maintain subject matter experts for that program
- Annual performance evaluations which include a quality component measurement
- Continuous feedback and training to Quality Assurance Analysts to ensure compliance to QA plan

Conclusion

We reviewed the eight loans tested for technical compliance and agree with the factual content of the findings that there were compliance issues within a small group of four loans identified in the audit. The audit findings will be integrated within our ongoing quality assurance performance feedback, providing a meaningful gauge to our origination and production offices.

We appreciate the opportunity to review and comment on the draft report prepared by the OIG. While we are confident that our overall performance as an FHA originator is among the best in the industry, we understand there are always opportunities for improvement. This response includes details on a number of steps we have taken to address the issues raised in the audit; steps that already have helped us further improve the quality of our FHA originations.

Wells Fargo Home Mortgage is proud of its role as the nation's premiere FHA lender and servicer. We are committed to a strong, long-term partnership with the Department of Housing and Urban Development. Please contact us if you have additional questions or need clarification on items included in this response.

Sincerely,

Cara K. Heiden
Co-President, Wells Fargo Home Mortgage,
a division of Wells Fargo Bank, N.A.

Michael J. Heid
Co-President, Wells Fargo Home Mortgage,
a division of Wells Fargo Bank, N.A.

Appendix C

SCHEDULE OF CASE FILE DISCREPANCIES

Case number	Mortgage amount	Unpaid principal balance	39% loss rate*	No rental history	Overstated income	High debt ratios	Borrower reimbursed for “sweat equity”
441-7823233	$241,570	$240,466	$93,782	X			
441-7737514	$202,401	$198,456	$77,398		X	X	
441-7817005	$191,987	$190,571	$74,323	X			
441-7780695	$189,971	$187,419	$73,093				X
Totals	**$825,929**	**$816,912**	**$318,596**	**2**	**1**	**1**	**1**

* This amount was calculated by taking 39 percent of the unpaid principal balance for the loans. On average, HUD loses 39 percent of the claim amount paid.

Appendix D

NARRATIVE CASE PRESENTATIONS

Case number: 441-7823233

Mortgage amount: $241,570

Date of loan closing: June 26, 2006

Status: First legal action to commence foreclosure

Payments before first default reported: One

Unpaid principal balance: $240,466

Summary:

The branch office did not verify the borrower's rental history.

Pertinent Details:

According to HUD Handbook 4155.1, REV-5, paragraph 2-3A, the payment history of the borrower's housing obligations holds significant importance in evaluating credit. The lender must determine the borrower's payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity of interest with the borrower), verification of mortgage directly from the mortgage servicer, or canceled checks covering the most recent 12-month period.

The buyer/borrower leased the subject property from the seller for almost a year before buying it. No verification of the $1,200 monthly rental payment was noted, and no rental history was noted on the borrower's credit reports.

Case number: 441-7737514

Mortgage amount: $202,401

Date of loan closing: December 30, 2005

Status: Reinstated by borrower

Payments before first default reported: 12

Unpaid principal balance: $198,456

Summary:

The branch office overstated the borrowers' income and, therefore, relied on incorrect debt-to-income ratios.

Pertinent Details:

The branch office overstated the borrower's income.

According to HUD Handbook 4155.1, REV-5, paragraph 2.7A, the lender must develop an average of bonus or overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes.

The borrower's combined monthly income was overstated by $607.98 per month. We calculated this amount by excluding the borrower's overtime income, which had not been continuous for two years. There was no written explanation documented in the file to indicate why the borrower's overtime income should be included in the calculation of his monthly income. Because the borrower's income was overstated, the debt-to-income ratios as calculated by the branch office were incorrect (see below).

The branch office used incorrect debt-to-income ratios.

HUD Handbook 4155.1, REV-5, paragraph 2-12, states that ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. The lender must compute two ratios: mortgage payment expense to effective income should not exceed 29 percent, and total fixed payment to effective income should not exceed 41 percent. Mortgagee Letter 2005-16 increased the qualifying ratios to 31 and 43 percent, respectively, for manually underwritten mortgages for which the direct endorsement underwriter must make the credit decision.

We recalculated the debt-to-income ratios based on the borrower's income without the $607.98 overstatement. As recalculated, the mortgage payment-to-income (front) ratio was 39.68 percent, and the total fixed payment-to-income (back) ratio was 54.69 percent. Both recalculated ratios significantly exceed the respective guidelines of 31 percent and 43 percent.

Case number: 441-7817005

Mortgage amount: $191,987

Date of loan closing: June 28, 2006

Status: Delinquent

Payments before first default reported: Five

Unpaid principal balance: $190,571

Summary:

The branch office did not verify the borrower's rental history.

Pertinent Details:

According to HUD Handbook 4155.1, REV-5, paragraph 2-3A, the lender must obtain the borrower's payment history of housing obligations through either a credit report, verification directly from the landlord (with no identity of interest with the borrower), or cancelled checks covering the most recent 12-month period.

There was no rental history in the file, no verification of the $800 monthly rental payments, and no rental history noted on the credit reports.

Case number: 441-7780695

Mortgage amount: $189,971

Date of loan closing: June 14, 2006

Status: Modification started

Payments before first default reported: 12

Unpaid principal balance: $187,419

Summary:

The branch office reimbursed the borrower for "sweat equity."

Pertinent Details:

According to HUD Mortgagee Letter 94-11, paragraph 17, labor to be performed by the borrower on the property being rehabilitated may be used to create additional equity in the property, but the borrower cannot receive any cash back for the labor performed. The borrower can only be reimbursed for the cost of any materials that the borrower may have purchased.

This case involved a Section 203K rehabilitation loan. The borrower performed the repair work on his property. He provided the branch office a quote/cost estimate prepared by a construction company that also happened to be his employer. The quote/cost estimate reflected a total of $9,998 in rehabilitation costs and showed that the amount included the cost of materials and labor. The total drawn amount from the borrower's escrow account for the repairs was $9,998, indicating that he was reimbursed the cost of his labor in violation of HUD requirements.