



# Mortgage Services III, LLC, Bloomington, IL

## Single-Family Housing Mortgage Insurance Program



**To:** Robert E. Mulderig, Acting Deputy Assistant Secretary for Single Family Housing, HU

**//signed//**

**From:** Kelly Anderson, Regional Inspector General for Audit, 5AGA

**Subject:** Mortgage Services III, LLC, Bloomington, IL, Generally Complied With HUD's Underwriting and Quality Control Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of Mortgage Services III, LLC's underwriting of Federal Housing Administration-insured loans.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at <http://www.hudoig.gov>.

If you have any questions or comments about this report, please do not hesitate to call me at 312-353-7832.



**Audit Report Number: 2016-CH-1011**

**Date: September 30, 2016**

**Mortgage Services III, LLC, Bloomington, IL, Generally Complied With HUD's Underwriting and Quality Control Requirements**

## Highlights

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### What We Audited and Why

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We audited Mortgage Services III, LLC, a Federal Housing Administration (FHA)-approved direct endorsement lender, as part of the activities in our fiscal year 2016 annual audit plan. We selected Mortgage Services for review based on an analysis of data in the U.S. Department of Housing and Urban Development's (HUD) Single Family Data Warehouse system<sup>1</sup> for single-family lenders with home offices in Region 5's jurisdiction.<sup>2</sup> Our objective was to determine whether Mortgage Services complied with HUD's regulations, procedures, and instructions for underwriting FHA-insured loans.

### What We Found

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With a few exceptions, Mortgage Services generally complied with HUD's underwriting and quality control requirements. For the 12 loans reviewed, Mortgage Services did not ensure that a borrower met HUD's minimum required investment for one loan. Additionally, it did not (1) perform a quality control review for one loan in accordance with HUD's requirements and (2) ensure that its quality control plan contained necessary provisions. By not performing required quality control reviews and without the necessary provisions in its quality control plan, Mortgage Services could increase the risk to the FHA insurance fund.

### What We Recommend

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We recommend that HUD's Acting Deputy Assistant Secretary for Single Family Housing require Mortgage Services to pay down the unpaid principal balance by \$5,343 for one loan.

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<sup>1</sup> HUD's Single Family Data Warehouse is a collection of database tables structured to provide HUD users easy and efficient access to single-family housing case-level data on properties and associated loans, insurance, claims, defaults, and demographics.

<sup>2</sup> Region 5 includes the States of Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin.

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# Background and Objective

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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 provides insurance to private lenders against losses as a result of homeowners defaulting on their mortgage loans. The basic mortgage insurance program is authorized under Title II, section 203(b), of the National Housing Act and governed by regulations in 24 CFR (Code of Federal Regulations) Part 203. In 1983, HUD implemented the direct endorsement program, which authorizes approved lenders to underwrite FHA loans without HUD's prior review and approval. On January 1, 2006, FHA established the lender insurance program, which enables high-performing lenders to insure FHA forward mortgage loans without a preendorsement review by HUD.

Mortgage Services III, LLC, a nonsupervised lender located in Bloomington, IL, was approved as an FHA lender on May 9, 2007. Nonsupervised lenders can submit applications for mortgage insurance and can originate, sell, purchase, hold, and service FHA-insured mortgages. Mortgage Services became an unconditional direct endorsement lender on December 13, 2007, and was approved under FHA's lender insurance program on December 15, 2009.

According to HUD's Single Family Data Warehouse system, Mortgage Services had underwritten 4,201 FHA-insured loans valued at more than \$734 million from January 1, 2013, through December 31, 2015. During this same period, 476 of the loans (11.33 percent) were in default status and 86 were seriously delinquent.<sup>3</sup>

Our objective was to determine whether Mortgage Services complied with HUD's regulations, procedures, and instructions for underwriting FHA-insured loans.

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<sup>3</sup> Seriously delinquent loans are loans 90 days or more delinquent (three or more consecutive payments due and unpaid).

# Results of Audit

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## **Finding: Mortgage Services Generally Complied With HUD's Underwriting and Quality Control Requirements**

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With a few exceptions, Mortgage Services generally complied with HUD's underwriting and quality control requirements. Of the 12 loans reviewed, Mortgage Services did not ensure that a borrower met HUD's minimum required investment for one loan. Additionally, it did not (1) perform a quality control review of one loan in accordance with HUD's requirements and (2) ensure that its quality control plan contained necessary provisions. These deficiencies occurred because of (1) errors made by Mortgage Services' employees and (2) the lack of oversight to ensure compliance with HUD's requirements. By not performing required quality control reviews and without the necessary provisions in its quality control plan, Mortgage Services could increase the risk to the FHA insurance fund.

### **Mortgage Services Did Not Ensure That a Borrower Met HUD's Minimum Investment Requirement**

We reviewed 12 loans<sup>4</sup> to determine whether Mortgage Services underwrote FHA-insured loans in compliance with HUD's requirements. Of the 12 loans reviewed, 1 did not comply with HUD's underwriting requirements. Specifically, for FHA case number 071-1514652, Mortgage Services did not ensure that the borrower met HUD's minimum required investment.<sup>5</sup> The borrower was required to make a minimum investment of \$6,930 (3.5 percent of the sale price of \$198,000). However, the loan's settlement statement showed that the borrower paid \$1,000 in earnest money and \$587 at the closing for the loan. Therefore, the borrower was \$5,343 (\$6,930 - \$1,587) short of meeting the minimum required investment of \$6,930. This deficiency occurred because a former Mortgage Services employee mistakenly allowed the seller to contribute an excessive credit to the borrower in addition to closing costs.

### **Mortgage Services Did Not Properly Perform a Quality Control Review for an Early Defaulted Loan in Accordance With HUD's Requirements**

Mortgage Services generally performed quality control reviews of FHA-insured loans in accordance with HUD's requirement with the exception of one loan. Of the 62 loans identified as early payment defaults during the period January 1, 2013, through December 31, 2015, Mortgage Services did not review FHA case number 132-3008338 as required. The loan went into early payment default in March 2015; however, Mortgage Services did not review the loan until 2016.<sup>6</sup> HUD Handbook 4060.1, REV-2,<sup>7</sup> paragraph 7-6(D), states that lenders must review

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<sup>4</sup> Our methodology for selecting the 12 loans is explained in the Scope and Methodology section of this audit report.

<sup>5</sup> HUD Handbook 4155.1, paragraph 5(B)(1)(a)

<sup>6</sup> Mortgage Services reviewed the loan as a result of our review.

<sup>7</sup> We used HUD Handbook 4060.1, REV-2, for criteria concerning the quality control reviews because it was effective during most of our audit scope from January 1, 2013, through September 13, 2015. The quality control section of HUD's new handbook, HUD Handbook 4000.1, which became effective September 14, 2015, was relevant to the quality control reviews performed from September 14, 2015, through December 31, 2015. However,

all loans going into default within the first six payments and early payment defaults are loans that become 60 days past due. According to Mortgage Services' quality control manager, it was an oversight that this loan was not reviewed.

### **The Quality Control Plan Was Missing Necessary Provisions**

Although Mortgage Services had a plan for its quality control program, the plan did not include the following provisions:

- It must confirm that it verified, through applicable systems,<sup>8</sup> that the designated employees were permitted to participate in FHA programs. Checks to verify employee eligibility must be conducted at least semiannually, and supporting documentation must be maintained (HUD Handbook 4000.1, V.b i (B)).<sup>9</sup>
- It must verify that its operations comply with applicable State and Federal fair lending laws and that a fair housing poster is prominently displayed in its home office and branches and the equal opportunity housing logo is prominently displayed on all documents. Further, the plan did not include that potential fair housing violations or instances of discrimination must be reported to HUD's Office of Fair Housing and Equal Opportunity (HUD Handbook 4000.1, V.b iii (B)(1) and (C)(1)).
- Its quality control reviews, both preclosing and postclosing, must include the areas of property flipping restrictions, prohibited restrictive covenants, and qualified mortgages (HUD Handbook 4000.1, V.c i).

According to Mortgage Services, although these provisions were omitted from its quality control plan, the computer software that it used to review the loans contained the necessary validations to ensure compliance with HUD's requirements. Although its software may have had validations,<sup>10</sup> the provisions that were missing from its quality control plan were items such as checks for employee eligibility and compliance with fair housing laws, including evidence that a fair housing poster was prominently displayed in its offices.

As of August 17, 2016, Mortgage Services revised its quality control plan to include the provisions addressing employee eligibility, fair housing, reviews of property flipping restrictions, restrictive covenants, and qualified mortgages. We reviewed the updated quality control plan and determined it was consistent with HUD's requirements.

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the quality control requirements for timeliness, early payment defaults, and the size of random samples were the same for both HUD handbooks.

<sup>8</sup> These systems include Excluded Parties List, Limited Denial of Participation, and National Mortgage Licensing System and Registry.

<sup>9</sup> HUD Handbook 4000.1, which was effective September 14, 2015, provides the criteria applicable to Mortgage Services' current quality control plan, which was last reviewed by the lender December 31, 2015.

<sup>10</sup> Mortgage Services provided screen prints from its computer system software to support that it contained the required provisions. However, the screen prints were not sufficient to show the entire process to ensure compliance.

**Conclusion**

The deficiencies identified above occurred because of (1) errors made by Mortgage Services' employees and (2) the lack of oversight to ensure compliance with HUD's requirements. By not performing required quality control reviews and without the necessary provisions in its quality control plan, Mortgage Services could increase the risk to the FHA insurance fund.

**Recommendations**

We recommend that HUD's Acting Deputy Assistant Secretary for Single Family Housing require Mortgage Services to

- 1A. Pay down the unpaid principal balance for FHA case number 071-1514652 by \$5,343, the amount the borrower was short the minimum required investment.

# Scope and Methodology

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We performed our audit work from February through July 2016. We conducted onsite work at Mortgage Services' office located at 502 North Hershey Road, Bloomington, IL. The audit covered the period January 1, 2013, through December 31, 2015, and was expanded as determined necessary.

To accomplish our objective, we reviewed applicable HUD regulations and loan file reviews performed by HUD's Quality Assurance Division. Additionally, we reviewed Mortgage Services' policies and procedures, quality control plan, and electronic and hardcopy loan origination files. We also interviewed Mortgage Services' employees.

Using data maintained in HUD's Single Family Data Warehouse system as of December 31, 2015, we determined that Mortgage Services sponsored 4,201 FHA-insured loans valued at more than \$734 million during the period January 1, 2013, through December 31, 2015. Of the 4,201 loans, HUD paid claims on 10 loans. We also identified 476 loans that were in default status during the period January 1, 2013, through December 31, 2015. Of the 476 loans, 62 went into default within the first 6 months of loan closing. After eliminating loans that had been reviewed by HUD's Processing and Underwriting and Quality Assurance Divisions, we selected a sample of 12 loans to determine whether Mortgage Services complied with HUD's underwriting requirements. The 12 loans consisted of 3 loans that had a claim status and 9 loans that were early payment defaults. The results of our detailed testing applied only to the 12 loans reviewed; thus, we do not intend to project our results.

For our review of Mortgage Services' quality control program, we reviewed its current quality control plan for adequacy and 100 percent of the 425 quality control reviews completed by Mortgage Services during our audit period for frequency. We also reviewed the 62 loans that we identified as early payment defaults to determine whether the loans were subject to a quality control review as required by HUD.

We relied on information maintained in HUD's Neighborhood Watch<sup>11</sup> and Single Family Data Warehouse systems for information and sampling purposes. Further, we relied on data maintained in Mortgage Services' system, such as electronic loan files and payment records. 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 to be adequately reliable for our purposes. The testing consisted of comparing data in the electronic files to information from HUD's systems. The audit results were based on our review of electronic and supporting hardcopy documentation maintained by Mortgage Services.

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<sup>11</sup> Neighborhood Watch refers to a Web-based software application that displays loan performance data for lenders using FHA-insured single-family loan information. The system is designed to highlight exceptions so that potential problems are readily identifiable.

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

# Internal Controls

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Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

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

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls 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 objective:

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Reliability of financial reporting – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

We evaluated internal controls related to our audit objective in accordance with generally accepted government auditing standards. Our evaluation of internal controls was not designed to provide assurance regarding the effectiveness of the internal control structure as a whole. Accordingly, we do not express an opinion on the effectiveness of Mortgage Services' internal controls.

# Appendixes

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## Appendix A

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**Schedule of Questioned Costs**

<b>Recommendation number</b>	<b>Ineligible 1/</b>
1A	\$5,343
<b>Totals</b>	<b>\$5,343</b>

- 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 policies or regulations.

## **Appendix B**

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### **Auditee Comments and OIG's Evaluation**

Mortgage Services chose not to provide written comments to the discussion draft audit report.