Issue Date July 20, 2009
Audit Report Number 2009-SE-1003

TO: David H. Stevens, Assistant Secretary for Housing - Federal Housing Commissioner, H

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region X, 0AGA

SUBJECT: Eagle Home Mortgage, Kirkland, Washington, Did Not Always Comply with HUD Guidelines When Underwriting Federal Housing Administration-Insured Loans.

HIGHLIGHTS

What We Audited and Why

We audited single-family loan originations at Eagle Home Mortgage (Eagle Mortgage) to determine whether it originated Federal Housing Administration (FHA)-insured loans in accordance with U.S. Department of Housing and Urban Development (HUD) requirements. Although its default rate was less than half the national average, we audited Eagle Mortgage because its default-to-claim rate was more than twice the national average.

What We Found

Eagle Mortgage did not always originate FHA insured loans in accordance with HUD requirements. Specifically, Eagle Mortgage did not follow HUD's underwriting requirements for 15 of the 36 FHA insured loans reviewed, three of which had deficiencies that affected the insurability of the loan. In addition, Eagle Mortgage did not adequately follow its HUD-approved quality control plan when reviewing loans with early payment defaults when it failed to review one loan which defaulted after only four payments.

What We Recommend

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner (1) require Eagle Mortgage to reimburse or indemnify HUD for actual and potential losses on three loans with underwriting deficiencies, (2) review loans recently underwritten by Eagle Mortgage to verify that the underwriting deficiencies noted during our review are no longer an issue, (3) review Eagle Mortgage's monthly quality control reports to ensure that they include all FHA-insured loans that defaulted within the first six months, and (4) require Eagle Mortgage to conduct training on its quality control plan.

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 our discussion draft to Eagle Mortgage on June 17, 2009, and held an exit conference on June 30, 2009. We requested a response by July 2, 2009 and Eagle Mortgage provided it on July 1, 2009. Eagle Mortgage generally disagreed with finding one and agreed with finding two.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVE

Eagle Home Mortgage

The U.S. Department of Housing and Urban Development (HUD) authorized Eagle Home Mortgage (Eagle Mortgage) as a Federal Housing Administration (FHA) nonsupervised lender on April 9, 1987. Headquartered in Kirkland, Washington, Eagle Mortgage currently has 23 active branches with offices in Arizona, Colorado, Florida, Idaho, Nevada, Oregon, and Washington. During our audit period, January 1, 2007, to December 31, 2008, Eagle Mortgage originated 1,405 loans. According to FHA's Neighborhood Watch[1] Web site, only 2.56 percent of these loans went into default within their first two years. However, the defaults-to-claims ratio[2] for Eagle Mortgage's defaulting loans was in excess of 11 percent, more than double the national average defaults-to-claims ratio of 4.5 percent.

Eagle Mortgage originates FHA-insured loans using an automated underwriting system that transmits loan application data to FHA's TOTAL Scorecard (scorecard). The scorecard then uses these data to evaluate the credit risk of the loans and classifies the risk as either "accept/approve" or "refer" in the automated underwriting system findings report (findings report). Along with the classification, the findings report lists the approval conditions and documentation requirements for the loan. For loans rated "accept/approve," the loan is eligible for FHA insurance provided the data entered into the automated underwriting system are true, complete, properly documented, and accurate and the loan package meets all other FHA requirements. For loans rated "refer," the lender must manually underwrite the loan in accordance with FHA standard credit policies and requirements. HUD allows reduced documentation requirements for loans processed with automated underwriting systems.

Federal Housing Administration

The Federal Housing Administration, created by Congress in 1934, is the largest mortgage insurer in the United States. The cost of this mortgage insurance is paid by the homeowners and this mortgage insurance fund is used to operate the program. The mortgage insurance fund pays claims to lenders in the event of a homeowner default. Between October 1, 2008 and February 28, 2009, FHA insured almost 669,000 single family mortgages totaling more than $119 billion, an increase of 186 percent over the same period in 2008. This was 68 percent of all insured mortgage endorsements.

Our Objective

Our objective was to determine whether Eagle Mortgage properly underwrote FHA-insured loans.

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[1] Neighborhood Watch system is HUD's web-based software that displays loan performance data using FHA-insured single family loan information.

[2] The percentage of first defaults reported by the servicing lender that were claim terminated within the first two years of origination.

RESULTS OF AUDIT

Finding 1: Eagle Mortgage Did Not Follow HUD Underwriting Requirements for Three FHA-Insured Loans

Eagle Mortgage did not always originate FHA insured loans in accordance with HUD requirements. Specifically, Eagle Mortgage did not follow HUD's underwriting requirements for 15 of the 36 FHA insured loans reviewed, three of which had deficiencies that affected the insurability of the loan. For these three loans, it did not (1) document compensating factors, (2) analyze borrower credit reports and income documents, or (3) satisfy automated underwriting system requirements for loan approval. As a result, it exposed the FHA insurance fund to an unnecessary risk of $626,711, the total insured amount for the three loans.

Eagle Mortgage Did Not Properly Underwrite FHA-Insured Loans

Of the 36 loans reviewed, three contained deficiencies that affected the insurability of the loans. Those deficiencies are discussed below. Twelve others contained less serious underwriting deficiencies that did not affect the overall insurability of the loans. However, the lender needs to ensure that it follows all facets of HUD requirements when underwriting FHA loans. We provided details of these deficiencies to Eagle Mortgage during our review. Appendix C summarizes the deficiencies in these 15 loans.

Eagle Mortgage Did Not Document Compensating Factors

FHA-Insured Loan # 431-4283353

FHA's scorecard rated this loan as "refer." For referred loans, the TOTAL Mortgage Scorecard User's Guide (user's guide) requires lenders to determine whether a borrower is creditworthy in accordance with standard FHA requirements.[3] In addition, the scorecard findings report required Eagle Mortgage to document the reasons, including compensating factors, for approving loans that exceed FHA-established debt ratios. Lenders use debt ratios to determine whether a borrower can reasonably be expected to meet the expenses involved with homeownership and otherwise provide for the family.

[3] See chapter two, underwriting requirements, in the "refer" paragraph in the risk classification and related responsibilities section.

In this manually underwritten loan, the borrowers' mortgage payment-to-income ratio[4] of 41 percent and total fixed payment-to-income ratio[5] of 49 percent exceeded HUD's limits of 31 percent and 43 percent, respectively. HUD allows ratios exceeding these limits if borrowers have compensating factors, but these borrowers did not.

HUD expects lenders to exercise sound judgment and due diligence in underwriting loans because simply establishing that a loan meets minimum standards does not necessarily constitute prudent underwriting. Other loan file documents raised additional concerns about the borrowers' ability to repay the loan. The borrowers reported five dependent children on their 2006 tax return and $87 in liquid assets on their loan application. Also, the borrower's recent $950 per month pay raise did not completely offset the $1,280 increase in monthly housing expense.

Eagle Mortgage approved this loan without compensating factors for the excessive debt ratios. In addition, the monthly housing expense effectively increased by $330, and the borrowers had no cash reserves. HUD paid a $251,155 claim on this loan, which reportedly defaulted after four payments due to excessive obligations.

Eagle Mortgage Did Not Verify All of the Borrower's Income Sources

<u>FHA-Insured Loan # 561-8321239</u>

The scorecard rated this loan as "approve/eligible." The scorecard user's guide[6] states that all income entered into the automated underwriting system for risk assessment purposes must meet the requirements for qualifying income listed in HUD Handbook 4155.1 REV-5[7] (handbook) and that lenders are responsible for ascertaining that the income meets those requirements. For this loan, Eagle Mortgage used the borrower's 2006 yearly income of $46,640 from a December 23, 2006 pay stub to determine a monthly income of $3,886. Eagle Mortgage then entered this amount into the automated underwriting system as the borrower's base pay. However, the pay stub showed a base pay of $15.29 per hour, or $2,650 per month, almost one-third less than the amount that Eagle Mortgage entered into the automated underwriting system as base pay.

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4 Also known as the front ratio, the mortgage payment-to-income ratio is the ratio of the borrower's total mortgage payment (principal and interest; escrow deposits for real estate taxes, hazard insurance, the mortgage insurance premium, homeowners' association dues, ground rent, special assessments, and payments for any acceptable secondary financing) to the borrower's effective income as defined in section 2 of chapter 2 of HUD Handbook 4155.1 REV 5.

5 Also known as the back ratio, the total fixed payment-to-effective income is the ratio of the borrower's mortgage payment and recurring charges to the borrower's effective income as defined in section 2 of chapter 2 of HUD Handbook 4155.1 REV 5.

6 Loan application information and definitions in Chapter 1.

7 Section 2-6

Although the pay stub did not explain the extra income, the most likely source is a bonus, overtime, or some combination of the two. In paragraph 2-7A, the handbook requires lenders to average overtime or bonus income over two years and to develop an earnings trend. Using the two-year average of the borrower's bonus/overtime income increases the borrower's total fixed payment-to-income ratio from 54.63 percent to 58.18 percent. Further, it would be impossible to determine the required earnings trend if the extra income is a combination of bonuses and overtime. For example, if the borrower received $7,000 in overtime and $2,000 in bonuses in 2005 and $4,000 in overtime and $11,000 in bonuses in 2006, this would show a decline in overtime requiring written rationalization to include it as effective income. Also, HUD requires lenders to average bonus income for more than two years if it varies significantly.

The scorecard approved this loan with a total fixed payment-to-income ratio of 54.63 percent based on the assumption that the borrower's base pay was $3,886 and that Eagle Mortgage verified that the income met HUD requirements. Instead, the total fixed payment-to-income ratio was 58.18 percent, and about one-third of the borrower's pay did not meet HUD requirements. This $154,280 loan was delinquent and reported as defaulted due to unemployment.

Eagle Mortgage Did Not Document Income Stability

FHA-Insured Loan # 561-8375765

The scorecard rated this loan as "approve/eligible." The scorecard findings report required Eagle Mortgage to obtain the borrower's most recent year-to-date pay stub and verify his current employment. Paragraph 2-7 of the handbook requires lenders to determine whether a borrower's income can be reasonably expected to continue through the first three years of the mortgage. The borrower, an enlisted man in the armed forces, provided a leave and earnings statement showing a discharge date in August 2007, the month of closing. The case file contained no evidence that the borrower was going to reenlist or that he was eligible for reenlistment.

Also, Eagle Mortgage did not include the $171 per month payment for a home equity loan on the borrower's rental property, which would have increased the total fixed payment debt-to-income ratio to more than 52 percent. Further, Eagle Mortgage did not determine the purpose of an $8,000 unsecured loan and a $300 line of credit shown on the coborrower's credit report. In addition, the loan application did not have the borrower's signature as required by paragraph 3-5 of the handbook, which states that military personnel overseas should sign either the original or final application by facsimile or mail.

The scorecard approved this loan, based on Eagle Mortgage's determination that the borrower's income could be reasonably expected to continue for three years; however, the loan file showed that the income used to qualify the borrower for the loan would end shortly after the loan closed. HUD paid a $91,280 claim on this loan, which defaulted after two payments reportedly due to unemployment.

Conclusion

Human error and inadequate management review caused the underwriting deficiencies found in the three loans identified above. Eagle Mortgage approved these three FHA-insured loans without (1) documenting acceptable compensating factors for excessive qualifying ratios, (2) verifying a borrower's income source, or (3) documenting a borrower's income stability. Eagle Mortgage's quality control reviews of FHA-insured loans did not always provide the feedback necessary for management to address the deficiencies and improve future loan originations (see finding 2). These deficiencies caused a projected loss to the FHA insurance fund of $249,772 (see appendix D).

As a result of the audit, Eagle Mortgage has revised its underwriting worksheets to provide a more in-depth review of file documentation and additional guidance to underwriters and quality assurance auditors.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner

1A. Require Eagle Mortgage to repay the FHA insurance fund $91,280 for the loss on FHA-insured loan 561-8375765.

1B Require Eagle Mortgage to indemnify HUD for $158,492, the projected loss on FHA-insured loans 431-4283353 and 561-8321239 (see appendix D).

1C. Review loans recently underwritten by Eagle Mortgage to verify that the underwriting deficiencies noted during our review are no longer an issue.

Finding 2: Eagle Mortgage Did Not Always Follow Quality Control Requirements

Eagle Mortgage did not review one FHA-insured loan on which the borrower defaulted after making only four monthly loan payments. Also, four of seventeen quality control reviews performed by Eagle Mortgage did not find observable deficiencies in the loans. As a result, Eagle Mortgage management did not always have the accurate feedback needed to improve its loan origination process.

Eagle Mortgage Did Not Review All Early Payment Defaults

Eagle Mortgage was aware that 15 of the 36 loans from our sample had defaulted within six months. Paragraph 7-6D of HUD Handbook 4060.1, REV 2, requires all lenders to review all such early defaulting loans. However, Eagle Mortgage did not perform a quality control review on one of these loans that was shown in HUD's Neighborhood Watch system as being in default after only four payments. Eagle Mortgage explained that the loan was not reviewed because the person responsible for reviewing early defaulting loans was laid off around the time that the loan was first reported by Neighborhood Watch as being in default.

Eagle Mortgage's Quality Control Reviews Were Not Always Effective

Eagle Mortgage performed quality control reviews on 17 of the 36 loans we examined, but the reviews were not always effective in finding deficiencies. Following Eagle Mortgage's FHA-approved quality control plan, we found four loans containing deficiencies that were not noted in its quality control reviews of the loans.

For FHA-insured loan # 023-2487210, the scorecard findings report showed that all of a borrower's income was base pay, but the associated pay stub in the loan file showed that the income included bonus income. The quality control plan methodology requires the reviewer to compare income from the findings report to the case file documentation.

For FHA-insured loan # 561-8308118, the scorecard findings report required Eagle Mortgage to obtain a verification of employment, an Internal Revenue Service (IRS) Form W-2, or acceptable electronic verification to document a two-year employment history for the coborrower. However, the loan file only contained a pay stub supporting a 10-month employment period. The quality control plan methodology requires the reviewer to check for the correct forms, pay stubs, and IRS Forms W-2 and to verify that all findings report conditions were met.

For FHA-insured loan # 561-8370071, the scorecard findings report required Eagle Mortgage to verify the borrower's depository assets, but Eagle Mortgage double-counted $10,000 in borrower assets. The quality control plan methodology requires the reviewer to compare assets and the source of funds from the findings report to the loan file and to verify that all findings report conditions were met.

For FHA-insured loan # 431-4283353, the scorecard findings report required Eagle Mortgage to document the reasons, including compensating factors, for approving loans that exceed FHA-established debt limits. However, for this loan with excessive debt ratios, Eagle Mortgage cited no compensating factors. The quality control plan methodology requires the reviewer to determine whether there are sufficient and documented compensating factors if the debt ratios exceed FHA limits.

Conclusion

HUD's single-family quality control program is designed to ensure compliance with loan origination requirements; protect FHA from unacceptable risk; guard against errors, omissions, and fraud; and ensure corrective action. Eagle Mortgage inadvertently overlooked the quality control review on one early payment default because of a consolidation of staff responsibilities after a downsizing and has since instituted procedures to ensure that it reviews all early payment defaults. However, other errors occurred because Eagle Mortgage did not follow its quality control plan, thus compromising the internal controls that protect the FHA insurance fund from unnecessary risk. Further, Eagle Mortgage management did not always have the information it needed to take corrective action to improve its loan origination process.

As a result of our audit, Eagle Mortgage stated it has revised its early payment default review process and is in the process of increasing its quality control staff.

Recommendations

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner

2A. Review Eagle Mortgage's monthly quality control reports to ensure that they include all FHA-insured loans that defaulted within the first six months.

2B. Require Eagle Mortgage to provide training for appropriate staff on the quality control plan audit methodology.

SCOPE AND METHODOLOGY

We selected Eagle Mortgage because of a default-to-claim rate that was more than double the national average. Eagle Mortgage underwrote 1,405 FHA-insured single-family loans with beginning amortization dates between January 1, 2007, and December 31, 2008. We reviewed all 36 of these loans that had a first default within two years of amortization. The total mortgage amount for these loans is almost $6,789,000. According to Neighborhood Watch, these loans were originated by Eagle Mortgage offices in Washington, Oregon, Idaho, Colorado, New Mexico, Nevada, or Arizona. Of these loans, FHA's scorecard approved 29, and seven were manually underwritten. In addition, we reviewed all 17 of the quality control reports that Eagle Mortgage performed on the 36 loans in our review.

We conducted our fieldwork at Eagle Mortgage's headquarters office in Kirkland, Washington, between February and April 2009. To accomplish our objectives, we

- Reviewed HUD regulations and reference materials related to single-family requirements.
- Reviewed Eagle Mortgage's underwriting policies and procedures.
- Reviewed Eagle Mortgage's loan files.
- Reviewed Eagle Mortgage's quality control plan and quality control review reports.
- Interviewed appropriate Eagle Mortgage staff.

We used the source documents in the loan case file to determine borrower income, employment history, and debt. For the loans underwritten by an automated underwriting system, we reviewed the FHA case file to determine whether it contained the documentation required by the findings report and whether the source documents supported the information in the findings report. For the manually underwritten loans, we reviewed the FHA case file to determine whether it supported the underwriting decision.

We used data maintained by HUD in the Neighborhood Watch system for background information and in selecting our sample of loans. We did not rely on the data to reach our conclusions, therefore we did not assess the reliability of the data.

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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

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

- Effectiveness and efficiency of operations,
- Safeguarding of assets and resources, 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. They include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Policies and procedures intended to ensure that FHA-insured loans are properly originated and underwritten.

- Policies and procedures intended to ensure that the quality control program is an effective tool for reducing underwriting errors.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- Eagle Mortgage's quality control process did not always detect underwriting deficiencies in FHA-insured loans (see finding 1).

- Eagle Mortgage did not adequately monitor the effectiveness of its quality control reviews of FHA-insured loans (see finding 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible costs 1/	Funds to be put to better use 2/
1A	$91,280	
1B		$158,492

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. The claim amount is HUD's actual loss on an insured loan for a home that was sold in a short sale.

2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. If HUD implements our recommendations to indemnify loans that were not originated in accordance with FHA requirements, it will reduce FHA's risk of loss to the insurance fund. The amount above reflects HUD's calculation that FHA loses an average of about 42 percent of the claim amount when it sells a foreclosed property.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	Auditee Comments

EAGLE HOME MORTGAGE

July 1, 2009

US Department of HUD
Attn: Joan S. Hobbs
909 First Avenue, Suite 126
Seattle, WA 98104-1000

Re: Draft Audit Report
Eagle Home Mortgage, LLC

Dear Ms. Hobbs:

Thank you for your letter dated June 17, 2009, which provided us a copy of the Draft Audit Report. Also, thank you for the exit interview performed on June 30, 2009. Following is our response to the Draft Audit Report.

Due to the national economic issues affecting not only property values, but also continuity and/or loss of employment, Eagle Home Mortgage (Eagle) has been proactive with changes to our underwriting over the last 12-24 months. These changes include (1) senior management approval of all loans with a debt-to-income ratio in excess of 45%, regardless of AUS findings; (2) senior management review of all government loans where the borrower owns more than one property; and (3) constant communication between senior management and the origination staff, addressing causes of past delinquencies and defaults.

Comment 1

We are concerned with the comments per the Discussion Draft Audit Report citing that "Eagle Home Mortgage did not always underwrite FHA-insured loans in accordance with HUD requirements, exposing the FHA insurance fund to unnecessary risk." Please be advised that at no time did Eagle intentionally underwrite a loan that we did not think was a sound loan. Based on the audit findings, there were limited instances where, due to inadvertent underwriting errors, Eagle did not follow all FHA guidelines as stated in the 4155.1 manual, however, Eagle has made every effort to find ways to make sound loans, allowing us to provide qualified individuals with home ownership.

We appreciate the detailed file review provided by the HUD audit. Based on the findings, we have made improvements to our internal processes for our Underwriters and Quality Assurance Auditors to use on every FHA loan.

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To specifically address HUD's findings:

Finding 1: Eagle Mortgage did not follow HUD underwriting requirements for four FHA-insured loans.

Response: Eagle continues to disagree with HUD's findings on the following three loans:

Comment 2

[redacted]/ 561-8321239: Stability of employment was apparent, as the borrower had been with the same employer for 9.5 years. Although the AUS did not break down the base income from the other earnings, the borrower's verified income was more than the base pay of $31,800 for the two previous years. The borrower earned $40,878 in 2005 and $46,640 in 2006. With the stability of employment for 9.5 years and the borrower's position as a supervisor, the Underwriter was confident that the borrower's income would continue at the same level. Additional compensating factors were credit scores of 696 and 736, savings ability, and the increase in housing expense was offset by increasing income.

Comment 3

The reason for default is unemployment. With 9.5 years with the same employer and increasing income, the Underwriter had no reason to believe unemployment would be imminent. We do agree the Underwriter gave the borrower the benefit of higher earning capacity for qualifying purposes; however, no one could predict the downturn in the economy or the changing employment market, which ultimately caused this borrower to default.

Comment 4

[redacted] / 431-4283353: The borrower's income increased from $2,997 to $3,943 monthly. In 2005 the borrower earned $28,800 and in 2006 $35,965. This reflects a monthly increase of $950 in income. The co-borrower is paid commission. She earned $5,549 in 2005 and $5,680 in 2006. Per the 4155, commission must be averaged over 24 months. The co-borrower's income did not show a decrease from one year to the next, but instead a slight increase. We do not agree that the underwriter should have placed more emphasis on year-to-date commission. Commission earnings vary and are cyclical in nature. The year-to-date only represented 4.5 months. The commission earnings used for qualifying are acceptable.

Comment 5

Compensating factors for ratios of 41%/49% and an increase in housing of $1,280 would be an increase in the borrower's income of $950 per month. This would place the borrowers in a financial position to handle the net increase in housing of $330. The increase in housing of $330 is an average increase without significant payment shock. This compensating factor is acceptable to meet the AUS requirement of ratios exceeding FHA established debt ratio.

Comment 6

Comment 7

Comment 8

Comment 8

Comment 9

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[redacted] / 023-2487210: The borrower's paystubs in file clearly show he receives $987.50 bi-monthly, or $1,975 monthly base income. In addition, the underwriter averaged the bonus income based on the 2005 and 2006 W2's (having subtracted the base income). The 24-month average of bonus income is $1,094. This would give the borrower total income of $3,069; however, the AUS used only $2,815. We do agree that the borrower's income was not broken down on the AUS and this was strictly an input error. We do not believe that this was cause for a default.

AUS does not require collection accounts be paid at closing, nor would there be a monthly payment to include in the qualifying ratios.

Finding 2: Eagle Mortgage did not always follow Quality Control requirements.

Subfinding: Eagle Mortgage Did Not Review All Early Payment Defaults

Response: As noted in the report this finding was limited to one loan that was missed due to the timing of a staffing change. This should not have occurred and we have revised our review process to assure that no loans are missed in the future.

Subfinding: Eagle Mortgage's Quality Control Reviews Were Not Always Effective

Response: The Quality Control deficiencies noted were limited to the audit of income. The Underwriting Manager has provided, and will continue to provide, the Quality Assurance Manager with training and training tools including the revision of the income worksheets noted below. Additionally, Eagle is in the process of increasing the Quality Assurance staff by adding an additional Quality Assurance Auditor.

Conclusion: Eagle has revised its underwriting worksheets to provide a more in-depth review of file documentation and to provide additional guidance to Underwriters and Quality Assurance Auditors. Copies of these worksheets are attached for your review.

Although Eagle's default-to-claim rate was more than twice the national average at the time of the audit, our Compare Ratio was at 49%, or less than half of the national average. The reason for the higher default-to-claim ratio could be due to a variety of factors. For example, some states have moratoriums currently in place for foreclosures, which may cause delays in claims being filed with HUD. A majority of Eagle's business occurs in Washington and Oregon, neither of which have a moratorium currently in place for foreclosures. Regardless, throughout our 20 plus year history we have been, and we will remain, committed to originating high quality loans. We believe that the proactive changes we have made and continue to make demonstrate that commitment.

Please feel free to contact me if you have any questions or require any additional information.

Sincerely,

Linda A. Geyen
Vice President

EAGLE HOME MORTGAGE
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This checklist is meant to serve as an underwriting and audit tool. It does not by any means supersede the AUS and TOTAL scorecard findings for any loan. In every case, the AUS and TOTAL Scorecard findings must be followed to the letter. Manually underwritten loans must be underwritten in accordance with the 4155.1.

EMPLOYMENT AND INCOME		
		YES NO N/A
1	**All Borrowers**	☐ ☐ ☐ The most recent 2 years employment has been verified ☐ ☐ ☐ All income used to qualify is likely to continue for 3 years (VOE does not reflect upcoming lay offs, Military LES does not reflect a ETS date within 3 years, etc.) ☐ ☐ ☐ Any gaps in employment that span one or more months have been explained. (If the Total Scorecard Accept Recommendation is present, only gaps >6 months require an explanation)
2	**Base Income - Wage Earner**	The following documentation is in file: ☐ ☐ ☐ Full Documentation: VOEs covering a minimum of two years and most recent pay stub reflecting borrower's name, SSN and year-to-date earnings. ☐ ☐ ☐ Alternative Documentation: Certified copies of the original of two years W2 forms and most recent pay stub covering one full month along with a Verbal VOE for each employer - detail job title and length of employment ☐ ☐ ☐ If pay stubs were not provided a pay ledger was obtained, in addition to VOE, and loan downgraded to a manual underwrite
3	**Other Employment Related Income**	A two (2) year average of the following income was used to qualify: ☐ ☐ ☐ Overtime or Bonuses **YES NO** ☐ ☐ VOE in file breaks down Overtime, bonus, etc. separately from base ☐ ☐ YTD overtime or bonus earnings are at least equal to or greater than 2 year average ☐ ☐ AUS breaks out OT & bonus income separately from base ☐ ☐ ☐ Commission **YES NO N/A** ☐ ☐ ☐ Commission income has been averaged over the previous two years OR ☐ ☐ ☐ If commission has been received for more than one (1) year but less than two (2) years the Underwriter has soundly justified accepting commission income and documented that it is likely to continue. ☐ ☐ ☐ The Borrower's current pay stub and copies of signed tax returns for the last two years were obtained (Tax returns required if the borrower receives more than 25%of his/her annual income from commissions.) ☐ ☐ ☐ Un-reimbursed business expenses from schedule A and/or 2106 have been subtracted from gross income. ☐ ☐ ☐ YTD commission earnings are at least equal to or greater than 2 year average ☐ ☐ ☐ Part-time, second jobs or seasonal work ☐ ☐ ☐ Part-time, second job: 2 year history has been documented or ☐ ☐ ☐ Underwriter has justified the use of part-time income received for less than two (2) years and has documented that it is likely to continue. ☐ ☐ ☐ Seasonal: Documentation has been provided to verify borrower has worked the same job for the past two (2) years and expects to be rehired the next season ☐ ☐ ☐ Employed by family owned business (verified no borrower ownership of business through copies of signed personal tax returns or signed copy of the corporate tax return showing ownership percentages)
4	**Non Employment Related Income**	☐ ☐ ☐ Social Security, Pension, Retirement **YES NO N/A** ☐ ☐ ☐ Non Taxable income has been grossed up based on tax liability ☐ ☐ ☐ Interest/Dividend and Trust Income documentation to verify 1.) Amount of Trust 2.) Frequency of distribution and 3.) Duration of payments ☐ ☐ ☐ Note Receivable income has been documented with: 1.) Copy of the note to establish the amount and duration of payment and 2.) Evidence that these payments have been consistently received for the last 12 months ☐ ☐ ☐ Evidence of continuance for a minimum of three (3) years must be documented in the file. (Required for all types of non employment related income.)
5	**Alimony, Child Support or Separate Maintenance**	A copy of one (1) of the following is in file to document receipt and continuance for a minimum of three (3) years: ☐ Signed, recorded divorce decree ☐ Legal Separation Agreement ☐ Voluntary Payment Agreement ☐ ☐ ☐ Manually Underwritten Loans/TOTAL Scorecard Refer recommendation - The most recent 12 months receipt of alimony, child support, and maintenance income has been documented. ☐ ☐ ☐ TOTAL Scorecard Accept recommendation - The most recent 3 months receipt of alimony, child support, and maintenance income has been documented. ☐ ☐ ☐ New child support or alimony (less than 12 months history): Payer's **ABILITY** and willingness to make timely payments has been documented. ☐ ☐ ☐ Alimony/separate maintenance has not been "grossed up" as it is typically taxable. (Child support may be "grossed up" under the same provisions of non-taxable income sources.)
6	**Self-Employed Borrower(s)**	The borrowers' earnings from self-employment has been averaged over a minimum of twenty-four (24) months, utilizing the following documentation: ☐ ☐ ☐ Most recent two (2) years signed and dated federal tax returns showing increasing self-employment income ☐ ☐ ☐ Current P&L Statement - income consistent with previous earnings (The TOTAL Scorecard Accept recommendation does not require a P&L and balance sheet unless the income used to qualify the borrower exceeds that of the 2 year average.) ☐ ☐ ☐ Self-employment less than two (2) years but equal to or greater than one (1) year - Previous successful employment (same/similar field) for two (2) years verified or combination of employment and education has been documented. ☐ ☐ ☐ 4506 IRS validation of 2 years SE income

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EMPLOYMENT AND INCOME [illegible]

		YES NO N/A
7	**Rental Income**	The following documentation has been obtained to substantiate use of this income: ☐ ☐ ☐ Federal tax returns [prior two (2) years] or ☐ ☐ ☐ Current Lease Agreement if property was acquired since last tax filing. ☐ ☐ ☐ If rental income from any property being vacated by the borrower is being used to qualify, the provisions of HUD 4155.1 4.E.4.h. have been met. ☐ ☐ ☐ Loans for borrowers that own more than one (1) property must be reviewed by Eagle Sr. Management
8	**Federal Tax Returns**	☐ ☐ ☐ If federal tax returns are used, they are to be signed and dated by the borrower(s). ☐ ☐ ☐ Form 4506-T signed and in the file.
9	**Declining Income**	☐ ☐ ☐ **Declining income has been reviewed and approved by Eagle Sr. Management**

[illegible]

		YES NO N/A
10	**Liabilities**	☐ ☐ ☐ Satisfactory documentation was provided to support any omitted liabilities
11	**Ratios**	☐ ☐ ☐ File meets standard ratios of 31/43 ☐ ☐ ☐ Ratios higher than 31/43 require DU Approved with FHA Total Scorecard AND documented compensating factors as per HUD 4155.1 4.F.3.b ☐ ☐ ☐ Ratios higher than 45% have been approved by Eagle Sr. Management approval and compensating factors have been documented
12	**Payment Shock**	☐ ☐ ☐ If borrower is facing a substantial housing payment increase they have provided a letter addressing how the increase will be handled. (Required regardless of AUS findings)
13	**New Debt**	☐ ☐ ☐ All credit inquiries within last 90 days have been addressed by borrower and any new debt has been documented.

FUNDS TO CLOSE

		YES NO N/A
14	**Cash Reserves**	Required on 3-4 unit purchase transactions ☐ ☐ ☐ Borrower has reserves equal to or greater than three (3) month's mortgage payment (PITI) after closing.
15	**Minimum Cash Investment**	Purchase loans - the borrower's cash investment in the property is equal to: ☐ ☐ ☐ The difference between the total cost of acquisition and the amount of the loan. ☐ ☐ ☐ A minimum 3.5% contribution (down payment or combination of down payment and appropriate borrower paid closing costs.)
16	**Source of Funds and/or Gift Funds**	☐ ☐ ☐ All funds (including gifts) for the borrower's funds to close/investment into the transaction have been verified (bank statements, stock statements, credit card statements, etc.) ☐ ☐ ☐ Retirement assets used have been calculated at 60% of vested balance Gift Funds Documentation: ☐ ☐ ☐ Fully completed Gift Letter(s) to reflect: YES NO ☐ ☐ The donor's name, address, telephone number ☐ ☐ Specify the dollar amount of the gift ☐ ☐ State the nature of the donor's relationship to the borrower and that no repayment is required ☐ ☐ ☐ Evidence that the gift came from the donor's own funds (bank statement) ☐ ☐ ☐ Evidence of transfer of gift funds and receipt by the borrower or closing agent

AUS VALIDATION

YES	NO	
☐	☐	Each finding has been reviewed
☐	☐	Special attention to comments regarding DE credit waiver and ratio waiver, appropriate action taken as applicable. N/A ☐
☐	☐	Income matches the Underwriting Transmittal and 1003 (If scored by TOTAL a 5% tolerance is allowed)
☐	☐	Liabilities match Underwriting Transmittal and 1003
☐	☐	Cash reserves match Underwriting Transmittal and 1003 (If scored by TOTAL a 10% tolerance is allowed)
☐	☐	Tax and Insurance escrows match Underwriting Transmittal and 1003 (If scored by TOTAL a 2% tolerance is allowed)
☐	☐	All AUS resubmissions have been checked to ensure no requirement/condition changes from original

Notes:

Signature and date

Printed Name

Title

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Income Calculation Worksheet

Borrower name: ____________________

A. Base Income
Full Time Employment

Multiplier	
Hourly	173.3
Weekly	4.333
Bi-weekly	2.166
Semi-monthly	2

________ (base pay) x ________ (multiplier) = ________ (monthly income)

Less than 40 hrs/week

________ (hourly rate) x ________ (hours per week) x 4.33 = ________ (monthly income)

Year ______ W2 = ____________

Year ______ W2 = ____________

YTD Paystub = ____________ /______ = ____________

Does YTD support monthly Income? Y N
Any excessive increases or decreases? Y N

B. Overtime

Year ______ = ____________ /12 = ____________

Year ______ = ____________ /12 = ____________

Total both years = ____________ /24 = ____________

YTD through ______ = ____________ / ______ = ____________

Monthly Qualifying OT = ____________

Does YTD support monthly OT? Y N
Any excessive increases or decreases? Y N

C. Bonus

Year ______ = ____________ /12 = ____________

Year ______ = ____________ /12 = ____________

Total both years = ____________ /24 = ____________

YTD through ______ = ____________ / ______ = ____________

Monthly Qualifying OT = ____________

Does YTD support monthly OT? Y N
Any excessive increases or decreases? Y N

D. Commissions

Year ______ = ____________ /12 = ____________

Year ______ = ____________ /12 = ____________

Total both years = ____________ /24 = ____________

YTD through ______ = ____________ / ______ = ____________

Mo Qualifying Comm. = ____________

Does YTD support monthly Comm? Y N
Any excessive increases or decreases? Y N
Is comm. 25% or more of total income? Y N
* If Yes, 2 years 1040s were obtained and un-reimbursed business expenses deducted from income? Y N
Amount of un-reimbursed business exp. ________

E. Total Income Calculation

Base ____________

OT (+) ____________

Bonus (+) ____________

Commissions (+) ____________

Un-reimbursed exp (-) ____________

Total = ____________

Borrower name: ____________________

A. Base Income
Full Time Employment

Multiplier	
Hourly	173.3
Weekly	4.333
Bi-weekly	2.166
Semi-monthly	2

________ (base pay) x ________ (multiplier) = ________ (monthly income)

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Year ______ W2 = ____________

Year ______ W2 = ____________

YTD Paystub = ____________ /______ = ____________

Does YTD support monthly Income? Y N
Any excessive increases or decreases? Y N

B. Overtime

Year ______ = ____________ /12 = ____________

Year ______ = ____________ /12 = ____________

Total both years = ____________ /24 = ____________

YTD through ______ = ____________ / ______ = ____________

Monthly Qualifying OT = ____________

Does YTD support monthly OT? Y N
Any excessive increases or decreases? Y N

C. Bonus

Year ______ = ____________ /12 = ____________

Year ______ = ____________ /12 = ____________

Total both years = ____________ /24 = ____________

YTD through ______ = ____________ / ______ = ____________

Monthly Qualifying OT = ____________

Does YTD support monthly OT? Y N
Any excessive increases or decreases? Y N

D. Commissions

Year ______ = ____________ /12 = ____________

Year ______ = ____________ /12 = ____________

Total both years = ____________ /24 = ____________

YTD through ______ = ____________ / ______ = ____________

Mo Qualifying Comm. = ____________

Does YTD support monthly Comm? Y N
Any excessive increases or decreases? Y N
Is comm. 25% or more of total income? Y N
* If Yes, 2 years 1040s were obtained and un-reimbursed business expenses deducted from income? Y N
Amount of un-reimbursed business exp. ________

E. Total Income Calculation

Base ____________

OT (+) ____________

Bonus (+) ____________

Commissions (+) ____________

Un-reimbursed exp (-) ____________

Total = ____________

Comments: ____

OIG Evaluation of Auditee Comments

Comment 1 Eagle Mortgage expresses concern about our comment in the internal control section "Eagle Mortgage did not always underwrite FHA-insured loans in accordance with HUD requirements, exposing the FHA insurance fund to unnecessary risk" and states that at no time did they underwrite a loan they did not think was sound. Since our statement might be misinterpreted, we revised the comment in the internal controls section associated with finding 1 to more accurately reflect the significant weakness associated with the finding.

Comment 2 Eagle Mortgage states that although it did not separate the borrower's base income from other earnings, the verified income was more than the base pay for the previous two years and that his income was increasing. Also, since the borrower had steady employment for nine and one-half years and was a supervisor, the underwriter was confident the borrower's income would continue. Our issue for this loan is not with the stability nor the amount of the borrower's income but that Eagle Mortgage did not accurately analyze that income. As a result, almost one-third of the borrower's income that Eagle Mortgage reported to the automated underwriting system was overtime or bonus income and did not meet the requirements of the handbook, as required by the user's guide.

Comment 3 Eagle Mortgage states that the reason for the default was unemployment and, with steady employment and increasing income, the underwriter had no reason to believe unemployment would be imminent. Regardless of the reason for the default, FHA-insured loans must meet HUD requirements when they are underwritten.

Comment 4 Eagle Mortgage states that it computed the co-borrower's income in accordance with HUD requirements. We agree that Eagle Mortgage documented the coborrower's earnings in accordance with HUD requirements. In our analysis, we did not use the co-borrower's reduced year to date income in any calculation, we mentioned it was an additional concern because it was 38 percent less than the average income as computed by the Eagle Mortgage, placing further strain on the family's financial situation. Since this statement may be confusing, we removed it from the report.

Comment 5 Eagle Mortgage states that compensating factors for the qualifying ratios of 41 percent and 49 percent, and the increase in housing expense of $1,280 would be an increase in the borrower's income of $950 per month. The Handbook does not list increased income as a compensating factor. In addition, this increased income in the form of a raise which the borrower received from his father, his employer, two months before the loan closed, is already included in the excessive qualifying ratios. Eagle Mortgage also states that the $330 increase in monthly housing expense is an average increase without significant payment shock, however, the actual increase in monthly housing expense was $1,280. In our opinion, even a monthly increase of $330 would not be minimal for a family of seven with $87 in the bank who was paying 49 percent of their income for housing and other fixed payments. The Handbook lists two compensating factors related to housing expense: (1) The borrower has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12-24 months and (2) There is only a minimal increase in the borrower's housing expense. Since the borrowers' monthly housing expense increased by $1,280, neither of these apply to this loan.

Comment 6 Eagle Mortgage states the underwriter averaged the bonus income based on the 2005 and 2005 IRS Forms W-2. We noted that the borrower's 2005 W-2 was from a different company than his present employer and his 2006 W-2s showed he worked for 5 different Sonic restaurants and were therefore not indicative of his current income. However, we reevaluated this loan and determined that even though the borrower's 2005 and 2006 bonus incomes were not representative of his current bonus income, the total current income Eagle Mortgage used was adequately supported by documentation in the loan file. Therefore, we are removing this loan from the finding.

Comment 7 Eagle Mortgage states that the automated underwriting system does not require collection accounts to be paid at closing nor would any of those amounts be included in the qualifying ratio calculations. The findings report for this loan required Eagle Mortgage to document why 16 accounts were omitted from the underwriting analysis and, although Eagle Mortgage did not specifically provide the reason the accounts were omitted in the case file as required, all 16 appear on the credit report as collections and would not have needed to have been paid at closing. This was the same loan discussed in Comment 6, which we removed from the finding.

Comment 8 Eagle Mortgage states that it has revised its review process to assure no loans are missed in the future and that it is in the process of increasing its quality assurance staff. In finding 2, we added a statement to that effect.

Comment 9 Eagle Mortgage provided underwriting worksheets to provide a more in-depth review of file documentation and to provide additional guidance to underwriters and quality assurance auditors. In finding 1, we added a statement to that effect.

Appendix C

SUMMARY OF LOAN DEFICIENCIES

Loan	A	B	C	D	E	F	G	H	I	J	K
561-8321239	X										
023-2480690			X								
331-1286823				X	X						
052-4230423	X										
431-4310357		X									
561-8308118[1]		X									
023-2487210	X										
361-3087627			X								
431-4283353[1]						X	X				
561-8314194[1]		X						X			
561-8353219[1]			X								
561-8370071					X						
561-8375765				X					X	X	
561-8482245											X
561-8480057	X										
Total	**4**	**3**	**3**	**2**	**2**	**1**	**1**	**1**	**1**	**1**	**1**

1) Eagle Mortgage manually underwrote these loans.

Legend

A. Failed to analyze bonus and overtime income
B. Failed to document employment history
C. Overstated Social Security income
D. Omitted liabilities from underwriting analysis
E. Failed to verify reserves
F. Failed to obtain adequate pay stub
G. Failed to document compensating factors
H. Overstated retirement fund amount
I. Failed to verify continuity of income
J. Failed to determine purpose of new debt
K. Failed to document gift

A. Eagle Mortgage submitted to the automated underwriting system that all borrower pay was base pay although some was bonus or overtime pay. Paragraph 2-7A of HUD Handbook 4155.1, REV-5 (handbook) requires an analysis before a bonus or overtime can be included as effective income.

B. Eagle Mortgage did not document borrowers' two-year employment history. The findings reports for three loans required the lender to obtain either IRS Forms W-2, verifications of employment, or other electronic documentation acceptable to FHA. The loan files for these three loans did not contain these documents.

C. Eagle Mortgage improperly increased Social Security income by 125 percent for three loans. Paragraph 2-7 of the handbook allows lenders to increase nontaxable income by 125 percent if the borrower was not required to file a federal income tax return. If a borrower filed a tax return, lenders may increase nontaxable income by the borrower's tax rate. For three loans, the borrowers had other income that may have required a tax return and, thus, might have affected taxability of the Social Security income, thereby decreasing the amount of the increase allowed.

D. Eagle Mortgage omitted monthly payments from the qualifying ratio calculations for two loans.

E. Eagle Mortgage did not verify borrower reserves for two loans. The findings report required the lender to verify the reported assets by either a verification of deposit or statements. For one loan, Eagle Mortgage did not obtain the required documentation for a retirement account and a savings account, and for the other, it failed to notice that a $10,000 gift had been counted twice.

F. Eagle Mortgage did not obtain a pay stub stating the borrower's year-to-date income as required by the findings report.

G. Eagle Mortgage failed to document compensating factors for a manually underwritten loan with qualifying ratios that exceeded HUD requirements. Paragraph 2-13 of the handbook lists the acceptable compensating factors necessary to approve loans with excessive qualifying ratios.

H. Eagle Mortgage used the entire amount of a retirement account in calculating the borrower's reserves, contrary to the findings report, which states that only 60 percent can be used.

I. Eagle Mortgage failed to document that the borrower's income would be likely to continue for three years as required by paragraph 2-7 of the handbook. The borrower's Leave and Earnings Statement stated that he would be discharged from military service the same month as the loan closed. The file had no indication of reenlistment or prospective employment.

J. Eagle Mortgage did not determine the purpose of more than $8,000 of new co-borrower debt, as required by the findings report.

K. Eagle Mortgage did not document the gift, possibly from the borrower's parents, that was used for earnest money.

Appendix D

PROJECTED LOSSES

FHA case number	Unpaid loan balance (1)	Estimated loss (2)	Actual loss	Total
431-4283353	$ 226,963	$ 95,325		
561-8375765			$ 91,280(3)	
561-8321239	$ 150,397	$ 63,167		
Total		$ 158,492	$ 91,280	$ 249,772

(1) Unpaid principal balance shown in Neighborhood Watch as of March 31, 2009.

(2) Unpaid principal balance multiplied by 42 percent. This estimates the loss to the FHA insurance fund.

(3) The property was sold in a short sale. The claim amount is HUD's actual loss.