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Preparing For OIG and State Regulatory Audits/Examinations**

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The OIG Audit Process:

- As the importance of government housing programs increases, the degree and prominence of HUD's Office of Inspector General ("OIG") audits increasingly will become a factor.
- The HUD office of OIG has two principal organizational elements:
 - An office of audit that performs audits of HUD program participants including mortgage lenders.
 - An office of investigation that performs investigations (including lenders) involving program fraud and makes referrals to the Department of Justice for prosecution.
 - OIG "Triggers" for selecting lenders for audit include:
 - Large volume of loan originations.
 - Early defaults.
 - Higher than average claim and default rates.
 - Complaints from borrowers, lenders, investors.
 - Referrals from HUD program offices.
- The OIG Audit Process Includes The Following Steps:
 - Opening conference with lender's staff.
 - Review of loan files, interviews with lender's staff and other parties to the transactions such as borrowers, real estate agents, and appraisers.
 - Exit conference with lenders staff.
 - Post audit issuance of draft and final audit reports.

Preparing for the OIG Audit

- Have all loan files and other information requested by the OIG ready.
- Take a professional, positive, and cooperative approach with any reasonable request (e.g. workspace, telephone access, copying machine, etc).
- Appoint an experienced senior manager to act as the contact person/coordinator through which information is provided to OIG staff.
 - To handle requests for explanation of lender's policies, practices, and procedures.
 - All of lender's employees should be instructed to route requests for information to the contact person/coordinator.
- Cooperate with OIG staff but do not volunteer any information beyond what the OIG staff requests.

- Provide all information requested promptly.
- If specific files have been requested in advance, review the files to determine if any patterns or problems are present that involve the same “players” (e.g. loan officer, underwriter, processor, real estate broker, title company, etc.).
- Make sure the file contains the required documentation and be prepared to explain missing documentation.
- Analyze the file to determine if documentation supports the underwriting decision.
 - Make sure that any document, handwritten note or record of any telephone confirmation of the borrower’s information has been placed in the file.
 - This will help to avoid incorrect findings by the OIG staff and potential demands by HUD for indemnification.

Opening Conference

- OIG staff will discuss the scope of the audit work with lender’s staff:
 - Provide information requested by OIG as promptly as possible.
 - Offer to follow-up in writing if information is not on hand or will take time to compile.
 - Stress to OIG staff that they will be given full cooperation during the audit.
 - Stress to OIG staff that they should ask for information if they have questions or concerns regarding any loan file, or aspect of the lender’s policies or operating procedures.
 - This will help to avoid incorrect findings as the OIG staff may not be experienced in FHA requirements.
 - This will also help to avoid the OIG staff applying the wrong FHA guidelines during the audit.
 - This will help to prevent unwarranted indemnification requests by HUD.

The Audit

- Steps that the lender should take during the audit:
 - Do not volunteer any information.
 - All questions that the OIG staff have regarding a loan file, lender policy, or operating procedure should, to the extent possible, be resolved during the audit.

- This will help to avoid incorrect audit findings and requests for indemnification.
- This will also help to avoid a potential referral to HUD's Mortgagee Review Board for administrative sanctions and civil money penalties.
- The designated contact person/coordinator should periodically "look-in" on the OIG staff to see that they have needed information and to offer any needed explanation or clarification.

Exit Conference

- At the conclusion of the audit the OIG staff conducts an exit conference with the lender:
 - OIG staff generally informs the lender of OIG's audit findings.
 - OIG staff generally offers the lender an opportunity to submit additional follow-up information in writing.
 - The lender should stress to OIG staff that it will promptly clarify all questions and concerns that the OIG may have.
 - This should be done to attempt to resolve any audit findings before the OIG issues its draft audit report.

Post Audit

- The OIG may perform additional work after the audit (e.g. interviews with borrowers and other parties with knowledge of the transactions particularly where serious violations are identified).
- At completion of the audit a Draft Audit Report is issued to the lender and the lender is provided an opportunity to submit a written response to the audit findings:
 - If serious violations are alleged the lender would be well served to obtain legal counsel to assist in preparing the audit response to protect its interest.
 - The response must be comprehensive addressing each finding and provide documentation to support the lender's arguments.
 - Carefully review the finding to make sure that the OIG has not incorrectly cited a violation of an FHA requirement (or the requirement is broader than interpreted by OIG staff).

- Submit copies of all available loan documentation, including any handwritten notes, and records of telephone calls (e.g. reconfirmation of borrowers income and employment prior to loan approval).
 - The key point is to demonstrate that the lender properly originated the loan and the underwriting decision to approve the loan was reasonable, consistent with FHA guidelines, and based on supporting documentation.
 - Identify the loans that were underwritten using an automated underwriting system (AUS) and FHA's Total Mortgage Scorecard and explain that the documentation requirements were complied with.
 - Re-underwrite the loans and identify any compensating factors that were used for loans with ratios exceeding FHA guidelines.
 - Where the audit findings allege that false information or documents were submitted the burden of proof is in the OIG to demonstrate that the lender knew or should have know of this.
 - If the lender believes that it was a victim of fraudulent acts on the part of other parties this should be fully explained.
 - If any of the alleged violations were previously reported to HUD prior to the audit this should be explained.
 - If the audit findings allege that the lender's employees participated in or were aware of the alleged violations, interview those employees to make sure the findings are correct in its allegations, and if not correct obtain written statements and submit them with the response.
 - Explain the corrective measures that have been implemented either prior to or after the audit to preclude a recurrence of any valid shortcomings cited by the audit.
- After reviewing the lender's response to the draft audit report the OIG issues a final audit report:
 - The lender's response is made part of the final audit report as an attachment.
 - The final audit report contains the OIG's recommendations to HUD (these can include indemnification, administrative sanctions, and civil money penalties).
 - The final audit report is issued to the FHA Commissioner or HUD's Mortgagee Review Board for action.

- The Mortgagee Review Board has authority to impose administrative sanctions (including withdrawal of FHA approval) and civil money penalties.
- The Mortgagee Review Board can impose civil money penalties of \$7,500 per violation up to \$1.375 million for all violations during any one year.

Preparing for a State Audit/Examination:

- Once a licensee is notified that an examination will take place, the company should immediately determine whether that regulatory agency has, in the past, audited the company. In the event that the company has been examined by the agency, the company should review all of the previous examination reports that it was provided and review any notes that may be maintained in the file regarding the examination.
 - In reviewing the previous examination reports (and the company's responses to those examination reports), the company should determine whether any corrective action was required and must ensure that it previously implemented such corrective action.
 - In reviewing the previous examination reports (and speaking to personnel who assisted with the past examination), the company should try to get a sense of the past examination (i.e., was the examiner interested in particular items; did the examiner characterize the examination as a good exam; was the examiner frustrated with the findings and/or issues that may have been uncovered during the examination process).
- To the extent that the company has a Quality Control ("QC") Department that is separate and apart from the Compliance Department and/or to the extent that QC reports are prepared, the company should review each of the QC reports that were prepared since the date of the last examination from this regulatory agency.
 - In reviewing the QC reports, you should seek to identify any common issues/persistent themes that have arisen in the reports. Similarly, to the extent that specific loans identified in the QC report were originated using the license/approval that is the subject of the audit/examination, those loan files should be reviewed to evaluate the issues that were identified and to illustrate issues that the company may wish to look for in performing the self-audit.
- When the examiners announce, in advance, that they will examine specific files, the company should promptly move forward with performing its own audit or examination on

those loan files. By conducting this review, the company will be in a position to ascertain whether there are any consistent themes that the examiner is likely to discover as he or she reviews the loan files (e.g., perhaps a particular compliance issue appears in all ARM loans because of a coding error in the company's Loan Origination System).

- Files should be reviewed to ensure that they include the appropriate disclosures and, to the extent those disclosures must be signed, signed disclosures are included in the files.
- Files also should be reviewed in the context of past examination reports. To the extent that issues that were identified in previous examinations have not been corrected, regulatory action could potentially take place.
- We generally suggest that the company prepare a checklist of all of the documents that should be included in each loan file. By preparing such a checklist, the individuals that are reviewing the loan files will more easily be in a position to verify that the loan file contains (or does not contain) all of the required disclosures, etc.
- To the extent that loan files are not identified in advance, we suggest that the company perform a random sampling of a number of files (to include loans the company made and loans the company may have brokered).
- The company also should consider its recent examination reports that were issued by other regulatory agencies. Although each state will have specific permissible and prohibited activities, other examination reports are illustrative in that they potentially may identify issues that arise in connection with complying with federal laws such as (but not limited to) the Real Estate Settlement Procedures Act ("RESPA"), the federal Truth-in-Lending Act ("TILA"), and the Equal Credit Opportunity Act ("ECOA").
- In connection with the examination, the company should pull a report to determine all of those locations that conducted licensable business in connection with residential real property located in that state. The company should perform a self-audit to ensure that all of those locations hold the appropriate licenses/approvals (including branch and loan officer licensing, if applicable).
- In advance of the audit, the company should identify the team that will be tasked with interacting with the examiner/examiners. The team generally should include the head of the compliance department, the person that is in charge of examinations (if different from the individual in charge of compliance), and may also include a senior officer. We suggest

that each of the members of the team be prepared to greet the examiners when they first arrive and all should participate in the closing review that the examiners provide.

- The team should be prepared, if necessary, to discuss the company's compliance functions and procedures in detail. For example, the team should be able to discuss the compliance department of the company generally. Possible items of discussion include the general responsibilities of employees, oversight of the compliance group, how resources are allotted within the group, and how the group addresses issues when they arise. In addition, the team should be prepared to comment on other resources that may be at the company's disposal (e.g., outside counsel, software that may be utilized to confirm that loans comply with applicable law, etc.).
- It is important to realize that compliance is a challenging and complex task. An examiner does not expect that every loan file that is reviewed will be perfect. Therefore, establishing a rapport with the examiner and his or her team (if there are multiple individuals) is important, to the extent possible. Importantly, if the self-audit that the company performs in advance of the examination reveals issues that will be consistent themes in the loan applications to be reviewed, the company may wish to self-disclose those issues to the examiner.