
AUDIT REPORT



FIRST COMMUNITY MORTGAGE, INC.

NON-SUPERVISED LOAN CORRESPONDENT

FORT MYERS, FLORIDA

2004-AT-1010

JUNE 17, 2004

OFFICE OF AUDIT, REGION 4
ATLANTA, GEORGIA



Issue Date	June 17, 2004
Audit Case Number	2004-AT--1010

TO: John C. Weicher, Assistant Secretary for Housing/Federal Housing
Commissioner, H, and

Margarita Maisonet, Director, Departmental Enforcement Center, CV

James D. McKay

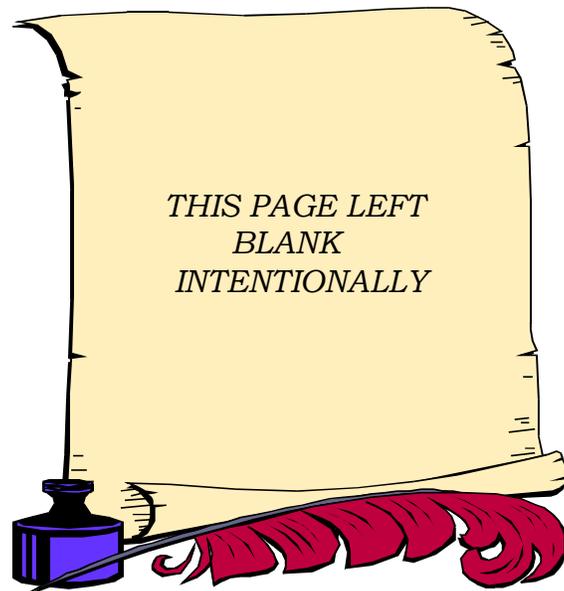
FROM: James D. McKay
Regional Inspector General for Audit, 4AGA

SUBJECT: First Community Mortgage, Inc.
Non-Supervised Loan Correspondent
Fort Myers, Florida

We have completed an audit of First Community Mortgage, Inc. (FCM), located at 3049 N. Cleveland Avenue, Fort Myers Florida. We conducted the audit as part of our annual plan emphasis on Single Family loans. Our audit objective was to determine whether FCM complied with HUD regulations and instructions in the origination of Federal Housing Administration (FHA)-insured single-family mortgages. Our report contains three findings and recommends withdrawal of authority to originate loans and debarment of FCM's principal owner/officers.

In accordance with the Department of Housing and Urban Development (HUD) Handbook 2000.06 REV-3, within 60 days please provide us, for each recommendation without a management decision, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after report issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact me or Terry Cover, Assistant Regional Inspector General for Audit, at (404) 331-3369.



Executive Summary

We conducted an audit of FCM of Ft. Myers Florida, a HUD approved loan correspondent, as part of our annual audit plan to audit Single Family loans. Our audit objective was to determine whether FCM complied with HUD regulations and instructions in the origination of FHA insured single-family mortgages.

FCM violated HUD requirements

FCM officer/owners effectively circumvented HUD's suspension of FCM by creating two new mortgage companies and obtaining HUD approval for them to originate loans. FCM officer/owners created, and FCM employees were named as officers of, the two new entities while the employees were still working for FCM. The new entities also used FCM's office address.

FCM did not comply with HUD requirements in its origination of FHA-insured loans. In 18 of the 19 loans we reviewed, FCM staff did not obtain complete documentation, made improper income determinations, or did not ensure compliance with other HUD standards.

FCM did not implement the Quality Control (QC) Plan it submitted to HUD in January 2003, and its QC processes did not comply with HUD regulations. FCM's QC Plan did not address key elements such as: (1) documenting corrective actions taken as a result of QC reviews, (2) reporting significant discrepancies to HUD, (3) timely performance of QC reviews, and (4) QC review of rejected loans. FCM's actual QC performance was materially deficient.

Recommendations

We recommend that HUD suspend FCM's authority, and the two new mortgage entities authority to originate FHA loans. We also recommend that the Departmental Enforcement Center (DEC) debar FCM principals from further participation in HUD and other Federal programs and consider imposing civil money penalties, as appropriate.

Auditee comments

We presented our results to the FCM officials and HUD officials during the audit. We provided a copy of the report to FCM officials and HUD's Assistant Secretary of Housing on February 27, 2004. We discussed the report with FCM officials at the exit conference on April 6, 2004. We received written comments from FCM on May 14, 2004. FCM's comments were extensive,

consisting of a 43-page letter and 24 multiple-page exhibits. We have included excerpts of their response in the auditee comments sections of each audit finding. The auditee's letter is included as Appendix F. The auditee's complete response, including exhibits, has been provided to HUD under separate cover.

We also received a written response from the former President of Family Home Funding Enterprise (FHFE), one of the new companies created by a FCM's owner/officer. This response included evidence that FCM's owner/officer also owned and controlled FHFE at the time its application was submitted to HUD. Their ownership interest was not disclosed in the application. This response was also provided to HUD.

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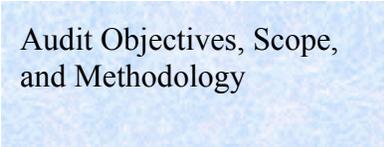
Abbreviations

DEC	Departmental Enforcement Center
FCM	First Community Mortgage
FHA	Federal Housing Administration
FHFE	Family Home Funding Enterprises, Inc.
HUD	Department of Housing and Urban Development
MAP	Mortgage Assistance Program
NFI	Neighborhood Funding, Inc.
QC	Quality Control
VOD	Verification of Deposit
VOE	Verification of Employment

Introduction

HUD approved FCM to act as a Title II loan correspondent in March 2000. As a loan correspondent, FCM may originate HUD-FHA insured mortgages and submit applications for mortgage insurance to sponsoring/underwriting mortgage companies. FCM may not sell insured mortgages to any mortgagees other than its sponsor(s) without the prior approval by the Department and may not hold, purchase, or service insured mortgages in its own portfolio. The sponsor mortgage company is responsible to HUD for the actions of its loan correspondent(s) in originating insured mortgages. From the period April 1, 2001, through April 30, 2003, FCM's Fort Myers office originated 221 loans, of which 40, or 18.1 percent, had defaulted as of May 21, 2003. During a similar time frame, April 1, 2001, through March 31, 2003, the national average of defaults was 3.97 percent.

On June 23, 2003, HUD suspended FCM's authority to originate loans in the Miami area because its default rate exceeded 200 percent of the average default rate in the HUD field office jurisdiction.



Audit Objectives, Scope, and Methodology

Our audit objective was to determine whether FCM complied with HUD regulations and instructions in the origination of FHA-insured single-family mortgages. Our audit reviewed FCM's pertinent management controls including its quality control plan and procedures. We reviewed 19 loans with beginning amortization dates between April 1, 2001, and April 30, 2003, and that went into default within 2 years of the beginning amortization date. We focused our selection on loans that defaulted with the fewest number of payments, and that had not been reviewed by HUD during its June 2002 quality assurance review of FCM. We reviewed FCM's loan origination files and related records to assess whether FCM complied with HUD requirements, and we compared FCM's files with HUD files to assess whether they were consistent. We interviewed FCM officials to gain an understanding of the business processes at FCM. We also interviewed HUD staff to obtain clarification of HUD's rules and regulations.

We also conducted audit work at Irwin Mortgage Co., 13773 Icot Boulevard, Clearwater, Florida, which was the underwriter/sponsoring mortgagee for 5 of the 19 FCM loans. We assessed whether loan origination data agreed with the data submitted to HUD-FHA for insurance approval, and that underwriting analyses were supported. We also performed audit work at 14 settlement agents' offices to determine whether loan settlement transactions as

reported on forms HUD-1, Settlement Statement, were supported and agreed with records submitted to HUD for insurance approval.

During the audit, we learned that the owner/officers of FCM had created two new mortgage companies. Since this was potentially in conflict with HUD rules, we expanded the scope of audit work to include collection of information concerning creation of the two new mortgage companies, and loans sponsored by one of the companies, Neighborhood Funding, Inc. (NFI).

We conducted the audit in accordance with generally accepted government auditing standards.

FCM Officers Created New Mortgagee Entities, Circumventing Suspension of FCM

FCM's Vice President/owner started two new mortgagee entities, Neighborhood Funding Inc. (NFI) and Family Home Funding Enterprises Inc. (FHFE), after HUD suspended FCM from originating FHA loans in the Miami/Coral Gables area¹ on June 23, 2003. FCM officers and employees were named as officers and employees of the two new entities, while they were still working for FCM. Subsequently, HUD approved the two new companies, one as a non-supervised lender and one as a non-supervised loan correspondent. Further, we noted that the two new companies were located in the same complex as FCM, and one was co-located with FCM. Thus, FCM owner/officers effectively circumvented HUD's suspension of FCM in Miami/Coral Gables. In concert with the poor loan origination practices and inadequate quality controls observed at FCM (see findings 2 and 3), this increased the risk of losses to FHA-insurance funds.

HUD Handbook 4060.1 REV-1, Mortgagee Approval Handbook, establishes the following requirements applicable to HUD approved mortgagees, and available administrative actions to address non-compliance:

- All employees of the mortgagee, except receptionists, whether full time or part-time, must be employed exclusively by the mortgagee at all times, and conduct only the business affairs of the mortgagee during normal business hours. Branch managers must be located at the branch office they manage and cannot operate or be the manager of more than one branch office at the same time.
- The senior corporate officers must spend their full time on the mortgagee's operations.
- A mortgagee's main and branch office facilities must be located in a space that is separate and apart from any other entity. A mortgagee may share general reception-type entrances or lobbies with another business entity.
- A mortgagee's main office must be its designated facility to which the Department directs all communications about the management affairs of the mortgagee, and from which the public obtains information on the activities of the mortgagee. The mortgagee may conduct its loan origination activities from any of its approved offices that are adequately staffed and qualified. A mortgagee is fully responsible for the actions of its branch office.
- Mortgagees are required to notify the Department within 10 days of all corporate changes including: corporation conversions, mergers, consolidations, successions, liquidations, termination; and changes in their charter provisions, name, location, control of ownership, character of business, executive officers or branch managers.

¹ On June 23, 2003, FCM was suspended from originating loans in the Miami/Coral Gables area of Florida due to its high number of defaults in the HUD field office jurisdiction.

Finding 1

- The Department's Mortgagee Review Board is authorized to take administrative action against approved mortgagees that do not comply with HUD-FHA requirements. The Board may issue a letter of reprimand, place a mortgagee on probation, suspend, withdraw a mortgagee's approval, or enter into a Settlement Agreement. The Board and Housing Civil Penalties Panel are authorized to impose a civil money penalty whenever an approved mortgagee knowingly and materially violates HUD-FHA program regulations or requirements.

Neighborhood Funding, Inc.

On January 24, 2003, the Vice President and 50 percent owner of FCM, incorporated NFI, naming herself as its sole Director. The address provided to the Florida State Department of Corporations was the same as FCM's except that NFI's suite number was 201 and FCM's was 200². On April 9, 2003, the President and 50 percent owner of FCM, who was also the husband of the Vice President, was named as sole Director and Officer of NFI. Finally, on July 2, 2003, an FCM employee (loan processor), and granddaughter of the FCM's President and Vice President, was named sole Director and President of NFI. The new President identified herself as the 100 percent owner and President of NFI in the application sent to HUD's Lender Approval Division. Further, she provided a resume stating that she had ended her employment with FCM on January 17, 2003. However, in July 2003 we interviewed the President of NFI as a loan processor for FCM, and we observed her working at FCM through mid September 2003. Also, documentation provided by FCM showed that she was an employee through October 2003. NFI received HUD approval as a non-supervised Lender in the Miami/Coral Gables area effective November 24, 2003.

Although the application to HUD stated that NFI had been in operation since January 2003, the financial statements submitted to HUD showed no operating revenues or expenses from January 2003 through September 30, 2003. The primary corporate asset, valued at \$200,000, was land. The land was transferred to NFI³ from FCM on March 6, 2003, via a quitclaim deed. According to FCM

² Suites 200 and 201 were the same office. At the time of our site visits, there were two doors, but the offices were not separate.

³ Property was transferred to "Neighbor Funding" per County records, but details of the transactions support that this was a clerical error and the intent was to transfer the property to Neighborhood Funding.

officials, this property was donated to NFI. At the time of donation, the same persons owned and controlled both FCM and NFI. Generally accepted accounting principles require that the land transfer be recorded on NFI's books at the carrying value of FCM⁴. Based on the county records we observed, the carrying value should have been \$50,000. As such, the net worth of NFI was overstated by \$150,000. Thus, NFI did not meet the minimum net worth requirement to obtain HUD approval as a non-supervised lender.

NFI had a storefront sign in front of the office complex where FCM was located, and we determined that location was NFI's main contact point with the public in December 2003. HUD requires that a mortgagee's main office must be its designated facility to which the Department directs all communications about the management affairs of the mortgagee, and from which the public obtains information on the activities of the mortgagee. HUD-web documentation showed a different main office address. We also noted that other documents such as mortgage lender licenses and corporate registrations showed different addresses than the address reported to HUD. The address on the corporate registration was changed on January 20, 2004, to the address reported to HUD. See Appendix D for a chronology of key events.

We also reviewed county records of NFI's lending activity from the date of its inception through March 31, 2004. We identified 10 loans made by NFI, of which 2 were FHA loans. One of these loans was within the Miami/Coral Gables jurisdiction and the other was in the Orlando jurisdiction. Mortgages for both of the FHA loans showed NFI's address as 1621 N Tamiami Trail Ste 3, but the remaining 8 mortgages showed NFI's address as 3049 Cleveland Ave. Ste 234. NFI closed non-FHA loans before and after closing the two FHA loans, indicating that NFI had more than one office. Neighborhood Watch shows that FHFE originated both of the FHA loans. Further, the underwriters of the two FHA loans were the vice-president of FCM and the operations manager of FCM. These facts show that FCM's Vice President underwrote loans for NFI

⁴ SFAS 141 *Business Combinations* Appendix D - When accounting for a transfer of assets between entities under common control, the entity that receives the net assets shall initially recognize the assets transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer.

Family Home Funding
Enterprises, Inc.

before terminating FCM's origination authority, and that NFI had a second office that was not timely reported to HUD.

One day after FCM was suspended, on June 24, 2003, the Vice President and 50 percent owner of FCM incorporated FHFE, naming herself as the sole Director. The address provided to the Florida State Department of Corporations was the same address as FCM except that the suite number was 201². On July 2, 2003, the directorship/presidency was transferred to an FCM employee (loan officer). The application to HUD's Lender Approval Division, dated September 8, 2003, showed the FCM employee was the President and 100 percent owner of FHFE. On the same date, a change of address was submitted to the Florida State Department of Corporations to change FHFE's address to the address reported on the HUD application. FHFE also provided a resume for its President stating that his employment with FCM ended in June 2003. However, we interviewed him as an employee of FCM in July 2003, and FCM provided documentation showing that he was an FCM employee as of July 21, 2003. Further, we observed that he remained employed at FCM during our on-site audit work through September 19, 2003. On October 31, 2003, FHFE was approved as a FHA non-supervised loan correspondent in the Miami/Coral Gables area as well as the Tampa and Orlando, Florida jurisdictions.

FHFE also had a storefront sign in front of the FCM office complex, and after our on-site work at FCM; we observed that FHFE was located in the same office space where FCM was located. FCM continued to be located in the same space as its window signs were still present, but FHFE appeared to be the prominent entity, displaying a door marker sign. We also determined that FHFE was no longer located at the address it reported to HUD as its main office. On November 24, 2003, FHFE changed its address with the Florida Department of Corporations back to the complex address where FCM is located. At that date, FHFE also added the President of FCM as its Vice President and Director, and the registered agent for FCM's Ohio branch as its Assistant Secretary and Director. The registered agent for FCM's Ohio branch is also the registered agent for FHFE and NFI branches in Ohio.

We also noted that FCM employees were reported as employees of FHFE. While applying for authority to originate FHA loans, HUD asked the FHFE President to provide resumes for its employees. He provided resumes for two persons that we observed were employees of FCM. One employee was identified as a loan officer for FHFE. Her resume identified her current employer as NFI and her responsibilities as Quality Control. The resume did not include her position with FCM. During our audit, we observed her working at FCM. Further, FCM staff identified her as their receptionist and Quality Control person. The second FHFE employee, identified as a loan processor, provided a resume stating that she had ended her employment with FCM in May 2003. However, we observed her working at FCM through mid September 2003, and FCM's employee listing as of July 21, 2003, identified her as a junior loan processor. See Appendix E for a chronology of FHFE key events.

The actions of the FCM owner/officials, creating and gaining HUD approval for new mortgagee companies while FCM was suspended in the Miami/Coral Gables areas, reporting FCM employees as employees of the new entities and co-locating the entities with FCM illustrate their disregard of HUD requirements. We concluded that FCM, NFI, FHFE, and their principal officers/owners cannot be relied upon to act in accordance with HUD rules and regulations. Therefore, any loans originated or underwritten by these entities pose a greater risk to the FHA-insurance fund.

We also noted that a similar pattern appears to be underway in Ohio, where FCM has a branch office. The Ohio office also had a high rate of defaults and appears to be at risk of a HUD suspension. We noted that FHFE and NFI have obtained business licenses in Ohio.

Auditee Comments

FCM disagreed with the finding. Excerpts from their written comments follow. The complete text is included as Appendix F. "...the owners of FCM at no time intended to circumvent FCM's Credit Watch termination of origination authority in the Miami/Coral Gables jurisdiction. FCM was a small company owned and operated by two individuals desiring to provide for their family. The owner's incorporation of two new entities was an exit strategy for them out of the mortgage business and into retirement to deal with their health issues. These companies were created for reasons wholly apart from the termination of FCM's origination authority in one of the

jurisdictions in which it was approved to engage in FHA lending. In addition, the incorporations were undertaken before FCM was informed that its Origination Authority Agreement for the Miami/Coral Gables jurisdiction had been terminated, and FCM did not need to circumvent the suspension, as it was still able to originate loans in other jurisdictions in Florida and through other branch offices. As the actions of the owners of FCM were not intended to circumvent the Credit Watch proceeding, we believe that the Report's recommendations regarding the suspension of the companies and the debarment of FCM's principals is unwarranted in this instance."

OIG Evaluation of
Auditee Comments

In general, the voluminous documents provided by FCM were copies of documents reviewed by OIG during the audit. FCM did not provide any significant new evidence to persuade us that its owner/officers made reasonable efforts to comply with HUD requirements.

We revised the report to eliminate any inferences of FCM's principals' intent in creating the two new mortgage companies. OIG recognizes that FCM's principals likely had multiple reasons or intentions for the actions they took to incorporate and make the companies operational. We also revised Finding 1 by adding information obtained from county records about 10 loans made by NFI from its inception through March 31, 2004, and information on Generally Accepted Accounting Principles related to the valuation of land acquired by donation from a related party.

OIG acknowledges that NFI was incorporated before FCM was notified by the Department of the potential termination of origination authority in the Miami/Coral Gables jurisdiction. However, all other actions, such as obtaining the requisite State licenses and HUD approval occurred after March 20, 2003, when FCM was informed of the potential termination of FCM's loan origination authority. Furthermore, the principals of FCM did not indicate to the OIG auditors or to their independent public accountant (via financial statement disclosures) that they intended to cease operations.

OIG does not view the actions by FCM principals as consistent with their stated intent of exiting the mortgage

industry and passing businesses to their children and grandchildren. The child and grandchild of FCM's owners were employed by FCM, and ownership of FCM could have been transferred to them rather than creating new companies. While FCM's principals gave NFI to their grandchild, ownership of FHFE was not transferred to a family member. FCM's owners remained active in both NFI and FHFE. The President/Owner of FCM was named as Vice President of FHFE on December 11, 2003, and remained through April 28, 2004. The Vice President /owner of FCM was identified as an underwriter for NFI on December 10, 2003. Further, the independent public accountant who audited NFI's financial statements as of September 30, 2003, identified FCM's Vice President as a NFI officer and as his primary contact with NFI for the financial audit. These positions with NFI and FHFE illustrate continued violation of HUD's exclusive employment requirement for officers of FCM.

FCM's reply to the audit stated: "As with NFI, above, at all times during the [surname's] ownership of FHFE, the new entity was a non-functioning, shell corporation without state licensing or federal approval." It further stated that FCM's owner/officers merely established shell companies, did not engage in substantive business of NFI and FHFE, and spent their full time on the operations of FCM. To the contrary, the former President of FHFE provided a written agreement documenting that when FHFE applied for and received HUD approval as a non-supervised loan correspondent, it was actually owned and controlled by the principals of FCM. Further, as cited above, exhibits to FCM's written reply show that FCM's owner/officers served as employees or officers of both NFI and FHFE before voluntarily terminating FCM's loan origination authority.

Information about the ownership of FHFE contained in FCM's written reply raised new questions about the accuracy of the application for lending authority submitted to HUD. The application identified a FCM employee as the sole owner of FHFE. Copies of stock issuance documents provided as exhibits to FCM's written reply showed 100 shares issued to the sole owner. This information conflicts with the audited financial statements for FHFE which show 500 shares authorized, issued, and outstanding. The existence of 400 additional shares would

indicate that the FCM employee was not the sole owner of FHFE.

FCM's written reply stated that since it retained loan origination authority in other Florida and Ohio jurisdictions, it did not need to circumvent the termination of authority in the Miami/Coral Gables area. The Miami/Coral Gables area was FCM's largest source of business. From July 1, 2001 through June 30, 2003, the Miami/Coral Gables jurisdiction represented 75 percent of all FHA loan activity for FCM's Fort Myers office. Further, the Miami/Coral Gables jurisdiction represented 40 percent of FCM's FHA loan activity for all branches. Loss of origination authority in Miami/ Coral Gables would have significantly impacted FCM's loan volume. Both NFI and FHFE were authorized by HUD to originate loans in Miami/Coral Gables.

FCM's reply acknowledged that its principals used FCM's address when they created the two new companies, and stated that neither company operated from FCM's office. It also stated that a wall was built separating suites 200 and 201 sometime prior to December 2003, before FHFE operated from one of the suites. FCM's reply does not explain why in December 2003 NFI's answering service was giving callers 3049 Cleveland Avenue as the point of contact, not 1621 N. Tamiami Trail Suite 3.

FCM's written response also stated that the resumes submitted to HUD, for the Presidents of NFI and FHFE and two NFI employees, all contained similar errors in the dates of employment with FCM and the new companies. All of the errors aligned the employment termination and start dates to show no overlap of employment between FCM and NFI or FHFE. FCM's reply states that employees were kept on FCM's payroll until the new entities became operational. FCM's reply also contradicted written comments provided by the President of NFI stating that she continued to work periodically as a fee processor for FCM during her employment with NFI.

Recommendations

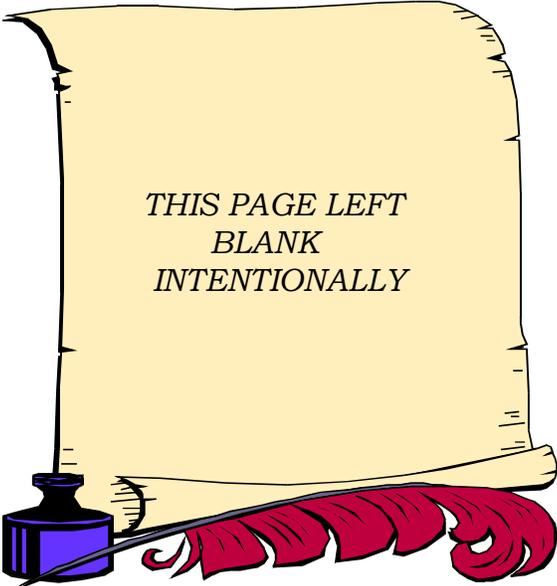
We recommend that HUD:

- 1A. Withdraw the authorization for FCM, FHFE, and NFI to originate and/or underwrite HUD-FHA loans.

- 1B. Consider imposing appropriate civil money penalties on FCM and its owners/officers.

We recommend that the DEC:

- 1C. Debar the principal officers/owners of FCM from participation in federal programs.
- 1D. Consider debarring the principal officers/owners of FHFE and NFI.



FCM Did Not Originate Loans In Accordance With HUD Requirements

FCM did not comply with HUD regulations in its origination of FHA-insured loans. Although FCM staff appeared to be aware of HUD requirements, they did not comply with one or more requirements when originating 18 of the 19 loans we reviewed. Furthermore, FCM's quality controls were inadequate to detect and prevent such errors (see Finding 3). As a result, substandard loan applications were submitted to underwriters, and HUD-FHA insurance funds were placed at greater risk of loss.

FCM's procedures for originating loans began with a loan officer or loan representative taking an application (HUD form 1003) from a potential borrower, including collection of a bank statement, four pay stubs, two W-2 forms, copies of a driver's license and social security card, 2-years of tax returns for self employed applicants, and any divorce decrees or bankruptcy papers. FCM's front desk then ordered a credit report and Verification of Deposit (VOD), if required. The process then passed to the loan processor. Loan processors received a fax copy and the original Verifications of Employment (VOE) from employers. The processor then compared the pay stubs and W-2 forms to the VOE to determine effective income. Loan processors were responsible for completing the remaining validations and the final Loan Application (HUD form 1003). The loan processor was also responsible for reviewing the loan file for completeness and sending it to an underwriter.

HUD Handbooks (4000.2 Revision 2, Mortgagees Handbook Application through Insurance, and 4155.1 Revision 4 Change 1, Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties) establish the following requirements for loan originations:

- Lenders must verify the applicant's employment for the most recent 2-years.
- VOEs must be sent by the mortgagee directly to the employer, and must be returned directly to the mortgagee.
- Effective income may include overtime/bonus income as long as it is verifiable and is documented by the employer as likely to continue. Where the employer does not indicate that continuance of such payments is likely, it may not be included as effective income in determining mortgage eligibility.
- Assets of borrowers must be verified by VODs and by obtaining bank statements.
- Lenders must obtain an understanding of the source of funds and the expected use of the property by the borrower.
- Lenders must document the receipt of all gifts, and
- Lenders must ensure that seller or third party contributions do not exceed HUD prescribed limits.

Finding 2

The HUD Home Ownership Center Reference Guide dated August 20, 2000, states that:

- Lenders may not charge application fees except for bond loans and MAP (Mortgage Assistance Program) loans.

We reviewed 19 defaulted loans and noted at least 1 origination deficiency in 18 loans. See Appendices A and B for a table of loans reviewed and a discussion of each deficiency noted.

FCM improperly computed effective income on five loans. Four of the five loans exhibited improper treatment of overtime income. FCM overstated three applicant's incomes by improperly including overtime when the employer stated that overtime was not likely to continue. This caused monthly incomes to be overstated on the three applications by \$87, \$160, and \$603, respectively. Such overstatements made the borrowers appear more able to assume additional debt, and could result in loans being approved when there was insufficient repayment ability. One borrower's income was understated because FCM improperly excluded overtime income. In the fifth case, FCM's files did not document, and FCM's staff could not explain, how the borrower's income was calculated. We calculated that the income was understated by \$163 per month. Additionally, on this fifth loan, FCM had not verified employment for a complete 2-year period, and had not explained a 6-month gap in employment during that period.

FCM also did not verify the availability and/or source of funds needed by three borrowers to close their loans. Two months before loan closing, one borrower documented a bank balance of \$771. However, closings costs were \$836, and FCM did not obtain current data to verify the source and availability of funds. Another borrower was required to bring \$256 to the loan closing. The only documentation obtained by FCM was a deposit slip for \$2,000. This deposit document did not verify the identity of the account owner or the source of funds. Similarly, in the third instance, FCM verified the availability of funds with two VODs from the bank, however, it was a new account, and FCM did not verify the source of funds deposited.

FCM did not properly verify employment on three loans. For one loan, FCM accepted a VOE and two explanatory letters that were faxed from a hotel where the borrower was residing. HUD regulations prohibit the handling of VOEs by the loan applicant/borrower. Letters purportedly from the employer attested to a promotion and showed a large increase in income from 2000 to 2001. However, the business phone number shown on the letters differed from the phone number on the VOE, and both numbers differed from the phonebook number shown for the employer. At the time of our audit, the employer was out of business and we were unable to confirm the validity of the documentation. On the other two loans, the borrowers provided information on the loan application indicating a complete 2-year job history, but FCM did not obtain verification to support 2 years. In one case, the loan application showed that the borrower had worked 2-years at one company, but the employment verification service reported only 18 months employment in the prior 2-years. FCM's files did not note, nor explain, this discrepancy. FCM's staff stated that the VOE showed wages over a 3-year period, thus they did not note the latest employment start date. FCM's staff also noted the underwriter did not request any clarification. In the third case, the applicant listed a previous employer, but FCM's files did not have a VOE or an explanation for not obtaining a VOE. FCM did obtain a VOE from an earlier employer (prior to the unverified employment), and this left an unexplained gap of 10 months.

In six cases, FCM allowed loans to close when settlement statements showed sellers or other interested third parties contributed more than 6 percent of the sales price toward closing costs. Where sellers or other interested parties contribute more than this threshold, HUD considers it an inducement to purchase and requires a reduction in the maximum insurable mortgage amount. In the six cases, no adjustments were made. The excess contributions ranged from \$28 to \$1,204.

FCM did not verify the receipt of gift funds in accordance with HUD requirements for 15 of 17 loans where gifts were received. In 14 cases, the gifts funds were received from ‘gift programs’ operated by non-profit entities such as AmeriDream, and in one case the gift was from a relative. FCM officials stated that they were not able to obtain documentation from the settlement agent or the nonprofit gift giver. We did note that settlement agents properly documented the receipt of gift funds in 14 of these cases. We did not visit the settlement agent for the 15th case.

On one refinancing loan, FCM charged the borrower an unallowable application fee of \$700. The loan was neither a MAP loan nor a bond loan. Thus, FCM was not allowed to charge an application fee. FCM staff reviewed the file and stated that the fee should have been listed as an origination fee. However, FCM and the underwriter/sponsor closed the loan with the application fee reported on the HUD-1. FCM also received a 1 percent loan discount fee. The ‘application fee’ was .75 percent of the sales price, whereas the typical origination fee charged by FCM was .985 percent. The application fee should be refunded to the borrower.

HUD requirements for originating FHA-insured loans were established to mitigate the risk associated with making loans to individuals. When these requirements are not met, HUD potentially assumes a greater risk to the FHA-insurance fund. Non-compliance occurred on 18 loans totaling \$1,462,009, and which defaulted within the first 2-years. As of January 20, 2004, 6 of the 18 loans had gone to foreclosure and FHA paid insurance claims totaling \$468,826. HUD had resold three of the foreclosed properties and incurred actual losses totaling \$82,320. See Appendix A for a schedule of loans reviewed and their status as of January 20, 2004.

Auditee Comments

FCM disagreed with the finding. Excerpts from their written comments follow. The complete text is included as Appendix F “...the Company’s review indicated that many of the findings in the Report are at variance with the facts, do not constitute violations of HUD/FHA requirements on the part of FCM, or do they affect the underlying loans’ insurability.”

“...Loan correspondents are not authorized to perform any underwriting function, including any analysis of the appraisal or the borrower’s credit. *Id.* Furthermore, HUD regulations dictate that ‘each sponsor shall be responsible for the actions of its loan correspondent lenders or mortgagees in originating loans or mortgagees.’ 24 CFR

§202.08(b)(7). In fact, the OIG acknowledges on page four of the draft Report that ‘the sponsor mortgage company is responsible to HUD for the actions of its loan correspondent(s) in originating insured mortgages.’

“In accordance with these FHA guidelines, the Department traditionally has accepted that loan correspondents take a borrower’s initial application, collect income and employment documentation, and process the loan, but [sic] that the evaluation and analysis of the borrower’s credit and the sufficiency of the loan documentation is the responsibility of the underwriter and sponsoring lender. When HUD determines that the borrower’s income, funds to close, or credit was insufficient, the Department in the past has held the underwriter and sponsoring lender accountable...”

OIG Evaluation of
Auditee Comments

In general the voluminous documents provided by FCM were copies of documents already reviewed by OIG during the audit. The comments were not persuasive and we did not amend our audit findings.

OIG acknowledges that the final determination of whether to underwrite a loan is the decision of the underwriter/sponsor. However, it is incumbent upon the loan correspondent, FCM, to ensure that all originating documentation is present in their files. In keeping with HUD quality assurance review standards, our report to FCM included finding that the sponsor did not adhere to HUD/FHA requirements, such as inadequate compensating factors. With the exception of recommending FCM repay one improperly charged fee, our audit recommendations do not specifically address any of the loan origination and underwriting issues. The finding identifies a trend of routine loan origination deficiencies and is presented as evidence supporting the overall audit recommendations to withdraw loan origination authority from FCM, FHFE, and NFI and to seek debarment of the principals of FCM.

Recommendations

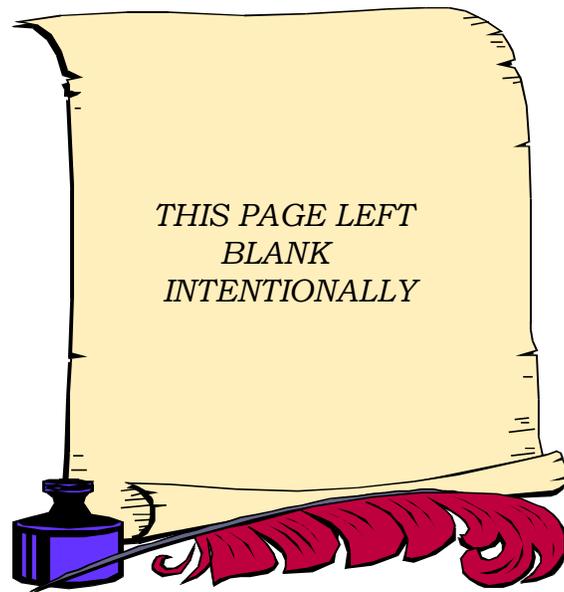
We recommend that HUD:

2A. Require FCM to repay the borrower for the improper \$700 application fee.

2B. See recommendations 1A and 1B

We recommend that the DEC:

2C. See recommendation 1C



FCM Quality Controls Did Not Comply With HUD Regulations

FCM did not implement the QC Plan it submitted to HUD in January 2003, and its QC processes did not comply with HUD regulations. FCM provided us with a QC Plan that was materially different than the Plan it provided to HUD, and did not address key elements such as: (1) documenting corrective actions taken as a result of QC reviews, (2) reporting significant discrepancies to HUD, (3) timely performance of QC reviews, and (4) QC review of rejected loans. FCM's actual QC performance was also materially deficient. FCM managers made little or no effort to implement a QC Plan as required by HUD regulations. The inadequate QC Plan and QC performance contributed to FCM's loan origination deficiencies (see Finding 2), its high rate of defaults, and ultimately increased losses to the FHA insurance fund.

HUD Handbook 4060.1, Chapter 6, requires that each FHA approved mortgagee, including loan correspondents, implement a QC Plan. The purpose of a QC Plan is to:

- Assure compliance with HUD's and the mortgagee's own origination requirements throughout its operations.
- Protect the mortgagee and HUD from unacceptable risk.
- Guard against errors, omissions, and fraud.
- Assure swift and appropriate corrective action.

The Handbook also sets out the following requirements to achieve these goals.

- Mortgagees may choose to review the lesser of 10 percent of all loans closed on a monthly basis, or a random sample that provides a 95 percent confidence level with 2 percent precision. Where mortgagees choose to use the random sample method, they must review all loans that went into default within six months of closing, in addition to the number selected for random sample.
- The QC Plan must require that reviews be performed within 90 days of the loan closing.
- The QC Plan must require that a minimum of 10 percent of total loans rejected be reviewed.
- The QC Plan must require written notification to the mortgagee's senior management, at least quarterly, of deficiencies cited in QC reviews.
- Actions taken by management must be formally documented by citing each deficiency, identifying the cause of the deficiency, and providing management's response or actions taken.
- QC documentation must be retained for 1 year.
- The QC Plan must require mortgagees to report any violation of law or regulation, false statements or program abuses by the mortgagee, its employees or any other party to the transaction, to the HUD Regional Office, the HUD Area Office, or to the HUD Regional Office of Inspector General.

In June 2002, HUD found that QC reviews performed for FCM by a contractor were deficient. In response, FCM assumed responsibility for its QC process, and in January 2003, submitted a written QC Plan to HUD. We requested FCM provide us with its QC Plan. The QC Plan it provided was not the same Plan it had provided to HUD. We noted material deficiencies in FCM's written Plan and in FCM's actual QC performance. The QC Plan that FCM provided to us did not address documenting corrective actions taken as a result of QC reviews, reporting significant discrepancies to HUD, timely performance of QC reviews, and review of rejected loans.

FCM's Plan did address the requirement that all loans defaulting within the first 6 months shall be reviewed. However, FCM's staff did not review 4 of 18 loans that defaulted from October 2002 through June 2003. FCM's officials were unable to explain why QC reviews were not performed.

FCM's QC Plan did not address the requirement to review 10 percent of all loans that were rejected by the sponsor/underwriter. This requirement is noted on HUD's QC checklist, which FCM's officials said was being used. A FCM employee stated that she and the vice-president reviewed all rejected loans, but stated that FCM does not maintain documentation of those reviews. FCM was unable to identify loans that were rejected, and could not provide any documentation of QC reviews on rejected loans. HUD requires that documentation of QC reviews be maintained for at least 1-year.

FCM's QC reviews were not timely performed. Only 3 of 40 loans that FCM performed QC reviews on in June 2003 were reviewed within 90 days of loan closing. This requirement was not addressed in FCM's QC Plan, but was an element noted in the HUD QC checklist that FCM said it was using.

Finally, FCM's QC Plan and actions did not ensure that corrective actions were identified, documented, and implemented. FCM's QC Plan did require that a report be produced for each QC review performed. However, QC reports only documented the actions taken in performing the review. Although the QC reviewer had, in many instances, noted discrepancies between the initial loan processing and the QC results, no corrective actions were recommended. We also noted no indication that FCM management was notified of the QC results. FCM management stated that they reviewed each QC report and had found no need for corrective actions.

Due to the significant differences between the QC Plan that FCM sent to HUD in January 2003, and the QC Plan it provided to us in July 2003, and our observations of FCM's actual performance, we conclude that FCM managers made little or no effort to implement a QC Plan as required by HUD regulations. It appears that FCM management places little importance on HUD requirements and on QCs. Thus, FCM loan origination deficiencies were not identified to enable prompt corrective actions, resulting in a high percentage of defaults and a greater risk to the FHA insurance fund. HUD regulations provide that when the mortgagee allows known and material violations of HUD requirements, the mortgagee is subject to corrective actions by the Department which include removal from the HUD program, and other federal programs, as well as civil money penalties.

Auditee Comments

FCM disagreed with the finding. Excerpts from their written comments follow. The complete text is included as Appendix F “...with regard to FCM’s Quality Control practices and procedures, contrary to the allegations in the Report, FCM at all times put forth a good faith effort to implement its Quality Control Plan and perform quality control reviews in a thorough and timely manner. Based on FCM’s continuous, good faith efforts to improve our Quality Control Plan and quality control review procedures and act in compliance with HUD requirements, we believe that the recommended sanctions are unwarranted in this instance.”

OIG Evaluation of Auditee Comments

As explained in the Finding, the QC Plan provided to HUD and the QC Plan provided to OIG were two distinctly different documents; and FCM did not adhere to either plan. The plan provided to OIG omitted material elements required by HUD regulations. Further, regardless of FCM’s good faith efforts, informal and undocumented meetings do not meet HUD QCR requirements. FCM did not provide any evidence to contradict the conditions cited in Finding 3.

Recommendations

We recommend that:

3A. See recommendations 1A and 1B.

We recommend that the DEC:

3B. See recommendation 1C.



Management Controls

In planning and performing our audit, we considered the management controls of FCM to determine our audit procedures, not to provide assurance on their management controls. Management controls are the plan of an organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Management Controls

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

- Loan origination process
- QC Plan and process

The following audit procedures were used to evaluate the management controls:

- Review of established procedures used by FCM in originating FHA insured loans.
- Review of FCM's QC Plan and process.
- Interviews with officials and employees of FCM and other related parties and entities.
- Examination of records and documents for FHA insured loans originated between April 1, 2001, and April 30, 2003.
- Review of records and files maintained by HUD's Quality Assurance Division in connection with the oversight of the HUD-FHA approved loan correspondent FCM.

Significant Weakness

A significant weakness exists if management controls do not give reasonable assurance that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data is obtained and maintained, and fairly disclosed in reports.

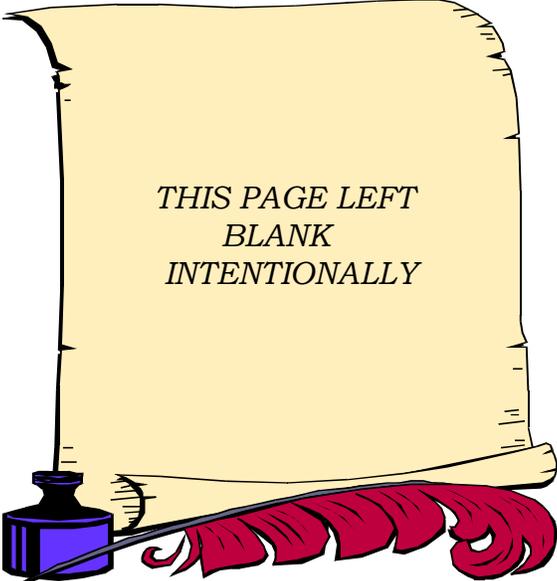
Our review of FCM's management controls over its loan origination and QC procedures for FHA insured loans showed that FCM did not comply with HUD requirements. Based on our audit we believe that significant weaknesses exist in the following areas:

- Operating in accordance with HUD and FHA requirements (Findings 1, 2 and 3)
- Quality control process (Finding 3)
- Loan origination process (Finding 2)

The deficiencies are discussed in the findings of this report.

Follow-Up On Prior Audits

This is the first Office of Inspector General audit of First Community Mortgage. Miriam De Toro, CPA, PA completed the most recent Independent Auditor audit report for the 12-month-period ended December 31, 2002. The report did not contain any findings.



Status of Loans Reviewed As Of January 20, 2004

FHA Case Number	Mortgage Amount	Status	If Claim, Has Property Been Sold?	If Sold, Gain/(Loss) Realized by HUD-FHA
092-8584081	\$ 93,759	D	N/A	N/A
092-8622768	54,834	C	N	N/A
092-8666769	104,176	D	N/A	N/A
092-8709785	92,783	D	N/A	N/A
092-8822776	76,200	C	Y	(\$ 24,121)
092-8838493	75,602	D	N/A	N/A
092-8851286	85,226	A	N/A	N/A
092-8862985	92,459	C	Y	(35,652)
092-8878072	58,834	C	Y	(22,547)
092-8943906	68,756	D	N/A	N/A
092-9027547	96,600	T	N/A	N/A
092-9042836	72,576	C	Y	(19,301)
092-9053789	74,411	D	N/A	N/A
092-9060087	94,105	A	N/A	N/A
092-9068413	82,845	C	N	N/A
092-9228763	61,414	D	N/A	N/A
092-9228792	128,720	D	N/A	N/A
093-4979173	106,657	T	N/A	N/A
093-5100268	63,696	C	N	N/A
Totals	\$ 1,583,653			(\$101,621.00)

Status:

T – Terminated, loan paid in full

C – Claim, mortgagee submitted claim to HUD-FHA/foreclosure

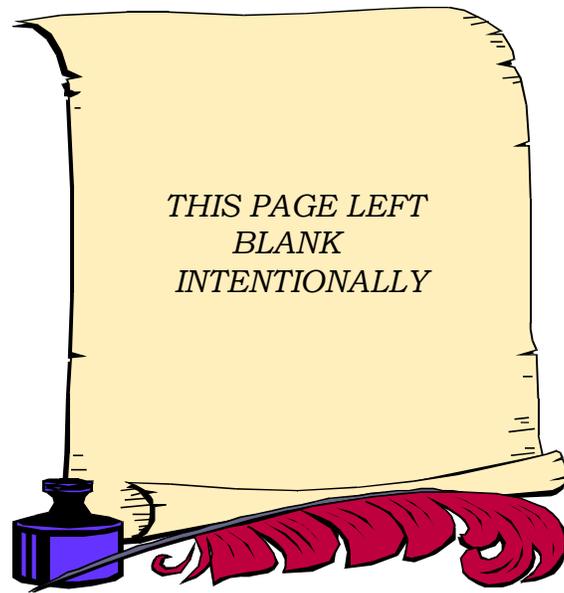
D – Default, loan is still FHA insured but payments have not been made as scheduled.

A – Active, loan is FHA insured. Mortgagor is not in default as of January 20, 2004.

N/A – Not Applicable

N – No

Y – Yes



Case Files Reviewed

(1)

FHA Case Number: 092-8584081
Sponsoring Mortgagee: Irwin Mortgage
Date of Closing: March 27, 2001
Original Principal Balance: \$93,759
Cash Due from Borrower at Close: \$0

Incomplete Loan Application

Preliminary loan application showed \$34,000 in assets not shown on final loan application.
FCM explanation: processing error.

Gift Fund Documentation

Receipt of gift funds from AmeriDream was not documented in FCM's file.

FCM explanation: FCM is generally unable to obtain documentation of receipt of these funds.

Compensating Factors

The debt-to-income ratios were not recomputed when the underwriter increased the mortgage payment. The ratios increased to .3209 and .4324, which are above HUD limits. Before correction, the ratios were .3074 and .4189. The underwriter provided the following compensating factors: 1) minimal credit user, 2) housing cost not increasing substantially, and 3) minimal recurring debt.

OIG analysis: Factors 1 and 3 are synonymous and do not meet HUD guidelines which require a borrower show both a conservative attitude toward credit and an ability to accumulate savings. The increased mortgage payment was a substantial 21 percent increase in housing costs. Thus, each compensating factor was invalid.

(2)

FHA Case Number: 092-8622768
Sponsoring Mortgagee: Irwin Mortgage
Date of Closing: April 19, 2001
Original Principal Balance: \$58,834
Cash Due from Borrower at Close: \$255.86

Credit Analysis

Documentation was not present in the file to substantiate that an acceptable credit history evaluation was performed. The file contained a credit report list of four credit sources, but did not provide outstanding balances and payment history.

FCM explanation: The credit report contained four sources of credit. HUD requirements only require three.

Income Analysis

FCM did not document how it arrived at effective income of \$1,560/mo. FCM's staff stated that it was based on average income for 2001. Using this same data, OIG calculated average monthly income to be \$1366/mo. Based on year-to-date income (including a new raise) OIG calculated effective income to be \$1473/mo. This is a difference of \$87/month.

FCM explanation: FCM staff was unable to explain the discrepancy.

Source of Funds/Verification of Deposit

FCM did not obtain a VOD or document the source of funds. The file contained a deposit slip identifying a \$2,000 deposit to an account. However, the account owner and source of funds was undeterminable from the information provided.

FCM explanation: FCM staff stated that they deemed the deposit slip sufficient documentation for a VOD.

Gift Fund Documentation

Receipt of gift funds from Nehemiah was not documented in FCM's file.

FCM explanation: FCM is generally unable to obtain documentation of receipt of these funds.

Compensating Factors

The mortgage to income ratio was .3325. Three compensating factors were provided, yet only one was acceptable by HUD guidelines. The factors provided by the underwriter were 1) overtime was received, 2) conservative attitude toward credit, and 3) not increasing housing expense. Factor 1 was invalid, because overtime had to be included in FCM's and the underwriter's effective income assessment and because the employer verified it was not likely to continue. Factor 2 was not valid because HUD requires the borrower show both a conservative use of credit and an ability to accumulate savings. Factor 3 was valid.

(3)

FHA Case Number: 092-8666769
Sponsoring Mortgagee: Ivanhoe Financial
Date of Closing: June 27, 2001
Original Principal Balance: \$104,176
Cash Due from Borrower at Close: \$0

Gift Fund Documentation

Receipt of gift funds from AmeriDream was not documented in FCM's file.

FCM explanation: FCM is generally unable to obtain documentation of receipt of these funds.

(4)

FHA Case Number: 092-8709785
Sponsoring Mortgagee: Wells Fargo
Date of Closing: July 24, 2001
Original Principal Balance: \$92,783
Cash Due from Borrower at Close: \$705.63

Overstated Maximum Mortgage

The maximum mortgage basis was overstated by \$677. This was attributable to the difference between the closing costs allowed by the underwriter (and later by FCM) versus the closing costs used by the sponsoring mortgagee in calculating the maximum insurable mortgage. Further, both FCM and the sponsoring mortgagee used an improper form, HUD 92900-PUR, to compute the maximum insurable mortgage. They should have used HUD 92900-WS.

Improper Fees

FCM charged a \$700 'application fee' to the borrower. HUD procedures preclude a lender from charging such fees to the borrower except when making a MAP (mortgage assistance program) loan or bond loan. FCM also received a \$928 discount fee.

FCM explanation: This fee was improperly recorded and should have been recorded as a loan origination fee.

(5)

FHA Case Number: 092-8822776
Sponsoring Mortgagee: Birmingham Bancorp Mortgage
Date of Closing: October 2, 2001
Original Principal Balance: \$76,200
Cash Due from Borrower at Close: \$0

Inaccurate Loan Application

The final loan application did not show all assets that were presented on the initial URLA.
FCM explanation: This was likely a processing error.

Gift Fund Documentation

Receipt of gift funds from Nehemiah was not documented in FCM's file.

FCM explanation: FCM is generally unable to obtain this documentation.

Excess Seller/3rd Party Contributions

Seller contributions exceeded the HUD prescribed limit of 6 percent of sales price by \$419.
HUD program staff identified the excess after we asked them to review the file for potential overage issues.

FCM explanation: FCM attests to seller paying \$2,788.70 in buyer closing costs.

(Auditor Note: FCM does not believe that the 6 percent rule was violated. FCM's explanation does not include \$2,119.10 shown on the HUD-1.)

Overstated Maximum Mortgage

The maximum mortgage basis was overstated by \$515. This was attributable to the difference between the closing costs allowed by the underwriter (and by FCM) versus the closing costs used by the sponsoring mortgagee in calculating the maximum insurable mortgage.

Compensating Factors

The total debt to income ratio was .415. The underwriter provided two compensating factors 1) minimal increase in housing costs and 2) 1-month reserves. The actual increase in housing expense was 13 percent. This is not a minimal increase. Further, HUD regulations require 3-months cash reserves to qualify as a compensating factor. We noted that the borrower did not have a complete 1-month reserve. Thus, there were no valid compensating factors to justify loan approval.

(6)

FHA Case Number: 092-8838493
Sponsoring Mortgagee: Wells Fargo
Date of Closing: October 15, 2001
Original Principal Balance: \$75,602
Cash Due from Borrower at Close: \$0

Gift Fund Documentation

Receipt of gift funds from Nehemiah was not documented in FCM's file.
FCM explanation: FCM is generally unable to obtain this documentation.

(7)

FHA Case Number: 092-8851286
Sponsoring Mortgagee: Wells Fargo
Date of Closing: October 30, 2001
Original Principal Balance: \$85,226
Cash Due from Borrower at Close: \$671.79

Income Analysis

The effective income for one of the borrowers was improperly computed. FCM reported the effective income as \$1,868/mo, but FCM staff was unable to explain how it calculated this amount. Upon reassessing the file, FCM staff arrived at an effective income of \$2,013/mo. This amount improperly included overtime and bonus income that the employer identified as unlikely to continue. OIG calculated effective monthly income as \$1,265/mo. FCM overstated effective income by \$603/mo.

Gift Fund Documentation

Receipt of gift funds from Future Homes was not documented in FCM's file.
FCM explanation: FCM is generally unable to obtain this documentation.

Intent to Occupy

This was a two-bedroom property that was being purchased by two married couples with one child. Documentation indicated that these families had previously lived in separate residences, thus they were 'downsizing' their dwelling size. One of the borrowers did not have a valid driver's license and his previous residence was at his place of employment. Thus, we questioned how the borrower intended to travel back and forth to work, or if he intended to maintain his residence at the workplace. FCM staff did not fulfill their responsibility to gain a complete understanding of the borrower's intended use of the property. We determined that this borrower continued to rent a residence at his workplace, and did not report this as a continuing housing cost on the loan application.

Compensating Factors

The underwriter adjusted the income for one of the borrowers from \$1,868 as reported by FCM to \$2,056/mo. The higher income included bonus and overtime. However, the employer reported these were not likely to continue, and they should have been excluded from the effective income. Based on the income numbers used by the underwriter, the ratios were .19 and .41. However, because FCM did not obtain a complete understanding of the borrower's intent, it did not include the continuing rent in the ratio calculation. Correcting for the rent and overstated income, OIG calculated the ratios at .3171 and .5920. Although the ratios reported by the underwriter were .19 and .41, the underwriter cited two compensating factors: 1) long stable job history and 2) decreasing housing expense. Job stability is not a valid compensating factor per HUD regulations. Actual housing expense increased by 14.6 percent including the unreported rent. Thus, the cited decrease in housing cost was not a valid compensating factor. However, based on the information provided by FCM, the underwriter would not have known about the unreported rent.

(8)

FHA Case Number: 092-8862985
Sponsoring Mortgagee: Irwin Mortgage
Date of Closing: October 30, 2001
Original Principal Balance: \$92,459
Cash Due from Borrower at Close: \$425.90

Source of Funds

FCM did document the availability of funds. The file contained two VODs for a new account, but no explanation as to the source of deposited funds. One of these documents showed \$881 available in checking prior to closing.

FCM explanation: FCM staff stated that payroll was the source of these funds, but it was not documented. They noted that this should have been documented in their file.

Gift Fund Documentation

Receipt of gift funds from Nehemiah was not documented in FCM's file.

FCM explanation: FCM is generally unable to obtain this documentation.

Compensating Factors

The mortgage to income ratio was .371. The underwriter provided three compensating factors: 1) potential for increase in earnings, 2) overtime not used in qualifying, and 3) minimal credit user. The potential for increased earnings was not documented as related to job training or education and thus would not meet HUD guidelines as an acceptable compensating factor. Documented overtime income was only 3.75 hours and was not a valid compensating factor. Finally, although the borrower was a minimal credit user, HUD's requirement states that the borrower must show a conservative attitude toward credit and exhibit an ability to save money. Since no ability to save had been demonstrated, this was an invalid compensating factor.

(9)

FHA Case Number: 092-88780872
Sponsoring Mortgagee: Irwin Mortgage
Date of Closing: November 20, 2001
Original Principal Balance: \$58,834
Cash Due from Borrower at Close: \$0

Inaccurate Loan Application

The initial loan application showed three places of employment. The final loan application omitted a job held from 2/2000 through 2/2001. As a result, FCM did not verify that employment and did not satisfy the requirement to examine a complete 2-year employment history. Further, the sponsoring mortgagee did not note this or take exception to the gap in employment from 3/2000 through 1/2001.

FCM explanation: FCM staff stated that this was a processing error and the employment should have been included on the final loan application.

Gift Fund Documentation

There were multiple gift fund applications in FCM's file, and the receipt of any gift funds was not documented in the file. Additionally, the HUD-1 showed that gifts funds were received from AmeriDream, but the sales contract stated the gift funds were provided by National Home.

FCM explanation: FCM is generally unable to obtain documentation of gift funds. However, the gift fund was properly identified on the HUD-1 and the sales contract should have been changed accordingly.

Compensating Factors

The mortgage to income ratio was .325, exceeding HUD's prescribed limit of .29. The underwriter provided no compensating factors.

(10)

FHA Case Number: 092-8943906
Sponsoring Mortgagee: Wells Fargo
Date of Closing: December 31, 2001
Original Principal Balance: \$68,756
Cash Due from Borrower at Close: \$0

Income Analysis

FCM staff did not properly compute and document their computations of effective income for the borrower. The borrower received non-taxable SSI benefits. FCM elected to 'gross-up' the non-taxable income, a practice accepted by HUD. However, they miscalculated the grossed up income due to a mathematical error. The error understated income by \$33/mo. The loan application also showed that the borrower earned \$740/mo through employment. FCM did not document and its staff could not explain how it calculated this amount. Based on documentation on file, we computed earned income to be \$870/mo.

Verification of Employment

FCM did not verify a full 2-year employment history for the borrower. The loan application showed that the borrower had the same employer for 2-years, but the VOE showed that the applicant had only been employed for 18 months. FCM staff did not follow-up on this discrepancy as required by HUD regulations.

FCM explanation: This was an oversight on FCM's part and should have been caught by the processor.

Compensating Factors

The mortgage to income ratio based on income reported by FCM was .3262. The underwriter revised the income downward, which raised the ratio to .344. The only compensating factor provided by the underwriter was excellent rental history. This is not a valid compensating factor in accordance with HUD guidelines.

(11)

FHA Case Number: 092-9027547
Sponsoring Mortgagee: Wells Fargo
Date of Closing: April 18, 2002
Original Principal Balance: \$96,660
Cash Due from Borrower at Close: \$0

Excess Seller/3rd Party Contributions

Seller contributions exceeded the HUD prescribed limit of 6 percent of sales price by \$28. HUD program staff identified the excess after we asked them to review the file for potential overage issues.

FCM explanation: FCM attests that the seller paid \$6 over the 6 percent limit. FCM staff stated that the lender (Wells Fargo) should not have approved this.

Overstated Maximum Mortgage

The maximum mortgage basis was overstated by \$736. This was attributable to the difference between closing costs allowed by HUD's underwriter (and by FCM) versus closing costs used by the underwriter to calculate the maximum insurable mortgage.

Compensating Factors

The debt to income ratio was .4281, exceeding HUD prescribed limits. The underwriter provided one compensating factor: "a similar payment history." However, information in the case file on prior housing cost was contradictory. The application prepared by the borrower listed his housing cost as \$657/mo. A previous sales contract on the house showed that the seller, who was also the landlord, had previously sold the house to the borrower with seller financing, and \$657 was the monthly payment excluding taxes and insurance. But the landlord/seller later provided a statement that the monthly rent had been \$861. The FHA loan application was presented as a sale, not as a refinancing. The prior sale had not been recorded. There was no evidence that the underwriter confirmed the relevant facts to ensure the compensating factor was valid.

(12)

FHA Case Number: 092-9042836

Sponsoring Mortgagee: Wells Fargo

Date of Closing: April 18, 2002

Original Principal Balance: \$72,576

Cash Due from Borrower at Close: \$0

Compensating Factors

The mortgage to income ratio was .314. The underwriter provided no compensating factors.

(13)

FHA Case Number: 092-9053789
Sponsoring Mortgagee: Wells Fargo
Date of Closing: July 1, 2002
Original Principal Balance: \$74,411
Cash Due from Borrower at Close: \$0

Inaccurate Loan Application

The loan application was not fully supported by the data contained in the credit report. The credit report showed a delinquent liability in the amount of \$7,462 that was reported by FCM to be the student loan identified by the borrower. However, the borrower identified an outstanding balance of \$2,056; a difference of over \$5000 for which there is no explanation in the file. A credit report noted that the borrower had entered into a repayment agreement and these payments were included in the ratio calculations.

Gift Fund Documentation

Receipt of gift funds from National Homes was not documented in FCM's file.
FCM explanation: FCM is generally unable to obtain this documentation.

Excess Seller/3rd Party Contributions

Seller contributions exceeded the HUD prescribed limit of 6 percent of sales price by \$70. HUD program staff identified the excess after we asked them to review the file for potential overage issues.

FCM explanation: FCM attests to seller paying \$3,542 in buyer closing costs. FCM does not believe the 6 percent rule was violated.

Compensating Factors

The mortgage to income ratio of .34 exceeded HUD prescribed limits. The underwriter provided three compensating factors: 1) child support was counted for only 2 of 3 children, 2) tax savings, and 3) client wasn't a credit user. The only valid factor was child support for the third child. Tax savings is not a valid compensating factor and HUD requires that the borrower be both a conservative credit user and show the ability to save money.

Additionally, the underwriter improperly 'grossed up' income from child support. Correcting this income raised the ratios to .3535 and .4150.

(14)

FHA Case Number: 092-9060087
Sponsoring Mortgagee: Wells Fargo
Date of Closing: April 25, 2002
Original Principal Balance: \$94,105
Cash Due from Borrower at Close: \$0

Income Analysis

FCM did not compute income in accordance with HUD guidelines. FCM computed income for the borrower as \$2947/mo based on a flat hourly rate and did not consider any overtime. The applicant routinely received overtime and the VOE attested that it was likely to continue. We calculated income was understated by \$201 per month.

Gift Fund Documentation

Receipt of gift funds from National Homes was not documented in FCM's file.
FCM explanation: FCM is generally unable to obtain this documentation.

Excess Seller/3rd Party Contributions

Seller contributions exceeded the HUD prescribed limit of 6 percent of sales price by \$450. HUD OIG analysis identified this overage.
FCM explanation: FCM attests to seller paying \$4376 in buyer closing costs. FCM does not believe that the 6 percent rule was violated.

(15)

FHA Case Number: 092-9068413
Sponsoring Mortgagee: Wells Fargo
Date of Closing: April 30, 2002
Original Principal Balance: \$82,845
Cash Due from Borrower at Close: \$0

Inaccurate Loan Application

Liabilities reported on loan application were incorrect. A debt of the applicant's ex-spouse was improperly reported as a debt of the applicant, and a derogatory account of the applicant was excluded from the loan application. As a result, debts were slightly understated.

FCM explanation: This was a processing error.

Verification of Employment

FCM accepted a VOE and two explanatory letters that were faxed from the hotel where the borrower was residing. The letters explained a large increase in salary from 2000 to 2001 and a recent promotion. The header on each of these documents clearly identified where the fax originated. Further, the employer phone number on one of the letters did not match the phone number provided on the VOE and neither number agreed with the phonebook number. At the time of the audit, the employer entity was out of business and we could not confirm the employment data.

Gift Fund Documentation

Receipt of gift funds from National Homes was not documented in FCM's file.

FCM explanation: FCM is generally unable to obtain this documentation.

(16)

FHA Case Number: 092-9228763
Sponsoring Mortgagee: MIT Lending
Date of Closing: October 16, 2002
Original Principal Balance: \$61,414
Cash Due from Borrower at Close: \$0

Gift Fund Documentation

Receipt of gift funds from National Homes was not documented in FCM's file.
FCM explanation: FCM is generally unable to obtain this documentation.

Excess Seller/3rd Party Contributions

Seller contributions exceeded the HUD prescribed limit of 6 percent of sales price by \$1,204. HUD program staff analyzed this file when we identified potential overages.
FCM explanation: FCM attests to seller paying \$4,025 in buyer closing costs when they should only have paid \$3,714. FCM staff states that the lender should not have approved this loan to close with this discrepancy.

(17)

FHA Case Number: 092-4979173
Sponsoring Mortgagee: Popular Mortgage
Date of Closing: July 23, 2001
Original Principal Balance: \$106,657
Cash Due from Borrower at Close: \$836.35

Gift Fund Documentation

The file indicates that the applicant received a gift from his aunt. However, there was no verification of receipt of funds from the relative in the FCM file. We later noted that proper documentation was present in the HUD case binder. However, FCM should have documented the gift in their file.

FCM explanation: FCM could not explain why documentation was not present in their file.

Sufficient Funds to Close/Source of Funds

FCM's file contained an ATM receipt showing the account balance of \$2,056.23 as of 6/18/2001, but not a bank statement or VOD. The ATM document is not sufficient to meet HUD requirements and did not identify the source of funds. Complete bank statements, the latest dated 4/10/2001, were present in the HUD case file, but funds available were not sufficient for closing. As of 4/10/2001, the available balance was \$771.87. Again, the source of funds was not identified. The HUD file also contained a copy of the ATM receipt.

(18)

FHA Case Number: 093-4983450
Sponsoring Mortgagee: Transland Financial Services
Date of Closing: May 10, 2001
Original Principal Balance: \$75,652
Cash Due from Borrower at Close: \$0

Income Analysis

Income reported by FCM on the loan application was not supported. The income calculation made by FCM included overtime, but the VOE provided that overtime was not likely to continue. As a result, FCM overstated monthly income by \$160/mo. The sponsoring mortgagee noted this and made the necessary adjustment on the mortgage credit analysis worksheet.

Gift Fund Documentation

Receipt of gift funds from AmeriDream was not documented in FCM's file.
FCM explanation: FCM is generally unable to obtain this documentation.

(19)

FHA Case Number: 093-5100268

Sponsoring Mortgagee: Irwin Mortgage

Date of Closing: September 24, 2001

Original Principal Balance: \$63,696

Cash Due from Borrower at Close: \$196.62

Gift Fund Documentation

Receipt of gift funds from AmeriDream was not documented in FCM's file.

FCM explanation: FCM is generally unable to obtain this documentation.

Excess Seller/3rd Party Contributions

Seller contributions exceeded the HUD prescribed limit of 6 percent of sales price by \$70. OIG analysis identified the overage.



Schedule of Questioned Costs

<u>Recommendation Number</u>	<u>Type of Questioned Cost</u>
3A	<u>Ineligible 1/</u> \$700

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.



Chronology of Key Events – Neighborhood Funding, Inc.

Date	Neighborhood Funding Event/ Information
06/02 thru 02/03	HUD QA review of FCM. QA results shared with FCM, review closed.
01/24/03	NFI incorporated at 3049 Cleveland Ave. Ste 201
03/20/03	HUD notified FCM of potential suspension of authority to originate FHA loans.
06/23/03	HUD suspended FCM in the Coral Gables/Miami area.
06/05/03	Granddaughter of NFI Director obtained mortgage broker license. Address at 3049 Cleveland Ave Ste 200. License expires 8/31/03.
06/26/03	Neighborhood Funding obtained mortgage lender license. Address at 3049 Cleveland Ave Ste 234, exp 8/31/04.
07/01/03	Effective date of fidelity bond for NFI. Address at 1621 N Tamiami Trail Ste 3.
07/01/03	Effective date of omissions and errors insurance for NFI. Address at 1621 N Tamiami Trail Ste 3.
10/02/03	NFI obtained warehouse Letter of Credit. Address at 1621 N Tamiami Trail Ste 3.
11/03/03	NFI applied to HUD for Lender Approval, the “owner’s” resume stated employment with FCM terminated on 01/17/03. NFI financial statements showed \$0 operating expenses thru 9/30/03. Address at 1621 N Tamiami Trail Ste 3.
11/17/03 (on or before)	NFI changed address to 1621 N Tamiami Trail Ste 3 on mortgage lender license.
12/10/03	FCM Vice-President and FCM Operations Manager approved as pre-closing Direct Endorsement Underwriters for NFI
12/11/03	OIG determined that 3049 Cleveland Ave Ste 234 was ‘main contact point’ for NFI.
01/20/04	NFI changed its address with FL Dept of Corp to 1621 N Tamiami Trail Ste 3.
03/2004	OIG determined vacant land owned by NFI, which was \$200,000 capital required by HUD, was acquired from FCM on March 6, 2003. The land was previously acquired by FCM on 4/12/2002 for \$50,000.
04/05/04	Registered Change of Address with Florida Licensing Agency to reflect address at 3830 Evans Avenue, Suite 1A, Fort Myers, FL 33901, Principal Representative of NFI identified (to state licensing agency) as President of FCM Changed address with HUD to 3830 Evans Avenue
04/28/04	Daughter of FCM principals, partial funder of FHFE, and previous Assistant Secretary of FHFE named as President and Director of NFI.



Chronology of Key Events – Family Home Funding Enterprises, Inc.

Date	Family Home Funding Enterprises Event/ Information
06/02 thru 02/03	HUD QA review of FCM. QA results shared with FCM, review closed.
03/20/03	HUD notified FCM of potential suspension of its authority to originate FHA loans.
06/23/03	HUD suspended FCM in the Coral Gables/Miami area.
06/24/03	FHFE incorporated at 3049 Cleveland Ave Ste 201
08/05/03	FHFE obtained Mortgage Lender License. Address listed at 3049 Cleveland Ave Ste 250J .
08/11/03	FHFE changed address with FL Dept of Corp to 3049 Cleveland Ave, Ste 250 J.
09/08/03	FHFE applied to HUD as Non-Supervised Loan Correspondent, Equity Financial Group as Sponsor. Address reported at 13180 North Cleveland Ave., Ste 320. FCM employee shown as President, Sole Director, and 100% owner. Resume of FHFE Director states employment with FCM terminated 6/03. FHFE financial statements showed \$0 operating expenses thru 8/27/03.
09/08/03	FHFE changed office address with State Dept of Corp to 13180 N Cleveland Ave Ste 320, filed on 09/18/03.
11/24/03	FHFE changed its address with FL Dept. of Corp. to 3049 Cleveland Ave., Ste 201. FCM President added as Vice-President of FHFE, named registered agent of FCM's Ohio office (child of FCM owners) as Assistant Secretary of FHFE.
04/01/04	Registered Change of Address with Florida Licensing Agency to reflect address at 2709 Swamp Cabbage Court, Fort Myers, FL 33901 Transfer of ownership of FHFE (via stock certificate exchange) from previously named owner to another FCM employee
04/07/04 (on or before)	Changed Address of FHFE with HUD to 2709 Swamp Cabbage Court
04/28/04	FHFE filed annual report with Florida State Department of Corporations. Named another FCM employee (same as State licensing change) as President and Director. Identified 4066 Evans Ave Ste 18, Fort Myers, FL 33901 as principal place of business. Removed the current President, (former FCM employee) as the President and director. Removed the President of FCM and Registered Agent of FCM's Ohio office as Vice-President/Director and Assistant Secretary/Director of FHFE, respectively.



Auditee Comments

FIRST COMMUNITY MORTGAGE, INC
5120 SW 18TH AVE.
CAPE CORAL, FL 33914
PHONE or FAX: (239) 540-5745
cmsmtgfm@aol. Com

May 11 , 2004

VIA FEDERAL EXPRESS

Mr. James McKay
Regional Inspector General for Audit
U.S. Department of Housing
and Urban Development
District Office of the Inspector General
Office of Audit, Box 42
Richard B. Russell Federal Building
75 Spring Street, SW, Room 330
Atlanta, Georgia 30303-3388

Re: First Community Mortgage, Inc.
Fort Myers, Florida
Office of the Inspector General Audit

Dear Mr. McKay:

The purpose of this letter is for First Community Mortgage, Inc. ("FCM" or "Company") to respond to the draft audit report ("Report") of preliminary findings issued by the District Office of the Inspector General ("OIG") of the U.S. Department of Housing and Urban Development ("HUD" or "Department"). The OIG's audit of FCM, which began on July 21, 2003, reviewed FCM's operations to determine compliance with HUD guidelines in the origination of Federal Housing Administration ("FHA") insured mortgage loans. The OIG's review was conducted between July and September 2003, covered the period between April 1, 2003 and April 30, 2003, and consisted of a review of 19 HUD/FHA insured mortgage loans. We understand that the OIG also conducted audit work at Irwin Mortgage Company, one of FCM's former sponsors, as well as at 14 settlement agents' offices.

The Report contains three findings, in which it alleges that: (1) FCM circumvented HUD's suspension of FCM through the Credit Watch Initiative by creating two new mortgage entities after the suspension of its Fort Myers office through the Credit Watch Initiative; (2) FCM did not adhere to HUD requirements in its origination of certain FHA-insured loans; and (3) FCM did not fully implement its Quality Control Plan. Based on these findings, the Report recommends that HUD suspend the origination

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Based on these findings, the Report recommends that HUD suspend the origination authority of FCM and the two new mortgage entities created by FCM's principals, and debar FCM's principals from further participation in HUD and other federal programs. The OIG provided the Company an opportunity to submit written comments for inclusion in the final report. We appreciate this opportunity to respond to the OIG's recommendations.

I. INTRODUCTION

While FCM responds below to the OIG's individual findings, we would like to generally address the Report's overall allegations against FCM and the two entities created by the owners of FCM. After receiving the Report, FCM conducted a thorough review of the referenced conduct and loan files. We also consulted applicable HUD Handbooks, Mortgagee Letters, and regulations, as well as examined Company policies and procedures, to provide pertinent information and documentation with this response. To the extent necessary to respond to the allegations in the Report, FCM provided information contained in the Report to the principals of the additional two entities that are the subject of the Report, and have included information from these entities in this response.

FCM's review indicated that suspension of the origination authority of the three companies that are the subject of this proceeding, as well as the debarment of FCM's principals, is unwarranted. An initial review of the OIG's Report paints a picture of a nefarious plot by the principals of FCM to circumvent HUD's termination of the Fort Myers office's Origination Approval Agreement in the Miami/Coral Gables jurisdiction through the Department's Credit Watch Initiative. When one closely examines the circumstances surrounding these entities, however, the facts and chronology of the creation of the two new entities demonstrates that most of the OIG's allegations are simply not true. Contrary to the allegation that FCM's owners intentionally tried to circumvent a Credit Watch termination of the Fort Myers office's origination authority in the Miami/Coral Gables jurisdiction, the owners of FCM decided to create new entities for the benefit of their family and slowly close down FCM well before they were made aware of the Department's determination in the Credit Watch proceeding.

As discussed in detail below, FCM's principals were diagnosed with serious illnesses and were approaching retirement in late 2002. In an effort to provide a legacy in the mortgage industry for their children and grandchildren, they began the process of setting up two new mortgage entities and shutting down FCM. The decision of FCM's owners to begin new entities rather than pass on FCM was a business decision to move from loan origination to wholesale lending that was made prior to the receipt of any correspondence from the Department regarding the Credit Watch proceeding. The

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establishment of these entities was an exit strategy for the owners of FCM and a way for them to pass along their mortgage business to their children. FCM has since closed its doors, and NFI and FHFE have been established as viable mortgage entities. We acknowledge that, as a small, family-run mortgage business without in-house counsel or a significant regulatory compliance staff, some technical mistakes were made in establishing these entities. Nevertheless, FCM's owners and the subsequent owners and officers of the new entities acted in good faith and strived to comply with FHA requirements at all times during the establishment of these entities. We are not suggesting that inexperience or lack of in-house counsel is an excuse, or that the entities are not responsible for full compliance with FHA requirements. Nevertheless, the relevant parties to this proceeding acted in good faith at all times in creating the new entities and winding down FCM, and none of these actions threatened the Department or caused harm to the FHA Insurance Fund. Based on these facts, the Report's recommended sanctions are excessive and inappropriate under the circumstances.

Furthermore, in connection with the allegations regarding the 19 loans reviewed by the OIG discussed in Finding 2 of the Report, the Company's review indicated that many of the findings in the Report are at variance with the facts, do not constitute violations of HUD/FHA requirements on the part of FCM, or do not affect the underlying loans' insurability. Importantly, it appears that the Report did not distinguish between the responsibilities and requirements of loan correspondents and sponsoring lenders in originating FHA-insured loans. Many of the findings in the Report go directly to the sponsor's underwriting decisions and not to the processing responsibilities of FCM. As FCM was not responsible and, in fact, was not authorized, to analyze the borrower's credit or make underwriting decisions in these cases, the Company should not be held responsible for any underwriting deficiencies in these cases.

Finally, with regard to FCM's Quality Control practices and procedures, contrary to the allegations in the Report, FCM at all times put forth a good faith effort to implement the Quality Control Plan submitted to the Atlanta Homeownership Center in connection with its prior audit by HUD's Quality Assurance Division. In addition, FCM acted in good faith to comply with HUD guidelines regarding quality control reviews. While FCM's quality control reviews were done on a very small scale, the Company consistently made an effort to conduct reviews in accordance with HUD guidelines. Based on our continuous, good faith efforts to improve our Quality Control Plan and quality control review procedures and act in compliance with HUD requirements, we believe that the recommended sanctions are unwarranted in this instance.

In summary, it appears that the Report chose to present the circumstances surrounding this case in the worst possible light, without regard to many of the facts involved in this case, and recommended the most draconian penalties in connection

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with the entities and their principals. After review of the actual facts and circumstances in this case, as well as the motivation of the individuals who created the entities at issue in the Report, it would be inappropriate for the Department to determine that these individuals and entities are unfit to participate in FHA programs. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate that suspension of the origination authority of FCM, NFI, and FHFE, as well as the debarment of FCM's former principals, is unwarranted. We ask that the OIG revise its recommendations to fit the facts of this case.

II. BACKGROUND

A. First Community Mortgage, Inc.

FCM was incorporated on November 9, 1999. It received approval to participate in the Department's FHA mortgage insurance programs as a loan correspondent on March 1, 2000. Headquartered in Fort Myers, Florida, with two branch offices in Elyria, Ohio and Las Vegas, Nevada, FCM employed between six and fifteen employees during its corporate history. As a loan correspondent, the Company took loan applications, gathered verification forms, as well as credit reports and other required documentation, and submitted loan packages to its sponsors for underwriting. At no time did FCM underwrite or approve the loans that it originated, and therefore did not make any credit decisions. FCM's sponsors are solely responsible for these functions. During the time period relevant to the OIG's audit, FCM's primary sponsors included Irwin Mortgage Company and Wells Fargo Home Mortgage.

As discussed in greater detail below, in 2002, the principals of FCM, [* Owner/President] and his wife [* Owner/Vice-President] (**Exhibit A**), decided to retire from the mortgage industry based on a combination of age, serious health problems, and the onset of social security retirement benefits. Wishing to pass their mortgage expertise onto their children and grandchildren, but realizing how little control over the origination process a loan correspondent has, the [*] decided to slowly wind up FCM and create a separate mortgage lender with full underwriting authority for their heirs. The [*] began the process of establishing two new companies for the benefit of their family members in January of 2003. As discussed below, these entities, Neighborhood Funding, Inc. ("NFI") and Family Home Funding Enterprises, Inc. ("FHFE") were formed and obtained HUD approval in 2003. After fully establishing independent mortgage businesses for their families, the [*] closed FCM's doors to the public and voluntarily terminated the Company's FHA origination authority on April 15, 2004 (**Exhibit B**). While FCM has ceased doing business, we wish to preserve our reputation and the reputation of FCM, as well as the viability of the mortgage entities created for

[*] Names of individual principals, family members, FCM employees, and borrowers were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

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the [*] family's future. Thus, we are responding to the allegations made in the Report.

FHA lending constituted approximately 95% of FCM's business operations. FCM was committed to working with marginal borrowers and concentrated its origination efforts in the minority and underserved communities in South Florida. Because FHA lending represented a significant portion of FCM's overall production, the Company remains committed to its relationship with the Department and takes its responsibilities under the FHA program seriously. While in operation, we were dedicated to working with HUD to extend credit to qualified borrowers, and we would never knowingly violate FHA requirements nor endanger the reputation of the Company or its employees.

B. Neighborhood Funding, Inc.

In 2002, the owners of FCM were diagnosed with serious illnesses. [*] was diagnosed with lupus on February 23, 2002 (**Exhibit C-1**). [*] was diagnosed with chronic obstructive pulmonary disease ("COPD") on April 18, 2002 (**Exhibit C-2**). After being diagnosed with these serious illnesses, and with retirement benefits on the horizon for both, the owners of FCM decided to begin the process of turning their mortgage business over to their children and grandchildren. In 2002, FCM's Fort Myers and Elyria, Ohio offices were audited by the HUD's Atlanta and Philadelphia Quality Assurance Divisions in June and May, respectively. While those audits were resolved on February 11, 2003 and August 14, 2003 (**Exhibit C-3**), during the course of the audits, FCM realized how little control a loan correspondent has over the mortgage process and the performance of the loans it originates by not being able to underwrite or service these loans. For example, based on the terms of agreements with sponsoring lenders, loan correspondents are not permitted to contact borrowers after closing and receive little if any information regarding a borrower's performance until a loan is seriously delinquent. As the owners of FCM had experienced first-hand through the Quality Assurance Division audits how loan correspondents may be held responsible for the actions of others over which the correspondent cannot control, the owners determined that the best course of action was to give their children and grandchildren control of their own destiny. Therefore, the [*] decided to establish a wholesale lender with non-supervised Direct Endorsement authority.

To this end, on January 24, 2003, two months before FCM received the March 20, 2003 letter informing the Company of the Credit Watch termination proceeding, and almost six months before the Coral Gables Origination Approval Agreement was terminated, NFI was incorporated (**Exhibit C-4**). The Articles of Incorporation listed [* FCM Vice-President] as the sole owner and director of NFI, and listed the new entity's

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address as 3049 Cleveland Avenue, Suite 201, Fort Myers, Florida 33901 (**Exhibit C-4**). NFI was established with the intent to create a wholesale mortgage lender that engaged in third party originations as a sponsoring lender. At no time did any of the principals of NFI intend for the company to originate loans in its name and, in fact, to date NFI has not originated a loan in its name. On March 14, 2003, NFI relocated to 3049 Cleveland Avenue, Suite 234, Fort Myers, Florida 33901, and [* FCM President] was added as an officer of the Company (**Exhibit C-5**), and briefly had complete ownership of NFI (**Exhibit C-6**).

As explained in [* granddaughter's] letter to the OIG dated March 9, 2004 (**Exhibit C-7**), the [*] desired to pass this new entity to their daughter, [*]. [*], however, is located in Ohio and has children who are still in high school. As [*] did not intend to relocate to Florida until June of 2004, the [*] transferred ownership to her daughter, [*], in the interim. Contrary to the allegation in the Report, [*] is the granddaughter, not the niece, of the [*].

At its inception, NFI could not open for business as a mortgage entity until it and its principals obtained the requisite licensing, approval, and credit line to operate as a wholesale lender. In preparation to take over NFI and establish its current "shell" into a mortgage lender, [* granddaughter] completed the requisite state and federal training courses to manage an FHA-approved wholesale lender. [*] completed FHA Direct Endorsement Training in February of 2003 (**Exhibit C-8**), and obtained her individual mortgage broker license from the state of Florida on June 5, 2003 (**Exhibit C-9**). As a state-licensed mortgage broker, [*] obtained a mortgage lender license for NFI from the state of Florida on June 26, 2003 (**Exhibit C-10**). Once [*] and NFI were properly licensed under Florida law, the [*] transferred ownership of NFI to [* granddaughter] on July 2, 2003 (**Exhibit C-11**).

As the corporation was finally licensed as a mortgage lender, it could legally open for business. Thus, [* granddaughter] set out to obtain a warehouse line and purchasing investors. [*] secured a warehouse line of credit from PCFS Mortgage Resources on October 2, 2003 (**Exhibit C-12**). NFI received its initial operating income on October 31, 2003, after obtaining the line of credit, when NFI closed its first, conventional loan.

After NFI became operational in October of 2003, NFI relocated to a larger office at 1621 Tamiami Trail, Suite 3, North Fort Myers, Florida 33917. NFI began paying rent for this office space in November 2003 (**Exhibit C-13**). While the company informed the Florida Department of Financial Services of NFI's new address and applied for FHA-approval from this new location, NFI inadvertently overlooked its corporate filing with the

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Florida Department of State regarding the address change. Upon discovering this oversight, NFI immediately filed the necessary corporate amendment regarding the address change (**Exhibit C-14**).

On November 24, 2003, after the Department reviewed NFI's application and audited financials, NFI received approval as a HUD/FHA non-supervised mortgagee (**Exhibit C-15**), and, on December 10, 2003, received approval to submit mortgages in the Direct Endorsement program for pre-closing review (**Exhibit C-16**). Since obtaining FHA approval, NFI has grown beyond the capacity of the Tamiami Trail office. Thus, it has relocated to 3830 Evans Avenue, Suite 1-A, Fort Myers, Florida 33901, its current registered address with the state of Florida and the Department (**Exhibit C-17**).

Finally, on April 20, 2004, the ownership of NFI was transferred from [* granddaughter] to her mother, [*], who was the [*] ultimate intended recipient of this new mortgage entity (**Exhibit C-18**). [* granddaughter] is expecting a child shortly, and [* daughter] has purchased property in Florida to accommodate her impending relocation from Ohio to South Florida (**Exhibit C-19**). Thus, to accommodate these changes, [* daughter] has taken control of NFI as the sole director, owner, and president of NFI (**Exhibit C-17**).

C. Family Home Funding Enterprises, Inc.

In approximately May of 2003, as NFI was being established, some of the [*] children and grandchildren expressed an interest in remaining in the loan origination business, instead of participating in the wholesale lender business being established. One of these children, [* daughter], pledged the assets for the new entity. As discussed above, however, [*] was located in Ohio and was not licensed as a mortgage broker under Florida law, but wanted to establish the new entity in Florida because she intended to relocate from Ohio to Florida in 2004. As the [*] had made a business decision in 2002 to wind up and close the doors of FCM, many of FCM's loan officers were aware that they would be unemployed upon the closing of FCM. One such loan officer was [*FCM Employee 1], a friend of the family. [*FCM Employee 1] expressed an interest in participating in the new corporation being set up for the benefit of the [*] heirs. As [*] was located in Florida and had a Florida broker's license, the [*] agreed to allow [*] to participate in the new venture.

To establish the new entity, [* FCM Vice-President] incorporated FHFE. [*] requested the corporate documentation on or around June 20, 2003. The incorporation documents were filed by the Florida Division of Corporations on June 24, 2003 (**Exhibit D-1**); however, the Division of Corporations received and reviewed the documents,

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accepted the corporate filing, and charged [* FCM Vice-President] the incorporation fees on June 23, 2003 (**Exhibit D-2**), the day before FCM received a letter sustaining the termination of the Company's origination authority in the Miami/Coral Gables jurisdiction. The initial address for FHFE was 3049 Cleveland Avenue, Suite 201, Fort Myers, Florida 33901 (**Exhibit D-1**). A few days after incorporating the new entity on her children's behalf, on July 2, 2003, [*] transferred ownership of FHFE to [* FCM Employee 1] (**Exhibit D-3**), who became the President and sole Director of FHFE (**Exhibit D-4**).

To begin establishing FHFE as a mortgage broker, [* FCM Employee 1] began the state licensing process and rented a small executive office for the corporation at 3049 Cleveland Avenue, Suite 250-J, Fort Myers, Florida 33901 (**Exhibit D-5**). FHFE obtained a correspondent mortgage lender license on August 5, 2003 (**Exhibit D-6**). On August 27, 2003, FHFE obtained audited financials from an independent account in preparation for its FHA application (**Exhibit D-7**). In September of 2003, [* daughter] deposited \$21,671 into a money market account established for FHFE (**Exhibit D-8**). Also in September of 2003, FHFE moved from its executive office to 13180 North Cleveland Avenue, Suite 320, North Fort Myers, Florida, 33903 (**Exhibit D-9**), a larger office that could accommodate a mortgage origination business. Finally, FHFE applied for FHA approval as a loan correspondent and, on October 31, 2003, received approval from the Department (**Exhibit D-10**). FHFE began making loans in December of 2003.

In November of 2003, [*FCM Vice-President] approached [*FCM Employee 1] and offered FHFE office space in Suite 201 at the 3049 Cleveland Avenue address. Suites 200 and 201 had been separated by walls at that time, and [*] stated that FHFE could take over Suite 200 when FCM closed in doors in the spring of 2004. [* FCM Employee 1] agreed and FHFE relocated to the Suite 201 offices (**Exhibit D-11**). At that time, [* FCM President] and [* daughter] were added as officers of FHFE to facilitate the establishment of an Ohio branch office of FHFE for one of the [*] grandchildren who intends to remain in Ohio (**Exhibit D-11**). After this relocation, however, the owner of the building raised the rent by \$635 per month. As FHFE was able to find adequate office space for less than the increased rent, FHFE again moved its operations to its present location at 2709 Swamp Cabbage Court, Fort Myers, Florida 33901 (**Exhibit D-12**). While at this location, FHFE has been in the process of renovating a larger office complex, and plans to move to a new office building in the new future.

In early 2004, [* FCM Employee 1] decided to leave FHFE. As FCM was within days of closing its doors, when an FCM employee, [* FCM Employee 2], expressed an interest in replacing [*]. Thus, on April 1, 2004, [*] transferred his ownership interest in FHFE to [*] (**Exhibit D-13**). [* FCM Employee 2] is currently the majority owner and sole officer of FHFE (**Exhibit D-14**).

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III. RESPONSE TO THE FINDINGS

As previously noted, the Report contains three findings with recommendations for action by HUD and the Departmental Enforcement Center. Contrary to the allegations in the Report, however, FCM and its principals substantially adhered to FHA requirements identified therein and their actions did not harm the FHA Insurance Fund. We address each finding in turn below.

A. Finding 1 - Incorporation of New Mortgage Entities

1. **FCM Did Not Intend to Circumvent the Credit Watch Termination When It Established NFI and FHFE**

In Finding 1, the Report alleges that FCM's owners effectively circumvented HUD's suspension of FCM in a termination proceeding under the Department's Credit Watch Initiative by creating two new mortgage companies and obtaining HUD approval for them to originate loans. The Report alleges that these entities were created to "continue business as usual" after the Credit Watch "suspension." The Report suggests that the alleged violations increased the risk to the FHA Insurance Fund and recommends that HUD withdraw the origination authority for FCM, NFI, and FHFE and invoke civil money penalties and that the Departmental Enforcement Center debar the principal officers of FCM from participation in federal programs and consider debarring the principals of NFI and FHFE.

Contrary to the allegations in the Report, at no time did FCM intend to circumvent HUD guidelines when its principals established the two mortgage entities. As discussed above in the introduction section of this response, the owners of FCM decided in late 2002, after being diagnosed with serious illnesses, to exit the mortgage industry and pass their business to their children and grandchildren. After being subject to two audits by the Department's Quality Assurance Divisions, the owners of FCM realized how little control a loan correspondent has over the loan process and the loans for which it is responsible. Thus, the owners initially decided to slowly wind down FCM's operations and incorporate a new entity that would engage in wholesale lending and third party originations. The [*] incorporated NFI in January of 2003 to accomplish this goal (**Exhibit C-4**). After discussing their plans to close FCM with their children and grandchildren, the [*] discovered that some of them desired to remain in the loan origination business. Thus, in June of 2003, the [*] incorporated a second company, FHFE, which they intended to act as the loan originating company for their children after FCM was closed. The new companies obtained authority to engage in the mortgage business in Ohio for the benefit of the [*] grandchildren as well. At least one grandchild intends to remain in Ohio, and the Ohio business licenses were obtained

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by NFI and FHFE for his benefit, not, as the Report suggests, to circumvent any suspension of the Ohio office of FCM. As discussed below, FCM was never suspended in Ohio.

The decision to create, and the process of creating, the two new mortgage entities was undertaken before FCM was made aware of the possible termination of its origination authority in HUD's Miami/Coral Gables jurisdiction. FCM received a letter from the Department dated March 20, 2003 informing the Company that HUD was considering terminating FCM's authority to originate FHA-insured loans from its Fort Myers office in HUD's Miami/Coral Gables jurisdiction (**Exhibit E-1**). After submitting a written response to the Department and engaging in an informal hearing via telephone with Department officials to discuss the termination notice, on June 24, 2003, FCM received a letter from HUD, dated June 23, 2003, indicating that the Department had terminated the Company's Origination Approval Agreement in the Miami/Coral Gables jurisdiction (**Exhibit E-2**). As discussed above, however, NFI was incorporated on January 24, 2003 (**Exhibit C-4**), two months before FCM received the March 20, 2003 letter and almost six months before the Coral Gables Origination Approval Agreement was terminated. In addition, FHFE's incorporation documents were submitted to the Florida Division of Corporations, and were reviewed, accepted, and paid for on June 23, 2003, the day the termination notice was issued. Therefore, FHFE was effectively created the day before FCM was made aware of the termination of its origination authority in the Miami/Coral Gables jurisdiction. The timing of the [*] decisions to incorporate two new mortgage entities evidence that they did not intend to circumvent the Credit Watch termination proceeding.

The allegations in the Report that the incorporation of these two entities was an attempt to continue FCM's "business as usual" are also incorrect. As discussed above, the owners of FCM decided to close their business and retire from the mortgage industry. These new, independent entities were created for the benefit of their children and grandchildren. As discussed in detail in the background section above, one of these entities, NFI, does not engage in loan origination, which was FCM's primary business as a loan correspondent, and has never originated a loan in its own name. Furthermore, while FHFE was incorporated with the intent to originate loans, the process of establishing FHFE with the proper licensing and approvals took months and the company did not begin originating loans until December of 2003, six months after FCM lost its origination authority in the Miami/Coral Gables jurisdiction. Thus, FCM's business did not move forward uninterrupted through these companies. Rather, FCM slowly wound down its loan origination business, as the owners decided to do in 2002, and the new, independent agencies were slowly established as a wholesale lender and loan correspondent for the benefit of persons other than the owners of FCM.

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Finally, circumvention of the Credit Watch "suspension" of FCM was unnecessary. As the OIG and the Department are aware, Credit Watch termination proceedings do not "suspend" a company from originating all FHA-insured loans. Rather, Credit Watch proceedings apply only to the specific office named in the termination notice and only terminate a company's origination authority in a specific FHA jurisdiction. In this case, the Credit Watch proceeding was limited to the Fort Myers office's authority to originate FHA-insured loans in the Miami/Coral Gables jurisdiction (**Exhibits E-1 and E-2**). At the time of the termination, FCM had two other branch offices with origination authority that were unaffected by the proceeding (**Exhibit B**). Furthermore, the Fort Myers office maintained origination authority in three other Florida jurisdictions after its Origination Approval Agreement was terminated in the Miami/Coral Gables jurisdiction (**Exhibit E-3**). Therefore, contrary to the allegations in the Report, FCM was not "suspended" from participation in FHA programs as a result of the Credit Watch termination proceeding. FCM retained authority to, and in fact did, engage in FHA originations in other Florida jurisdictions from its Fort Myers office and in its two branch offices after receiving the June 23, 2003 termination letter. As the Company maintained the ability to originate FHA loans in other offices and FHA jurisdictions, any effort to circumvent the termination of its Origination Approval Agreement in one FHA jurisdiction was unnecessary and certainly not a motive for creating NFI or FHFE.

In summary, as demonstrated by the attached documents, the owners of FCM at no time intended to circumvent FCM's Credit Watch termination of origination authority in the Miami/Coral Gables jurisdiction. FCM was a small company owned and operated by two individuals desiring to provide for their family. The owner's incorporation of two new entities was an exit strategy for them out of the mortgage business and into retirement to deal with their health issues. These companies were created for reasons wholly apart from the termination of FCM's origination authority in one of the jurisdictions in which it was approved to engage in FHA lending. In addition, the incorporations were undertaken before FCM was informed that its Origination Authority Agreement for the Miami/Coral Gables jurisdiction had been terminated, and FCM did not need to circumvent the suspension, as it was still able to originate loans in other jurisdictions in Florida and through other branch offices. As the actions of the owners of FCM were not intended to circumvent the Credit Watch proceeding, we believe that the Report's recommendations regarding the suspension of the companies and the debarment of FCM's principals is unwarranted in this instance.

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2. Employees of NFI and FHFE Were Exclusive at All Relevant Times

a. NFI Employees

Finding 1 further alleges that FCM's officers created, and FCM's employees were named as officers of, the two new entities while the employees were still working for FCM. In connection with NFI, Finding 1 specifically alleges that: (1) the owners of FCM were named the initial owners and directors of NFI; (2) the owners of FCM transferred ownership to [* granddaughter]; and (3) [* granddaughter] continued to work for FCM until October 2003, contrary to her resume supplied to the Department.

The owners of FCM, as well as the officers and employees of NFI, understand and appreciate that all employees of FHA-approved entities, except receptionists, must be employed exclusively by the mortgagee at all times, and conduct only the business affairs of the mortgagee during normal business hours and may not have additional employment in the mortgage or real estate industry. HUD Handbook 4060.1 REV-1, ¶ 2-14; Mortgage Letter 94-39. The owners of FCM and NFI are also aware that senior corporate officers of FHA-approved entities are required to spend their full time on the mortgagee's operations. HUD Handbook 4060.1, ¶11 2-11 (A). Notwithstanding this requirements, FHA guidelines permit corporate officers to represent more than one company, provided that: (1) there is a clear and effective separation of the two entities and mortgagors know at all times exactly with which entity they are doing business; and (2) there is a duly constituted senior corporate officer designated to conduct exclusively the affairs of the mortgagee during normal business hours. Id. ¶ 11 2-11 (8). The officers and employees of FCM and NFI substantially complied with these requirements.

With respect to the allegation that FCM's owners were the initial corporate officers and owners of NFI before transferring the company to [* granddaughter], the owners of FCM acknowledge this fact. As discussed above, the [*] initially incorporated a shell corporation in January of 2003 to begin the process of establishing a wholesale lender for their children and grandchildren. The [*] relied on their business experience to begin this process as their granddaughter, [*], was obtaining the requisite training to take over the shell corporation and establish it as a wholesale lender. Upon her completion of this training, the [*] transferred ownership to [* granddaughter] in July of 2003 (**Exhibit C-11**).

At all times during the [*]'s ownership of NFI, the new entity was a non-functioning, shell corporation. The company was not licensed in the state of Florida, was not approved to engage in FHA lending, and did not have a warehouse line of

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credit enabling it to engage in mortgage lending. The [*] merely began the process of establishing the corporate entity for their heirs, and transferred ownership of the entity to their granddaughter upon her obtaining the requisite training. NFI was transferred to [* granddaughter] immediately upon its license as a mortgage lending entity and prior to its approval by HUD as a mortgagee. At no time did the [*] engage in any substantive business through NFI. Rather, the [*] spent their full time on the operations of FCM in accordance with FHA guidelines and, where they served as joint officers, FCM had a senior corporate officer dedicated to FCM's operations and NFI was essentially a non-functioning start-up entity without any corporate responsibilities for the officers to fulfill.

With regard to the allegations concerning [* granddaughter], at all times during which NFI was operational and open to the public, [* granddaughter] was exclusively working at NFI and serving as its senior corporate officer. As discussed above, [* granddaughter] took over ownership of NFI in July of 2003 (**Exhibit C-11**), but did not obtain a warehouse line of credit to engage in business until October 2, 2003 (**Exhibit C-12**). By that time, [* granddaughter] had completely ceased her employment with FCM and was concentrating her full efforts on NFI's success. Prior to that time, although [* granddaughter] had ceased her employment with FCM, she was included on the payroll of FCM to maintain her health benefits. [*] was expecting a child and her grandparents, the owners of FCM, wanted her to receive health benefits even as she established NFI. Thus, after consulting with [*], a compliance officer in the U.S. Department of Labor's Wage and Hour Division, the owners of FCM retained [* granddaughter] on FCM's payroll to maintain her health benefits. While this decision gave the appearance that [*] was still working at FCM, she had already left her duties at FCM to concentrate her efforts on NFI.

Finally, [* granddaughter] was exclusively employed by and working for NFI at the time NFI applied for and received HUD approval in November of 2003. [* granddaughter], however, acknowledges that her resume incorrectly stated that she had been so exclusively employed by NFI since its incorporation in January of 2003; however, as discussed above, [*] remained employed by FCM until NFI began obtaining the requisite licensing and credit line. [* granddaughter's] resume should have more properly stated that she did not begin employment with NFI until the entity was properly licensed and had obtained a warehouse line of credit enabling the entity to actually conduct business. Employment situations similar to [*granddaughter's] are fairly common in established mortgage entities when the established entity sets out to incorporate subsidiaries or affiliated entities. Often, the established entity wishes to transfer employees to the new entity; however, such employees understandably do not want to forego salaries and health benefits while the new entity obtains requisite licensing and capital. Under such circumstances, lenders often inform the Department's Office of

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Lender Approval and Recertification Division that employees of an established mortgage business will be reassigned to the new mortgage entity once it becomes operational. Had NFI taken this approach when submitting her resume to the Department, [*granddaughter's] employment likely would not have been at issue.

In summary, the corporate officers of FCM complied with HUD requirements in their incorporation of NFI. In addition, while [*granddaughter's] resume and appearance on FCM's employee list after NFI was incorporated suggest that [*] did not adhere to HUD's exclusivity requirements, [*]'s continued employment by FCM was for the purpose of continuing to receive health benefits through her pregnancy, not to engage in substantive loan origination activities. While inaccuracies occurred in [*]'s employment documentation, at no time while NFI was operational or approved by the Department did [*] perform work for another company. Since NFI has become operational, [*] has been exclusively employed by NFI. Given that [*] was exclusively employed by only one operational company at any time, we maintain that the Report's recommendation to debar these individuals or suspend NFI is inappropriate in this instance.

b. FHFE Employees

In connection with FHFE's officers and employees, Finding 1 specifically alleges that: (1) the owners of FCM were named the initial owners and directors of FHFE; (2) the owners of FCM transferred ownership to a loan officer who was employed by FCM at the time; and (3) employees of FHFE submitted resumes to HUD listing them as employees of FHFE while the employees were still employed by FCM.

With respect to the allegation that FCM's owners were the initial corporate officers and owners of FHFE before transferring the company to [* FCM Employee 1], the owners of FCM acknowledge this fact. As discussed above, the [*] initially incorporated a shell corporation in June of 2003 to begin the process of establishing a loan origination entity for their children and grandchildren who wished to continue in this line of business after FCM ceased doing business. The [*] relied on their business experience to begin this process and subsequently transferred ownership to [* FCM Employee 1] in July of 2003 (**Exhibit D-3**). As with NFI, above, at all times during the [*] ownership of FHFE, the new entity was a non-functioning, shell corporation without state licensing or federal approval. The [*] merely began the process of establishing the corporate entity for their heirs. At no time did the [*] engage in any substantive business through FHFE. Rather, the [*] spent their full time on the operations of FCM in accordance with FHA guidelines and, where they served as joint officers, FCM had a senior corporate officer dedicated to FCM's operations.

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With regard to the allegations in the Report concerning [* FCM Employee 1], at all times during which FHFE was operational and open to the public, [* FCM Employee 1] was exclusively working at FHFE and serving as its senior corporate officer. As discussed above, [*] took over ownership of FHFE in July of 2003 (**Exhibit D-3**), but the entity did not obtain a state license to engage in loan origination until August 5, 2003 (**Exhibit D-6**) and did not obtain FHA approval until October 31, 2003 (**Exhibit D-10**). By that time, [* FCM Employee 1] had completely ceased his employment with FCM and was concentrating his full efforts on FHFE's success. We acknowledge that while [*] resume incorrectly indicated that he ended his employment with FCM in June of 2003, [*] remained with FCM for a few more months to close out his existing files and await approval of the new entity as a viable mortgage entity.

With regard to the allegations regarding the two employees whose resumes were submitted with FHFE's FHA application, [*FCM Employee 3] and [* FCM Employee 4], at no time during which FHFE was operational and open to the public did these employees engage in non-exclusive employment. As discussed above, FHFE did not obtain FHA approval until October 31, 2003, and did not begin originating loans until December of 2003. While the resumes submitted to HUD incorrectly listed FHFE's incorporation date as the employees' start date, these employees did not cease working for FCM until FHFE became a viable mortgage business able to originate loans. In the months between FHFE's incorporation and its establishment as an operational mortgage business open to the public, [* FCM Employee 3] served as FCM 's receptionist and performed FCM's quality control on a contract basis. [*]'s income from FCM ceased in July of 2003 (**Exhibit E-4**). [* FCM Employee 4] was employed as a fee processor for FCM during this period. While their resumes reflect earlier start dates at FHFE, these employees were not engaged in business on behalf of FHFE until it obtained the proper approvals and opened to the public. Furthermore, neither employee engaged in loan origination activities for FCM, but rather performed clerical and ministerial duties.

With regard to the allegations concerning the initial employees of FHFE, as discussed above, employment situations similar to these circumstances are fairly common in established mortgage entities when the established entity sets out to incorporate subsidiaries or affiliated entities. Under such circumstances, lenders often inform the Department's Office of Lender Approval and Recertification Division that employees of an established mortgage business will be reassigned to the new mortgage entity once it becomes operational. Had FHFE taken this approach when submitting her resume to the Department, the employment allegations regarding FHFE likely would not have been at issue.

We appreciate that FHFE employees' resumes should have reflected the employees' actual start dates and not the incorporation date of FHFE. Furthermore, we

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understand and appreciate that employees of FHA-approved entities must strictly adhere to FHA requirements regarding exclusive employment. While we acknowledge that some overlap in employment by FHFE and FCM occurred, at no time did such overlap occur when FHFE was a viable mortgage business open to the public. Thus, we do not believe that the harsh sanctions recommended by the OIG are warranted in this instance.

3. NFI and FHFE Established Separate Office Space Upon Becoming Licensed Mortgage Entities

Finding 1 alleges that both NFI and FHFE were incorporated using an address that, while listed as a different suite number, was the same office space in which FCM was located. In connection with NFI, the Report alleges that NFI had a storefront sign in front of the office complex where FCM was located, and the OIG determined that complex to be NFI's main contact point with the public in December of 2003; however, HUD documentation listed a different address for NFI. Finding 1 further alleges that NFI's corporate licenses and documentation listed an address different than the one listed in HUD's documentation. In connection with FHFE, Finding 1 alleges that FHFE had a storefront sign in front of FCM's office complex and was located in the same office space as FCM. Finding 1 also alleges that FHFE changed its address back to the complex address where FCM was located and added officers, including [* daughter] and [* FCM President], to its list of directors.

With regard to the allegation concerning the incorporation address of NFI and FHFE, we acknowledge that both entities were incorporated using the address of 3049 Cleveland Avenue, Suite 201. Nevertheless, the use of the Suite 201 address to establish these two shell corporations constituted, at worst, harmless error. At the time these entities were listed as being located at this address, both were shell corporations without state licensing, FHA approval, or employees. HUD requirements regarding the separate of office space are in place to ensure that the public can easily locate and discern mortgage companies. In this case, NFI and FHFE were not open to the public during their brief tenures at Suite 201 in the Cleveland Avenue building and, at all times during its location there, it was clear to the public that FCM was operating out of Suite 200. Both entities were quickly relocated to separate office space to obtain licenses, approvals, and hire employees. NFI was relocated to separate office space in Suite 234 in March of 2003 (**Exhibit C-5**), two months after incorporation, and FHFE was relocated to Suite 250J a few weeks after incorporation in June of 2003 (**Exhibit D-5**). Both entities relocated to completely different office buildings before becoming operational and holding themselves out to the public (**Exhibits C-13, C-14 and D-9**). Thus, while the official addresses of these two entities at their inception placed them in

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the same office space at FCM, NFI and FHFE did not engage in business or make contact with the public from this space.¹

In connection with the allegations regarding NFI's conflicting addresses, the differing addresses listed in NFI's corporate documentation and in HUD's documentation occurred because NFI inadvertently omitted filing a change of address with the state of Florida. Contrary to the allegation in Finding 11 NFI's main point of contact with the public in December of 2003 was its location at Tamiami Trail, where it moved and began paying rent in November of 2003 (**Exhibit C-13**). NFI filed its address change to the Tamiami Trail location with the Florida Department of Financial Services at the time of the relocation, as well as with HUD in accordance with its filing requirements for location changes. See HUD Handbook 4060.1 REV-1, ¶ 2-21. Unfortunately, NFI inadvertently omitted filing a corporate resolution of address change with the Florida Department of State. When NFI realized its oversight, the company immediately filed the requisite corporate amendment with the Secretary of State on January 20, 2004 (**Exhibit C-14**). Currently, all state and HUD records demonstrate NFI's current address, which is located at 3830 Evans Avenue (**Exhibit C-17**). With regard to the storefront sign, NFI placed the sign in front of the office complex while it was located in Suite 234 of that building. As explained in [* granddaughter's] March 9, 2004 letter to the OIG, this sign was abandoned when NFI relocated to the Tamiami Trail address, as the sign did not fit in the new location (**Exhibit C-7**).

In connection with the allegations regarding FHFE, as discussed in detail above, FHFE relocated several times during its brief corporate history to accommodate its loan origination activities. In December of 2003, FHFE relocated to the Suite 201 office at the 3049 Cleveland Avenue address (**Exhibit D-11**). This relocation was not accomplished to merge the two entities or to do business from the same location. To the contrary, this relocation complied with HUD requirements, as Suite 201 had been separated from Suite 200 in compliance with HUD requirements and, as the OIG acknowledges in the Report, FHFE displayed a door-front sign and was the prominent entity in Suite 201. In addition, FCM was in the process of closing, and FHFE was aware that Suite 200 would become available when FCM closed its doors and vacated the space. Thus, the storefront sign in front of this office complex accurately informed the public of FHFE's location inside the building. When the owner of the building, however, raised the rent on this office space, FHFE relocated to its present location at

¹ Please note that, as discussed above, FHFE did relocate to Suite 201 after it obtained state licensing and FHA approval and began engaging in business (**Exhibit D-11**). This relocation occurred after Suites 200 and 201 had been separated in accordance with HUD guidelines and could clearly be identified to the public as separate and apart from FCM, which was winding up its operations at the time.

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2709 Swamp Cabbage Court, Fort Myers, Florida 33901 (**Exhibit D-12**). With regard to the allegation concerning the addition of directors to FHFE, [* FCM President] and [* daughter] were added to FHFE's board to facilitate state licensing of the entity in Ohio. FHFE sought to establish a branch office in Ohio for one of the [* grandchildren, who intends to remain in Ohio. [*FCM President] and [* daughter] have since been removed as directors of FHFE (**Exhibit D-13**), and [* daughter] has purchased property in anticipation of relocating to Florida (**Exhibit C-19**).

In summary, while we appreciate that HUD-approved lenders must strictly adhere to all FHA requirements, and that separate office space should have been established for NFI and FHFE prior to incorporation, we do not believe that this oversight should result in the termination of NFI's origination authority or the debarment of the principals of FCM or NFI. The above discussions demonstrate that NFI and FHFE: (1) were merely shell corporations with no corporate function during their initial location in Suite 201; (2) otherwise strictly complied with HUD's office space requirements; and (3) maintain separate locations from FCM and each other throughout the remainder of their corporate histories. Based on these facts, we believe that the Report's recommended sanctions would be overly harsh and are not appropriate in this circumstance.

4. NFI Satisfied the Requisite Net Worth Requirements

Finally, Finding 1 alleges that the OIG's computerized searches of county land records did not uncover any land or other assets owned by NFI, although NFI's primary corporate asset used to satisfy its net worth requirement was land. Furthermore, the timeline submitted during the OIG's exit interview alleges that the vacant land owned by NFI that was valued at \$200,000 in NFI's FHA application was purchased from FCM on March 6, 2003 for \$39,100.

With regard to the allegation that NFI does not own the land listed as its corporate asset, we respectfully disagree. As discussed in [* granddaughter's] March 9, 2004 letter to the OIG, there was an apparent clerical error at the Lee County recording office, where the property in question is recorded (**Exhibit C-7**). Upon receipt of the OIG's Report, NFI investigated the ownership of the land that is listed as an asset of NFI in its application for FHA approval. NFI discovered that the owner of the property is listed as "Neighbor Funding, Inc." instead of "Neighborhood Funding, Inc." (**Exhibit F-1**). NFI is not aware if this incorrect spelling of the company's name occurred because of a data entry error or because county tax records do not allow enough spaces for the word "Neighborhood" to be completely spelled out. Whatever the reason for the error on the part of the recorder's office, there is no question that NFI owns the property in question and, thus, that the property is a component of NFI's net worth.

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With regard to the allegation concerning the value of the property, we respectfully disagree with the suggestion in the Report that the property was worth only \$39,100 in March of 2003. As the Department is aware, the accepted process of determining the value of property is to consult an appraisal of the property from an independent appraiser. In preparing NFI's audited financials in connection with its initial FHA application in November of 2003, NFI's accountants based the value of the property on an appraisal prepared on December 16, 2002, in which the property was valued at \$300,000 (**Exhibit F-2**). NFI's accountants, however, used a much more conservative value of \$200,000 in land to calculate NFI's net worth (**Exhibit F-3**). Furthermore, in preparation of this response, NFI obtained another independent appraisal of the property on April 13, 2004, which valued the land at \$207,000 (**Exhibit F-4**).

We believe that the value of \$39,100 cited in the OIG's timeline resulted from the OIG's examination of the deed of the land from FCM to NFI. In Florida, when a property has no outstanding mortgage and is transferred via quitclaim deed, as was the case with the property at issue, the county charges the seller transfer fees in the amount of the property's assessed value for tax purposes. The tax assessment value is stamped on the deed. In this case, the 2002 assessed value of the property for tax purposes was \$39,100. As evidenced by the 2003 tax assessment statement, this assessed value has already increased to \$93,100 (**Exhibit F-1**). As the Department and the OIG are aware, the tax assessment value of a property is often much less than the property's market value. In this case, the recent appraisal of \$207,000 represents an accurate market value of the property, and is \$7,000 more than the listed value of the property in NFI's audited financials used to meet HUD's net worth requirements.

In summary, the property used to achieve NFI's required net worth is properly owned by NFI and was accurately valued in the audited financials submitted in connection with NFI's FHA application.

B. Finding 2 -Loan Origination Issues

In Finding 2, the Report alleges that FCM did not comply with HUD requirements in the origination of 18 loans that the OIG reviewed during its audit, as FCM did not obtain complete documentation, made improper income determinations, or did not ensure compliance with other HUD standards. Specifically, Finding 2 alleges that FCM: (1) improperly computed effective income in five of 18 loans; (2) did not verify the availability and/or source of funds needed by three borrowers to close their loans; (3) did not verify the borrower's employment in three of the 18 loans reviewed; (4) allowed six loans to close when settlement statements showed sellers or other interested third parties contributed more than six percent of the sales price toward closing costs; (5) did not verify the receipt of gift funds in accordance with HUD requirements in 15 of 17

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loans in which gift funds were received, 14 of which were gifts from non-profit downpayment assistance organizations; and (5) in one refinancing loan, charged the borrower an unallowable application fee of \$700. Based on these allegations, the Report recommends that FCM repay the borrower, and repeats its recommendations that HUD withdraw the origination authority for FCM, FHFE, and NFI and debar the principal officers/owners of FCM in participation in federal programs.

- Allegations Regarding Underwriting Deficiencies

Below, FCM responds to each individual allegation made in the Report and in Appendix A. First and foremost, however, we would like to point out that it appears that the Report and Appendix A do not distinguish between the responsibilities and requirements of loan correspondents and sponsoring lenders in originating FHA-insured loans. As the Department and the OIG are aware, loan correspondents are responsible for taking the initial loan application, handling the appraisal assignment with HUD, procuring verifications of deposit and employment and the credit report, and closing and submitting the loan for endorsement after it has been underwritten. HUD Handbook 4000.4 REV-1, CHG-2, ¶ 2-13. Loan correspondents are not authorized to perform any underwriting function, including an analysis of the appraisal or the borrower's credit. Id. Furthermore, HUD regulations dictate that "each sponsor shall be responsible for the actions of its loan correspondent lenders or mortgagees in originating loans or mortgages." 24 C.F.R. § 202.08(b)(7). In fact, the OIG acknowledges on page four of the draft Report that "the sponsor mortgage company is responsible to HUD for the actions of its loan correspondent(s) in originating insured mortgages."

In accordance with these FHA guidelines, the Department traditionally has accepted that loan correspondents take a borrower's initial application, collect income and employment documentation, and process the loan, but that the evaluation and analysis of the borrower's credit and the sufficiency of the loan documentation is the responsibility of the underwriter and the sponsoring lender. When HUD determines that the borrower's income, funds to close, or credit was insufficient, the Department in the past has held the underwriter and sponsoring lender accountable. In this case, contrary to HUD's practices in the past, the Report appears to hold FCM, a loan correspondent, responsible for the credit and document analysis performed by its sponsors. Many of the findings in the Report, go directly to the sponsor's underwriting decisions and not to the processing responsibilities of FCM. FCM was not responsible and, in fact, was not authorized to analyze the borrower's credit or make underwriting decisions in these cases.

Finally, we note that one of FCM's former sponsors, Irwin Mortgage Company, underwrote 5 of the 18 loans reviewed by the OIG. We understand that the OIG audited

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Irwin in connection with its audit of FCM. During its Quality Assurance Division audits in late 2002 and early 2003, FCM developed concerns regarding the prudence of some of the underwriting decisions made by this sponsor. Therefore, as a result of those audits, FCM ceased doing business with Irwin Mortgage Company. The loans that are the subject of the OIG's audit were originated before the quality assurance audits were conducted and before FCM terminated its relationship with this sponsor.

- Allegations Regarding Downpayment Assistance Gift Documentation

With regard to the allegations concerning documentation of downpayment assistance gifts from non-profit organizations, FCM understands and appreciates that it must fully document any downpayment assistance gifts provided to borrowers by non-profit organizations. As you know, Page 2-11 of HUD's Single Family Reference Guide ("Guide") expressly states that, with respect to gifts provided by a nonprofit or municipality through a downpayment assistance program, "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1 [Settlement Statement]." As demonstrated in the individual responses below, in each of the 14 cases at issue in the Report, FCM obtained a HUD-1 demonstrating that the borrower received a downpayment assistance grant from a nonprofit organization.

FCM also understands and appreciates that Page 2-11 of the Guide requires lenders to obtain evidence from the nonprofit organization of the amount of the downpayment assistance grant. In several cases, at issue here, documentation from the non-profit organization in FCM's file evidenced the grant amount. As FCM explained to the OIG during its audit, it is difficult for a loan correspondent to obtain complete documentation of the transfer of these funds at closing. Often, gift funds in the form of downpayment assistance are provided to the borrower through a wire transfer of the funds from the non-profit organization to the borrower's settlement agent. After closing, the settlement agent forwards copies of the fund transfer documentation to the sponsoring lender, but does not forward that documentation to the loan correspondent. In fact, FCM had great difficulties obtaining copies of the documentation from either the sponsoring lender or the settlement agent for its files. Employees of FHFE have learned from FCM's past difficulties and obtain documentation of the transfer of gift funds directly from the non-profit organization that provides the gift funds when such funds are used by a borrower.

In each of the 14 cases reviewed by the OIG in which downpayment assistance funds were used, FCM attempted but was unable to obtain complete documentation of the transfer of funds from the sponsoring lender at the time of closing. Nevertheless, the Report acknowledges that it audited 14 settlement agents in connection with these loans and, in all 14 cases, the settlement agents properly documented the receipt of gift

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funds. Thus, in each of these gift funds cases, the borrowers actually received the gift funds necessary to close the loan and any lack of documentation in FCM's files constituted, at worst, harmless error.

- Remaining Loan Documentation Allegations

With regard to the remaining allegations in Finding 2 and Appendix A, FCM respectfully disagrees with many of the Report's findings. Several of the findings in the Report are at variance with the facts, do not constitute violations of FHA requirements on the part of FCM, or do not affect the underlying loans' insurability. FCM acknowledges that file documentation could have been more specific in certain instances. Where FCM's loan files did not contain adequate documentation, FCM has attempted to obtain the documentation in response to this audit from the borrower, sponsor, or employer, as applicable. In addition, please note that the OIG examined loans originated between April 1, 2001 and April 30, 2003. This time period is the same time period examined during the Quality Assurance Division audits of the Fort Myers office of FCM. Thus, although FCM made significant changes to its practices and procedures as a result of the Quality Assurance Division's audit, the OIG reviewed loans originated before these improvements could be reflected in the loans the Company originated. Our individual responses follow.

1. [*] - FHA Case Number 092-8584081

In the [*] case, Finding 2 alleges that: (1) the preliminary Uniform Residential Loan Application ("URLA") showed \$34,000 in assets that were not shown on the final URLA; (2) receipt of gift funds from a non-profit downpayment assistance organization was not documented in FCM's file; and (3) the borrower's debt-to-income ratios were not recomputed when the underwriter increased the mortgage payment and the loan file did not document sufficient compensating factors.

With regard to the absence of the \$34,000 in assets on the final URLA, FCM understands and appreciates the importance of accurately completing all applications and ensuring that all relevant information is included in loan documents. In this case, the initial URLA demonstrated that the borrower had a car, furniture, and other personal property valued at \$34,000 (**Exhibit G-1**). FCM acknowledges that this information should have been included on the borrower's final URLA, as well. During its operation, it was FCM's policy and practice to ensure that all final URLAs were completed fully and accurately to permit the underwriter in each case to evaluate the borrower's complete financial situation. In this case, the absence of these assets on the borrower's final URLA was an oversight. Nevertheless, any oversight in this regard constituted, at worst, harmless error. The assets were recorded on the initial URLA in the loan file, the

[*] Names of individual principals, family members, FCM employees, and borrowers were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

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inclusion of the personal property assets would not have altered the underwriter's evaluation of the borrower, and the borrower in this case qualified for FHA financing without consideration of these assets.

With regard to the downpayment assistance documentation, as discussed above, FCM obtained a copy of the HUD-1, which demonstrates that the borrower received a downpayment assistance grant of \$2,835 from a nonprofit organization (**Exhibit G-2**). Furthermore, the loan file contained a gift letter from the nonprofit organization informing the borrower that she had received gift funds in the amount of \$2,835 (**Exhibit G-3**). Thus, FCM complied with the Reference Guide's downpayment assistance grant documentation requirements in this case. While FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. If the gift funds had not been given to the settlement agent at closing, then the agent would not have permitted the loan to close, and neither the settlement agent nor the buyer and seller should have certified on the HUD-1 that the gift funds were received. Finally, the Report acknowledges that the OIG's audit of 14 settlement agents in connection with this audit revealed documentation that the borrower received gift funds in these cases.

With regard to the borrower's qualifying ratios and compensating factors, these allegations relate to underwriting deficiencies in the loan file. As discussed above, FCM was a loan correspondent and did not underwrite the [*] loan. According to HUD/FHA requirements, FCM gathered borrower's financial information in this case and submitted the information to its sponsor for underwriting and credit approval. The sponsor evaluated the loan application and made the underwriting decision. It was the sponsor's responsibility to determine and demonstrate that the borrower had sufficient credit to qualify for this loan. To the extent that the OIG disagrees with the sufficiency of the credit analysis in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

2. [*] -FHA Case Number 092-8622768

In Finding 2, the Report alleges that: (1) FCM did document how it arrived at the borrower's effective income of \$1,556 per month; (2) FCM did not obtain a Verification of Deposit ("VOD") or document the source of funds, as the deposit slip included in the loan file identifying a \$2,000 deposit did not include the account owner and source of funds; (3) the receipt of downpayment assistance gift funds was not documented in FCM's file; (4) documentation substantiating that an acceptable evaluation of the borrower's credit history was not in the loan file; and (5) the compensating factors listed were unsatisfactory.

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With regard to the allegation concerning income calculation, FCM acknowledges the importance of accurately calculating the borrower's income to ensure that the underwriter has an accurate picture of the borrower's financial situation and ability to repay the FHA loan. During its operation, it was FCM's policy and practice to ensure that income was calculated accurately using all available documentation regarding a borrower's income. In this case, FCM acknowledges that the loan processor, as well as the underwriter, miscalculated the borrower's income. Please note that this was an isolated incident in which the loan processor and underwriter inadvertently miscalculated the borrower's income as \$87 more per month than demonstrated by the borrower's income documentation. Nevertheless, the loan file contained evidence that the borrower was not increasing his housing expense and had minimal debt in addition to his mortgage payment (**Exhibit H-1**). Using the borrower's accurate monthly income, this borrower would have qualified for FHA financing and, thus, any oversight in this case constituted harmless error.

With regard to the allegation that FCM did not document the borrower's source of funds, FCM is aware that loan correspondents must verify borrower deposits by obtaining a VOD and verifying the source of the funds the borrower uses to close a loan. See HUD Handbook 4155.1, REV-4, CHG-1, ¶ 3-1 (F). FCM acknowledges that the deposit slip in this loan file did not document the source of the \$2,000 deposited. During operation, it was FCM's policy and practice to obtain a VOD in each case and verify that the funds used to close a loan were not obtained from an improper source. In this case, there is no evidence to suggest that the \$2,000 was derived from an improper source. Furthermore, the borrower needed only \$255.86 to close the loan on April 19, 2001 (**Exhibit H-2**). The loan file contained income documentation demonstrating that the borrower earned approximately \$375 per week (**Exhibit H-3**). Thus, the borrower would have received a weekly paycheck the week of April 19, 2001, and could have used a portion of that \$375 to cover the \$255.86 needed to close the loan. Thus, any oversight on the part of FCM and the underwriter did not affect the borrower's eligibility for FHA financing.

With regard to the downpayment assistance documentation, as discussed above, FCM obtained a copy of the HUD-1, which demonstrates that the borrower received a downpayment assistance grant of \$1,779 from a nonprofit organization (**Exhibit H-3**). Furthermore, the loan file contained a gift letter from the nonprofit organization informing the borrower that she had received gift funds in the amount of \$1,779, as well as instructions to the settlement agent regarding disbursement of these assistance funds (**Exhibit H-4**). Thus, FCM complied with HUD's downpayment assistance grant documentation requirements in this case. As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at

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the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. If the gift funds had not been given to the settlement agent at closing, then the agent would not have permitted the loan to close, and neither the settlement agent nor the buyer and seller should have certified on the HUD-1 that the gift funds were received. Finally, the Report acknowledges that the OIG's audit of 14 settlement agents in connection with this audit revealed documentation that the borrower received gift funds in these cases.

Finally, with regard to the allegations concerning the analysis of the borrower's credit history and the borrower's compensating factors, these allegations relate to underwriting deficiencies in the loan file. As discussed above, FCM was a loan correspondent and did not underwrite the [*] loan. The sponsor evaluated the loan application and made the underwriting decision in this case. It was the sponsor's responsibility to analyze the borrower's credit and to document that analysis in the file. To the extent that the OIG disagrees with the sufficiency of the credit analysis in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

3. [*] - FHA Case Number 092-8666769

In Finding 2, the Report alleges that the receipt of gift funds by this borrower from a nonprofit downpayment assistance organization was not documented in FCM's file.

In this case, FCM obtained a copy of the HUD-1, which demonstrates that the borrower received a downpayment assistance grant of \$3,150 from a nonprofit organization at settlement on June 27, 2001 (**Exhibit 1-1**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. If the gift funds had not been given to the settlement agent at closing, then the agent would not have permitted the loan to close, and neither the settlement agent nor the buyer and seller should have certified on the HUD-1 that the gift funds were received. Nevertheless, in response to this audit, FCM contacted the nonprofit organization in this case, and was able to obtain a wire transfer statement demonstrating that the nonprofit organization, The Ameridream Charity, Inc., transferred \$3,150 to the settlement agent in this case on June 26, 2001, one day before closing (**Exhibit 1-2**). This documentation demonstrates that the borrower in fact received gift funds used for the downpayment in this case.

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4. [*] - FHA Case Number 092-8709785

In the [*] case, Finding 2 alleges that the maximum mortgage amount in this case was overstated by \$677, which was attributable to the difference between the closing costs allowed by the underwriter and FCM and the closing costs used by the sponsor to calculate the maximum insurable mortgage amount. Finding 2 also alleges that the underwriter used form HUD 92900-PUR to compute the maximum insurable mortgage, but should have used form HUD 92900-WS to do so. Furthermore, the Report alleges that FCM charged the borrower a \$700 application fee and also received a \$928 discount fee in this case.

With regard to the allegations concerning the calculation of the maximum mortgage amount and the use of the improper form to do so, these allegations relate to underwriting deficiencies in the loan file. As discussed above, FCM was a loan correspondent and did not have the authority to complete these forms, calculate the borrower's maximum mortgage amount, or underwrite the [*] loan. The sponsor evaluated the loan application and the documents obtained by FCM in this case and calculated the maximum mortgage amount in this case. It was the sponsor's responsibility to calculate this amount and to document that analysis on the correct Mortgage Credit Analysis Worksheet ("MCAW") form. To the extent that the OIG disagrees with the calculation of the maximum mortgage amount in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

With regard to the \$700 fee FCM charged the borrower, FCM did not intentionally charge the borrower an application fee in this case. FCM understands and appreciates that FHA lenders and loan correspondents are not authorized to charge application fees, except in connection with bond loans or Mortgage Assistance Program loans. See HUD Single Family Reference Guide, ¶ 2-15. The original Good Faith Estimate ("GFE") prepared by FCM did not indicate that the borrower would be charged a \$700 application fee, but only that the borrower would be charged an origination fee of \$920, which was within one percent of the original principal amount of the mortgage, as permitted by FHA requirements. See HUD Handbook 4000.2 REV-2, ¶ 5-3(0). The revised GFE also evidences that FCM intended only to charge the permissible origination fee (**Exhibit J-2**).² When the sponsoring lender in this case prepared the

² Finding 2 also states that FCM received a discount fee in connection with this loan. FCM acknowledges that it did receive a discount fee in this case, which is permissible under FHA requirements, which provide that lenders may receive an agreed upon percentage of the principal amount of the mortgage, including any financed up-front MIP. See HUD Handbook 4000.2 REV-2, ¶ 5-3(P)(1).

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HUD-1, the origination fee was inadvertently listed as an "application fee" and reduced to \$700. This fee should have been listed as an origination fee on the HUD-1, as it was so listed on the GFES prepared by FCM. Thus, the listing of this fee as an "application fee" was merely a clerical error.

5. [*] - FHA Case Number 092-8822776

In the [*] case, Finding 2 alleges that: (1) the final loan application did not show all assets that were presented on the Initial URLA; and (2) that the receipt of gift funds by the borrower were not documented in FCM's file. Appendix A to the Report also alleges that seller contributions exceeded the HUD prescribed limit of 6%, the maximum mortgage basis was overstated, and the loan file did not document sufficient compensating factors to justify the borrower's qualifying ratios.

With regard to the allegation concerning the loan application, FCM understands and appreciates the importance of accurately completing all applications and ensuring that all relevant information is included in loan documents. In this case, the initial URLA, which was completed on July 24, 2001, demonstrated that the borrower had a car and other personal property valued at approximately \$17,000 (**Exhibit K-1**). The final URLA, however, lists personal assets valuing at approximately \$12,000 (**Exhibit K-2**). This difference could have occurred because the borrower reevaluated his personal property and estimated a lower asset value, or could have been a processing oversight on the part of FCM. Whatever the reason for the difference in the asset amount on the borrower's loan applications, the inclusion of the \$5,000 in personal property assets on the final URLA would not have altered the underwriter's evaluation of the borrower, and the borrower in this case qualified for FHA financing without consideration of these assets.

With regard to the allegation concerning the downpayment assistance documentation, FCM obtained a copy of the HUD-1, which demonstrates that the borrower received a downpayment assistance grant of \$2,307 from a nonprofit organization (**Exhibit K-3**). Furthermore, the loan file contained instructions from the downpayment assistance organization to the settlement agent regarding disbursement of these assistance funds (**Exhibit K-4**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. If the gift funds had not been given to the settlement agent at closing, then the agent would not have permitted the loan to close, and neither the settlement agent nor the buyer and seller should have certified on the HUD-1 that the gift funds were received. Finally, the Report acknowledges that the OIG's audit of

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14 settlement agents in connection with this audit revealed documentation that the borrower received gift funds in these cases.

Finally, with regard to the allegations in Appendix A concerning the seller contributions, maximum mortgage amount and compensating factors, these allegations relate to underwriting deficiencies in the loan file. As discussed above, FCM was a loan correspondent and did underwrite this loan. The sponsor evaluated the loan application and the documents obtained by FCM in this case, calculated the maximum mortgage amount and maximum seller contribution, and made a credit decision in this case. To the extent that the OIG disagrees with the underwriter's calculations or decisions in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

6. [*] - FHA Case Number 092-8838493

In the [*] loan, Finding 2 alleges that the borrower's receipt of gift funds was not documented in FCM's file.

In this case, FCM obtained a copy of the HUD-1 , which demonstrates that the borrower received a downpayment assistance grant of \$2,286 from a nonprofit organization (**Exhibit L-1**). Furthermore, the loan file contained instructions from the downpayment assistance organization to the settlement agent regarding disbursement of these assistance funds (**Exhibit L-2**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. If the gift funds had not been given to the settlement agent at closing, then the agent would not have permitted the loan to close, and neither the settlement agent nor the buyer and seller should have certified on the HUD-1 that the gift funds were received. Finally, the Report acknowledges that the OIG's audit of 14 settlement agents in connection with this audit revealed documentation that the borrower received gift funds in these cases.

7. [*] - FHA Case Number 092-8851286

In the [*] case, Finding 2 alleges that: (1) the effective income for one of the borrower's was improperly calculated, as it included overtime and bonus income that was unlikely to continue; (2) FCM's staff did not fulfill their responsibility to gain a complete understanding of the borrowers' intended use of the property; (3) the receipt of gift funds from a downpayment assistance organization was not documented in FCM's file; and (4) the compensating factors were not satisfactory.

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During its operation, FCM's policy and practice was to properly calculate a borrower's effective income by verifying a borrower's income and calculating the average income over a monthly basis. FCM understood and appreciated that overtime income could only be included in a borrower's effective income if the borrower had been earning such income for approximately the past two years and there were reasonable prospects that such income would continue. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-7(A). In this case, FCM acknowledges that the loan processor, as well as the underwriter, analyzed overtime income without evidence of its likelihood of continuance. Please note that this was an isolated incident in which the loan processor and underwriter included overtime income after inadvertently overlooking the employer's indication on the VOE that such income may not continue. Nevertheless, as the underwriter was ultimately responsible for ensuring that the income was calculated accurately, any disagreement should be resolved with the sponsor in this case.

With regard to the allegation concerning FCM's investigation into the borrower's intended use of the property secured by the FHA loan, the Report suggests that, as the borrower had previously lived at his workplace and did not have a valid driver's license, FCM should have known that he would not occupy the property. The Report states that the OIG determined that the borrower continued to rent a residence at his workplace, and did not report this housing cost on the loan application. In this case, the borrowers did not speak English as a first language. In our interviews with the borrowers, FCM attempted to the best of our ability to determine who would in fact occupy the property. The borrowers assured us that they would both be living in the house, and made no mention of any intent to continue to rent housing at one borrower's workplace. FCM was not aware before or after closing that the borrower continued to rent housing at his place of employment. In fact, the borrowers certified under the threat of penalties that they both intended to occupy the property at issue within 30 days of closing (**Exhibit M-1**). Thus, FCM complied with its duty to ensure to the best of its ability that the borrowers would in fact occupy the property secured by this FHA loan.

With regard to the allegation concerning downpayment assistance gift funds, FCM obtained a copy of the HUD-1, which demonstrates that the borrower received a downpayment assistance grant of \$2,577 from a nonprofit organization (**Exhibit M-2**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. If the gift funds had not been given to the settlement agent at closing, then the agent would not have permitted the loan to close, and neither the settlement agent nor the buyer and seller should have certified on the HUD-1 that the gift funds were received. Finally, the Report acknowledges that the OIG's audit of 14 settlement agents in connection with this audit revealed documentation that the borrower received gift funds in these cases.

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With regard to the compensating factors allegation, this allegation relates to an underwriting deficiency in the loan file. As discussed above, FCM was a loan correspondent and did underwrite this loan. To the extent that the OIG disagrees with the underwriter's credit analysis in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

8. [*] - FHA Case Number 092-8862985

In the [*] case, Finding 2 alleges that FCM did not document the source of funds, as the files contained two VODs for a new account, but no explanation as to the source of deposited funds. Finding 2 also alleges that the borrower's receipt of gift funds from a downpayment assistance organization was not documented in FCM's file, and that the compensating factors used to qualify the borrower were unsatisfactory.

With regard to the allegation that FCM did not properly document the source of funds in the borrower's banking account, FCM respectfully disagrees. In this case, the borrower was employed as licensed nurse, and was earning net income of approximately \$945 on a bi-weekly basis (**Exhibit N-1**). The borrower in this case did not have a bank account prior to applying for FHA financing. Therefore, in an effort to demonstrate an ability to save, the borrower opened a bank account in October of 2001 and deposited a total of \$880.79 before closing to demonstrate her ability to save (**Exhibit N-2**). The borrower obtained the deposited funds from her two October paychecks, each in the amount of \$945. Contrary to the allegation in Finding 2, this income source was documented on the VOD dated October 30, 2001 (**Exhibit N-2**). Thus, the loan file did document the borrower's source of funds in this case.

With regard to the allegation concerning the transfer of downpayment assistance funds, FCM obtained a copy of the HUD-1, which demonstrates that the borrower received a downpayment assistance grant of \$2,795 from a nonprofit organization (**Exhibit N-3**). Furthermore, the loan file contained instructions from the downpayment assistance organization to the settlement agent regarding disbursement of these assistance funds (**Exhibit N-4**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. Nevertheless, the Report acknowledges that the OIG's audit of 14 settlement agents in connection with this audit revealed documentation that the borrower received gift funds in these cases.

With regard to the compensating factors allegation, this allegation relates to an underwriting deficiency in the loan file. As discussed above, FCM was a loan

[*] Names of individual principals, family members, FCM employees, and borrowers were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

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correspondent and did underwrite this loan. To the extent that the OIG disagrees with the underwriter's credit analysis in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

9. [*] - FHA Case Number 092-88780872

In the [*] case, Finding 2 alleges that, while the initial URLA evidences three places of employment, the final loan application omitted a job held from February 2001 through February 2002 and, as a result, FCM did not verify that employment and failed to examine the borrower's employment history for a two-year period. Finding 2 also alleges that the borrower's receipt of gift funds from a downpayment assistance organization was not documented in FCM's file, and that the borrower's qualifying ratios were unsatisfactory .

With regard to the borrower's employment, FCM understands and appreciates that a borrower's employment must be verified for the most recent two full years prior to closing. HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-6. During FCM's operations, it was the Company's policy and practice to obtain employment verifications for each job held by the borrower during that two-year period, and to obtain explanations from borrowers regarding any gaps in employment. Nevertheless, in this case, one of the borrower's jobs was inadvertently overlooked on the initial URLA, and it appears that neither the loan processor nor the underwriter attempted to obtain verification that the borrower held this position. Please note that this was an isolated oversight of a loan processor who was no longer employed by FCM at the time of the OIG's audit. At any rate, FCM did verify that the borrower had been at his current position for the past eight months, and that the probability of his continued employment in this position was "good" (**Exhibit 0-1**). While the loan file omitted certain documentation, the borrower still qualified for FHA financing.

As to the allegation concerning the downpayment assistance funds, while the sales contract stated that the gift funds were to be provided by National Home, during the course of closing, the borrower decided to apply for such funds from Ameridream. The buyer was awarded a downpayment assistance gift by Ameridream, and the borrower's receipt of \$1,779 in gift funds from this source is documented on the HUD-1 (**Exhibit 0-2**). Furthermore, the loan file contained instructions from the Ameridream to the settlement agent regarding disbursement of these assistance funds (**Exhibit 0-3**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. Nevertheless, in response to the OIG's audit, FCM contacted Ameridream and obtained evidence that the nonprofit agency transferred \$1,779 in gift funds to the settlement

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agent in this loan on 11, 20, 2001 (Exhibit 0-4), the day the loan closed (**Exhibit 0-2**). This documentation demonstrates that the borrower in fact received the downpayment assistance grant.

With regard to the qualifying ratios allegation, this allegation relates to an underwriting deficiency in the loan file. As discussed above, FCM was a loan correspondent and did underwrite this loan. To the extent that the OIG disagrees with the underwriter's credit analysis in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

10. [*] -FHA Case Number 092-8943906

In the [*] case, Finding 2 alleges that: (1) FCM staff did not properly compute and document their computations of effective income, as it miscalculated the borrower's grossed up social security income due to a mathematical error, which resulted in a \$33 understatement of the borrower's income; (2) FCM did not verify a full two-year employment history for the borrower, as the loan application showed that the borrower had a two year employment history, but the VOE showed only an 18-month history with the employer; and (3) that the compensating factors were unsatisfactory.

In connection with the allegations regarding income calculation, HUD regulations permit the use of social security income to qualify a borrower, provided that the income is verified by the Social Security Administration or through federal tax returns. See HUD Handbook 4155 REV-4, CHG-1, ¶ 2-7(E). Furthermore, HUD guidelines permit lenders to "gross up" social security income. Id. 2-7(0). FCM complied with these requirements in this instance by obtaining evidence of the borrower's social security benefits from the Social Security Administration (**Exhibit P-1**). In this case, FCM acknowledges that the loan processor misstated the borrower's social security income by \$33 per month. However, this misstatement was an understatement. While FCM appreciates the importance in accurately calculating each borrower's income, any miscalculation in this case provided the underwriter with a more conservative income calculation. Any error in connection with the borrower's income in this case constituted, at worst, harmless error, as the borrower qualified for FHA financing with a more conservative income amount than she actually earned.

As to the allegation regarding the borrower's employment history, FCM understands and appreciates that income must be documented for a full two year period prior to the loan closing. HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-6. During FCM's operations, it was the Company's policy and practice to obtain employment verifications for each job held by the borrower during that two-year period, and to obtain explanations from borrowers regarding any gaps in employment. Nevertheless, in this

[*] Names of individual principals, family members, FCM employees, and borrowers were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

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case, although the URLA indicated that the borrower held her current job for two years prior to closing, the VOE obtained indicated a continuous employment history of 18 months. Nevertheless, the VOE indicated that the borrower had earned income from this employer in 1999, which indicated that the borrower had been employed there more than two years before the loan closing date (**Exhibit P-2**). Furthermore, the loan file contained a letter from the borrower's doctor indicating some past health problems, which may have been the reason for her gap in employment with her current employer (**Exhibit P-3**). At any rate, FCM did verify that the borrower had been at her current position for the past eighteen months, and there was no evidence to suggest that her employment would not continue. While the loan file omitted certain documentation, the borrower still qualified for FHA financing in this case.

Finally, with regard to the compensating factors allegation, this allegation relates to an underwriting deficiency in the loan file. As discussed above, FCM was a loan correspondent and did underwrite this loan. To the extent that the OIG disagrees with the underwriter's credit analysis in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

11. [*] - FHA Case Number 092-9027547

In the [*] case, Finding 2 alleges that the seller contributions exceeded HUD's prescribed limit of six percent, the maximum mortgage amount was overstated, and the compensating factors were unsatisfactory. These allegations relate to underwriting deficiencies in the loan file. As discussed above, FCM was a loan correspondent and did underwrite this loan. To the extent that the OIG disagrees with the underwriter's credit analysis and calculations in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

12. [*] - FHA Case Number 092-9042836

In the [*] case, Finding 2 alleges that the qualifying ratios were not sufficient and the underwriter did not provide compensating factors. This allegation relates to an underwriting deficiency in the loan file. As discussed above, FCM was a loan correspondent and did underwrite this loan. To the extent that the OIG disagrees with the underwriter's credit analysis in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

13. [*] - FHA Case Number 092-9053789

In the [*] case, Finding 2 alleges that the loan application was not fully supported by the data in the credit report. Specifically, the credit report showed a

[*] Names of individual principals, family members, FCM employees, and borrowers were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

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delinquent liability of \$7,462, which FCM reported as the student loan identified by the borrower. The borrower, however, identified the outstanding balance on the loan as \$2,056. Finding 2 further alleges that FCM's loan file did not document the receipt of downpayment assistance funds by the borrower, that the seller contributions exceeded HUD-prescribed limits, and that the compensating factors were unsatisfactory.

In connection with the borrower's liabilities, FCM appreciates that any discrepancies in the loan documentation that require an explanation or resolution by contacting the homebuyer are the responsibility of the loan correspondent. See Mortgagee Letter 94-56. The Company acknowledges that the difference between the outstanding balance of the student loan on the borrower's credit report and the URLA should have been resolved prior to closing. In any event, the Report acknowledges the credit report indicated that the borrower had entered into a repayment plan with the lender, and that these payments were included on the MCAW (**Exhibit Q-1**). Thus, any discrepancy between the outstanding loan amounts reported by the borrower and on the credit report did not affect the borrower's eligibility for FHA financing.

With regard to the allegation concerning the receipt of downpayment assistance by the borrower, FCM obtained a copy of the HUD-1, which demonstrates that the borrower received a downpayment assistance grant of \$2,250 from a nonprofit organization at settlement on July 1, 2002 (**Exhibit Q-2**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. Nevertheless, in response to this audit, FCM contacted the nonprofit organization in this case, and was able to obtain a letter stating that the nonprofit agency wired \$2,250 in gift funds to the borrower on June 28, 2002 (**Exhibit Q-3**), a few days before settlement (**Exhibit Q-2**). This documentation demonstrates that the borrower in fact received gift funds used for the downpayment in this case.

Finally, the allegations regarding the seller's contribution and the compensating factors relate to underwriting deficiencies in the loan file. As discussed above, FCM was a loan correspondent and did underwrite this loan. To the extent that the OIG disagrees with the underwriter's credit analysis and calculations in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

14. [*] - FHA Case Number 092-9060087

In the [*] case, Finding 2 alleges that the Company miscalculated the borrower's income, as FCM used only the borrower's base salary without including the borrower's overtime income. Finding 2 further alleges that FCM's loan file did not

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document the borrower's receipt of downpayment assistance funds and that seller contributions exceeded the HUD-prescribed limit.

With regard to the allegation concerning income calculation, FCM respectfully disagrees with Finding 2. In this case, although the loan file evidenced regular overtime earnings by the borrower (**Exhibit R-1**), FCM conservatively calculated the borrower's qualifying income using only the borrower's base salary. While FHA guidelines provide that overtime income may be used to calculate effective income, provided certain conditions are met, these guidelines do not require such use. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-7(A). Thus, FCM's calculation of the borrower's income did not violate FHA requirements and, in fact, provided a more conservative qualifying income to the underwriter (**Exhibit R-2**).

With regard to the allegation concerning the transfer of downpayment assistance funds, FCM obtained a copy of the HUD-1, which demonstrates that the borrower received a downpayment assistance grant of \$2,845 from a nonprofit organization on April 25, 2002 (**Exhibit R-3**). Furthermore, the loan file contained letters from the nonprofit organization setting forth the requirements for the provision of the downpayment assistance funds (**Exhibit R-4**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. Nevertheless, in response to this audit, FCM contacted the nonprofit organization in this case, and was able to obtain a letter stating that the nonprofit wired \$2,845 in gift funds to the borrower on April 24, 2002 (**Exhibit R-5**), a few days before settlement (**Exhibit R-3**). This documentation demonstrates that the borrower in fact received gift funds used for the downpayment in this case.

With regard to the allegation concerning seller contributions, this allegation relates to an underwriting deficiency in the loan file. As discussed above, FCM was a loan correspondent and did underwrite this loan. To the extent that the OIG disagrees with the underwriter's credit analysis in this case, the sponsor who underwrote the loan should resolve this disagreement.

15. [*] - FHA Case Number 092-9068413

In the [*] loan, Finding 2 alleges that the liabilities reported on the loan application were incorrect, as a debt of the applicant's ex-spouse was improperly reported as a debt of the applicant and a derogatory account of the applicant was excluded from the loan application, resulting in the borrower's liabilities being slightly understated. Finding 2 further alleges that FCM accepted a VOE and two explanatory letters that were faxed from a hotel where the borrower was residing and the phone

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number of the borrower's employer on one of the letters did not match the phone number provided on the VOE. Finally, Finding 2 alleges that FCM's loan file did not document the borrower's receipt of downpayment assistance funds.

With regard to the allegations concerning the borrower's liabilities, FCM understands and appreciates the importance of accurately completing all applications and ensuring that all relevant information is included in loan documents. In this case, the URLA misstated the liabilities of the borrower. The credit report obtained by FCM indicated that, absent the account for which the borrower's ex-spouse was responsible, the borrower's monthly debt obligation was \$233 (**Exhibit 5-1**). This amount is \$2.00 less than the ex-spouse's obligation of \$235 (**Exhibit 5-1**). Thus, while the liabilities were inaccurate on the URLA, the borrower's debt obligation was actually overstated by \$2.00. Thus, any inaccuracy on the URLA in this case constituted, at worst, harmless error. The borrower qualified for the loan with a debt obligation of \$235 (**Exhibit 5-2**) and, thus, would have qualified for the loan with a debt obligation of \$233.

As to the allegation regarding the borrower's employment documentation, FCM respectfully disagrees. With regard to the borrower's letters of explanation, such letters are always obtained directly from the borrowers. The fact that the borrower provided these documents via facsimile did not violate any FHA requirement of which we are aware. With regard to the faxed employment verification, FCM understands and appreciates that employment verification forms must not pass through the hands of the applicant, a real estate agent, or other interested third party. HUD Handbook 4000.2 REV-2, ¶ 3-6. During its operation, FCM required that all employment and deposit verification forms were derived directly from the employer or financial institution. To the best of our knowledge and recollection, the employment verification form was faxed by the employer in this case. As demonstrated in the loan file, the borrower was employed by Pride Lawn Services, a small, owner-operated company (**Exhibit 5-3**), which was conducted out of the owner's home instead of a formal office. The owner of the business picked the borrower up on the way to the business's daily lawn care jobs and, as the small business did not have a fax machine, used the machine located at the borrower's temporary hotel residence to forward the VOE to FCM. While FCM should have mailed a copy of the VOE to the employer to verify this faxed document, the VOE in this case did not pass through the hands of an interested third party. With regard to the differing phone numbers on the VOE and the borrower's letter, one phone number was the business owner's home number and the other phone number was the owner's cell phone number, which was provided so that FCM could contact the owner during normal business hours when he was working on-site.

With regard to the allegation concerning the transfer of downpayment assistance funds, FCM obtained a copy of the HUD-1, which demonstrates that the borrower

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received a downpayment assistance grant of \$2,505 from a nonprofit organization on April 30, 2002 (**Exhibit 5-4**). Furthermore, the loan file contained letters from the nonprofit organization setting forth the requirements for the provision of the downpayment assistance funds (**Exhibit 5-5**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. Nevertheless, in response to this audit, FCM contacted the nonprofit organization in this case, and was able to obtain a letter stating that the nonprofit agency wired \$2,505 in gift funds to the borrower on April 25, 2002 (**Exhibit 5-6**), a few days before settlement (**Exhibit 5-4**). This documentation demonstrates that the borrower in fact received gift funds used for the downpayment in this case.

16. [*] - FHA Case Number 092-9228763

In the [*] case, Finding 2 alleges that FCM's loan file did not document the borrower's receipt of downpayment assistance funds and that seller contributions exceeded the HUD-prescribed limit.

With regard to the allegation concerning the transfer of downpayment assistance funds, FCM obtained a copy of the HUD-1 , which demonstrates that the borrower received a downpayment assistance grant of \$1,857 from a nonprofit organization on October 16, 2002 (**Exhibit T-1**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. Nevertheless, in response to this audit, FCM contacted the nonprofit organization in this case, and was able to obtain a letter stating that the nonprofit agency wired \$1,857 in gift funds to the borrower on October 16, 2002 (**Exhibit T-2**), the date of closing (**Exhibit T-1**). This documentation demonstrates that the borrower in fact received gift funds used for the downpayment in this case.

With regard to the allegation concerning seller contributions, this allegation relates to an underwriting deficiency in the loan file. As discussed above, FCM was a loan correspondent and did underwrite this loan. To the extent that the OIG disagrees with the underwriter's credit analysis in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

17. [*] - FHA Case Number 092-4979173

In the [*] loan, Finding 2 alleges that the loan file contained an ATM receipt showing an account balance of \$2,056.23, but did not include a bank statement or VOE.

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Complete bank statements dated April 10, 2001 were contained in the file; however, Finding 2 alleges that these statements demonstrated that the \$771.87 in available funds was not sufficient to close the loan. In addition, Finding 2 alleges that loan file indicates that the borrower received a gift from his aunt; however, the loan file did not verify receipt of these gift funds.

With regard to the allegation regarding the borrower's source of funds to close in this case, FCM respectfully disagrees. Contrary to Finding 2, the documentation from the borrower's financial institution was not an ATM receipt; rather, the document was a mini-statement provided by the financial institution between regular monthly statements (**Exhibit U-1**). This mini-statement indicated that, as of June 11, 2001, the borrower had \$2,056.23 in his account, which was more than sufficient to satisfy the \$836.35 needed to close the loan on July 23, 2001 (**Exhibit U-2**). Furthermore, to the extent that the mini-statement is not acceptable to verify the borrower's source of funds to close, the loan file contained documentation demonstrating that the borrower had an annual salary of \$60,000 per year, and received weekly paychecks of \$1,153 (**Exhibit U-3**). Thus, the borrower could easily have used a portion of his weekly paycheck to cover the \$836.35 needed to close the loan. Finally, the loan file contained evidence that the borrower had \$3,457 in an IRA account as of December 31, 2000, which also could have been used to close the loan (**Exhibit U-4**). Therefore, the documentation contained in the loan file demonstrated that the borrower had several sources from which to derive the funds needed to close this loan.

With regard to gift funds obtained from a relative, FCM understands and appreciates that HUD guidelines require a lender to obtain the following documents when the gift funds are in the home buyer's account prior to closing: (1) a gift letter specifying, among other items, the dollar amount given, the donor's name, address, telephone number, and relationship to the borrower, and stating that no repayment is required; (2) a copy of the canceled check or other withdrawal document showing the withdrawal from the donor's personal account; and (3) the homebuyer's deposit slip or bank statement that shows the deposit of the gift funds. See HUD Handbook 4155.1, REV-4, CHG-1, ¶ 2-10 (C); Mortgage Letter 00-28. In this case, FCM's loan file contained a gift letter from the borrower's aunt, indicating that she would provide \$2,700 in gift funds to the borrower (**Exhibit U-5**). The loan file also contains a letter from the settlement agent indicating that it was holding \$2,700 in its account for the borrower on May 31, 2001 (**Exhibit U-6**), almost two months prior to closing on July 23, 2001 (**Exhibit U-2**). Thus, the loan file indicates that the borrower received the gift funds in this case. Furthermore, while the Company's file did not contain a deposit or withdrawal slip, the Report acknowledges that the HUD file contained documentation sufficient to evidence receipt of these funds by the borrower. Therefore, FCM must have obtained the requisite documentation and inadvertently passed it along to HUD before making

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copies for the Company's file. In any event, the borrower in fact received the gift funds in this case and any deficiency in FCM's loan file documentation did not affect the borrower's eligibility for FHA financing.

18. [*] - FHA Case Number 093-4983450

In the [*] case, Finding 2 alleges that the income reported by FCM on the loan application was not supported, as FCM's income calculation included overtime, but the VOE provided that such income was not likely to continue. Finding 2 also alleges that the receipt of downpayment assistance funds by the borrower was not documented in FCM's file.

With regard to the calculation of the borrower's income, FCM understands and appreciates the importance of accurately calculating the borrower's income. In this case, while the VOE did not indicate that overtime income would continue, it also did not indicate that the borrower was paid overtime income (**Exhibit V-1**). The borrower's pay stubs, however, indicated that the borrower often worked more than 40 hours per week and earned significantly more than her base salary (**Exhibit V-2**). Thus, the inclusion of such income was not unreasonable on FCM's part. Nevertheless, FCM appreciates that such income should not be included in the borrower's effective income unless the loan file demonstrates that such income is likely to continue. In this case, however, the underwriter recalculated the borrower's effective income without considering her overtime earnings, and the borrower qualified for FHA financing based on this reduced income calculation (**Exhibit V-3**). Thus, any deficiency in this case did not affect the borrower's eligibility for FHA financing.

With regard to the allegation concerning the transfer of downpayment assistance funds, FCM obtained a copy of the HUD-1 , which demonstrates that the borrower received a downpayment assistance grant of \$2,287 from a nonprofit organization on May 10, 2001 (**Exhibit V-4**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. Nevertheless, in response to this audit, FCM contacted the nonprofit organization in this case, and was able to obtain a letter stating that the nonprofit agency wired \$2,287 in gift funds to the borrower on May 4, 2001 (**Exhibit T - 2**), a few days before settlement (**Exhibit V-4**). This documentation demonstrates that the borrower in fact received gift funds used for the downpayment in this case.

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19. [*] -FHA Case Number 093-5100268

In the [*] case, Finding 2 alleges that FCM's loan file did not document the borrower's receipt of downpayment assistance funds and that seller contributions exceeded the HUD-prescribed limit.

With regard to the allegation concerning the transfer of downpayment assistance funds, FCM obtained a copy of the HUD-1 , which demonstrates that the borrower received a downpayment assistance grant of \$1 ,926 from a nonprofit organization on October 16, 2002 (**Exhibit W**). As discussed above, while FCM attempted to obtain documentation regarding the actual receipt of these gift funds by the borrower at the time of closing, FCM was unable to obtain this documentation from the settlement agent or the sponsoring lender. However, if the gift funds had not been given to the settlement agent at closing, then the agent would not have permitted the loan to close, and neither the settlement agent nor the buyer and seller should have certified on the HUD-1 that the gift funds were received.

With regard to the allegation concerning seller contributions, this allegation relates to an underwriting deficiency in the loan file. As discussed above, FCM was a loan correspondent and did underwrite this loan. To the extent that the OIG disagrees with the underwriter's credit analysis in this case, the sponsor who underwrote the [*] loan should resolve this disagreement.

C. Finding 3 -Quality Control Plan and Procedures

In Finding 3, the Report alleges that FCM did not implement the Quality Control Plan that it submitted to the Department in January of 2003 in connection with its prior review by HUD's Quality Assurance Division and that FCM's Quality Control processes did not comply with HUD regulations. Finding 3 further alleges that FCM's Quality Control Plan did not address the following key elements: (1) documenting corrective actions taken as a result of quality control reviews; (2) reporting significant discrepancies to HUD; (3) timely performance of quality control reviews; and (4) quality control review of rejected loans. Finding 3 finally alleges that FCM's actual quality control performance was materially deficient. Based on these allegations, the Report repeats its recommendations that HUD withdraw the origination authority for FCM, FHFE, and NFI and debar the principal officers/owners of FCM in participation in federal programs.

In connection with its Quality Control Plan, FCM strived to adopt and adhere to a Quality Control Plan that met HUD requirements. Prior to the Quality Assurance

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Division's audit of the Fort Myers office, FCM relied on a Quality Control Plan prepared by its third-party quality control contractor. As a result of the audit, FCM moved its quality control procedures in-house and redrafted its Quality Control Plan to meet the needs of this small loan correspondent. Contrary to the allegations in the Report, FCM at all times put forth a good faith effort to implement the Quality Control Plan submitted to the Atlanta Homeownership Center in connection with its prior audit. A large component of that Plan was the Quality Control Plan Checklist -Loan Origination (**Exhibit X-1**). Contrary to the allegations in the Report, it was FCM's policy and practice to make use of this checklist, as well as bullet-point quality control outlines (**Exhibit X-2**), to ensure that quality control reviews were performed in a thorough and timely manner. Despite our best efforts, FCM recognizes that its Quality Control Plan may have omitted certain items and could have been more specific in some instances. Specifically, While FCM was aware of HUD's rules and regulations concerning quality control, we did not express all of the Company's quality control policies in our written plan. Nevertheless, based on our continued efforts to improve our Quality Control Plan and bring it into compliance with HUD requirements, we believe that the recommended sanctions are unwarranted in this instance.

With regard to FCM's performance of quality control reviews, FCM respectfully disagrees with the allegations in the Report. First, FCM conducted a review of all loans defaulting within the first six months, in compliance with HUD requirements. The Report alleges that FCM's staff did not review 4 of 18 loans that went into default between October 2002 and June 2003; however, a review of FCM's Neighborhood Watch data identified only 12 loans in that category during that time period. FCM performed a quality control review of all 12 of the loans identified on the Neighborhood Watch system. Furthermore, FCM performed the requisite ten percent review of all loans that were rejected by its sponsors. As a small loan correspondent that originated a small number of loans on a monthly basis, FCM did not generate a large number of loans that met these criteria.

With regard to the allegation that FCM did not properly generate quality control reports and document corrective actions taken, the Company disagrees. As a small mortgage lender, very few loan files were reviewed on a monthly basis. Thus, instead of issuing a formal report, FCM generated documentation of the quality control review performed and held meetings to discuss any review findings. Where discrepancies were noted, FCM management met with the relevant FCM personnel to discuss the problems and provided training to ensure improved performance. While corrective actions were taken, such occurrences were rare. Thus, the documentation of such actions was maintained in personnel files for two years in accordance with FHA requirements. Contrary to the allegations in the Report, FCM acted in good faith to comply with HUD guidelines regarding quality control reviews. While FCM's quality

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control reviews were done on a very small scale, the Company consistently made an effort to conduct reviews in accordance with HUD guidelines.

In summary, FCM has always engaged quality control. During its operation, FCM consistently reviewed and analyzed Company practices and procedures, and took responsibility to ensure that FHA requirements are met. As discussed above, FCM continued to improve upon its Quality Control Plan and quality control review procedures throughout its corporate existence to ensure compliance with HUD/FHA requirements. Based on the Company's good faith effort to comply with HUD's Quality Control requirements, we believe that the sanctions recommended in the Report would be unduly severe.

IV. CONCLUSION

In summary, FCM's thorough review of the findings set forth in the Report indicated that the recommended suspension of the origination authority of the three companies that are the subject of this proceeding, as well as the debarment of FCM's principals, is unwarranted.

An initial review of the allegations in Finding 1 of the Report suggests a that FCM engaged in a plot to circumvent HUD's termination of the Fort Myers office's Origination Approval Agreement in the Miami/Coral Gables jurisdiction through the Department's Credit Watch Initiative. A close examination of the circumstances surrounding these entities, however, demonstrates that most of the OIG's allegations are simply not true. Contrary to the allegation that FCM's owners intentionally tried to circumvent a Credit Watch termination of the Fort Myers office's origination authority in the Miami/Coral Gables jurisdiction, the owners of FCM decided to create new entities for the benefit of their family and slowly close down FCM well before they were made aware of the Department's determination in the Credit Watch proceeding. The establishment of these entities was an exit strategy for the owners of FCM and away for them to pass along their mortgage business to their children. FCM has since closed its doors, and NFI and FHFE have been established as viable mortgage entities. FCM's owners and the subsequent owners and officers of the new entities acted in good faith and strived to comply with FHA requirements at all times during the establishment of these entities. None of their actions threatened the Department or caused harm to the FHA Insurance Fund. Based on these facts, the Report's recommended sanctions are excessive and inappropriate under the circumstances.

Furthermore, in connection with the allegations regarding the 19 loans reviewed by the OIG discussed in Finding 2 of the Report, the Company's review indicated that many of the findings in the Report are at variance with the facts, do not constitute

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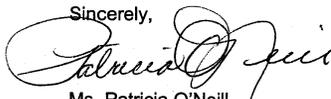
violations of HUD/FHA requirements on the part of FCM, or do not affect the underlying loans' insurability. In addition, many of the findings in the Report go directly to the sponsor's underwriting decisions and not to the processing responsibilities of FCM. As FCM was not responsible and, in fact, was not authorized, to analyze the borrower's credit or make underwriting decisions in these cases, the Company should not be held responsible for any underwriting deficiencies in these cases.

Finally, with regard to FCM's Quality Control practices and procedures, contrary to the allegations in the Report, FCM at all times put forth a good faith effort to implement its Quality Control Plan and perform quality control reviews in a thorough and timely manner. Based on FCM's continuous, good faith efforts to improve our Quality Control Plan and quality control review procedures and act in compliance with HUD requirements, we believe that the recommended sanctions are unwarranted in this instance.

After review of the actual facts and circumstances in this case, as well as the motivation of the individuals who created the entities at issue in the Report, it would be inappropriate to determine that these individuals and entities are unfit to participate in FHA programs. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate that the draconian penalties recommended by the Report in connection with the entities and their principals are unwarranted. We ask that the OIG revise its recommendations to fit the facts of this case.

If you have any additional questions, or if you need additional information, please do not hesitate to contact our Washington counsel, Phillip L. Schulman, at (202) 778-9027.

Thank you for your kind consideration.

Sincerely,

Ms. Patricia O'Neill
Vice President of FCM

cc: Terry A. Cover, Assistant Regional Inspector General, HUD
Phillip L. Schulman, Esq.