Issue Date
January 25, 2005
Audit Report Number
2005-KC-1003

TO: John C. Weicher, Assistant Secretary for Housing – Federal Housing Commissioner, and Chairman, Mortgagee Review Board, H

FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: Leader Mortgage Company Did Not Follow HUD Requirements When Processing Loans

HIGHLIGHTS

What We Audited and Why

We reviewed Leader Mortgage Company (Leader Mortgage), a non-supervised direct endorsement lender located in Lenexa, KS, because its default rate was significantly higher than the U.S. Department of Housing and Urban Development (HUD) Kansas City field office's average over the past three years.

Our audit objectives were to determine whether Leader Mortgage properly originated Federal Housing Administration loans and to determine whether it properly developed and implemented a quality control plan.

What We Found

Leader Mortgage did not follow HUD requirements when processing and submitting loans for Federal Housing Administration insurance endorsement. It improperly originated 7 of the 23 loans reviewed. These seven loans contained deficiencies that affected the insurability of the loans, including unsupported assets, underreported liabilities, unsupported income, and derogatory credit. As a result, HUD insured seven loans that placed the insurance fund at risk for $911,738.

Further, Leader Mortgage's quality control process did not comply with HUD requirements. Leader Mortgage's written quality control plan lacked many required elements. In addition, Leader Mortgage did not ensure that it obtained quality control reviews that met HUD requirements or that were completed within the established timeframes. Leader Mortgage also did not take prompt corrective action when quality control reports identified material deficiencies. As a result, HUD lacks assurance that Leader Mortgage is able to ensure the accuracy, validity, and completeness of its loan origination operations.

What We Recommend

We recommend that the Assistant Secretary for Housing - Federal Housing Commissioner, and Chairman, Mortgagee Review Board, take appropriate administrative action against Leader Mortgage based on the information contained in these findings. This action should, at a minimum, include requiring indemnification for the seven actively insured loans. Leader Mortgage should also reimburse the appropriate parties for unallowable costs charged to borrowers.

Additionally, HUD should require Leader Mortgage to implement controls to ensure that it follows HUD's quality control requirements and verify that Leader Mortgage has implemented proper controls.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

Leader Mortgage agreed that it had not consistently followed HUD requirements when processing Federal Housing Administration loans, but disagreed with specific deficiencies identified in three of the seven loans that we concluded had material deficiencies that affected the insurability of the loan. Further, Leader Mortgage agreed that it had not met all of HUD's quality control program requirements, but disagreed with our conclusion that it had not met specific elements of the requirements. We provided a draft report to Leader Mortgage and requested a response by January 4, 2005, and Leader Mortgage provided its written comments on that date.

Appendix B of this report contains the complete text of Leader Mortgage's response, except for specific loan documents that we omitted to maintain the privacy of the borrowers. Appendix B also contains our evaluation of Leader Mortgage's response.

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BACKGROUND AND OBJECTIVES

Leader Mortgage Company is a non-supervised lender that began doing business and performing Federal Housing Administration loan originations in 1992. Leader Mortgage maintains a primary office in Lenexa, KS, and a branch office in St. Louis, MO.

Leader Mortgage originated 320 Federal Housing Administration-insured mortgages that closed from May 1, 2002, through April 30, 2004. We selected Leader Mortgage for review because its default rate was significantly higher than the HUD Kansas City field office's average over the past three years.

Our audit objectives were to determine whether Leader Mortgage properly originated loans by correctly documenting and evaluating income, assets, liabilities, credit history, qualifying ratios, allowable charges, and borrower eligibility and to determine whether it properly developed and implemented a quality control plan.

RESULTS OF AUDIT

Finding 1: Leader Mortgage Did Not Follow HUD Requirements When Originating Loans

Leader Mortgage did not follow U.S. Department of Housing and Urban Development (HUD) requirements when processing and submitting 7 of the 23 loans reviewed for compliance. The loans contained deficiencies that affected the credit quality (insurability) of the loans. The loan origination deficiencies occurred because Leader Mortgage did not have an adequate control environment to ensure that its employees followed HUD requirements when processing and underwriting loans. As a result, HUD insured seven loans that placed the insurance fund at risk for $911,738 and incurred other related losses.

Loans Did Not Comply with HUD Requirements

Leader Mortgage originated seven loans totaling $911,738 that contained significant loan origination deficiencies. These loans contained material errors, including unsupported assets, underreported liabilities, unsupported income, and derogatory credit. These deficiencies occurred because Leader Mortgage did not have adequate controls to ensure that its employees followed HUD requirements when originating loans. Leader Mortgage's deficient quality control process may have also contributed to the loan origination deficiencies (see finding 2).

As of October 5, 2004, HUD's data systems showed that all seven loans were actively insured with Federal Housing Administration insurance and HUD had incurred $5,387 in partial claims on one of the seven loans and $400 in loss mitigation costs on another loan. The following table summarizes the categories of loan deficiencies on the seven loans.

Deficiency	*Number of Loans*
Unsupported assets	4
Underreported liabilities	3
Unsupported income	2
Derogatory credit	1

The deficiencies noted in the table are not independent of one another as several of the loans contained more than one deficiency. Detailed descriptions of the deficiencies noted are presented below. Appendix C presents a table summarizing the deficiencies on each of the loans, and appendix E contains detailed case studies of each of the loans with significant deficiencies.

Unsupported Assets

Leader Mortgage did not sufficiently verify borrower assets in four of the seven loans with material deficiencies. The material deficiencies related to insufficient verification of gift fund transfers and bank account assets.

HUD requires lenders to verify all funds for the borrower's investment in the property. More specifically, HUD requires the lender to properly document the transfer of gift funds from the donor to the borrower and to ensure that the gift funds are provided by an allowable donor.

For example, in Federal Housing Administration Case #182-0715856, the borrower claimed only $7 in personal assets and anticipated gift funds of $6,200. The borrower paid $5,299 to close the loan. According to the gift letter, the donor was the the borrower's relative. However, Leader Mortgage did not verify that the donor had the funds available to provide to the borrower or that the donor provided the funds to the borrower before the loan closing.

As another example, in Case #182-0723158, Leader Mortgage based its loan evaluation on the borrower having bank assets of $28,388. However, the same bank statement used to support the deposit of the $28,388 also showed that the borrower had withdrawn $13,337 within 4 days following the deposit and had withdrawn another $8,337 to close the Federal Housing Administration loan at the end of that same month. The bank statement balance was only $5,291 on the day that the lender approved the loan using an automated underwriting system.

Underreported Liabilities

Leader Mortgage did not consider all relevant liabilities when approving three of the seven loans. HUD requires lenders to consider all recurring obligations, contingent liabilities, and projected obligations that meet HUD's specific stipulations when evaluating a loan application.

For example, in Case #291-3101558, Leader Mortgage ommitted liabilities for both the borrower and coborrower when evaluating the loan. It did not consider monthly debts of $547 and $317 for the borrower and coborrower, respectively, as shown on the credit reports. Considering the ommitted liabilities of $864 monthly, the borrowers' debt ratio would increase from 38.6 percent to 71 percent, significantly exceeding HUD's limit of 41 percent.

Unsupported Income

Leader Mortgage used an unsupported income amount for two of the seven loans. Lenders may not use any income in evaluating the borrower's loan that it can not verify, is not stable, or will not continue.

For example, Leader Mortgage originated Case #291-3001035 using a calculated monthly income of $2,969. It calculated the income based on an hourly rate of $17.13 per hour and full-time employment of 40 hours per week. However, the most current pay stub supported earnings of only $2,611 per month, while only one of the four pay stubs obtained supported a 40-hour work week. An average of the four pay stubs supported only $2,663 per month.

Derogatory Credit

Leader Mortgage did not properly evaluate the borrowers' past credit performance and ensure that the borrowers demonstrated financial responsibility in one of the seven loans. Leader Mortgage originated the mortgage when the borrowers' credit reports and other file documentation indicated significant credit deficiencies. HUD considers past credit performance of the borrowers to be the most useful guide in determining the attitude toward credit obligations that will govern the borrowers' future actions.

The borrowers' credit report in Case# 291-3101558 showed numerous delinquent payments on a mortgage loan owed in the year immediately preceding the closing of the the Federal Housing Administration loan. The same borrower was also delinquent on a U.S. Department of Education student loan and owed a balance of $13,498. Leader Mortgage had not obtained any documentation indicating that the Federal student loan had been brought current, deferred, forgiven, or paid off.

Other Deficiencies

Leader Mortgage also originated 15 loans that contained minor underwriting deficiencies. While these deficiencies did not affect the overall credit quality (insurability) of the individual loans, they do indicate a lack of commitment to quality underwriting. Lenders need to ensure that they follow all facets of HUD requirements when originating Federal Housing Administration loans. We provided details of these deficiencies to Leader Mortgage during our review. Appendix C presents a table summarizing the deficiencies on each of the 15 loans.

Most notably, in multiple instances Leader Mortgage charged fees to borrowers that are specifically prohibited on Federal Housing Administration mortgage loan closings. HUD requires lenders to disclose all closing costs charged to borrowers on the HUD-1 Settlement Statement and provides guidance for lenders regarding whether the lender can charge borrowers certain closing costs. For 9 of the 23 loans, Leader Mortgage charged $3,896 in fees to borrowers that were specifically prohibited by HUD or were not sufficiently detailed to ensure that the charges were allowable. Borrowers paid fees such as broker's administrative commissions, corporate assignment fees, buyer's coordination fees, and excessive loan origination and loan discount fees. Detailed descriptions of the unallowable fees charged to borrowers is presented in appendix D.

Conclusion

Leader Mortgage did not have an effective control environment to prevent its employees from approving loans that did not meet HUD requirements. As a result, Leader Mortgage originated seven loans that contained deficiencies which have placed the Federal Housing Administration insurance fund at risk for $911,738 and caused HUD to incur other related losses.

Recommendations

We recommend that the Assistant Secretary for Housing - Federal Housing Commissioner, and Chairman, Mortgagee Review Board

1A. Take appropriate administrative action against Leader Mortgage for not complying with HUD requirements, including requiring Leader Mortgage to indemnify HUD for the seven loans totaling $911,738 (see appendix C).

1B. Require Leader Mortgage to reimburse the appropriate borrowers for $3,896 in unallowable fees (see appendix D).

Finding 2: Leader Mortgage ’s Quality Control Process Did Not Comply with HUD Requirements

Leader Mortgage had not established and implemented an adequate quality control process. Leader Mortgage’s written quality control plan lacked many required elements, and it had not ensured that it conducted adequate quality control reviews of its loans. As a result, Leader Mortgage is unable to ensure the accuracy, validity, and completeness of its loan originations.

Leader Mortgage’s Process Did Not Meet HUD Standards

Leader Mortgage’s written quality control plan lacked many HUD-required elements. The more significant deficiencies included the absence of guidance on conducting onsite branch reviews at least once per year; ensuring proper release of rehabilitation funds on 203(k) loans; confirming that loans are current when submitted for insurance endorsement; including loans from all branches, loan officers, underwriters, and appraisers in quality control reviews; and reporting any violation of law or regulation, false statement, or program abuse to the appropriate parties.

In addition, Leader Mortgage did not perform the required reviews in accordance with HUD regulations or within the timeframe required, nor did it take prompt corrective action when deficiencies were identified. Leader Mortgage did not

- Review any rejected loans, although HUD requires review of at least 10 percent of rejected loans.
- Review all loans defaulting within 6 months of the closing date. HUD’s systems showed that eight loans had first defaults reported before the sixth payment; however, Leader Mortgage did not review any of these loans.
- Ensure that its quality control contractor conducted reviews within 90 days of the loan closing.
- Conduct onsite reviews of branch offices.
- Ensure that all required quarterly reviews were conducted and reports provided to management. As of mid-August 2004, the quality control contractor had not conducted any reviews for the year because Leader Mortgage did not provide the necessary information until mid-July 2004.
- Take prompt corrective action to eliminate deficiencies. The quality control contractor continued to report the same exceptions in the seven quarterly reports available for the period of our review.

Leader Mortgage outsourced its quality control reviews to an external independent contractor. However, Leader Mortgage remains responsible for providing adequate information to the contractor in order for the contractor to conduct quality control reviews that meet HUD’s requirements.

Under HUD's Single Family Endorsement program, the lender underwrites and closes the loan without prior HUD review or approval. Therefore, it is imperative that approved lenders establish and implement quality control policies and procedures that meet HUD requirements. Without an adequate quality control process, HUD cannot be assured that Leader Mortgage is properly processing and submitting Federal Housing Administration loans for insurance endorsement.

Conclusion

Leader Mortgage did not establish and implement a quality control process that complied with HUD requirements. Leader Mortgage's written plan lacked many significant elements necessary to conduct proper quality control reviews, and it did not ensure that it provided adequate information to its quality control contractor to ensure that it conducted reviews in accordance with HUD regulations. Without a properly implemented quality control process, the lender cannot ensure that its loan originations comply with HUD requirements; that it is protecting itself and HUD from unacceptable risk; and that it is guarding against errors, omissions, and fraud.

Recommendations

We recommend that the Assistant Secretary for Housing - Federal Housing Commissioner, and Chairman, Mortgagee Review Board

2A. Require Leader Mortgage to establish and implement an adequate quality control process.

2B. Verify that Leader Mortgage's quality control process is fully implemented in accordance with HUD regulations.

SCOPE AND METHODOLOGY

Leader Mortgage originated 320 Federal Housing Administration-insured loans that closed from May 1, 2002, through April 30, 2004. Of these 320 loans, we reviewed all 23 loans that defaulted within the first 2 years of the loan.

To achieve our objectives, we reviewed HUD’s rules, regulations, and guidance for proper origination and submission of Federal Housing Administration loans. We also reviewed previous HUD reviews of Leader Mortgage and the HUD case binders for the 23 defaulted loans. In addition, we interviewed HUD staff to obtain background information on HUD requirements and Leader Mortgage.

We interviewed Leader Mortgage’s management and staff to obtain information regarding its policies, procedures, and management controls. Additionally, we reviewed Leader Mortgage’s case binders for the 23 defaulted loans; and reviewed its written policies and procedures to gain an understanding of how its processes are designed to function. We also reviewed Leader Mortgage’s quality control plan and available quality control reports.

We relied upon computer-processed data contained in HUD’s Single Family Data Warehouse system. We assessed the reliability of these data, including relevant general and application controls, and found them to be adequate. We also performed sufficient tests of the data, and based on the assessments and testing, we concluded that the data are sufficiently reliable to be used in meeting our objectives.

We performed audit work from July through October 2004. The audit was conducted in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Controls over origination of Federal Housing Administration loans.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- Leader Mortgage has not properly implemented a quality control plan and process (see finding 2).

APPENDIXES

Appendix A

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

Recommendation Number	Ineligible 1/	Unsupported 2/	Unreasonable or Unnecessary 3/	Funds to be Put to Better Use 4/
1A				$911,738
1B	$3,896			

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law, contract or Federal, State or local polices or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity where we cannot determine eligibility at the time of audit. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

3/ Unnecessary/Unreasonable costs are those costs not generally recognized as ordinary, prudent, relevant, and or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.

4/ Funds Put to Better Use are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented resulting in reduced expenditures in subsequent period for the activities in question. Specifically, this includes costs not incurred, de-obligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

December 23, 2004

Mr. Ronald J. Hosking
Regional Inspector General for Audit
Gateway Tower II – 5th Floor
400 State Avenue
Kansas City, Kansas 66101

Dear Mr. Hosking,

Thank you for sending the draft report to Leader Mortgage Company and for your examination of Leader Mortgage Company. In addition, let me congratulate you on your employees, Dan Tipton and Kim Randall. Both were pleasant and easy to work with, always working within the schedules of Leader Mortgage and not interrupting our current work flow. Both asked several questions and attempted to determine to the extent of their underwriting knowledge what was correct and incorrect according to FHA guidelines. They made the audit process, while not an exciting process, at least a pleasant one. They continued the tradition of HUD audits in the past where by HUD employees have evaluated Leader's policies and procedures and have done so pleasantly and courteously. Leader Mortgage Company is proud to have been a HUD lender since 1992.

I would like to comment on the overall reason for the audit, the comments on our quality control process, and on some of the issues regarding the seven loans finally selected for the audit.

Comment 1

First, the overall reason for the audit. In your prologue, the reason stated for the audit was "its (Leader Mortgage Company) default rate has ranged from 200% to 300% of the Kansas City Field office average over the past three years". At no time in the past three years has Leader Mortgage Company ever exceeded HUD's stated default rates according to the Credit Watch information that we have been given according to Mortgagee Letter 99-15 and 00-20. This information was taken from the credit watch information available to lenders, and as such, includes loans that have paid off, been reinstated, or are in repayment plans. HUD's credit watch procedures do not include loans that have been paid off, been reinstated, or that are in repayment when HUD figures true default rates. In fact, at our last check as of 9/30/2004, Leader Mortgage Company was at 81% of the national default rate when loans in repayment and loans that have been reinstated are taken into account. We believe your statement does not clearly state the facts and is not in line with HUD's own statements concerning default rates. We would note as a final fact, that of the seven loans that OIG selected of the total of 320 originated by Leader, only three were in default currently. Four of the seven were in repayment or had been reinstated.

As to our quality control process, Leader Mortgage Company, at the recommendation of a previous HUD audit several years ago by the local field office, hired outside companies to perform quality control for Leader Mortgage Company. There have been two outside firms who have performed quality control for Leader Mortgage Company, QC-MAC and M & T Enterprises. Both are well-established firms with a long history and much experience. Two previous audits by HUD found both companies to be acceptable and that they were providing Leader Mortgage Company with competent service. Specifically we disagree with the following statements:

Comment 2

1) Leader did not review all loans defaulting within six months of the closing date.
2) Conduct onsite reviews of branch offices.
3) Take prompt corrective action to eliminate deficiencies.

First, Leader Mortgage Company does not receive notification from its investors if a loan defaults in the first six months. Even when we have asked for such information in the past, we do not receive it since the investor tells us it is not within the privacy rights for us to have this information. We believe having such information would have helped us to work with these clients and help HUD's goals of loss mitigation.

As to the second item, Leader Mortgage Company opened its St. Louis office in January of 2003 and senior management has visited this office no less than once every three months.

As to the third item, Leader Mortgage Company does take prompt and corrective action including but not limited to, weekly training classes, one-on-one training, and where necessary, firing. Simply because a quality control contractor notes similar exceptions does not mean that Leader Mortgage Company does not take prompt corrective actions.

Finally, as to loans with deficiencies that affected insurability. Leader Mortgage Company wishes to make the following statements regarding each of the loans that the OIG audited.

292-4377252

Liabilities –

Comment 3

There are cashiers checks in the file clearly showing that these debts (Bk of America and 2 Commerce accounts) were paid There is also a statement in the file from Leader's St Louis branch that indicates the checks were mailed to the respective creditors. The discussion of including these debts into the borrower's ratios in DU belabors the point that there were no debts to include on the closing date of this loan. The debts were obviously not included in the underwriting analysis on this file as verified by the 1003 and by the AUS findings. The source of the funds to pay these debts ($3726) and the Yamaha debt of $4374 are no mystery. They were paid from the gifts received by the borrower prior to closing. The acceptability of the gift is another issue (discussed as Assets). In retrospect, these debts should have been paid on the HUD to alleviate any confusion paying them out of closing may have caused, but the net effect is the same – the debts were paid off in certified funds and mailed directly to the debtors by an agent of the lender.

Comment 3

Assets-

This borrower received three gifts. One was from Ameridream (non-profit) down payment assistance in the amount of $5192.15. We were cited for not having a copy of the wire transfer on this gift. A copy was not in the file at the time of audit, but it was provided to the OIG auditor on 9/9/04. An additional copy of that wire transfer is attached for your convenience. Please note that the funds to close for this transaction were all covered by that gift. The additional two gifts, from relatives were used for debt payoff and reserves. They were in the amount of $10,000 each. We have called the borrower and the donors of these gifts, since our lack of documentation was noted by OIG, but were unable to get the additional documentation that was sought. We have verbally verified with all parties concerned that these funds were received and used for debt payoff. We failed, however, to meet the burden of documentation required on the gifts.

Point of note: This file was a 203K renovation loan. The servicer incorrectly placed this loan in default after 90 days because they did not realize the payments has been escrowed. The renovation escrow included payments for the first three months of this loan because of the substantial amount of renovation being done (uninhabitable). The default misunderstanding occurred when the borrower was expected to pick the payment up on their own. This was attributable to a misunderstanding of how many mortgage payments were escrowed.

The loan has been reinstated or actually reported correctly, the credit report corrected, and the loan is current.

182-0715856

Assets-

Comment 4

The sole issue on this loan was the gift documentation. The borrowers received a gift of $6200 to pay closing costs of 5299. If the underwriter received that documentation, it is no longer in the physical file. We called the borrowers and the donor after this discrepancy was noted and verbally verified the receipt of this gift, but could not get the physical documentation required, this long after the closing of the loan.

Point of note: This borrower defaulted after the 12th payment. Reviewing this file in retrospect, the underwriter believes that the gift fund documentation did not cause this loan to default a full year after the fact.

182-0769020

Assets-

Comment 5

The borrower had assets totaling 9663.23 and required 10,781.98 for funds to close. There is a bank statement in the file showing the mother having the ability to give the gift of $10,000 and a gift letter indicating her intent to do so. We did not, however, complete the documentation to show the actual transfer of the funds from the mother to the borrower.

This loan is reinstated and is current.

291-3001035

Income-

Comment 6 The underwriter, admittedly, miscalculated the income for these borrowers. The ratios on this loan were moved to 33.79/36.59 with the OIG calculated income. These are still very much within the approvable range, and do not adversely impact the performance of this loan. The other issues stated by the auditors have all been corrected at the time of this writing.

291-3182227

Liabilities-

Comment 7 This loan boils down to one issue. The borrowers had a debt to Central Nat Bank that had 7 payments remaining. The underwriter did not consider this a significant debt and did not count it in the borrower's ratios, as it had less than 10 payments left. The auditor on the other hand subjectively thought that it was significant and that it should have been counted. Two points of contention… (1) FHA does not specify what should be considered "significant". This is a call that is left to the individual underwriter. Without clear cut guidelines, every underwriter will view things differently. The auditor is looking at this loan in retrospect and will undoubtedly view the loan differently, because he has information that the original underwriter did not. (2) This loan defaulted after its 7th payment, not while this liability was still viable. Therefore LMC believes it is inaccurate to assign the responsibility of this default on an issue that was already resolved prior to the default.

This loan is reinstated and is current.

182-0723158

Assets-

The OIG auditor indicated that the DU approval on this file was based on the strength of the borrower's reserves, when he has no actual knowledge of the legitimacy of that statement. The divorce clearly documented that the borrower was to receive a settlement

Comment 8 of 28,388 and the deposit of exactly that amount is recorded into the borrower's bank account on 10/25. The AUS findings do overstate reserves as noted by the auditor. Please note, however, that even with the OIG calculations, the borrowers had 5291 in reserves, which represents over 5 months PITI in the borrower's account. This is a strong statement on an FHA loan. We do not feel that the strength of the borrower's assets have diminished significantly from the AUS findings to the OIG reinterpretation of the borrower's asset position. The loan should still have been approved, and the performance of the loan was not compromised by this miscalculation.

Comment 8

Income-

The borrower's pay stub indicated a current salary amount of $2250 per month. Why would we also need that amount repeated on the verification of employment. If the salary is indicated on the pay stub, the verification would not need to specify whether this was for part time or full time employment. The 2002 W2 from Leader mortgage is attached, to document the borrower's propensity to earn this amount.

<u>As to the unallowable fees charged to borrowers.</u> We believe the following charges of the OIC findings to be accurate and allowable:

Comment 9

Real Estate Commission Fee of $1850

According to HUD guidelines (HUD handbook 4000.2 and HUD handbook 4155.1), a buyer may pay a real estate agent a fee if they have signed an exclusive buyer agency agreement. Leader Mortgage Company did not receive this fee and it is allowable. Therefore this is not a charge that LMC will pay.

291-3019751 Real Estate Commission - $1850

Comment 10

Excessive Discount Points and Loan Origination Fees:

To determine whether a loan had "excessive discount points" / "excessive loan origination fees", one would have to review every loan that was locked on the same date as the subject loan . One would also have to review loans made on the same date to borrowers of similar credit characteristics for an accurate comparison of the points and fees charged for the rate received. The OIG auditors did not perform this level of review. They are looking only at the subject loan and making a subjective value guess of what appears to be excessive in their opinion. Therefore LMC will not pay these amounts.

182-0726661 $1450 Discounts
182-0722653 $2038 Discounts
291-2979865 $1216 Loan Origination Fee

Comment 11

Commitment Fee:

This is an allowable charge on a loan that was locked 15 days prior to closing per HUD regulations. The loan in question was locked on 5/29/02 as evidenced by the attached lock in sheet from the investor. The loan actually closed on 6/12/02. Since we count the day of lock-in as the first day, there were actually 15 days. Therefore this is an allowable charge and LMC will not pay this amounts.

291-2974795 $200 Commitment Fee

Sincerely,

A.W. Pickel, III
President/CEO, Leader Mortgage Company

**While we reviewed the additional documentation provided by Leader Mortgage in its written response to the report, we did not include this information in the Auditee Comments to maintain the privacy of the borrowers.

OIG Evaluation of Auditee Comments

Comment 1 We reviewed Leader Mortgage Company because its default rate was significantly higher than the HUD Kansas City field office's average over the past three years. We changed the report to reflect the significance of Leader Mortgage's default rate as compared to other area lenders.

Comment 2 HUD requires lenders to review all loans that default within the first six payments due. Although Leader Mortgage may not receive notification from its investors when a loan defaults within the first six payments due, Leader Mortgage remains responsible for monitoring its loans for defaults, as required by HUD. Leader Mortgage, as well as other lenders, can obtain access to Federal Housing Administration loan status data in HUD's systems. During the audit, we provided Leader Mortgage with the necessary access information.

While Leader Mortgage's senior management may make visits to its branch office, these visits are not an acceptable substitute for required quality control reviews performed by in-house quality control staff, or by independent contractors. HUD requirements state that a lender's branch offices engaged in origination or servicing of Federal Housing Administration-insured loans must be reviewed to ensure that branch offices are in compliance with HUD requirements. Further, annual visits are mandatory for offices meeting certain higher risk criteria, such as high early default rates, new branches or new key personnel, sudden increases in volume, and past problems. Therefore, we maintain that Leader Mortgage has not conducted required branch office reviews.

Although Leader Mortgage may be conducting frequent training of its employees, recurring loan origination deficiencies during our two-year audit period indicated that Leader Mortgage had not taken prompt corrective action to mitigate loan processing deficiencies. Further, because Leader Mortgage did not conduct timely quality control reviews for 2004, senior management had not received timely feedback and was therefore unable to take prompt corrective action.

Comment 3 While the cashiers checks may have been used to pay off the significant outstanding debts, Leader Mortgage did not obtain proper documentation prior to closing the loan to show that the creditors had released the debts and that the borrower was no longer responsible for these debts. Without proper assurance that the borrower's outstanding debts were released, Leader Mortgage should have included these liabilities as debts that affected the borrower's ability to repay the Federal Housing Administration loan.

We agree that Leader Mortgage obtained documentation for the transfer of the non-profit gift funds, and we have changed the report accordingly. Further, Leader Mortgage confirmed that it had not met HUD's documentation requirements for the two $10,000 gifts, but had only verbally verified the transfer of funds. HUD regulations require documentation, not verbal verification, of gift fund transfers; therefore, Leader Mortgage still has not ensured that the two $10,000 gifts were from a proper source of funds.

We selected the loans for review from the universe of loans originated by Leader Mortgage that had defaulted during the first two years of the loan. Although the reporting of the default to HUD may have been an error on the part of the servicer, our review of the loan origination disclosed major underwriting deficiencies.

Comment 4 Leader Mortgage confirmed that it had not met HUD's documentation requirements for the gift fund transfer, but had verbally verified the transfer of funds. HUD regulations require documentation, not verbal verification, of gift fund transfers; therefore, Leader Mortgage still has not ensured that the gift funds were from a proper source of funds.

Comment 5 HUD requires lenders to verify the source of all funds used to close a Federal Housing Administration loan. Leader Mortgage confirmed that it had verified only a portion of the necessary funds to close the loan, and did not properly document the source and transfer of the gift funds necessary to close the loan.

Comment 6 Leader Mortgage agreed that it miscalculated the borrower's income and used incorrect income data to gain approval from an automated underwriting system; therefore, we still question the data integrity and automated approval of this loan.

We agree that subsequent to our review and notification of Leader Mortgage, Leader Mortgage obtained and provided to us proper documentation showing that the non-profit gift funds were transferred from the donor to the borrower at closing. We have changed the report to recognize receipt of the documents.

We disagree that Leader Mortgage corrected the unallowable charge of $150 for a "broker's administrative commission" during our review. Leader Mortgage has not provided documentation showing that the broker's fee was an allowable charge to the borrower.

Comment 7 We maintain that the $341 monthly debt was significant to the borrower's ability to repay the mortgage during the months immediately following the loan closing. The borrower's credit history shows that the borrower had multiple late payments on the installment loan in question, and the loan was in delinquent status. Leader Mortgage had no assurance that the borrower would make the remaining monthly payments as required (i.e. in full or on time). Therefore, the debt was significant to the borrower's ability to repay the Federal Housing Administration loan and should have been considered in the loan evaluation.

Comment 8 Leader Mortgage agreed that it had overstated the borrower's reserves in gaining approval for the loan from the automated underwriting system. Because the loan approval was based on significantly overstated funds available to the borrower, we still question the data integrity, and therefore the automated approval, of this loan.

We disagree that the monthly salary indicated on the pay stub from the current employer was sufficient to support the monthly income claimed in the automated underwriting system to gain loan approval. Leader Mortgage relied on the salary rate indicated on a two-week pay stub – the only pay stub for the borrower, as the borrower had just begun new employment. The verbal Verification of Employment provided no confirmation of the borrower's salary or likelihood of continued employment; and the only pay stub available for the current employment showed only 16 hours worked and earnings of $205. Although the W-2 for the previous employment supported a higher monthly income than claimed to qualify for the loan, the borrower's current employment showed a decline in monthly income.

Comment 9 Upon further review of the loan documentation, we agree that the real estate commission of $1,950 was allowed as a buyer-broker fee. We removed the questioned fee from the report.

Comment 10 On Case #182-072661, Leader Mortgage charged the borrower a 7 percent ($1,450) discount fee on the $20,699 loan. Leader Mortgage charged other borrowers that we reviewed less than 3 percent in discount fees, which caused us to conclude that the 7 percent charged to this borrower was excessive. Mortgagee Letter 94-16, "Tiered Pricing Final Rule," says that a lender's customary lending practices may not provide for a variation in mortgage charge rates, including discount points, origination fees, and other such fees, exceeding two percentage points on its Federal Housing Administration-insured loans within a geographic area. Any variation within two percentage points must be based on actual variations in fees or costs to the lender to make a loan. Leader Mortgage did not demonstrate that the 7 percent discount fee was warranted.

Based on our analysis of loan discount fees charged to other borrowers reviewed, we agree that the discount fee of 2.31 percent ($2,038) on Case #182-0722653 was reasonable. We removed this questioned fee from the report.

On Case #291-2979865, Leader Mortgage charged a 2 percent loan origination fee of $1,216. According to the HUD Homeownership Center Reference Guide, Chapter 2, Mortgage Credit Guidelines, "Closing Costs and Other Fees," the loan origination fee can not exceed 1 percent of the principal amount of the mortgage, excluding any upfront mortgage insurance premium. Leader Mortgage exceeded the 1 percent limit on loan origination fees.

Comment 11 Leader Mortgage provided additional documentation to show that the $200 commitment fee was allowed under HUD regulations. We removed the questioned fee from the report.

Appendix C

LOAN PROCESSING DEFICIENCY CHARTS

Loans with Deficiencies that Affected Insurability

Case Number	Unsupported Assets	Underreported Liabilities	Unsupported Income	Inadequate Documentation	Unallowable Charges	Derogatory Credit	Total Number Of Deficiencies
292-4377252	X	X					2
182-0715856	X						1
182-0769020	X			X			2
291-3001035			X		X		2
291-3182227		X					1
182-0723158	X		X				2
291-3101558		X		X	X	X	4
Totals	**4**	**3**	**2**	**2**	**2**	**1**	**14**

***We considered the Inadequate Documentation and Unallowable Charges deficiencies included in the above chart to be minor deficiencies; however, we included these deficiencies with the relevant loans to summarize all deficiencies related to the seven loans with deficiencies that affected the insurability of the loans.

Loans with Minor Deficiencies

Case Number	Unsupported Assets	Unallowable Charges	Inadequate Documentation	Unsupported Income	Derogatory Credit	Total Number Of Deficiencies
291-2964303				X	X	2
291-2996892	X				X	2
291-3220529	X					1
291-2952567		X				1
181-1942028	X	X	X			3
182-0726661	X	X				2
182-0729697	X					1
291-2974795	X	X				2
291-2979865	X	X				2
291-3114551	X	X				2
181-2005198		X				1
291-3087115			X			1
291-3118179			X			1
182-0722653	X					1
291-3019751	X			X		2
Totals	**10**	**7**	**3**	**2**	**2**	**24**

Appendix D

Unallowable Fees Charged to Borrowers

FHA Case Number	Description of Unallowable Charges	Total Unallowable Charges
291-3001035	Broker's Admin Commission	$ 150
291-3101558	Rec/Filing Fee Assign	$ 30
291-2952567	Misc. Charges	$ 214
181-1942028	Prepare Seller Documents	$ 50
182-0726661	Buyer Coordination Fee ($355) Excessive Loan Discount ($1,450)	$1,805
291-2974795	Misc. Charges ($10) Wire Fee ($10)	$ 20
291-2979865	Misc. Fee ($165) 2% Loan Origination Fee ($1,216)	$1,381
291-3114551	Corporate Assignment ($29) Loan to Title Company ($205)	$ 234
181-2005198	Corporate Assignment	$ 12
Totals		**$3,896**

Appendix E

Case Studies of Improperly Submitted Loans

<u>FHA Case Number:</u> 292-4377252

<u>Insured Amount:</u> $171,272

<u>Section of Housing Act:</u> 203(k)

<u>Status Upon Selection</u>
Default status after 3 payments

<u>Date of Loan Closing:</u> 6/27/03

<u>Current SFDW Status:</u>
Reinstated by Mortgagor who retains Ownership

<u>HUD Costs Incurred:</u>
$0

<u>Underreported Liabilities:</u>
Leader Mortgage did not include $149 in monthly liabilities when using Desktop Underwriter to approve the loan, which would have increased the borrower's financial ratios even further beyond HUD's limits. The Mortgage Credit Analysis Worksheet, Application, and credit report of 5/2/03 showed total monthly obligations as $524, with child support accounting for $375 and other debt of $149. However, the Desktop Underwriter Findings Report showed only $375 for child support, and did not include the other debts owed to Bank of America and Commerce Bank. The Bank of America monthly payments were $25 per month with 47 payments remaining. One of the Commerce Bank accounts required $83 in monthly payments with 34 payments remaining, while the other Commerce Bank account required a $41 payment and 33 payments remaining.

The HUD case file contained additional documentation concerning the three outstanding debts omitted from Desktop Underwriter. The HUD file contained a copy of a cashiers check to Bank of America for $993 and another cashiers checks to Commerce Bank for $2,733, both dated 6/27/2003 (the date of closing). Although these cashiers checks may have been for pay off of the three outstanding debts not included in the loan evaluation, Leader Mortgage provided no documentation showing that the debts were actually paid off and that the creditor had released the debt. Leader Mortgage also did not verify the source of the $3,726 to pay off the three debts to ensure that the funds came from an allowable source.

Further, the borrower's credit report of 5/2/03 also showed $4,374 owed to Yamaha. The borrower's bank statement showed a deposit of $5,094 on 5/14/03, and a payoff statement from Yamaha shows that the borrower paid off the entire Yamaha account on 5/23/03. Leader Mortgage did not verify the source of the deposit of $5,094 to ensure that the funds came from an allowable source.

The case file also contained gift letters for anticipated gifts of $25,192, which are addressed below.

HUD Requirements:
HUD Handbook 4155.1, Revision 4, Paragraph 2-10-B: Saving and Checking Accounts: If there is a large increase in an account or the account was opened recently, an explanation and evidence of source of funds must be obtained by the lender.

HUD Handbook 4155.1, Revision 4, Paragraph 2-11-A: Recurring Obligations: The borrower's liabilities should include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the housing expense, and all other additional recurring charges including payments on installment accounts, child support, or separate maintenance payments, revolving accounts, and alimony, etc., extending ten months or more.

Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans dated July, 2002, Chapter 2, paragraph 3, states that the lender remains accountable for compliance with all Federal Housing Administration guidelines, as well as for any Federal Housing Administration eligibility requirements, credit capacity, and documentation requirements that are not covered in the User's Guide. All data that is entered into Desktop Underwriter, or that is downloaded or imported into the system must be true, accurate, and complete.

The Desktop Underwriting Findings Report notified Leader Mortgage that it had omitted the Bank of America, Yamaha, and Commerce Bank accounts from the underwriting analysis during liability reconciliation. The Findings Report also instructed Leader Mortgage to provide documentation that supported the omission of each of these liabilities.

Unsupported Assets:
Leader Mortgage did not verify the source of funds used to close the loan. The Application listed assets of $1,083 in Commerce Bank and $25,192 in gift funds. The anticipated gift funds were:

- $10,000 from the borrower’s stepmother,
- $10,000 from the borrower’s father, and
- $ 5,192 non-profit gift from Ameri-Dream.

Leader Mortgage included the $20,000 in gift funds in Desktop Underwriter, which approved the borrower's loan. However, Leader Mortgage did not obtain bank statements from either the donors or borrower to indicate whether the donors had the funds available to give, or that the gift funds were actually transferred to the borrower prior to or at closing. The HUD-1 Settlement Statement did not show that the borrower received gift funds at closing, other than the gift from Ameri-Dream. However the borrower paid off significant debts just prior to the loan closing (explained above).

Further, the Application, Mortgage Credit Analysis Worksheet, and HUD-1 Settlement Statement showed that the borrower expected to receive gift funds of $5,192 from a non-profit, Ameri-Dream. Leader Mortgage obtained no evidence that the non-profit provided the funds to the borrower prior to or at closing. During our audit, we informed Leader Mortgage of the deficiencies, and it subsequently obtained and provided proper gift funds transfer documentation for the non-profit funds. However, Leader Mortgage did not provide documentation of the two additional $10,000 gifts.

<u>HUD Requirements</u>:
HUD Handbook 4155.1, Revision 4, Paragraph 2-10-C: An outright gift of cash investment is acceptable if the donor is an approved provider. The lender must document the transfer of funds from the donor to the borrower. If the funds are not deposited to the borrower's account prior to closing, the lender must obtain verification the closing agent received funds from the donor for the amount of the gift.

Mortgagee Letter 00-28: Gift Transfer Documentation: The donor must be able to furnish conclusive evidence that the funds given to the homebuyer came from the donor's own funds and, thus, were not provided directly or indirectly by the seller, real estate agent, builder, or any other entity with an interest in the sales transaction. The Mortgagee Letter details appropriate documentation for transfers into the homebuyer's account or funds to be provided at closing. Further, when the transfer occurs at closing, the lender remains responsible for obtaining verification the closing agent received funds from the donor for the amount of the gift.

Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans dated July, 2002, Chapter 2, paragraph 3, states that the lender remains accountable for compliance with all Federal Housing Administration guidelines, as well as for any Federal Housing Administration eligibility requirements, credit capacity, and documentation requirements that are not covered in the User's Guide. All data that is entered into Desktop Underwriter, or that is downloaded or imported into the system must be true, accurate, and complete.

FHA Case Number: 182-0715856

Insured Amount: $129,615

Section of Housing Act: 203(b)

Status Upon Selection:
Default status after 12 payments

Date of Loan Closing: 8/30/02

Current SFDW Status:
First Legal Action to Commence Foreclosure

HUD Costs Incurred:
$200 in Loss Mitigation

Unsupported Assets:
Leader Mortgage did not verify the source of funds used to close the loan. The borrower's Application dated 8/30/02, the same day as closing, showed the borrower's assets as only $7. The Mortgage Credit Analysis Worksheet listed the borrowers' only assets as $7, plus a $500 earnest deposit, and an anticipated gift of $6,200. According to the gift letter, the co-borrower's relative was to provide the gift funds. The HUD-1 Settlement Statement did not credit the borrowers with the gift funds, but the borrowers paid $5,299 to close the loan on 8/30/02. The borrowers' bank statement dated 7/23/02 showed only the $7 in the borrowers' account, and no deposits that appeared to be the gift funds. Further, the loan file did not contain evidence that the donor had the means to provide the gift funds, nor did it contain deposit slips, canceled checks, or withdrawal slips to support that the gift funds were transferred from the donor to the borrowers, or that the funds used to close the loan were from an allowable source.

HUD Requirements:
HUD Handbook 4155.1, Revision 4, Paragraph 2-10: All funds for the borrower's investment in the property must be verified.

HUD Handbook 4155.1, Revision 4, Paragraph 2-10-C: An outright gift of cash investment is acceptable if the donor is an approved provider. The lender must document the transfer of funds from the donor to the borrower. If the funds are not deposited to the borrower's account prior to closing, the lender must obtain verification the closing agent received funds from the donor for the amount of the gift.

Mortgagee Letter 00-28: Gift Transfer Documentation: The donor must be able to furnish conclusive evidence that the funds given to the homebuyer came from the donor's own funds and, thus, were not provided directly or indirectly by the seller, real estate agent, builder, or any other entity with an interest in the sales transaction. The Mortgagee Letter details appropriate documentation for transfers into the homebuyer's account or funds to be provided at closing. Further, when the transfer occurs at closing, the lender remains responsible for obtaining verification the closing agent received funds from the donor for the amount of the gift.

FHA Case Number: 182-0769020

Insured Amount: $149,863

Section of Housing Act: 203(b)

Status Upon Selection:
Default status after 1 payment

Date of Loan Closing: 12/15/03

Current SFDW Status:
Reinstated by Mortgagor who retains Ownership

HUD Costs Incurred:
$0

Unsupported Assets:
Leader Mortgage did not verify the source of funds used to close the funds. The Application and Mortgage Credit Analysis Worksheet showed that the borrower anticipated a $10,000 gift to use in closing the loan, and Leader Mortgage included the anticipated gift of $10,000 in the automated underwriting system used to approve the loan (Desktop Underwriter). The HUD-1 Settlement Statement did not indicate a credit to the borrower for gift funds, but the borrower paid $10,782 to close the loan.

According to the gift letter, the gift funds were to be provided by the borrower's relative, but Leader Mortgage did not verify that the donor had the funds to provide, or that the donor transferred the funds to the borrower prior to or at closing. The loan file contained a bank activity report of 12/3/03, but the report did not provide the bank account owner's name or account number; therefore, it is not clear whether the bank information was that of the donor or the borrower. The bank activity report showed a $10,000 deposit on 12/3/2003, two weeks before the loan closing. The loan file did not contain any additional documentation of a potential transfer of gift funds from the donor to the borrower, such as proper bank statements, deposit slips, canceled checks, or withdrawal slips. Therefore, Leader Mortgage did not verify that the funds used to close the loan were from an allowable source.

HUD Requirements:
HUD Handbook 4155.1, Revision 4, Paragraph 2-10: All funds for the borrower's investment in the property must be verified.

HUD Handbook 4155.1, Revision 4, Paragraph 2-10-C: An outright gift of cash investment is acceptable if the donor is an approved provider. The lender must document the transfer of funds from the donor to the borrower. If the funds are not deposited to the borrower's account prior to closing, the lender must obtain verification the closing agent received funds from the donor for the amount of the gift.

Mortgagee Letter 00-28: Gift Transfer Documentation: The donor must be able to furnish conclusive evidence that the funds given to the homebuyer came from the donor's own funds and, thus, were not provided directly or indirectly by the seller, real estate agent, builder, or any other entity with an interest in the sales transaction. If the gift funds are in the homebuyer's account, the lender must document the transfer of the funds from the donor to the homebuyer by obtaining a copy of the canceled check or other withdrawal document showing the withdrawal is from the donor's personal account, along with the homebuyer's deposit slip or bank statement that shows the deposit.

Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans dated July, 2002, Chapter 2, paragraph 3, states that the lender remains accountable for compliance with all Federal Housing Administration guidelines, as well as for any Federal Housing Administration eligibility requirements, credit capacity, and documentation requirements that are not covered in the User's Guide. All data that is entered into Desktop Underwriter, or that is downloaded or imported into the system must be true, accurate, and complete.

The Desktop Underwriting Findings Report notified Leader Mortgage that it was required to verify and document the transfer of the $10,000 in gift funds in accordance with HUD Mortgagee Letter 00-28 (as described above).

Inadequate Documentation:
The HUD-1 Settlement Statement showed that the borrower owed total settlement charges of $6,521, and the seller owed total settlement charges of $7,306. However, the Addendum to the HUD-1 showed different settlement charges than the HUD-1. The Addendum showed the borrower's charges as $6,488 (a slight reduction), and the seller's charges as $420, significantly less than the HUD-1. Leader Mortgage did not explain the differences in the settlement charges to ensure that the seller was not making unallowable concessions to the borrower.

HUD Requirements:
In HUD Handbook 4000.4, Paragraph 2-5(c): The mortgagee must review all closing statements, certifications on the closing statements, legal instruments and other documents executed at closing, and certify to HUD that the transaction and loan meet statutory and regulatory requirements of the National Housing Act and HUD, and that the loan has been closed in accordance with the terms and sales price as specified in the sales contract.

Additional Information:
Leader Mortgage told us that it erred in the documentation of the settlement charges. The lender told us that when it prepared the HUD-1 Settlement Statement and entered the information into its computer system, it failed to update some of the changes in the settlement charges. As a result, its computer system issued an Addendum to the HUD-1 that showed different charges than the original HUD-1. Leader Mortgage told us to rely on the HUD-1 for the correct information. Leader Mortgage did not provide any additional documentation to explain the differences; therefore, it remains unclear whether the seller made unallowable concessions to the borrower.

FHA Case Number: 291-3001035

Insured Amount: $121,099

Section of Housing Act: 203(b)

Status Upon Selection:
Default status after 18 payments

Date of Loan Closing: 8/13/02

Current SFDW Status:
Supplemental Preclaim

HUD Costs Incurred:
$5,387 in Partial Claim

Unsupported Income:
Leader Mortgage overstated the borrower's income when using an automated underwriting system, Loan Prospector, to originate and obtain approval of the loan. The lender calculated the borrower's monthly income as $2,969, based on a 40-hour work week ($17.13 X 40 X 52 / 12 months). However, the most recent pay stub, dated 7/21/02, shows that the borrower had year-to-date earnings of $17,496, or $2,611 monthly ($358 less than claimed). The borrower provided four pay stubs, and only one pay stub showed the borrower working at least 40 hours per week. Further, if the pay indicated on each weekly pay stub were averaged together, the borrower's monthly income was equate to only $2,663 per month ([518 + 711 + 548 + 681] / 4 X 52 / 12 months). Regardless of the calculation method used, Leader Mortgage significantly overstated the borrower's income in Loan Prospector. Using the reduced monthly income, the borrower's housing ratio becomes 33.79 percent, which exceeds HUD's allowable housing ratio of 29 percent.

HUD Requirements:
HUD Handbook 4155.1, Revision 4, Chapter 2- Section 2: The anticipated amount of income, and likelihood of its continuance, must be established to determine the borrower's capacity to repay the mortgage debt.

HUD Handbook 4155.1, Revision 4, Paragraph 2-12: Ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership, and otherwise provide for the family. The lender must compute two ratios: (A) Mortgage payment expense to effective income, which can not exceed 29 percent of gross effective income unless significant compensating factors are presented; and (B) Total fixed payment to effective income, which can not exceed 41 percent of gross effective income unless significant compensating factors are presented.

Mortgagee Letter 98-14: FHA has approved Freddie Mac's Loan Prospector for use on FHA insured mortgages, effective March 2, 1998. The lender remains accountable for compliance with FHA guidelines and those credit, capacity, and documentation aspects not addressed in the LP Users Guide.

Freddie Mac's Loan Prospector Automated Underwriting Service Training and Users Guide, Section 2: The data the user inputs into Loan Prospector must match the application, underwriting documentation, and delivery information at the time the data is entered, and the user is responsible for data integrity.

Unsupported Assets:
The lender did not properly verify the source of funds to close the loan. Although the HUD-1 Settlement Statement credited the borrower with a gift of $7,251 from a non-profit, Partners in Charity, Leader Mortgage did not obtain evidence that the non-profit provided the funds to the settlement agent or borrower prior to or at closing. During our audit, we informed Leader Mortgage of the deficiency, and it subsequently obtained and provided to us proper gift funds transfer documentation for the non-profit funds.

HUD Requirements:
HUD Handbook 4155.1, Revision 4, Paragraph 2-10-C: An outright gift of cash investment is acceptable if the donor is an approved provider. The lender must document the transfer of funds from the donor to the borrower. If the funds are not deposited to the borrower's account prior to closing, the lender must obtain verification the closing agent received funds from the donor for the amount of the gift.

Mortgagee Letter 00-28: Gift Transfer Documentation: The donor must be able to furnish conclusive evidence that the funds given to the homebuyer came from the donor's own funds and, thus, were not provided directly or indirectly by the seller, real estate agent, builder, or any other entity with an interest in the sales transaction. The Mortgagee Letter details appropriate documentation for transfers into the homebuyer's account or funds to be provided at closing. Further, when the transfer occurs at closing, the lender remains responsible for obtaining verification the closing agent received funds from the donor for the amount of the gift.

Unallowable Charges:
The HUD-1 Settlement Statement showed that Leader Mortgage charged the borrower $150 for a "broker's administrative commission." HUD regulations generally do not allow this fee, and the lender did not explain the fee to determine whether it may be allowable under HUD regulations as another type of allowable closing cost.

HUD Requirements:
HUD Homeownership Center Reference Guide, Chapter 2, Mortgage Credit Guidelines: All closing costs associated with a HUD-insured loan, including Paid Outside of Closing items, must be itemized on the HUD-1 for Real Estate Settlement Procedures Act Compliance.

HUD Homeownership Center Reference Guide, Chapter 2, Mortgage Credit Guidelines: Broker Administration/Processing/Transaction Fees are not allowed.

Additional Information:
During our audit, Leader Mortgage agreed that it erred and improperly charged the borrower the $150 "broker's administrative commission."

FHA Case Number: 291-3182227

Insured Amount: $92,263

Section of Housing Act: 203(b)

Status Upon Selection:
Default status after 7 payments

Date of Loan Closing: 8/08/03

Current SFDW Status:
Reinstated by Mortgagor who Retains Ownership

HUD Costs Incurred:
$0

Underreported Liabilities:
Leader Mortgage did not properly consider all recurring debts when evaluating and approving the loan. The only recurring debt considered by the lender was a $366 per month auto loan payment. The credit report of 7/13/03 showed that this account was in delinquent status, had approximately 12 more months due, and had 18 late payments recorded in the 62 months reviewed. Leader Mortgage did not consider a $341 monthly payment on an installment account with a remaining balance of $2,428. This account was also in delinquent status, and the borrower was behind by two payments. The borrower had approximately eight monthly payments left on this account.

While HUD regulations generally require consideration of monthly recurring debts if at least 10 months remain on a debt, this debt was significant to the borrower's ability to repay the mortgage in the first few months of the federal loan. If Leader Mortgage had included the $341 monthly debt in its financial ratio calculations, the debt ratio would have increased from 38.36 percent to 50.65 percent, which greatly exceeds HUD's limit of 41 percent. Further, the Mortgage Credit Analysis Worksheet showed that the borrower had limited cash reserves of only $1,268.

HUD Requirements:
HUD Handbook 4155.1, Revision 4, Paragraph 2-11-A: Recurring Obligations: The borrower's liabilities should include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the housing expense, and all other additional recurring charges including payments on installment accounts, child support, or separate maintenance payments, revolving accounts, and alimony, etc., extending ten months or more. Debts lasting less than ten months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing.

HUD Handbook 4155.1, Revision 4, Paragraph 2-12: Ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership, and otherwise provide for the family. The lender must compute two ratios: (A) Mortgage payment expense to effective income, which can not exceed 29 percent of gross effective income unless significant compensating factors are presented; and (B) Total fixed payment to effective income, which can not exceed 41 percent of gross effective income unless significant compensating factors are presented.

FHA Case Number: 182-0723158

Insured Amount: $130,524

Section of Housing Act: 203(b)

Status Upon Selection:
Default status after 1 payment

Date of Loan Closing: 10/30/02

Current SFDW Status:
First Legal Action to Commence Foreclosure

HUD Costs Incurred:
$0

Unsupported Assets:
Leader Mortgage significantly overstated the borrower's assets when entering data into an automated underwriting system (Desktop Underwriter) to gain approval for the loan. The Mortgage Credit Analysis Worksheet and the Desktop Underwriting Findings Report (dated 10/30/02 - the same day as the loan closing) showed that the lender included $28,388 in assets when evaluating the loan. Per the loan file, the borrower obtained the funds in a divorce settlement. The borrower's bank statement of 10/30/02 showed the $28,388 deposit on 10/25/02, but also showed that the borrower withdrew $13,337 in the following four days (between 10/25/02 and 10/29/02). The borrower used another $8,337 to close the loan on 10/30/02, leaving a balance of $5,291. Leader Mortgage had the bank statement showing the true balance of the borrower's assets, but included the improper amount in the automated system evaluation.

Further, Desktop Underwriter approved the loan with a housing ratio of 42.40 percent and debt ratio of 43.75 percent, which exceed HUD's limits; but this approval was based on significantly more reserves than the borrower actually possessed.

HUD Requirements:
Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans, dated July, 2002, Chapter 2, paragraph 3: The lender remains accountable for compliance with all Federal Housing Administration guidelines, as well as for any eligibility requirements, credit capacity, and documentation requirements that are not covered in this User's Guide. All data that is entered into the Desktop Underwriter, or that is downloaded or imported into Desktop Underwriter must be true, accurate, and complete.

The Desktop Underwriting Findings Report notified Leader Mortgage that the system had used the $28,388 as assets to underwrite the case, and that the entire amount must be confirmed to verify the sufficiency of funds to close. Further, the funds were also considered in the evaluation of cash reserves, and the system notified the lender that it must verify all cash reserves after closing that were submitted to Desktop Underwriter.

HUD Handbook 4155.1, Revision 4, Paragraph 2-12: Ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership, and otherwise provide for the family. The lender must compute two ratios: (A) Mortgage payment expense to effective income, which can not exceed 29 percent of gross effective income unless significant compensating factors are presented; and (B) Total fixed payment to effective income, which can not exceed 41 percent of gross effective income unless significant compensating factors are presented.

Unsupported Income:
Leader Mortgage did not properly support/verify the monthly income of $2,250 used by Desktop Underwriter to approve the loan. The borrower began her current job on 10/14/02, only two weeks before the closing of the Federal Housing Administration loan; therefore, the lender obtained only one pay stub, which encompassed a two-week period. The pay stub showed the borrower's monthly pay rate as $2,250, but the pay stub showed only 16 hours worked during the period and total earnings of $205. The lender obtained a verbal Verification of Employment from the current employer, but the Verification did not confirm the borrower's income or full-time/part-time status.

In addition, the borrower previously worked at Leader Mortgage, the lender on this loan, for the 1½ year period prior to the current job (hire date of 3/9/01). The W-2 for 2001 showed that the borrower earned about $1,600 per month. However, the loan file contained no information regarding the earnings while an employee at Leader Mortgage in 2002 for 9 ½ months. In its written response to the audit, Leader Mortgage provided the borrower's 2002 W-2, which indicated a monthly income of $2,440. While the employment immediately preceding the current employment provided a monthly income higher than claimed to qualify for the loan, the current employment also shows a declining income.

HUD Requirements:
HUD Handbook 4155.1, Revision 4, Chapter 2- Section 2: The anticipated amount of income, and likelihood of its continuance, must be established to determine the borrower's capacity to repay the mortgage debt.

HUD Handbook 4155.1, Revision 4, paragraph 2-6: HUD does not impose an arbitrary minimum length of time a borrower must have held a position to be eligible. However, the lender must verify the borrower's employment for the most recent two full years.

HUD Handbook 4155.1, Revision 4, Chapter 3-Paragraph 3-1: The application package should contain sufficient documentation to support the lender's decision to approve the mortgage loan.

HUD Handbook 4155.1, Revision 4, Chapter 3-Paragraph 3-1-E: Mortgage credit analysis requires documentation of income by Verification of Employment and most recent pay stub (i.e. most recent at time of application and provided the document is not more than 120 days old when the loan closes). As an alternative to obtaining a VOE, the lender may choose to obtain original pay stubs covering the most recent 30-day period, along with copies of the previous two years' IRS W-2 forms. The lender must also verify by telephone all current employers.

Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans, dated July, 2002, Chapter 2, paragraph 3, states: The lender remains accountable for compliance with all Federal Housing Administration guidelines, as well as for any eligibility requirements, credit capacity, and documentation requirements that are not covered in this User's Guide. All data that is entered into Desktop Underwriter, or that is downloaded or imported into Desktop Underwriter must be true, accurate, and complete.

FHA Case Number: 291-3101558

Insured Amount: $117,102

Section of Housing Act: 203(b)

Status Upon Selection:
Default status after 9 payments

Date of Loan Closing: 3/25/03

Current SFDW Status:
Repayment

HUD Costs Incurred:
$200 in Loss Mitigation

Underreported Liabilities:
Leader Mortgage did not consider all relevant liabilities when evaluating and approving the loan. The Application and Mortgage Credit Analysis Worksheet showed no recurring liabilities, other than the anticipated mortgage payment for the Federal Housing Administration loan. However, the borrower's credit report showed:

- a delinquent account for a Department of Education student loan. The borrower owed a balance of $13,498, and $2,089 was shown as past due. The loan file did not contain any information indicating that the loan had been brought current, deferred, forgiven, or paid off. The credit report did not list the monthly payment due.
- a credit card account with numerous delinquencies in 2001 and 2002 (the two years just prior to the loan closing). The account had an outstanding balance of $9,083, with $823 past due, and a monthly payment due of $360.
- a credit card account with an outstanding balance of $655, with $75 past due, and a $15 minimum monthly payment.
- a credit card account with an outstanding balance of $2,188 in collection status, and a $109 monthly payment.
- a credit card account with an outstanding balance of $1,264 in collection status and $63 monthly payment.

These monthly payments total $547 ($360 + $15 + $109 + $63) that Leader did not consider in evaluating the loan, excluding any monthly payment that was due on the federal student loan. These additional monthly liabilities would increase the debt ratio from 38.6 percent to 59.11 percent, which greatly exceeds HUD's limit of 41 percent.

The credit report also showed that the borrower was delinquent numerous times in 2002 in making his mortgage payments on his present mortgage. This was the year just prior to the Federal Housing Administration loan closing of 3/25/03.

In addition, Leader Mortgage provided only the borrower’s credit report to HUD, and omitted the co-borrower’s credit information that it had obtained on a joint credit report. The Application and Mortgage Credit Analysis Worksheet included the co-borrower’s information and signatures, and the co-borrower also signed the Note, showing that the co-borrower was also responsible for the mortgage debt.

The co-borrower's credit report in the Leader Mortgage file showed an open installment account with an outstanding balance of $9,548 and a $317 monthly payment. The credit report also showed four late payments on this account within the year prior to the Federal Housing Administration loan closing. Leader Mortgage did not include this monthly debt in the total monthly obligations considered when approving the loan.

Considering the underreported liabilities of the borrower of $547 (without considering the federal student loan), and the non-reported liabilities of the co-borrower of $317, Leader Mortgage did not consider $864 in monthly payments owed by the borrower and co-borrower. These additional monthly liabilities would have increased the debt ratio from 38.6 percent to 71 percent, which greatly exceeds HUD's limit of 41 percent.

<u>HUD Requirements</u>:
HUD Handbook 4155.1, Revision 4, Paragraph 2-11-A: Recurring Obligations: The borrower's liabilities should include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the housing expense, and all other additional recurring charges including payments on installment accounts, child support, or separate maintenance payments, revolving accounts, and alimony, etc., extending ten months or more.

HUD Handbook 4155.1, Revision 4, Paragraph 2-12: Ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership, and otherwise provide for the family. The lender must compute two ratios: (A) Mortgage payment expense to effective income, which can not exceed 29 percent of gross effective income unless significant compensating factors are presented; and (B) Total fixed payment to effective income, which can not exceed 41 percent of gross effective income unless significant compensating factors are presented.

HUD Handbook 4155.1, Revision 4, Paragraph 2-2-A: Co-borrower: Co-borrowers take title to the property and obligate themselves on the mortgage note. We also permit a cosigner with no ownership interest in the property (does not take title) to execute the loan application and mortgage note, and thus, become liable for repayment of the obligation. The cosigner's income, assets, liabilities, and credit history are included in the determination of creditworthiness.

HUD Handbook 4155.1, Revision 4, Paragraph 2-5: Delinquent Federal Debts: If the borrower is presently delinquent on any Federal debt (e.g. VA-guaranteed mortgage, Title I loan, Federal student loan, Small Business Administration Loan, delinquent Federal taxes, etc), or has a lien, including taxes, placed against his or her property for a debt owed to the United States, the borrower is not eligible until the delinquent account is brought current, paid or otherwise satisfied, or a satisfactory repayment plan is made between the borrower and the Federal agency owed and is verified in writing.

<u>Derogatory Credit:</u>
The co-borrower’s credit report in the Leader Mortgage file but not submitted to HUD showed the co-borrower had numerous accounts in collection. The co-borrower also had accounts that had charged off by the creditor.

<u>HUD Requirements</u>:
HUD Handbook 4155.1, Revision 4, Paragraph 2-3: Past credit performance serves as the most useful guide in determining the attitude toward credit obligations that will govern the borrower's future actions. If the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong offsetting factors will be necessary to approve the loan.

HUD Handbook 4155.1, Revision 4, Paragraph 2-2-A: Co-borrower: Co-borrowers take title to the property and obligate themselves on the mortgage note. We also permit a cosigner with no ownership interest in the property (does not take title) to execute the loan application and mortgage note, and thus, become liable for repayment of the obligation. The cosigner's income, assets, liabilities, and credit history are included in the determination of creditworthiness.

Unallowable Charges:
The HUD-1 Settlement Statement showed that Leader Mortgage charged the borrower $30 for a "Rec/Filing Fee Assignment." The lender did not adequately explain these charges in the loan file to ensure that they were allowable under HUD regulations.

HUD Requirements:
HUD Homeownership Center Reference Guide, Chapter 2, Mortgage Credit Guidelines: All closing costs associated with a HUD-insured loan, including Paid Outside of Closing items, must be itemized on the HUD-1 for Real Estate Settlement Procedures Act Compliance. Whenever "actual costs" are permitted, it is expected that they do not exceed what is reasonable and customary for the area. Recording Fee-Assignment charges are not allowed on the assignment of the mortgage to the investor.

Inadequate Documentation:
The HUD-1 Settlement Statement shows different totals for the borrower's settlement charges than the charges shown on the Addendum to the HUD-1 Settlement Statement. Although the difference was minor, the file contained no explanation of the difference in charges.

HUD Requirements:
In HUD Handbook 4000.4, paragraph 2-5(c) states: The mortgagee must review all closing statements, certifications on the closing statements, legal instruments and other documents executed at closing, and certify to HUD that the transaction and loan meet statutory and regulatory requirements of the National Housing Act and HUD, and that the loan has been closed in accordance with the terms and sales price as specified in the sales contract.

Additional Information:
During the audit, Leader Mortgage agreed that it had not considered all relevant liabilities. The lender also agreed that it had improperly charged the borrower the $30 Rec/Filing Fee Assignment in the closing costs.

Leader Mortgage told us that it erred in the documentation of the settlement charges. The lender told us that when it prepared the HUD-1 Settlement Statement and entered the information into its computer system, it failed to update some of the changes in the settlement charges. As a result, its computer system issued an Addendum to the HUD-1 that showed different charges than the original HUD-1. Leader Mortgage told us to rely on the HUD-1 for the correct information.