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| Issue Date | August 12, 2005 |
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| Audit Report Number | 2005-LA-1007 |
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TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing  
Commissioner, H

*Joan S. Hobbs*

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Pacific/Hawaii Region,  
9DGA

SUBJECT: KB Home Mortgage Company, Los Angeles, California, Improperly Submitted  
13 Late Requests for Single Family Mortgage Insurance

## **HIGHLIGHTS**

### **What We Audited and Why**

We audited KB Home Mortgage Company (KB), a nonsupervised lender approved to originate, underwrite, and submit insurance endorsement requests under the U.S. Department of Housing and Urban Development's (HUD) Single Family Direct Endorsement program. We selected KB for audit because of its high late endorsement rate. Our primary objective was to determine whether KB complied with HUD's regulations, procedures, and instructions in the late submission of insurance endorsement requests. Our secondary objective was to determine whether KB established and implemented a written quality control plan in accordance with HUD requirements.

### **What We Found**

Our review of KB's automated system and selected loan files disclosed that KB improperly submitted only 13 of 1,083 loans for late endorsement during the period August 11, 2002, through April 11, 2004. Additionally, by establishing a

new process for loan submission in 2003, KB substantially reduced the number of loans submitted for late endorsement. Of the 13 loans totaling \$1,774,049, two were conveyed to HUD and resulted in losses, three were terminated through streamline refinances, and eight remain active. Because the borrowers were behind on five of the 13 loans when they were endorsed and there were late payments on the other eight loans within six months prior to being submitted, KB increased HUD's insurance risk. Data entered into KB's automated system was often erroneous and may have contributed to the high incidence of late endorsed loans.

KB's current written quality control plan, adopted in 2003, meets HUD requirements. The implementation of the quality control plan will be evaluated as part of a separate concurrent audit of KB's loan origination process.

### **What We Recommend**

We recommend that HUD take administrative action up to and including the recovery of losses on \$79,260 in paid claims and indemnification of loans with a total mortgage value of \$537,578. These loans were not current when submitted for endorsement. We also recommend that HUD take appropriate administrative action against KB for violating the requirements in effect at the time when it submitted loans without proper six-month payment histories. In addition, we recommend HUD require KB to establish and implement written policies and procedures to ensure loans submitted to HUD for late endorsement meet late submission requirements and to reasonably ensure that valid and reliable data are obtained, maintained, and accurately disclosed in reports.

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

### **Auditee's Response**

We provided KB a draft report on June 20, 2005, and held an exit conference with KB officials on June 29, 2005. KB provided written comments on July 25, 2005, revised on July 26, 2005. The written comments only partially agreed with our report findings. After the receipt of the auditee's comments we adjusted our recommendations to reflect HUD's recent change in the late submission requirements. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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## BACKGROUND AND OBJECTIVES

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The National Housing Act, as amended, established the Federal Housing Administration, an organizational unit within the U.S. Department of Housing and Urban Development (HUD). The Federal Housing Administration provides approved mortgage lenders with insurance against losses on mortgage loans to qualifying homebuyers. The mortgage insurance program is authorized under Title II, section 203(b), of the National Housing Act and governed by regulations in Title 24, *Code of Federal Regulations*, Part 203.

HUD Handbook 4165.1, REV 1, requires that loans submitted for insurance endorsement more than 60 days after closing meet certain late request standards. These standards include ensuring that the borrower has made, within the calendar month due, all loan payments up to the time of submission or at a minimum, made six consecutive monthly payments within the calendar month due. Appendix C provides details of HUD requirements for late endorsement requests.

On April 15, 1965, HUD approved KB, a wholly owned subsidiary of the builder/developer KB Home, to originate Federal Housing Administration loans as a nonsupervised lender. KB also originates Department of Veterans Affairs loans and conventional loans, primarily for customers purchasing homes from its parent company. Currently, KB operates 11 branches in 9 states. KB has a corporate office located at 10990 Wilshire Boulevard, Los Angeles, California, and a processing and underwriting center in Las Vegas, Nevada. During a two-year period from August 11, 2002, through August 11, 2004, KB originated 10,250 Federal Housing Administration loans with total original mortgage amounts of more than \$1.4 billion.

The audit's primary objective was to determine whether KB's late requests for endorsement complied with HUD's requirements. We also reviewed KB's quality control plan to determine whether it met the requirements detailed in HUD Handbook 4060.1, REV 1.

## RESULTS OF AUDIT

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### Finding 1: KB Improperly Submitted 13 Late Requests for Endorsement

From August 2002 through April 2004, KB improperly submitted 13 loans to HUD with mortgages totaling more than \$1.7 million. These loans were submitted for insurance endorsement, even though borrowers had delinquent payments within six months prior to the loan submission date. This occurred because KB did not have adequate controls to ensure that its employees consistently enter and maintain accurate information in its data systems or always follow HUD's requirements for late requests for insurance endorsement. Although these inappropriate submissions were only a small percentage of the total loans KB submitted for endorsement, they were still a risk to the Federal Housing Administration insurance fund.

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#### **KB Improperly Submitted 13 Requests for Late Endorsement**

Our analysis of the mortgage payment histories provided by KB and endorsement data from HUD's systems showed that KB improperly submitted only 13 out of 1,083 late requests for insurance endorsements tested (see appendix D in this report). KB initially agreed that the 13 loans had late payments and were improperly submitted.

After endorsement, two loans, having original mortgage amounts totaling \$298,467, were foreclosed and conveyed to HUD. After selling the properties, HUD incurred a loss of \$104,706. HUD also suffered a loss of \$4,157 from a partial claim on a loan that is currently active. The insurance fund remains at risk for 11 loans as follows:

- The insurance was terminated without a claim on three of the loans with original mortgage amounts of \$370,989 through streamline refinances. Because the loans were replaced with new Federal Housing Administration-insured loans and the streamline refinance process assumes the original loan was properly submitted, the improper submission and the risk to the insurance fund carries through to the new loan. The risk, based on the mortgage amounts for the new loans, is \$375,916.
- The remaining eight loans, with \$1,104,593 in total original mortgage amounts, hold active Federal Housing Administration insurance and still pose a future risk to the insurance fund.

## **HUD Changed its Late Loan Submission Requirements**

On May 17, 2005, after the completion of our audit, HUD issued Mortgagee Letter 2005-23. This Mortgagee Letter changed HUD's requirements for loans submitted late for endorsement and only requires lenders to certify that the most recent payment that came due was made within the month that the loan was submitted. The Mortgagee Letter eliminates the requirement that loans submitted late are not eligible for endorsement until six consecutive payments have been made prior to and/or within the calendar month due.

Of the 13 loans reported above, five were not current at the time they were submitted to HUD for insurance endorsement and would not have met the new requirements.

## **To Ensure Lasting Improvement, KB Needs to Establish Written Controls for Late Endorsements and Data Entry Integrity**

KB made a proactive effort to reduce the number of late submissions to HUD. The loans we tested were submitted during a period of 2 1/2 months in 2002, 12 months in 2003, and 3 months in 2004. The number of late endorsement requests KB submitted during that period dropped from an average of 69 per day in 2002 to less than one per day in 2004, showing significant improvement. KB officials explained that they recognized a problem in 2002 and instituted a new process in early 2003 to reduce the number of late submissions.

Overall, between 2002 and 2003, the percentage of improper late submissions was small, less than two percent of the total loans submitted late. In addition, we did not identify any loans that were improperly submitted during the first three months of 2004. Officials said KB reviews the printed payment histories before submitting the late endorsement requests to HUD to ensure they meet payment standards. However, officials were unable to provide any written procedures, and the reviews are not documented. As a result, there is no assurance all loan submissions will consistently meet HUD requirements.

We also tested KB's data reliability and found inconsistencies, indicating KB lacked adequate controls to ensure that valid and reliable data are obtained, maintained, and accurately disclosed in reports. KB cannot consistently ensure compliance with HUD requirements for submission of loans without accurate records of closing, submission, and resubmission dates. Because of these

inconsistencies in the KB database, we had to modify our audit techniques to meet our objectives. Problems included

- KB's data included illogical submission dates. We tested 43 loans and found six cases in which KB's data indicated the loans were submitted after HUD endorsed them and one case in which KB's data indicated HUD endorsed the loan the same day KB shipped it. When the submission dates were not reasonable, we had to rely on the endorsement dates.
- When HUD returned an endorsement request to KB because of deficiencies in the submission package, KB did not track resubmission dates in a date field. Resubmission dates were entered into a text field, along with other comments, or not at all. In addition, KB recorded the resubmission day and month but not the year. Therefore, we had to rely on HUD's resubmission dates.

## Recommendations

We recommend that HUD's Assistant Secretary for Housing – Federal Housing Commissioner

- 1A. Take appropriate administrative action against KB up to and including recovery of losses on \$79,260 in paid claims and indemnification of four loans, totaling \$537,578, that were not current when submitted for endorsement.
- 1B. Take appropriate administrative action against KB for violating the requirements in effect at the time when it submitted eight loans without proper six-month payment histories.
- 1C. Require KB to establish and implement adequate written policies and procedures to ensure loans submitted to HUD for late endorsement meet late submission requirements and to reasonably ensure that valid and reliable data are obtained, maintained, and accurately disclosed in reports.

## SCOPE AND METHODOLOGY

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We performed our audit work between January 4, 2005, and May 31, 2005, which included fieldwork at KB's Las Vegas, Nevada, office. The audit covered the period from August 11, 2002, through April 11, 2004, and was modified as needed to meet our objectives.

To accomplish our audit objectives, we reviewed (1) relevant statutory, regulatory, and HUD handbook requirements; (2) electronic loan records from KB and HUD; and Federal Housing Administration files from HUD's Homeownership Centers; (3) KB's internal controls relating to submission of late requests for endorsement; and (4) KB's quality control plan. We also looked at the results of reviews of KB by HUD's Quality Assurance Division, and we interviewed KB's management, employees, and quality control contractor.

We relied on computer-processed data provided by KB and data contained in HUD's Single Family Data Warehouse. We modified audit techniques as necessary to accomplish audit objectives despite some problems with KB's data integrity. We assessed the reliability of HUD's data and determined the data were sufficiently reliable to be used in meeting our audit objectives.

To determine the sample of loans for electronic review, we used HUD's Single Family Data Warehouse to identify the 10,250 Federal Housing Administration loans originated by KB with closing dates between August 11, 2002, and August 11, 2004. The total original mortgage amount of these loans was more than \$1.4 billion. The following table shows the adjustments made to the initial universe to arrive at the universe of 1,083 loans submitted for late endorsement, which we tested for late payments.



| <b>Description of loans</b>  | <b>Number of loans</b> | <b>Original mortgage amount</b> |
|--|------------------------|---------------------------------|
| Originated by KB from August 11, 2002, through August 11, 2004                               | 10,250                 | \$1,440,902,501                 |
| Submitted within 60 days after closing   | <8,055>                | <1,132,527,146>                 |
| <i>Subtotal</i>  | 2,195                  | 308,375,355                     |
| Due to a change in HUD requirements, we filtered out loans closed on or after April 11, 2004 | <99>                   | <14,139,110>                    |
| <i>Subtotal</i>  | 2,096                  | 294,236,245                     |
| Federal Housing Administration numbers found in HUD's system but not in KB's system          | <14>                   | <2,083,724>                     |
| New construction loans and loans submitted for endorsement before first payment due date     | <811>                  | <111,780,279>                   |
| Subject to late endorsement requirements   | 1,271                  | 180,372,242                     |
| Transferred to an investor before first payment due date – no payment history in KB's system | <175>                  | <24,778,884>                    |
| <i>Subtotal</i>  | 1,096                  | 155,593,358                     |
| Loans with final submission dates after April 11, 2004                                       | <13>                   | <1,842,001>                     |
| Loans tested for late payments   | 1,083                  | \$153,751,357                   |

We found that some of the submission dates KB recorded were illogical. Most of the illogical dates were after the endorsement dates, which would indicate HUD endorsed the loans for insurance before KB submitted a request. In some cases, KB's record of the submission date indicated HUD endorsed the loans on the same day KB shipped them. In those cases, we substituted the endorsement date for the illogical submission date.

When HUD rejected a loan and sent it back to KB for correction of deficiencies, we used resubmission dates from HUD's databases because KB did not maintain a date field for this information. We compensated for likely differences between actual submission and endorsement by only reviewing loans with at least 63 days between closing and submission, instead of 60.

Finally, we reviewed Federal Housing Administration files for all loans in which electronic testing indicated the late submissions had unacceptable late payments. We provided KB an opportunity to provide additional documentation or information.

We performed our review in accordance with generally accepted government auditing standards.

# INTERNAL CONTROLS

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Internal controls are 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,
- Compliance with applicable laws and regulations, and
- Safeguarding resources.

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.

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## Relevant Internal Controls

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

- Program operations - Policies and procedures that management has implemented to reasonably ensure that the delayed loan endorsement process complies with HUD's requirements and meets the objectives of the direct endorsement program.
- Validity and reliability of data - Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with laws and regulations - Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding resources - Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

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:

- Program operations - KB did not establish procedures and controls to ensure employees only submitted loans meeting HUD's payment requirements for late insurance endorsement (see finding).
- Validity and reliability of data - KB's management did not establish policies and procedures that reasonably assured valid and reliable data were obtained and maintained (see finding).
- Compliance with laws and regulations - KB did not always follow HUD's regulations when it improperly submitted late requests for mortgage insurance when borrowers had not made timely mortgage payments (see finding).
- Safeguarding resources - KB improperly submitted late requests for insurance endorsement for 13 loans with mortgages totaling more than \$1.7 million. The improper submissions increased the risk to the Federal Housing Administration insurance fund (see finding).

## **FOLLOWUP ON PRIOR AUDITS**

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This was the first audit of KB by HUD's Office of Inspector General (OIG). Under a separate audit, we are also reviewing KB's loan originations in one branch office during 2002.

The last two independent auditors' reports for KB covered the years ending November 30, 2002, and November 30, 2003. Neither report contained any findings.

From July 2002 through June 2004, HUD's Homeownership Centers performed multiple quality assurance reviews of KB branches in California, Texas, Nevada, Arizona, and Florida. Most of the findings were related to loan origination and underwriting deficiencies.

## APPENDIXES

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### Appendix A

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

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| Recommendation number | Ineligible 1/ | Unsupported 2/ | Unreasonable or unnecessary 3/ | Funds to be put to better use 4/ |
|-----------------------|---------------|----------------|--------------------------------|----------------------------------|
| 1A                    | \$79,260      |                |                                | \$537,578                        |

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.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a 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/ Unreasonable/unnecessary 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 to be put to better use” are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation 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



July 25, 2005

**VIA HAND DELIVERY**

Joan S. Hobbs  
Regional Inspector General for Audit  
Office of Inspector General  
Region IX  
611 West Sixth Street, Suite 1160  
Los Angeles, California 90017-3101

Re: HUD OIG Draft Audit Report

Dear Ms. Hobbs:

KB Home Mortgage Company ("KBHMC" or "Company") is in receipt of the Draft Audit Report ("Report"), dated June 20, 2005, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of the Inspector General ("OIG"). The Report is based on a review of KBHMC's procedures and practices in the submission of loans to the Department for Federal Housing Administration ("FHA") insurance endorsement. The review was conducted between January 4, 2005 and May 31, 2005, and it covers the period between August 11, 2002 and April 11, 2004.

The Report alleges that the Company improperly submitted late requests for FHA insurance endorsement to the Department. Based on those findings, the Report recommends that HUD require the Company to indemnify or reimburse the Department for losses in connection with the improperly submitted loans. The OIG provided the Company with an opportunity to submit written comments for inclusion in the final report. This response summarizes KBHMC's history and operations, including improvements the Company has implemented in its case binder submission practices, and addresses the individual findings in the Report. We appreciate the additional time afforded to July 25, 2005 to reply to the Report, as well as this opportunity to comment on the OIG's findings and recommendations.

#### I. INTRODUCTION

KBHMC is a wholly-owned subsidiary of KB Home, one of the nation's largest homebuilders and a publicly held Delaware corporation. The Company operates through its home office in Los Angeles and 11 additional registered branch offices, and employs approximately 500 individuals. KBHMC received approval to participate in HUD's FHA mortgage insurance programs in April 1985, and received Direct Endorsement authority in 1984. The Company is also

KB HOME MORTGAGE COMPANY 7540 SOUTH INDUSTRIAL ROAD, SUITE 2216 LAS VEGAS, NV 89139  
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an approved lender for the Veterans Administration (VA), Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), and Government National Mortgage Association (Ginnie Mae). In recent years, KBHMC has originated 15,000 to 20,000 mortgage loans per year, and as stated in the Report, the Company originated over 10,000 FHA loans during the 24 month period ending August 11, 2004.

As a significant FHA lender, with a strong dedication to low-income and minority borrowers, KBHMC values its relationship with the Department. It is committed to educating and training Company employees on issues regarding FHA compliance and would never knowingly violate FHA guidelines.

## II. RESPONSE TO THE FINDINGS

Upon receipt of the draft report, and throughout the OIG's audit process, the Company has performed its own stringent analysis of the loans subject to the OIG's review. Based on KBHMC's diligent examination, while the Company acknowledges that deficiencies existed in past late case endorsement submissions, the Company believes that the Report's calculation of the number of improper late endorsement requests is inaccurate. Below we: (1) address each finding; and (2) provide a brief discussion of the significant steps the Company has taken to ensure compliance with FHA requirements regarding late case endorsement requests.

### A. Late Case Endorsement Submissions and Corrective Actions taken by KBHMC

The Report alleges that, after reviewing 1,083 late case endorsement submissions made by the Company, KBHMC improperly submitted 14 late requests for FHA insurance endorsement, claiming that 10 loans were delinquent and 4 loans reflected late payments within six months of being endorsed. The Report further alleges that all 14 loans represent a risk to the FHA Insurance Fund and recommends that HUD: (1) require the Company to indemnify the Department in connection with a partial claim and any future losses on 12 of the loans that are active or have been streamline refinanced by another lender; and (2) reimburse the Department for losses it has incurred in connection with two loans for which HUD has paid claims. The Company takes exception to the figures cited in the Report.

#### 1. **Any Deficiency in Connection With the Cases Cited Was Contrary to Company Policy and Resulted During the Company's Transition of its Insuring Unit to Las Vegas Nevada**

As you know, HUD requires lenders to submit case binders involving a mortgage originated under the Direct Endorsement program for FHA insurance endorsement to

the appropriate HUD Homeownership Center ("HOC") so that it is received within 60 days after closing. See 24 C.F.R. § 203.255; (b) HUD Handbook 4165.1 REV-2, ¶ 2-2; HUD Handbook 4000.2 REV-3, ¶ 5-5(A). While HUD requires a mortgagee to submit a case binder for FHA insurance endorsement within 60 days of loan closing or funding, it permits late requests for endorsement so long as certain requirements are met. At the time the loans that are the subject of the Report were submitted for endorsement, HUD Handbook 4165.1 REV-1, ¶ 3-1 governed late case endorsement requirements.<sup>1</sup> These guidelines provided that, when submitting a late request for insurance endorsement, a lender was required to include: (1) an explanation for the delay; (2) a certification that the escrow accounts were current and intact; (3) a certification that the lender did not provide the funds to bring a loan current; and (4) a payment ledger reflecting that all payments received, including the payment due in the month in which the lender submitted the case binder, were made within the calendar month due. See HUD Handbook 4165.1 REV-1, ¶ 3-1(B). If a payment was made outside the calendar month due, HUD required lenders to ensure that the borrower made six consecutive payments within the calendar month due before the lender could submit the loan for FHA insurance endorsement.

**Comment 1**

KHBMC understands and appreciates that, at the time it submitted the loans subject to the OIG's review for FHA insurance endorsement, the Company was responsible for ensuring that late requests for endorsement complied with these provisions. It was the Company's policy and procedure to strictly comply with these requirements, and ensure that, if a case binder was submitted more than 60 days after closing, the loan was either current or the borrower had made six consecutive payments prior to submission, and that the case binder contained all additional required documentation. The Company acknowledges, however, that a small percentage, less than 1%, of the 1,083 late case endorsement requests made during the audit period did not strictly comply with these requirements.

**Comment 1**

These deficiencies occurred as a result of transitioning KHBMC's Post Closing Operations from California to Nevada, in August 2002. Since several members of the Insuring team in California could not make the move to Nevada, the majority of the Las Vegas team was new to the Company. While late endorsement payment history errors noted were few, they were simply the result of human error: (1) in either analyzing the payment history, or (2) neglecting to run a new payment history immediately prior to

<sup>1</sup> As discussed above, the Report reviewed loans originated between August 11, 2002 and April 11, 2004. While HUD amended its late case endorsement requirements for late case submissions in Mortgage Letter 04-14, which was issued on April 12, 2004, the vast majority of the loans subject to the audit were originated prior to the issuance of that Mortgage Letter and, in any event, the Report's allegations concern HUD requirements that were unchanged by the amendments made in Mortgage Letter 04-14.



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submitting the case binder for FHA insurance endorsement. As discussed in detail below, KBHMC has since taken significant steps to reduce the number of late endorsement requests to FHA and to reduce the number of payment history errors.

**Comment 1**

The Company introduced significant process changes in late 2002. As noted in the Report, the number of late endorsement requests submitted to FHA by KBHMC decreased dramatically, representing a 98% improvement rate from the beginning of the audit period in August 2002 to the end of the audit period in April 2004. Today, the number of late endorsement requests submitted to FHA by KBHMC are negligible. In fact, of the 679 FHA loans originated by KBHMC from January to May 2005, only one loan was submitted outside of the 60-day window.

As indicated above, the Company diligently pursues the submission of all FHA case binders within 60 days of loan closing. Each week, the KBHMC Insuring Unit prepares a detailed report reflecting the insuring status of the applicable loan production month. This report is reviewed and distributed to the Company's management team by the Senior Vice President responsible for the KBHMC Insuring Unit. All FHA loans are carefully monitored until endorsement is verified and the Mortgage Insurance Certificate ("MIC") is generated.

**Comment 2**

While Company Management believes the efforts described above will result in rare instances of late endorsement requests, it has expanded its written procedures to include a more stringent review of loan payment histories. Each payment history must be reviewed by two members of the KBHMC Insuring Unit and any case binder submission requiring a late endorsement request must obtain a third review by the Senior Vice President overseeing the Unit.

As described above, KBHMC efforts have significantly reduced the number of late endorsement requests to a negligible level. Nevertheless, the Company is willing to take responsibility and work with the OIG and the Department to resolve any concerns with regard to the late case submissions identified in the Report that did not fully comply with FHA requirements.

**Comment 3**

The Report also takes issue with some of the submission dates reflected in KBHMC records. The Company diligently reviewed the records associated with the loans in question and found only one loan that does not reflect a reasonable date sequence. The Company can provide this information upon request.

**2. KBHMC Disagrees With the Number of Case Binders Containing Inaccuracies Cited in the Report**

While the Company recognizes that certain errors occurred in some of the cases cited in the Report, KBHMC takes exception to the number of loans that the Report

**Comment 4**

alleges were inaccurately submitted. The Report alleges that during the audit period, the Company improperly submitted 10 late case endorsement requests and that four loans incurred late payment activity within six months of being endorsed. With regard to these four loans, HUD guidelines require that a loan is current at the time of submission, but does not dictate that the loan must remain current for any period of time after endorsement. Thus, to the extent that the borrowers in these four cases made late payments after endorsement, such activity did not affect the loans' insurability and did not constitute a violation of HUD requirements. Therefore, indemnification would be appropriate in these four cases.

**Comment 5**

Based on KBHMC's review of the remaining 10 loans cited, two loans were current at the time the Company submitted the case binder to HUD for insurance endorsement. In one of these cases (Brown – Case No. 492-6418088 – "Exhibit 1"), the borrower sent the first payment due KBHMC to the new servicer, in error. Accordingly, the borrower was notified and instructed to send the second payment due on the loan to KBHMC. Both borrower payments were remitted within the month due, and thus were on time. Additionally this borrower continued to make timely payments to the new servicer throughout the life of the loan. In the second case (Palma – Case No. 052-2382816 – "Exhibit 2"), the loan was submitted for insuring endorsement before the first payment was due, however, a Notice of Return ("NOR") was issued. In this instance, the case was re-submitted the same day and meets the following HUD requirement: "If the HOC returns a case binder to the lender by issuing a NOR (or a subsequent NOR), the HOC must receive the reconsideration request for insurance endorsement within the original 60-day window, or 30 days from the date of issuance of the original NOR, whichever is greater. Cases resubmitted after expiration of the applicable date must follow the late request instructions." See Mortgagee Letter 2004-14. While this loan was submitted prior to the issuance of Mortgagee Letter 2004-14, it would have complied with these requirements<sup>1</sup>. As such, indemnification in both of these cases is unwarranted, and would reduce the number of loans cited in the Report to eight loans.

**Comment 6**

**Comment 7**

Finally, it is important to note that, in three of the eight remaining cases (Amaya – Case No. 493-7177876 – "Exhibit 3"; King – Case No. 495-6268006 – "Exhibit 4"; and Baltimore – Case No. 495-6258327 – "Exhibit 5"), the borrowers have since made six consecutive payments and, had the case binders been submitted at a later date, the loans would have been eligible for FHA financing. While the Company understands and appreciates that inaccuracies may have occurred at the time of submission, these loans have since performed and no longer pose a risk to HUD. Therefore, KBHMC does not believe that indemnification or reimbursement is an appropriate remedy in these three loans.

We also note that, in each of the cases cited, the review practices of HUD's staff were also deficient. As you know, the Department conducts a pre-endorsement review

on 100% of the case binders submitted for endorsement. When those case binders contain late requests for endorsement, HUD staff members review the binders to determine whether all additional documentation is included, and to ensure that the loan is current, before endorsing the loan. In each of the cases cited in the Report, a HUD employee reviewed the case binder documents, determined that all information was accurate and complete, and issued an FHA insurance policy. We suspect that the oversights that occurred in the Department's pre-endorsement reviews resulted from having to hire inexperienced staff to timely review the increased volume of loans being submitted for insurance endorsement during the high volume of the refinance boom. Had these individuals diligently reviewed the case binders and identified the incorrect submissions at that time, the Department could have significantly mitigated its risk in connection with these cases. While KBHMC acknowledges that it is ultimately the lender's responsibility to ensure that all case binder documentation is accurate and complete, we believe that this discussion demonstrates that human error occurred at both our Company and the Department in connection with the loans cited.

In summary, evidence provided by KBHMC demonstrates that the Company in fact complied with HUD requirements at the time of submission or re-submission in six cases and as such, indemnification is unwarranted in all six cases. Additionally, three borrowers have made six consecutive payments and eventually would have complied with HUD requirements if submitted at a later date. Therefore, only five cases should be under consideration in connection with this review.

**B. Corrective Actions Taken By KBHMC**

Finally, while the Report alleges that the Company lacked adequate procedures and controls to ensure that it followed HUD requirements regarding late requests for insurance endorsement during the audit period, the Company has taken significant steps to ensure that future case binder submissions made 60 days or more after loan closing fully comply with all applicable HUD guidelines and documentation requirements.

**III. CONCLUSION**

In summary, the Company's thorough review of the findings set forth in the Report indicated that, while certain inaccurate case binder submissions occurred in a small percentage of late endorsement requests, any oversights occurred as a result of human error. While the Company agrees to work with the OIG and the Department to resolve the cases in which deficiencies took place, KBHMC's review demonstrated that a significant number of the loans cited in the Report either complied with HUD requirements at the time of submission or do not represent an increased risk to the Department. We therefore respectfully request that the OIG revise the number of loans

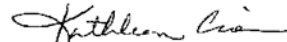
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cited in the Report based on the figures set forth in this response and supported by evidence KBHMC provided during the review.

If you have any additional questions, or if you need additional information, please do not hesitate to contact me.

Thank you for your kind consideration.

Sincerely,



Kathleen Ciocca  
SVP, Investor Relations/Quality Control

### OIG Evaluation of Auditee Comments

- Comment 1** We agree KB improved on its submission of late endorsements during the audit period, and that the improper late submissions were only a small portion of KB's overall loan activity, as mentioned in the report. However, if KB had adequate controls in place, the move of its post-closing operations should not have impacted its submission of proper late endorsements.
- Comment 2** KB has not provided any expanded written procedures over late submissions.
- Comment 3** KB has also not provided us with explanations over submission date discrepancies.
- Comment 4** KB's response appears to indicate it misunderstood a portion of the report. In the case of the four loans cited by KB, we are questioning late payments within the six months *prior* to submission, not after submission. This has been clarified in the report.
- Comment 5** In case 492-6418088, we reviewed the additional information submitted by KB and have accepted KB's position that the payment was timely. As a result, this case was removed from the report, reducing the number of improper late submission from 14 to 13.
- Comment 6** In case 052-2382816, we agree that HUD's current requirements would have excluded this loan from late endorsement requirements, and we have therefore removed it from our questioned costs. However, the criteria was not in effect at the time KB submitted the loan to HUD for endorsement, and HUD's change in policy was not retroactive. As a result, it would have been considered an improper late submission under HUD Handbook 4165.1, REV 1.
- Comment 7** Although three loans did not default or have additional late payments within the six-month period after submission, this does not mean that the submissions were retroactively acceptable. HUD was still at an increased risk upon submission, and the loans would have violated HUD requirements over late submissions.

## Appendix C

### Federal Requirements

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Title 24, CFR (*Code of Federal Regulations*), part 203.255(b), states, “For applications for insurance of mortgages originated under the direct endorsement program under this part, the mortgagee shall submit to the Secretary of Housing and Urban Development (HUD) within 60 days after the date of the loan or such additional time as permitted by the Secretary, properly completed documentation and certifications.”

HUD Handbook 4165.1, REV-1, “Endorsement for Insurance for Home Mortgage Programs (Single Family),” dated November 30, 1995, chapter 3, section 3-1(A), states late requests for endorsement procedures apply if

- The loan is closed after the firm commitment,
- Direct endorsement underwriter’s approval expires, and/or
- The mortgage is submitted to HUD for endorsement more than 60 days after closing.

Section 3-1(B) states a loan request for endorsement from the lender must include

- (1) An explanation for the delay in submitting for endorsement and actions taken to prevent future delayed submissions.
- (2) A certification that the escrow account for taxes, hazard insurance, and mortgage insurance premiums is current and intact except for disbursements which may have been made from the escrow accounts to cover payments for which the accounts were specifically established.
- (3) A payment ledger that reflects the payments received, including the payment due for the month in which the case is submitted if the case is submitted after the 15<sup>th</sup> of the month. For example, if the case closed February 3 and the case is submitted April 16, the payment ledger must reflect receipt of the April payment, even though the payment is not considered delinquent until May 1. Payments under the mortgage must not be delinquent when submitted for endorsement.
  - (a) The lender must submit a payment ledger for the entire period from the first payment due date to the date of submission for endorsement. Each payment must be made in the calendar month due.
  - (b) If a payment is made outside the calendar month due, the lender cannot submit the case for endorsement until six consecutive payments have been made within the calendar month due.
- (4) A certification that the lender did not provide the funds to bring the loan current or to effect the appearance of an acceptable payment history.

## Appendix D

### LOANS SUBMITTED FOR LATE ENDORSEMENT WITH LATE PAYMENTS

| Case no.      | Original mortgage amount | Loan status          | New case no. – streamline refinances | New mortgage amount | Original mortgage amount – active loans | HUD’s loss on sale - claims |
|---------------|--------------------------|----------------------|--------------------------------------|---------------------|---|-----------------------------|
| 361-2686984   | \$133,278                | Claim                |                                      |                     |   | \$25,446                    |
| 491-7506428 * | \$165,189                | Claim                |                                      |                     |   | \$79,260                    |
| 495-6301772   | \$94,953                 | Streamline refinance | 495-6502950                          | \$95,395            |   |                             |
| 493-7177876   | \$131,957                | Streamline refinance | 493-7742111                          | \$134,281           |   |                             |
| 495-6268006   | \$144,079                | Streamline refinance | 495-6590065                          | \$146,240           |   |                             |
| 495-6258327 * | \$111,193                | Active               |                                      |                     | \$111,193                               |                             |
| 052-2382816   | \$192,918                | Active               |                                      |                     | \$192,918                               |                             |
| 495-6328644 * | \$141,526                | Active               |                                      |                     | \$141,526                               |                             |
| 091-3653998 * | \$127,687                | Active               |                                      |                     | \$127,687                               |                             |
| 495-6319773   | \$135,096                | Active               |                                      |                     | \$135,096                               |                             |
| 491-7631213   | \$104,717                | Active/partial claim |                                      |                     | \$104,717                               | \$4,157                     |
| 091-3630090   | \$134,284                | Active               |                                      |                     | \$134,284                               |                             |
| 492-6532719 * | \$157,172                | Active               |                                      |                     | \$157,172                               |                             |
| <b>Totals</b> | <b>\$1,774,049</b>       |                      |                                      | <b>\$375,916</b>    | <b>\$1,104,593</b>                      | <b>\$108,863</b>            |

\* Loans that were not current when submitted.