Issue Date	December 12, 2005
Audit Report Number	2006-KC-1002

TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing Commissioner, H

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

SUBJECT: First Magnus Financial Corporation Did Not Follow HUD Regulations When Underwriting 23 Federal Housing Administration Loans

HIGHLIGHTS

What We Audited and Why

We reviewed 45 Federal Housing Administration loans underwritten by the Overland Park, Kansas, branch office of First Magnus Financial Corporation (First Magnus). Our audit objectives were to determine whether First Magnus's Overland Park branch properly processed Federal Housing Administration loans and to determine whether adequate quality control procedures are implemented at the branch office.

We audited First Magnus because it had a default rate of 183 percent of the U.S. Department of Housing and Urban Development (HUD) Kansas City office area average for loans that closed from January 2003 through December 2004. We reviewed the Overland Park branch because it underwrote the majority of First Magnus's loans in the Kansas City office area.

What We Found

First Magnus did not follow HUD regulations when underwriting 23 of the 45 loans reviewed. These loans contain material deficiencies that affect the insurability of the loans. Material deficiencies include unsupported income and assets, questionable gift funds, underreported liabilities, and questionable employment and credit histories. As a result, HUD insured 23 loans that place the Federal Housing Administration insurance fund at risk for $2,239,504.

What We Recommend

We recommend that the assistant secretary for housing – federal housing commissioner take appropriate administrative action against First Magnus for not following HUD requirements. At a minimum, HUD should require First Magnus to indemnify 21 loans with material deficiencies with original mortgage amounts totaling $2,018,167 and to indemnify HUD for future losses on two properties not yet sold that HUD paid claims totaling $221,337.

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

First Magnus agreed with our conclusions and to indemnify HUD for potential losses on loans currently insured and loans which HUD has already paid claims. We provided the draft report to First Magnus on November 8, 2005, and requested a response by December 2, 2005. First Magnus provided written comments on December 2, 2005.

The complete text of the auditee's response can be found in appendix B of this report.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVES

First Magnus Financial Corporation (First Magnus) is a direct endorsement lender based in Tucson, Arizona. It was founded in 1996 and became an approved direct endorsement lender for the Federal Housing Administration the same year. First Magnus has 238 active branch offices.

HUD authorized the Overland Park, Kansas, branch office to sponsor Federal Housing Administration loans in December of 2001. The branch office underwrites loans originated by loan correspondents but does not originate loans.

For loans that closed from January 2003 through December 2004, First Magnus had a default rate of 3.48 percent, which was 183 percent of the U.S. Department of Housing and Urban Development (HUD) Kansas City office area average. The Overland Park branch office underwrote 975 Federal Housing Administration loans between January 1, 2003, and December 31, 2004. Of the 975 loans, 65 defaulted within the first two years after closing.

Our audit objectives were to determine whether First Magnus's Overland Park, Kansas, branch office properly processed loans by correctly documenting and evaluating income, assets, liabilities, credit history, qualifying ratios, and borrower eligibility and charging only allowable fees; and to determine whether it implemented adequate quality control procedures.

RESULTS OF AUDIT

Finding: First Magnus Did Not Follow HUD Regulations When Underwriting 23 Federal Housing Administration Loans

First Magnus did not comply with HUD regulations, procedures, and instructions in the underwriting of 23 Federal Housing Administration-insured single-family mortgages. The loans contain deficiencies that affect the credit quality (insurability) of the loans. As a result, HUD is insuring 21 improperly underwritten loans with original mortgage amounts totaling $2,018,167 and has paid claims of $221,337 on two improperly underwritten loans.

First Magnus Did Not Follow HUD Underwriting Requirements

First Magnus's Overland Park branch office underwrote 23 loans that contain significant underwriting deficiencies. These deficiencies primarily involve the following:

Unsupported Income/Questionable Employment Histories

First Magnus did not properly assess income or employment history for borrowers. Borrower income is either overstated or not adequately supported. Lenders must accurately assess borrower income to make informed decisions on income stability and the borrower's ability to repay the mortgage.

First Magnus also did not adequately assess borrowers' employment histories. Borrowers have unexplained gaps in the two-year employment history required by HUD, or the lender did not obtain transcripts for borrowers who claim to have been students during the two-year period. HUD requires lenders to evaluate borrowers' employment history to establish stability of income.

For example, in case number 182-0760589, the lender used $6,193 per month to qualify the borrower. However, the $6,193 was computed using the borrower's previous employment that ended almost three months before the loan closed. The borrower began new employment during the loan approval process and was earning only $5,416 per month at that time ($777 less per month). The lesser monthly income resulted in the borrowers' total debt ratio increasing to 49.2 percent, well above HUD's limit of 41 percent.

Unsupported Assets/Questionable Gift Funds

First Magnus did not adequately support assets (funds available to close) claimed by borrowers. HUD requires a verification of deposit from the financial institution and the most recent bank statement for automated underwriting approvals. If a verification of deposit is not available, additional months of bank statements are required. HUD requires two months of bank statements on manual approvals. The deficient loans either contain verifications of deposit but no bank statements to evaluate the source of funds deposited or do not contain a verification of deposit or bank statements when the borrowers paid closing costs.

One common form of assets is gift funds provided to borrowers. First Magnus did not always obtain adequate gift documentation. In some cases, it did not obtain donor bank statements to show that the donor had the funds available, verifications that the borrower received the gift funds, or explanations of discrepancies between the gift letter and the gift amount on the HUD-1 settlement statement. HUD requires extensive gift documentation to ensure the gift funds are coming from an acceptable source and not from a party related to the sales transaction.

For example, in case number 132-1665315, the HUD-1 settlement statement reflects gift funds of $3,135. The gift letter shows that the donor was giving $1,925 to the borrower, and the money was obtained from a credit card advance. The advance was applied to the borrower’s credit card debts. The remaining gift funds of $1,210 are not explained. In addition, the borrower (or someone on the borrower’s behalf) paid off $2,245 in debt collections before the loan closing. Therefore, at least $1,210 in gift funds is unsupported and the amount could be as much as $1,490.

Underreported Liabilities/Questionable Credit Histories

First Magnus did not include all applicable liabilities when approving loans. Credit reports for the borrowers reflect recurring debts that the underwriter did not include when calculating borrowers’ total debt ratio. Underwriters must accurately assess borrower debts to make reasonable decisions on the borrower’s ability to repay the mortgage.

Also, First Magnus did not adequately assess borrower credit histories. Credit histories show significant derogatory credit and collection items within the two years before closing. HUD requires the lender to analyze whether late payments were a disregard for financial obligations or factors beyond the control of the borrower. First Magnus did not document its analyses of the credit reports. In some cases, borrowers did not have credit histories established. These borrowers are required by HUD to provide letters of credit from utility companies, insurance companies, landlords, or other credit providers to establish their regard for financial obligations. The letters of credit used in these cases show either multiple late payments or no detail of payments for the lender to review.

For example, in case number 291-3183919, the lender did not include a $347 monthly debt on a $14,356 auto loan shown on the credit report. The $347 monthly payment significantly affects the borrowers' ability to repay the mortgage.

Appendix D summarizes the significant deficiencies and appendix G provides details of the deficiencies on each of the 23 questioned loans.

Other Deficiencies

First Magnus also underwrote 13 loans that contain minor underwriting deficiencies. While these deficiencies do not affect the overall credit quality (insurability) of the individual loans, they 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 First Magnus during our review. Appendix E summarizes the deficiencies on each of the 13 loans.

Insurance Status of Improperly Underwritten Loans

As of September 23, 2005, HUD systems show that 16 of the 23 materially deficient loans are in default or HUD has paid a claim or a claim is in process.

Current status of loans with material deficiencies as of September 23, 2005	Number of loans	Percent of total deficient loans
Claim Paid - Property Conveyed to Insurer	2	8.70%
Claim Paid - Nonconveyance Claim	1	4.35%
Foreclosure Process Started	8	34.78%
Active Insurance Status - Currently in Default	5	21.74%
Active Insurance Status - Not Currently in Default	6	26.09%
Paid In Full	1	4.34%
Totals	**23**	**100.00%**

First Magnus Charged Prohibited Fees to Borrowers

First Magnus charged unallowable fees totaling $4,611 to 13 borrowers. It charged six borrowers commitment fees, which are not allowed unless a written agreement of loan terms is present in the loan file, but the files do not contain the agreements. The lender also charged borrowers wire transfer, e-mail, and courier fees that are allowable only on refinance loans, but none of the loans are refinances. First Magnus charged one borrower $1,276 in excess of the 1 percent allowed for an origination fee. Other prohibited fees include tax service fees, underwriting fees, and excessive credit report fees. Appendix F details the prohibited fees charged on the 13 loans.

Inadequate Supervision and Training of Underwriters

The underwriting deficiencies occurred because First Magnus's Overland Park branch office management did not adequately supervise underwriters approving Federal Housing Administration loans or ensure that underwriters were adequately trained on HUD requirements.

HUD requires direct endorsement lenders to conduct their business operations in accordance with sound mortgage lending practices, ethics, and standards. HUD also requires lenders to practice quality control as a routine function of operations. These quality controls must assure compliance with HUD loan processing requirements; protect HUD from unacceptable risk; guard against errors, omissions, and fraud; and assure swift and appropriate corrective action when deficiencies are identified.

The Overland Park branch office managers did not practice acceptable quality control functions, including adequate supervision of underwriters. The managers did not identify and take swift action to correct material noncompliance by underwriters approving Federal Housing Administration loans. Repeated material deficiencies throughout the two-year audit period are evidence of the absence of acceptable management oversight.

Underwriters are an integral part of the loan approval process, but branch office managers did not ensure that underwriters processing Federal Housing Administration loans received adequate training. HUD requires lenders to ensure that underwriters are adequately trained and have completed a direct endorsement training program. The current underwriter, who underwrote about 50 percent of the 975 Federal Housing Administration loans sponsored during the two-year period reviewed, told us that she had not received formal training on underwriting Federal Housing Administration loans.

Lenders need an effective quality control process at all business levels and adequately trained underwriters to protect HUD from unnecessary risk. Because of inadequate controls at the Overland Park branch office, HUD insured 23 loans that place the Federal Housing Administration insurance fund at risk for $2,018,167 in outstanding loans and $221,337 in claims.

Conclusion

First Magnus did not comply with HUD requirements when underwriting 23 Federal Housing Administration loans. The loans contained the following deficiencies:

- Unsupported income,
- Questionable employment histories,
- Unsupported assets,
- Questionable gift funds,
- Underreported liabilities, and
- Questionable credit histories.

Therefore, HUD is unnecessarily at risk for 21 improperly underwritten loans with original mortgage amounts totaling $2,018,167, and has paid claims on two improperly underwritten loans with claim amounts totaling $221,337.

First Magnus also charged $4,611 in prohibited fees to 13 borrowers. Because the monetary value of the unallowable fees is minimal, we have made no formal recommendations to HUD in this regard.

Recommendations

We recommend that the assistant secretary for housing - federal housing commissioner and chairman, Mortgagee Review Board,

1A. Take appropriate administrative action against First Magnus for not complying with HUD underwriting requirements. This action, at a minimum, should include requiring First Magnus to indemnify HUD for 21 actively insured loans with original mortgage amounts totaling $2,018,167 (see appendix D).

1B. Take appropriate administrative action against First Magnus for two loans for which HUD has already paid claims totaling $221,337, including requiring First Magnus to indemnify HUD for future losses on the two properties that have not yet been sold (see appendix D).

1C. Verify that First Magnus implements an adequate quality control process at the Overland Park branch office. This process should allow branch office management to identify and mitigate problems in underwriting and prevent First Magnus from submitting loans for Federal Housing Administration endorsement that do not meet HUD requirements.

SCOPE AND METHODOLOGY

The First Magnus Overland Park, Kansas, branch office processed 975 Federal Housing Administration loans between January 1, 2003, and December 31, 2004. Of the 975 loans, 65 defaulted within the first two years after the loans closed. We reviewed 45 of the 65 defaulted loans. We did not review 16 streamline refinance loans because the underwriter's assessment of these loans is limited and we also excluded four loans that HUD's Quality Assurance Division recently reviewed.

To accomplish our objectives, we reviewed the Federal Housing Administration underwriting policies and procedures for HUD and the Overland Park branch office and interviewed the branch office management and staff. We reviewed the HUD and branch office's loan files for all 45 loans and provided results of our loan file reviews to HUD's Quality Assurance Division for feedback.

When identifying underwriting deficiencies, we assessed whether the deficiencies were material and should have caused the lender to disapprove the loan. We considered any deficiencies that affected the approval and insurability of the loans as significant and are recommending that HUD take appropriate action on these loans. When identifying underwriting deficiencies that we considered minor, we informed First Magnus of the deficiencies but have not recommended that HUD take action on these loans.

Additionally, we reviewed First Magnus's companywide quality control plan. First Magnus's quality control reviews are performed by its corporate office, not by individual branch offices. Therefore, we limited our assessment of First Magnus's implementation of its quality control process to the quality control responsibilities of the branch office.

We relied on computer-processed data contained in HUD's Single Family Data Warehouse system. During the audit, we assessed the reliability of the data, including relevant general and application controls, and found it 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 April through September 2005 and conducted our audit 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 underwriting 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 Weakness

Based on our review, we believe the following item is a significant weakness:

- First Magnus did not have adequate controls over its underwriters' assessment of information provided by loan correspondents for loan approval (see finding).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A		$ 2,018,167
1B	$ 221,337	

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/ "Funds to be put to better use" are quantifiable savings that are anticipated to occur if an Office of Inspector General (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

FIRST MAGNUS
FINANCIAL CORPORATION

December 2, 2005

Ronald J. Hosking
Regional Inspector General for Audit
U.S. Department of HUD
Region 7, Office of Audit
Gateway Tower II – 5th Floor
400 State Avenue
Kansas City, KS 66101-2406

Re: Draft Audit Report
First Magnus Financial Corporation
Overland Park, KS Branch Office
Tucson, AZ Corporate Office

Dear Mr. Hosking:

We are in receipt of a discussion draft dated November 8, 2005 that reports on your audit findings of the First Magnus Financial Corporation office located in Overland Park, KS. In addition, certain First Magnus Corporate and Branch personnel attended and participated in the exit conference held on November 22, 2005 that was conducted by OIG Auditor Christy Thomas. At this conference, First Magnus was granted an extension until December 2, 2005 to provide written comments for this report.

This report offers certain recommendations that the Assistant Secretary for Housing, Federal Housing Commissioner and Chairman, Mortgagee Review Board should take against First Magnus. The First Magnus response to these recommendations is as follows:

1A. Take appropriate administrative action against First Magnus for not complying with HUD underwriting requirements. This action, at a minimum, should include requiring First Magnus to indemnify HUD for 21 actively insured loans with original mortgage amounts totaling $2,018,167, as denoted in appendix D of this report.

Risk Management personnel located at the Corporate Office of First Magnus Financial Corporation reviewed each of these 21 loans for underwriting deficiencies in direct correlation with HUD/FHA underwriting guidelines. We concur that First Magnus should be required to indemnify HUD against the possibility of future loss on each of these 21 loans.

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1B. Take appropriate administrative action against First Magnus on two loans for which HUD has already paid claims totaling $221,337, including requiring First Magnus to indemnify HUD for future loss on the two properties that have not yet been sold, as denoted in appendix D of this report.

Risk Management personnel located at the Corporate Office of First Magnus Financial Corporation reviewed these two loans for underwriting deficiencies in direct correlation with HUD/FHA guidelines. We concur that First Magnus should be required to indemnify HUD against the possibility of future loss with regard to these two loans.

1C. Verify that First Magnus implements an adequate quality control process at the Overland Park branch office. This process should allow branch office management to identify and mitigate problems in underwriting and prevent First Magnus from submitting loans for Federal Housing Administration endorsement that do not meet HUD requirements.

The Corporate Office of First Magnus Financial Corporation and its Overland Park branch office is committed to creating a quality control process that will mitigate future underwriting deficiencies like those that were brought forth in this audit. Since the cited underwriting deficiencies came about primarily due to inadequate training at the branch level, and not because of intentional disregard of HUD/FHA guidelines, we feel confident that the Overland Park branch process can be enhanced to where HUD/FHA loans are continually underwritten in accordance with published guidelines. We also feel confident that the quality of work produced by the branch Direct Endorsement Underwriter can be monitored by knowledgeable Branch Management and Regional Management personnel, working in tandem with the First Magnus Corporate Quality Control Department.

The actions that First Magnus will take to mitigate future underwriting deficiencies at its Overland Park branch are as follows:

- The current Direct Endorsement Underwriter on-site at this branch will immediately be relieved of her FHA underwriting responsibilities.
- A new Direct Endorsement Underwriter with the proper background and level of experience will be hired to work on site at this branch.
- Until a new Direct Endorsement Underwriter is hired at this branch, all current and future FHA loans originated by this branch will be underwritten by experienced Direct Endorsement Underwriters located at First Magnus offices located in either in Denver, CO. or Boston, MA.
- The quality of the FHA work product produced by the new Direct Endorsement Underwriter at this branch will be monitored by the current Branch Manager and by a Regional Underwriting Manager, who when hired, will be experienced in FHA underwriting guidelines. This Regional Underwriting Manager will be located at the First Magnus office in St. Louis, MO.
- The current Branch Manager of the Overland Park office will attend FHA underwriting training scheduled in January, 2006. In addition, this person as well

as other appropriate branch personnel will be required to attend all future FHA training classes conducted in the local area, as appropriate.

- The Regional Underwriting Manager working at the First Magnus office in St. Louis, MO., when hired, will be accountable for the training and continued development of all appropriate personnel at the Overland Park office including the branch manager. This on-going training will concentrate on HUD/FHA lending techniques with emphasis on the Direct Endorsement Underwriting process resulting in the production of a quality work product. The training efforts of the Regional Underwriting Manager will be assisted by two Direct Endorsement Underwriters that have been recently hired to work at the First Magnus office in St. Louis, MO. who have combined 19-years worth of quality underwriting experience in HUD/FHA lending techniques.

- The Overland Park branch will immediately begin to rely more heavily upon the LP and DU automated approval processes for FHA loans, with a corresponding reduction in FHA loans that require a manual underwrite.

The actions that the Corporate Office of First Magnus will take to assist its Overland Park branch in mitigating future HUD/FHA underwriting deficiencies are as follows:

- For a minimum of six months after the new Direct Endorsement Underwriter is hired, an increased percentage of FHA loans originated from this branch will be audited by the First Magnus Quality Control Department for underwriting deficiencies. Results of these audits will be immediately communicated to regional and branch management personnel for training purposes and corrective action. At the end of the six month period an assessment will be made by appropriate First Magnus corporate management personnel with regard to the future of FHA lending at the Overland Park branch.

First Magnus Financial Corporation is committed to originating quality FHA loan products throughout its offices Nationwide. We firmly believe that the actions described above will dramatically improve the quality of the FHA loan product being originated at the Overland Park branch.

Sincerely,

Steve Hartung
Assistant Vice President
Senior Manager, Loss Mitigation

Appendix C

CRITERIA

Criteria 1
HUD Handbook 4000.2, chapter 5, section 5-2, paragraph O, says courier fees and wire fees may be charged only on refinances and only for delivery of the mortgage payoff statement to the lien holder and for closing documents to the settlement agent. The borrower must agree in writing to pay for the courier and wire fees, prior to loan closing.

Criteria 2
HUD Handbook 4000.4, REV-1, CHG-2, chapter 1, section 1-11, says that no extra fees and charges may be collected from the borrower on the basis of direct endorsement processing. Only those fees normally charged to the borrower in HUD/Federal Housing Administration transactions—lock-in fee, origination fee, appraisal fee, inspection fees, costs of a credit report, any charges for verifying deposits, and discount points—may be charged to the borrower in a direct endorsement case. No underwriting fee may be charged to the borrower.

Criteria 3
HUD Handbook 4000.4, REV-1, CHG-2, chapter 2, section 2-5, says the underwriter's role and responsibility are critical elements of the direct endorsement program. The underwriter executes the underwriter certification, which enables HUD to endorse the mortgage loan without a detailed technical underwriting review. The underwriter certifies that he or she has personally reviewed the application documents and finds compliance with the applicable requirements. One of the underwriter's responsibilities is the coordination of all phases of the underwriting of the mortgage loan. This role enables the underwriter to ensure that prudent underwriting procedures are followed.

Criteria 4
HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 2, says that the anticipated amount of income and likelihood of its continuance must be established to determine the borrower's capacity to repay the mortgage debt. Income from any source that cannot be verified, is not stable, or will not continue may not be used in calculating the borrower's income ratios.

Criteria 5
HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 2-3, says past credit performance serves as the most useful guide in determining the attitude toward credit obligations that will govern the borrower's future actions. A borrower who has made payments on previous or current obligations in a timely manner represents reduced risk. Conversely, 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.

When analyzing the borrower's credit record, it is the overall pattern of credit behavior that must be examined, rather than isolated occurrences of unsatisfactory or slow payments. A period of financial difficulty in the past does not necessarily make the risk unacceptable if a good payment record has been maintained since. When delinquent accounts are revealed, the lender must determine whether the late payments were due to a disregard for or an inability to manage financial obligations or to factors beyond the control of the borrower including delayed mail or disputes with creditors.

While minor derogatory information occurring two or more years in the past does not require explanation, major indications of derogatory credit, including judgments and collections, and any other recent credit problems, require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

HUD also recognizes that some prospective borrowers may not have established a credit history. For those borrowers, and those who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider or may elect to use a nontraditional mortgage credit report developed by a credit reporting agency. Neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejection.

The basic hierarchy of credit evaluation is the manner of payments made on previous housing expenses, including utilities, followed by the payment history of installment debts, then revolving accounts. Generally, an individual with no late housing or installment debt payments should be considered as having an acceptable credit history unless there is major derogatory credit on his or her revolving accounts.

Criteria 6

HUD Handbook 4155.1, REV-4, CHG-1, chapter 2, section 2-3, paragraph B, says the lender must ascertain the purpose of any recent debts as the indebtedness may have been incurred to obtain part of the required cash investment on the property being purchased. Similarly, a satisfactory explanation must be provided by the borrower to account for the omission of any significant debt shown on the credit report but not listed on the loan application. The borrower must explain all inquiries shown on the credit report.

Criteria 7

HUD Handbook 4155.1, REV-4, chapter 2, section 2-6, says that 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. If a borrower indicates he or she was in school or in the military during any of this time, the borrower must provide supporting evidence, such as college transcripts or discharge papers. The borrower must also explain any gaps in employment of a month or more. Allowances for seasonal employment, such as is typical in the building trades, etc., may be made.

Criteria 8

HUD Handbook 4155.1, REV-4, chapter 2, section 2-7, paragraph A, says that overtime and bonus income may be used to qualify if the borrower has received such income for approximately the past two years and there are reasonable prospects of its continuance. The lender must develop an average of bonus or overtime income for the past two years, and the employment verification must not state categorically that such income is not likely to continue. Periods of less than two years may be acceptable provided the underwriter adequately justifies and documents his or her reason for using the income for qualifying purposes.

An earnings trend must also be established for either source of income. If either type of income shows a continual decline, the lender must provide a sound rationalization for including the income for borrower qualifying. If bonus income varies significantly from year-to-year, a period of more than two years must be used in calculating the average income.

Criteria 9

HUD Handbook 4155.1, REV-4, chapter 2, section 2-7, paragraph F, says that child support may be considered as effective income if such payments are likely to be consistently received for approximately the first three years of the mortgage. The borrower must provide a copy of the divorce decree, legal separation agreement, or voluntary payment agreement and evidence that payments have been received during the last 12 months. Periods of less than 12 months may be acceptable provided the payer's ability and willingness to make timely payments is adequately documented by the lender.

Criteria 10

HUD Handbook 4155.1, REV-4, chapter 2, section 2-10, says that all funds for the borrower's investment in the property must be verified.

Criteria 11

HUD Handbook 4155.1, REV-4, chapter 2, section 2-10, paragraph B, of the handbook states that a verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account or the account was opened recently the lender must obtain a credible explanation of the source of those funds.

Criteria 12

HUD Handbook 4155.1, REV-4, chapter 2, section 2-10, paragraph C, says that an outright gift of the cash investment is acceptable if the donor is a relative of the borrower, the borrower's employer or labor union, a charitable organization, a governmental agency or public entity that has a program to provide homeownership assistance to low- and moderate-income families or first-time homebuyers, or a close friend with a clearly defined interest in the borrower. A gift from any other source is considered an inducement to purchase and requires a reduction to the sales price. No repayment of the gift may be expected or implied.

The lender must document the transfer of the funds from the donor to the borrower. Acceptable procedures include obtaining a copy of the donor's withdrawal slip or canceled check, along with the borrower's deposit slip or bank statement showing the deposit. If the funds are not deposited to the borrower's account before closing, the lender must obtain verification the closing agent received funds from the donor for the amount of the gift.

Criteria 13

HUD Handbook 4155.1, REV-4, chapter 2, section 2-11, paragraph A, states that the borrower's liabilities 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 monthly housing expense and all other recurring charges including payments on installment accounts, child support or separate maintenance payments, revolving accounts, alimony, etc., extending 10 months or more. Debts lasting less than 10 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, particularly if the borrower will have limited or no cash assets after loan closing.

Criteria 14

HUD Handbook 4155.1, REV-4, chapter 2, section 2-11, paragraph C, says, if a debt payment, such as a student loan, is scheduled to begin within 12 months of the mortgage loan closing, the lender must include the anticipated monthly obligation in the underwriting analysis unless the borrower can provide evidence that the debt may be deferred to a period outside this timeframe. Similarly, balloon notes that come due within one year of loan closing must be considered.

Criteria 15

HUD Handbook 4155.1, REV-4, chapter 2, section 2-12, says that 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. If the total mortgage payment (principal and interest; escrow deposits for real estate taxes, hazard insurance, mortgage insurance premiums, any homeowners' association dues, ground rent, and any special assessments; and payments for any acceptable secondary financing) does not exceed 29 percent of gross effective income, the relationship of the mortgage payment to income is considered acceptable. A ratio exceeding 29 percent may be acceptable if significant compensating factors are presented. Typically, for borrowers with limited recurring expense, greater latitude is permissible on this ratio than the total fixed payment ratio described below.

B. If the total mortgage payment and all recurring charges does not exceed 41 percent of gross effective income, the relationship of total obligations to income is considered acceptable. A ratio exceeding 41 percent may be acceptable if significant compensating factors are presented.

Criteria 16

HUD Handbook 4155.1, REV-4, section 2-13, says compensating factors that may be used in justifying approval of mortgage loans with ratios exceeding the guidelines include those listed below. Underwriters must state on the "remarks" section of the HUD-92900WS the compensating factors used to support loan approval.

A. The borrower has successfully demonstrated the ability to pay housing expenses equal to or grater than the proposed monthly housing expense for the new mortgage. If the borrower over the past 12-24 months has met his or her housing obligation as well as other debts, there should be little reason to doubt the borrower's ability to continue to do so despite having ratios in excess of those prescribed.

B. The borrower makes a large down payment toward the purchase of the property.

C. The borrower has demonstrated a conservative attitude toward the use of credit and an ability to accumulate savings.

D. Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses.

E. The borrower receives compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and similar public benefits.

F. There is only a minimal increase in the borrower's housing expense.
G. The borrower has substantial cash reserves after closing.
H. The borrower has substantial nontaxable income (if no adjustment made previously in the ratio computations).
I. The borrower has potential for increased earnings, as indicated by job training or education in the borrower's profession.
J. The home is being purchased as the result of relocation of the primary wage-earner and the secondary wage-earner has an established history of employment, is expected to return to work, and there is reasonable prospects for securing employment in a similar occupation in the new area. The underwriter must address the availability of such possible employment.

Criteria 17

HUD Handbook 4155.1, REV-4, CHG-1, section 3-1, says that HUD expects the application package to contain sufficient documentation to support the lender's decision to approve the mortgage loan. When standard documentation does not provide enough information to support the decision, the lender must provide additional explanatory statements, consistent with other information in the application, to clarify or supplement the documentation submitted by the borrower.

Credit documents may be up to 120 days old at the time the loan closes (180 days for proposed construction). Updated, written verifications must be obtained when the age of the documents exceed these limits. Verification forms must pass directly between lender and provider without being handled by any third party.

Criteria 18

HUD Handbook 4155.1, REV-4, CHG-1, section 3-1, paragraph F, says a verification of deposit and most recent bank statements are typically required for mortgage credit analysis in all transactions. (By "most recent," HUD means at the time the initial loan application is made. Provided the document itself is not more than 120 days old when the loan closes (180 on new construction), there is no need to update.

Criteria 19

HUD Handbook 4155.1, REV-5, chapter 2, section 2-3, says past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions. A borrower who has made payments on previous and current obligations in a timely manner represents reduced risk. Conversely, if the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan.

When analyzing a borrower's credit history, examine the overall pattern of credit behavior, rather than isolated occurrences of unsatisfactory or slow payments. A period of financial difficulty in the past does not necessarily make the risk unacceptable if the borrower has maintained a good payment record for a considerable time period since the difficulty. When delinquent accounts are revealed, the lender must document their analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including delayed mail delivery or disputes with creditors.

While minor derogatory information occurring two or more years in the past does not require explanation, major indications of derogatory credit-including judgments, collections, and any other recent credit problems-require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

Neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejecting the loan application. HUD also recognizes that some prospective borrowers may not have an established credit history. For those borrowers, and for those who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider. The lender must document that the providers of non-traditional credit do, in fact, exist and verify the credit information. Documents confirming the existence of a non-traditional credit provider may include a public record from the state, county, or city records, or other means providing a similar level of objective confirmation. To verify the credit information, lenders must use a published address or telephone number for that creditor.

As an alternative, the lender may elect to use a non-traditional mortgage credit report developed by a credit-reporting agency, provided that the credit reporting agency has verified the existence of the credit providers and the lender verifies that the non-traditional credit was extended to the applicant. The lender must verify the credit using a published address or telephone number to make that verification.

The basic hierarchy of credit evaluation is the manner of payments made on previous housing expenses, including utilities, followed by the payment history of installment debts, and then revolving accounts. Generally, an individual with no late housing or installment debt payments should be considered as having an acceptable credit history, unless there is major derogatory credit on his or her revolving accounts.

Criteria 20

HUD Handbook 4155.1, REV-5, chapter 2, section 2-3, paragraph A, says the payment history of the borrower's housing obligations holds significant importance in evaluating credit. The lender must determine the borrower's payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity-of-interest with the borrower) or verification of mortgage directly from the mortgage servicer, or through canceled checks covering the most recent 12-month period.

Criteria 21

HUD Handbook 4155.1, REV-5, chapter 2, section 2-3, paragraph B, says the lender must ascertain the purpose of any recent debts, as the indebtedness may have been incurred to obtain part of the required cash investment on the property being purchased. Similarly, the borrower must provide a satisfactory explanation for any significant debt that is shown on the credit report but not listed on the loan application. The borrower must explain in writing all inquiries shown on the credit report in the last 90 days.

Criteria 22

HUD Handbook 4155.1, REV-5, chapter 2, section 2-6, says the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower’s capacity to repay mortgage debt. Income may not be used in calculating the borrower’s income ratios if it comes from any source that cannot be verified, is not stable, or will not continue. This section describes acceptable types of income, procedures for calculating effective income, and requirements for establishing income stability.

HUD does not impose a minimum length of time a borrower must have held a position of employment to be eligible. However, the lender must verify the borrower’s employment for the most recent two full years. If a borrower indicates he or she was in school or in the military during any of this time, the borrower must provide supporting evidence, such as college transcripts or discharge papers. The borrower also must explain any gaps in employment spanning one month or more. Allowances for seasonal employment, such as is typical in the building trades, etc., may be made if documented by the lender.

To analyze and document the probability of continued employment, lenders must examine the borrower’s past employment record, qualifications for the position, previous training and education, and the employer’s confirmation of continued employment. A borrower who changes jobs frequently within the same line of work, but continues to advance in income or benefits, should be considered favorably. In this analysis, income stability takes precedence over job stability.

Criteria 23

HUD Handbook 4155.1, REV-5, chapter 2, section 2-7, says the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage loan. If the borrower intends to retire during this period, the effective income must be the amount of documented retirement benefits, social security payments, or other payments expected to be received in retirement. No inquiry may be made regarding possible future maternity leave.

In most cases, the borrower’s income will be limited to salaries or wages. Income from other sources can be included as effective income with proper verification by the lender. Procedures for analyzing other acceptable income sources besides salaries and wages are described below:

M. Rental Income. Rent received for properties owned by the borrower is acceptable if the lender can document that the rental income is stable. Examples of stability may include a current lease, an agreement to lease, or a rental history over the previous 24 months that is free of unexplained gaps greater than three months. (Student, seasonal, or military renters, or property rehabilitation would provide such an explanation). A separate schedule of real estate is not required for rental properties, provided all properties are shown on the loan application.

If the borrower resides in one or more units of a multiple-unit property and charges rent to tenants of other units, that rent may be used for qualifying purposes. However, projected rent of additional units only and not the owner-occupied unit(s) may be considered gross income only after deducting the Home Ownership Center’s vacancy and maintenance factor. It may not be used as a direct offset to the mortgage payments.

The following is required to verify all rental income:

2. Current Leases. If a property was acquired since the last income tax filing and is not shown on Schedule E, a current signed lease or other rental agreement must be provided. The gross rental amount must be reduced for vacancies and maintenance by 25 percent (or the percentage developed by the jurisdictional Home Ownership Center) before subtracting principal, interest, taxes, and insurance, and any homeowners' association dues, etc., and applying the remainder to income (or recurring debts, if negative).

Criteria 24
HUD Handbook 4155.1, REV-5, chapter 2, section 2-10, says that all funds for the borrower's investment in the property must be verified and documented.

Criteria 25
HUD Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph B, says a verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account or the account was opened recently, the lender must obtain a credible explanation of the source of those funds.

Criteria 26
HUD Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph C, says an outright gift of the cash investment is acceptable if the donor is the borrower's relative, the borrower's employer or labor union, a charitable organization, a governmental agency or public entity that has a program to provide homeownership assistance to low- and moderate-income families or first-time homebuyers, or a close friend with a clearly defined and documented interest in the borrower. The gift donor may not be a person or entity with an interest in the sale of the property, such as the seller, real estate agent or broker, builder, or any entity associated with them. Gifts from these sources are considered inducements to purchase and must be subtracted from the sales price. No repayment of the gift may be expected or implied. (As a rule, HUD is not concerned with how the donor obtains the gift funds provided they are not derived in any manner from a party to the sales transaction. Donors may borrow gift funds from any other acceptable source provided the mortgage borrowers are not obligors to any note to secure money borrowed to give the gift.) This rule also applies to properties of which the seller is a government agency selling foreclosed properties, such as the Veterans Administration or Rural Housing Services. Only family members may provide equity credit as a gift on a property being sold to other family members.

The lender must document the gift funds by obtaining a gift letter, signed by the donor and borrower, that specifies the dollar amount of the gift, states that no repayment is required, shows the donor's name, address and telephone number, and states the nature of the donor's relationship to the borrower. In addition, the lender must document the transfer of funds from the donor to the borrower, as follows:

1. If the gift funds are in the homebuyer's bank 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 that the withdrawal is from the

donor's account. The homebuyer’s deposit slip and bank statement that shows the deposit is also required.

2. If the gift funds are to be provided at closing,
    a. If the transfer of the gift funds is by certified check made on the donor’s account, the lender must obtain a bank statement showing the withdrawal from the donor’s account, as well as a copy of the certified check.
    b. If the donor purchased a cashier’s check, money order, official check, or any other type of bank check as a means of transferring the gift funds, the donor must provide a withdrawal document or canceled check for the amount of the gift, showing that the funds came from the donor’s personal account. If the donor borrowed the gift funds and cannot provide documentation from the bank or other savings account, the donor must provide written evidence that those funds were borrowed from an acceptable source, i.e., not from a party to the transaction, including the lender. “Cash on hand” is not an acceptable source of the donor’s gift funds.

Regardless of when the gift funds are made available to the homebuyer, the lender must be able to determine that the gift funds ultimately were not provided from an unacceptable source and were indeed the donor’s own funds. When the transfer occurs at closing, the lender remains responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source.

Criteria 27
HUD Handbook 4155.1, REV-5, chapter 2, section 2-11, paragraph A, says the borrower’s liabilities 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 monthly housing expense and all other recurring charges extending ten months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts, alimony, etc. Debts lasting less than 10 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.

Criteria 28
HUD Handbook 4155.1, REV-5, chapter 2, section 2-11, paragraph C, says if a debt payment, such as a student loan, is scheduled to begin within 12 months of the mortgage loan closing, the lender must include the anticipated monthly obligation in the underwriting analysis, unless the borrower provides written evidence that the debt will be deferred to a period outside this timeframe. Similarly, balloon notes that come due within one year of loan closing must be considered in the underwriting analysis.

Criteria 29
HUD Handbook 4155.1, REV-5, chapter 2, section 2-12, says 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. If the total mortgage payment (principal and interest; escrow deposits for real estate taxes, hazard insurance, the mortgage insurance premium, homeowners' association dues, ground rent, special assessments, and payments for any acceptable secondary financing) does not exceed 29 percent of the gross effective income, the relationship of the mortgage payment to income is considered acceptable. A ratio exceeding 29 percent may be acceptable only if significant compensating factors are documented and are recorded on the mortgage credit analysis worksheet. Typically, for borrowers with limited recurring expense, greater latitude is permissible on this ratio than on the total fixed payment ratio.

B. Total fixed payment to effective income. If the total of the mortgage payment and all recurring charges does not exceed 41 percent of the gross effective income, the relationship of total obligations to income is considered acceptable. A ratio exceeding 41 percent may be acceptable only if significant compensating factors are documented and are recorded on the mortgage credit analysis worksheet.

Criteria 30

HUD Handbook 4155.1, REV-5, chapter 2, section 2-13, says compensating factors that may be used to justify approval of mortgage loans with ratios exceeding our benchmark guidelines are those listed below. Underwriters must record in the "remarks" section of the HUD 92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation.

A. The borrower has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12-24 months.

B. The borrower makes a large downpayment (10 percent or more) toward the purchase of the property.

C. The borrower has demonstrated an ability to accumulate savings and a conservative attitude toward the use of credit.

D. Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses.

E. The borrower receives documented compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and similar public benefits.

F. There is only a minimal increase in the borrower's housing expense.

G. The borrower has substantial documented cash reserves (at least three months' worth) after closing. In determining if an asset can be included as cash reserves or cash to close, the lender must judge whether or not the asset is liquid or readily convertible to cash and can be done so absent retirement or job termination.
Funds borrowed against these accounts may be used for loan closing, but are not to be considered as cash reserves. "Assets" such as equity in other properties and the proceeds from a cash-out refinance are not to be considered as cash reserves. Similarly, funds from gifts from any source are not to be included as cash reserves.

H. The borrower has substantial non-taxable income (if no adjustment was made previously in the ratio computations).

I. The borrower has a potential for increased earnings, as indicated by job training or education in the borrower's profession.

J. The home is being purchased as a result of relocation of the primary wage-earner, and the secondary wage-earner has an established history of employment, is expected to return to work, and reasonable prospects exist for securing employment in a similar occupation in the new area. The underwriter must document the availability of such possible employment.

Criteria 31

HUD Handbook 4155.1, REV-5, chapter 3, section 3-1, says the application package must contain all documentation supporting the lender's decision to approve the mortgage loan. When standard documentation does not provide enough information to support this decision, the lender must provide additional explanatory statements, consistent with other information in the application, to clarify or to supplement the documentation submitted by the borrower.

All documents may be up to 120 days old at the time the loan closes (180 days for new construction) unless this or other applicable HUD instructions specify a different time frame or the nature of the document is such that its validity for underwriting purposes is not affected by being older than the number of prescribed days (e.g., divorce decrees, tax returns). Updated, written verifications must be obtained when the age of the documents exceed these limits. Verification forms or documents used as an alternate to these verifications must pass directly between the lender and the provider without being handled or transmitted by any third party or using any third party's equipment. No document used in the processing or underwriting of a loan may be handled or transmitted by or through an interested third party to the transaction.

The verification of deposit and verification of employment may be faxed documents or printed pages from the Internet if they clearly identify their sources (e.g., contain the names of the borrower's employer or depository/investment firm). The lender is accountable for ascertaining the authenticity of the document by examining information included in a document's headers and footers. The lender should verify the authenticity of printed Web pages by examining the pages for similar information. A printed Web page also must show its uniform resource locator address, as well as the date and time the document was printed.

Lenders may not accept or use documents relating to the credit, employment or income of borrowers that are handled by or transmitted from or through interested third parties (e.g., real estate agents, builders, sellers) or by using their equipment.

Criteria 32

HUD Handbook 4330.1, REV-5, section 4-12, paragraph B, says there are services a lender may not charge to the borrower, including fees for tax services to furnish tax data and information necessary to pay property taxes or in some circumstances to make the payments on behalf of the lender.

Criteria 33

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

Criteria 34

Mortgagee Letter 99-26 approved Fannie Mae's desktop underwriter automated underwriting system for Federal Housing Administration loan approvals. The lender remains accountable for compliance with Federal Housing Administration guidelines and those credit, capacity, and documentation aspects not addressed in the user's guides provided by Fannie Mae. A Federal Housing Administration-registered direct endorsement underwriter must fully underwrite those applications for which the system refers the file to an individual underwriter.

Criteria 35

Mortgagee Letter 00-28 says that in determining whether an asset can be included as cash reserves or cash to close, the lender must judge whether or not the asset is liquid or readily converted to cash absent retirement or job termination. Assets such as 401(k)s, individual retirement accounts, thrift savings plans, etc., may be included in the underwriting analysis up to only 60 percent of value unless the borrower provides credible evidence that a higher percentage may be withdrawn after subtracting any federal income tax and any withdrawal penalties.

Criteria 36

Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans, chapter 1, 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 entered into desktop underwriter or that are downloaded or imported into the system must be true, accurate, and complete.

Criteria 37

Freddie Mac's Loan Prospector Automated Underwriting Service Training and Users Guide, section 2, states that the data the user inputs into loan prospector must match the application, underwriting documentation, and delivery information at the time the data are entered and that the user is responsible for data integrity.

Criteria 38

HUD Homeownership Center Reference Guide, chapter 2, Mortgage Credit Guidelines, page 2-15, "Closing Costs and Other Fees," states that all closing items associated with a HUD-insured loan, including paid-outside-closing items, must be itemized on the HUD-1 settlement statement for Real Estate Settlement Procedures Act compliance. Commitment fees are only allowable if the lock-in or commitment agreement for which a fee is charged is in writing and guarantees the rate and/or discount points for a period of not less than 15 days before the anticipated closing date.

Appendix D

SCHEDULE OF SIGNIFICANT UNDERWRITING DEFICIENCIES

Federal Housing Administration case number	(1) Original insured mortgage amount	(2) Claim paid by HUD	Unsupported income	Questionable employment history	Unsupported assets	Questionable gift funds	Underreported liabilities	Questionable credit history
132-1665315	$ 62,208					x	x	
181-1985370	$ 65,569		x		x		x	
181-1998771	$ 117,638		x		x		x	x
181-2012858	$ 63,995		x		x	x		
181-2021633	$ 43,645		x					
182-0734198	(3)				x		x	
182-0760589	$ 177,523		x		x			
182-0771581	$ 165,404		x				x	
182-0783328	$ 93,532			x			x	
291-3089848	$ 81,216		x		x		x	
291-3092637	$ 97,727		x					
291-3183919	$ 103,274						x	
291-3224520	$ 65,964		x					
291-3226284	$ 63,995				x			x
291-3232527	$ 82,702		x		x		x	x
291-3241230	$ 89,294			x		x		
291-3245514	$ 90,074				x			x
291-3248743	$ 129,862		x		x			
291-3264571	$ 155,312		x				x	
291-3270679		$ 175,328	x		x			x
291-3281528		$ 46,009			x	x		
291-3292555	$ 155,759				x		x	
291-3300350	$ 113,474				x		x	
Totals	**$ 2,018,167**	**$ 221,337**	**13**	**2**	**14**	**4**	**12**	**5**

(1) Loans actively insured as of September 23, 2005.
(2) Loans that have defaulted and HUD has paid a claim and acquired the property. As of September 23, 2005, the two properties have not been sold.
(3) Case number 182-0734198 was paid in full during the course of our audit work. The loan contained material deficiencies; however, it no longer poses a risk to the insurance fund.

Appendix E

SCHEDULE OF MINOR DEFICIENCIES

Federal Housing Administration case number	Unsupported income	Questionable employment history	Unsupported assets	Underreported liabilities	Questionable credit history
181-2012388	x				
181-2047489	x				
182-0769831				x	
182-0779194	x				
291-3065065	x				
291-3085449	x				
291-3132004	x				
291-3179683					x
291-3219911	x				
291-3245812	x				
291-3250555			x		
291-3252958	x				
291-3317050	x	x			
Totals	**10**	**1**	**1**	**1**	**1**

Appendix F

SCHEDULE OF UNALLOWABLE FEES

Federal Housing Administration case number	Commitment fee	Tax service fee	Underwriting fee	Credit report overcharge	Origination fee overcharge	Wire transfer fee	E-mail/ courier fee	Total
132-1665315						$ 75		**$ 75**
181-2021633	$ 275							**$ 275**
291-3085449							$ 40	**$ 40**
291-3135942						$ 30		**$ 30**
291-3179683	$ 350							**$ 350**
291-3182358	$ 350							**$ 350**
291-3219911				$ 36	$1,276			**$ 1,312**
291-3226284			$ 214					**$ 214**
291-3241230	$ 350	$ 75	$ 395				$ 25	**$ 845**
291-3245812	$ 250						$ 25	**$ 275**
291-3248743		$ 75	$ 395					**$ 470**
291-3250555	$ 250							**$ 250**
291-3270679		$ 75					$ 50	**$ 125**
Totals	**$1,825**	**$225**	**$1,004**	**$ 36**	**$1,276**	**$105**	**$140**	**$ 4,611**

Appendix G

CASE STUDIES FOR 23 QUESTIONED LOANS

Case number: 132-1665315	Insured amount: $62,208
Section of Housing Act: 203(b)	Status upon selection: Defaulted on 14th payment
Date of loan closing: May 29, 2003	Underwriter type: Manual

Underreported Liabilities
The lender excluded recurring debts of the borrower when evaluating the loan. The lender identified an auto loan as a duplicate of another auto loan on the borrower's credit report and included only one monthly debt of $292 in the financial ratios. The debt is $292 per month for each loan. The two loans have the same payment, but the account numbers are different, and the high balances are different, indicating they may be two different loans. The loan file contained no other documents to support that the lender verified possible duplications on the credit report. When including the $292 liability in the total debt ratio, the ratio exceeds HUD's guidelines.

HUD Requirements – Appendix C
Handbook 4155.1, REV-4, chapter 2, section 2-11, paragraph A (Criteria 13)
Handbook 4155.1, REV-4, chapter 2, section 2-12 (Criteria 15)

Questionable Gift Funds
The lender did not adequately document gift funds. The HUD-1 settlement statement reflected gift funds of $3,135. The gift letter showed that the mother is gifting $1,925 to the borrower, and the money was obtained from a credit card advance. The advance was applied to the borrower's credit card debts. The remaining gift funds of $1,210 were not explained. In addition, the borrower (or someone on the borrower's behalf) paid off $2,245 in debt collections before the loan closed. Therefore, undocumented potential gift funds are at least $1,210 and could be as much as $1,490.

HUD Requirements – Appendix C
Handbook 4155.1, REV-4, chapter 2, section 2-10, paragraph C (Criteria 12)
Handbook 4155.1, REV-4, chapter 3, section 3-1 (Criteria 17)

Unallowable Charges
The lender charged the borrower a $75 wire transfer fee according to the HUD-1 settlement statement. Wire transfer fees are allowed only on refinances. This is not a refinance loan.

HUD Requirements – Appendix C
Handbook 4000.2, chapter 5, section 5-2, paragraph O (Criteria 1)

Case number: 181-1985370 | Insured amount: $65,569

Section of Housing Act: 203(b) | Status upon selection: Defaulted on 12th payment

Date of loan closing: May 15, 2003 | Underwriter type: Manual

Unsupported Income

The lender overstated the borrower's income by at least $376 per month and possibly as much as $762 per month when approving the loan. The mortgage credit analysis worksheet listed employment income of $1,992 and child support income of $400 per month (total of $2,392). The verification of employment stated that the borrower made $9.09 per hour and averaged 44 hours per week, which is $1,630 per month including overtime. The only pay stub provided showed the borrower worked 38 hours that week, bringing into question the likelihood of an average of 44 hours per week.

Also, there was no documentation to support the likelihood of future receipt of the child support income. The divorce decree provided does not identify the child support. The loan file contained a history of child support payments collected through garnished wages, but the collection efforts were for past-due child support. There was no indication that the borrower was likely to receive child support payments due during the first three years of the mortgage. Also, because the support provider was in arrears before loan closing, it is questionable whether the borrower would consistently receive child support.

The borrower's 26.3-month income history supported a monthly income of $2,016. Therefore, income is overstated between $376 and $762 per month. See below for the effect on the financial ratios.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2 (Criteria 4)
Handbook 4155.1, REV-4, chapter 2, section 2-7, paragraph F (Criteria 9)
Mortgagee Letter 99-26 (Criteria 34)
Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans, dated July 2002, chapter 2, paragraph 3 (Criteria 36)

Underreported Liabilities

According to the borrower's credit report, the borrower had two open accounts with payments totaling $45 per month that were not included in the liabilities on the mortgage credit analysis worksheet or the loan application. The borrower asserted that one account was a duplicate of the other account; however, the total amount owed, account number, and payment amount were different for the two accounts. See below for the effect on the financial ratios.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2-11, paragraph A (Criteria 13)

Excessive Ratios
The mortgage credit analysis worksheet reflected financial ratios of 24.46 percent and 41.55 percent. No compensating factors were identified on the worksheet. Using only supported income and all recurring liabilities, the ratios increase to 35.9 percent and 63.8 percent per the verification of employment, or 29 percent and 51.5 percent using the 26.3-month income history.

HUD Requirements – Appendix C
Handbook 4155.1, REV-4, chapter 2, section 2-12 (Criteria 15)

Unsupported Assets
The lender did not support assets that it considered available when approving the loan. The mortgage credit analysis worksheet showed that the borrower needed $3,400 to close the loan, which was supported by a March 5, 2003, verification of deposit from the borrower's credit union. However, the lender obtained only the January 31, 2003, bank statement, which showed a balance of only $699 in the account. Without the February and March 2003 statements, the lender could not verify the source of the March 5, 2003 balance of $3,523. An April 22, 2003, letter from the borrower stated she withdrew $3,000 from a savings account at Bank of America and deposited it into the credit union account. The Bank of America bank statement as of March 13, 2003, showed a $3,000 withdrawal; however, it also showed an unexplained deposit of $2,577 on February 28, 2003. The account showed a balance of only $1,549 before the large deposit.

The loan file also contained Bank of America bank statements as of March 13, 2003, for two additional accounts with balances of $470 and $2,108. Both of the bank statements had only the borrower's nonpurchasing spouse's name on the accounts. The accounts were opened after the transaction dates of the $2,577 deposit and the $3,000 withdrawal.

HUD Requirements – Appendix C
Handbook 4155.1, REV-4, chapter 2, section 2-10 (Criteria 10)
Handbook 4155.1, REV-4, chapter 3, section 3-1, paragraph F (Criteria 17)

Case number: 181-1998771 Insured amount: $117,638

Section of Housing Act: 203(b) Status upon selection: Defaulted on 17th payment

Date of loan closing: May 23, 2003 Underwriter type: Manual

Unsupported Assets

The lender did not adequately evaluate the source of assets available when it approved the loan. According to the mortgage credit analysis worksheet, the borrower needed $7,256 to close the loan and had $7,343 in assets available. A May 20, 2003, verification of deposit confirmed that the borrower had $7,343 available, but the average balance for the previous two months was only $1,191. The lender obtained no bank statement(s) to support the balance, and the April 22, 2003, bank statement showed only $590 available. Without bank statements, the lender could not review for the source of the $6,000 increase from the account average.

The loan file also contained an account statement from another institution, which showed a balance of $3,420 as of March 31, 2003. The loan file also contained a May 12, 2003, withdrawal slip on this account showing a withdrawal for $3,482 and an ending balance of $25. Even if the $3,482 withdrawal was transferred to the first account described above, the transfer does not explain the $6,000 increase from the average balance.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2-10 (Criteria 10)

Underreported Liabilities

The lender did not consider all recurring debts when approving the loan. The credit report showed a 60-month car loan opened in July 1999, which would not mature until June 2004—more than a year after the Federal Housing Administration loan closing of May 23, 2003. The monthly payment of $638 was excluded from the liabilities on the mortgage credit analysis worksheet and loan application. Even though the loan appeared to pay off in eight months, this significant debt could have affected the borrower's ability to repay the mortgage in the months immediately following closing. The credit report also showed 20 late payments on the auto loan in the 46 months reviewed, so timely pay off within eight months is questionable.

The loan file also contained a supplement to the credit report that showed a debt of $399, with a monthly payment of $10, that the lender excluded from liabilities. In addition, the borrower's bank statements showed a March 28, 2003, signature loan (identified as "new loan") for $1,500. This could indicate an unreported liability. See below for the effect on the financial ratios.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2-11, paragraph A (Criteria 13)

Derogatory Credit/Open Judgment
The lender did not adequately evaluate the borrowers' credit history. In addition to the 20 late payments on an auto loan, the credit report reflected two student loans sent to collections and a college-related judgment for $1,664. According to the credit report, the status of the judgment was unknown. The credit report also showed 70 inquiries on the borrower's credit in the previous 12 months. The loan file contained no explanation for the derogatory credit or whether the judgment was resolved.

HUD Requirements – Appendix C
Handbook 4155.1, REV-4, chapter 2, section 2-3 (Criteria 5)

Unsupported Income
Base pay is overstated by $269 per month. The mortgage credit analysis worksheet reflected a base pay rate for the coborrower of $2,080. The verification of employment and the pay stubs supported only $1,811 per month in base pay.

HUD Requirements – Appendix C
Handbook 4155.1, REV-4, chapter 2, section 2 (Criteria 4)

Excessive Ratios
The total debt ratio on the mortgage credit analysis worksheet was 28.8 percent. When including the underreported liabilities and using only the supported income, the debt ratio increases to 42.3 percent, which exceeds HUD's limit. In addition, the housing expense was increasing from $465 per month to $1,213 per month, or 261 percent.

HUD Requirements – Appendix C
Handbook 4155.1, REV-4, chapter 2, section 2-12 (Criteria 15)

Case number: 181-2012858 | Insured amount: $63,995

Section of Housing Act: 203(b) | Status upon selection: Defaulted on 4th payment

Date of loan closing: July 1, 2003 | Current status: First legal action to commence foreclosure (August 1, 2005)

Underwriter type: Manual

Unsupported Income

The lender did not verify a two-year work history for the borrower. The 18-year-old borrower had established only a one year work history. The work history began in May 2002, with the borrower working part time. An underwriter noted that the borrower started working full time in May 2003, just two months before the Federal Housing Administration loan closing.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2 (Criteria 4)
Handbook 4155.1, REV-4, chapter 2, section 2-6 (Criteria 7)

Questionable Gift Funds

The lender did not adequately evaluate the source of the gift funds used to qualify for the loan. A gift letter stated the donor was giving $1,500 to the borrower; however, the donor's bank statement did not show sufficient funds to gift the $1,500. The loan file contained copies of money orders, made out to the title company, to document the gift to the borrower. The money orders were for the same date (June 26, 2003) as a $1,800 withdrawal from the donor's bank account. However, the donor's bank statement did not indicate a history of having the funds to provide $1,500. There was an unexplained deposit on June 20, 2003, for $2,000, which appears to have been used to purchase the money orders for the gift funds. Therefore, the source of gift funds is questionable.

In addition, the gift was not shown on the HUD-1 settlement statement. The borrower paid $1,563 at closing, but the loan file did not show that the borrower had the funds to close the loan (also see Unsupported Assets below).

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2-10, paragraph C (Criteria 12)

Unsupported Assets

The lender did not verify borrower assets needed to close the loan. The HUD-1 settlement statement indicated the borrower paid $1,563 at closing. Bank statements and a verification of deposit confirmed a balance of only $486, an amount insufficient to close the loan.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2-10 (Criteria 10)

Case number: 181-2021633 | Insured amount: $43,645

Section of Housing Act: 203(b) | Status upon selection: Defaulted on 9th payment

Date of loan closing: November 20, 2003 | Current status: Foreclosure started (August 1, 2005)

Underwriter type: Automated

Unsupported Income

The lender overstated income when approving the loan. The lender used $3,767 on the mortgage credit analysis worksheet to qualify the borrower, but the verification of employment and recent pay stub supported only $3,500 per month.

The lender derived the $3,767 per month from the year-to-date gross income of $27,461 on the borrower's pay stub for pay period ending August 9, 2003. Using the lender's method yielded $267 more income per month than supported by the verification of employment and pay stubs. The employer noted on the verification of employment that overtime and bonuses were not applicable. Overstating the income by $267 per month causes the total debt ratio to increase to 51.7 percent.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2 (Criteria 4)
Handbook 4155.1, REV-4, chapter 2, section 2-12 (Criteria 15)
Mortgagee Letter 98-14 (Criteria 33)
Freddie Mac's Loan Prospector Automated Underwriting Service Training and Users Guide, section 2 (Criteria 37)

Unallowable Charges

The lender charged the borrower a prohibited closing fee. The HUD-1 settlement statement showed a $275 commitment fee paid by the borrower. There was no written agreement in the file that served as an interest rate lock-in/loan discount points agreement. Without the written agreement, there was no evidence that the lender made the commitment to the borrower and properly charged the borrower the commitment fee.

HUD Requirements – Appendix C

HUD Homeownership Center Reference Guide, chapter 2, Mortgage Credit Guidelines, page 2-15, "Closing Costs and Other Fees," (Criteria 38)

Case number: 182-0734198 | Insured amount: $145,847

Section of Housing Act: 203(b) | Status upon selection: Defaulted on 7th payment

Date of loan closing: February 20, 2003 | Current status: Paid in full (August 1, 2005)

Underwriter type: Manual

Unsupported Assets

The lender did not adequately support assets available to the borrower when approving the loan. According to the mortgage credit analysis worksheet, the borrower needed $7,921 to close the loan and had $14,800 in assets available. A verification of deposit showed $8,109 available as of February 18, 2003. A copy of an $8,000 check, dated February 14, 2003, from the borrower's mother to the borrower was used to support the claim that the borrower sold a truck to his mother for $8,000. The lender did not obtain bank statements to confirm that the sale of the truck was the source of the $8,109 in the borrower's bank account. According to the HUD-1 settlement statement, the borrower paid $5,690 at closing.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2-10 (Criteria 10)
Handbook 4155.1, REV-4, chapter 2, section 2-10, paragraph B (Criteria 11)

Excessive Ratios

The lender identified invalid compensating factors when approving the loan with financial ratios that exceeded HUD's limits. Ratios on the mortgage credit analysis worksheet were 30.21 percent and 50.31 percent, both of which exceeded HUD's guidelines. The compensating factor on the mortgage credit analysis worksheet stated, "borrower has shown ability to save." The compensating factor was invalid because the lender did not obtain bank statements to confirm the source of funds verified, and the potential source of the funds (the sale of the borrower's truck) does not demonstrate the borrower's ability to save.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, section 2-12 (Criteria 15)

Underreported Liabilities

The lender did not consider all recurring liabilities when evaluating the borrower's ability to repay the mortgage. The lender's loan file contained a $3,000 promissory note between the borrower and the borrower's bank. The balloon loan began in December 2002, and was due in June 2003, four months after the Federal Housing Administration loan closing. Although the loan was to be paid off in less than 10 months after the mortgage closing, the large amount due four months after the mortgage closing ($3,000) could have caused a financial hardship for the borrower, making it difficult to make future mortgage payments, and should have been considered by the lender.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2-11, paragraph A (Criteria 13)
Handbook 4155.1, REV-4, chapter 2, section 2-11, paragraph C (Criteria 14)

Case number: 182-0760589 Insured amount: $177,523

Section of Housing Act: 203(b) Status upon selection: Defaulted on 5th payment

Date of loan closing: October 13, 2003 Underwriter type: Manual

Unsupported Income and Excessive Ratios

The lender overstated the borrower's monthly income when it used income from a previous job instead of the job held during processing of the loan. The mortgage credit analysis worksheet showed the lender used $6,193 per month to qualify the borrower. However, the $6,193 was computed using the borrower's previous employment that ended before July 28, 2003, almost three months before the loan was closed. The borrower began new employment during the loan approval process. The borrower's verification of employment and pay stub from the new employer showed a $65,000 salary, or $5,416 per month. As a result, the base employment income was overstated by $777 per month. Using the supported monthly income of $5,416, the total debt ratio increases from 42.9 percent shown on the mortgage credit analysis worksheet to 49.2 percent. The lender was aware of, but did not take into account, the significant decrease in employment income.

The lender identified compensating factors of "borrower has good job stability and lowering housing," to justify the loan approval. Job stability is not a valid compensating factor when income decreases significantly. The housing payment was decreasing from $1,838 per month to $1,475 per month ($363 decline), but the decline was not sufficient to offset the overstated income and the excessive total debt ratio of 49.2 percent.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2 (Criteria 4)
Handbook 4155.1, REV-4, chapter 2, section 2-12 (Criteria 15)

Unsupported Assets

The borrower paid fees outside of closing and at closing, but the lender did not verify that the borrower had the funds available or that the funds were from another allowable source. The mortgage credit analysis worksheet showed that the borrower did not need cash to close the loan. The borrower identified $1,200 in bank assets on the loan application, but the lender did not obtain a verification of deposit or bank statements to verify assets available to the borrower. However, the HUD-1 settlement statement showed several fees were paid outside of closing, and the borrower paid $801 at closing, showing that the borrower needed cash assets to close the loan.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2-10 (Criteria 10)

Case number: 182-0771581 | Insured amount: $165,404

Section of Housing Act: 203(b) | Status upon selection: Defaulted on 1st payment

Date of loan closing: January 27, 2004 | Underwriter type: Manual

Unsupported Income

The lender did not adequately support the monthly income claimed when approving the loan. The lender used a monthly income of $5,307 to qualify the borrower. The verification of employment stated the borrower's salary was $63,681 ($5,307 per month) as of January 11, 2004. The borrower did not provide pay stubs. The verification of employment indicated the borrower recently received a pay increase to $63,681 that would be reflected in February 2004, after the loan closed. The borrower worked for a federal agency and the federal pay tables (general schedule and locality) did not show a salary of $63,681 for the borrower's metropolitan area. The schedules also did not show the expected pay increase salary of $65,617. The Internal Revenue Service Forms W-2 for 2002 and 2003 show that the borrower's income decreased from $4,556 in 2002 to $4,161 in 2003, but the lender did not explain the decrease. Conversely, the borrower's income increased significantly from 2003 to 2004, just before the loan closing. The borrower's monthly income increased from $4,161 in 2003 to $5,307 in January 2004, with no explanation documented in the loan file.

Using the monthly income from the 2003 Internal Revenue Service Form W-2, which was within two weeks of the underwriting of the loan, the ratios increase and far exceed HUD's guidelines. The housing ratio increases from 24.4 percent to 31.07 percent, and the total debt ratio increases from 44.6 percent to 56.91 percent.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-6 (Criteria 22)
Handbook 4155.1, REV-5, chapter 2, section 2-12 (Criteria 29)
Handbook 4155.1, REV-5, chapter 2, section 2-13 (Criteria 30)
Handbook 4155.1, REV-5, chapter 3, section 3-1 (Criteria 31)

Underreported Liabilities

The lender omitted a significant monthly mortgage debt when evaluating the borrower's ability to repay the mortgage. The borrower's credit report showed a mortgage debt of $1,182 per month, with a balance of $111,114. The lender did not include the debt in the financial ratios, nor did the underwriter or borrower explain why it was not included. The borrower's divorce decree awarded the related residence to the ex-spouse but did not indicate who was responsible for the mortgage payment. It is unclear whether the lender should have included (or excluded) the $1,182 mortgage payment in the borrower's loan evaluation.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-3, paragraph A (Criteria 20)
Handbook 4155.1, REV-5, chapter 2, section 2-3, paragraph B (Criteria 21)

Case number: 182-0783328

Insured amount: $93,532

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 4th payment

Date of loan closing: June 30, 2004

Underwriter type: Manual

Current status:
First legal action to commence foreclosure (July 1, 2005)
Preforeclosure acceptance plan available (August 1, 2005)

Underreported Liabilities

The mortgage credit analysis worksheet showed the underwriter included no recurring liabilities, other than the housing payment, in calculating the borrower's financial ratios. However, the borrower was likely responsible for monthly child support and auto loan payments. An October 2000 to June 2004 history confirmed child support payments of $162 per month. The borrower's pay stub of May 14, 2004, also confirmed that the borrower's wages were garnished for child support of $81 per biweekly pay period.

In addition, the borrower's credit report showed a $366 monthly payment for an auto loan. Even though the auto debt had less than 10 months remaining to be paid, the $366 payment substantially affected the borrower's ability to repay the mortgage in the months immediately following the loan closing and should have been included in the financial ratios. The borrower provided a letter to the lender stating that he returned the vehicle to a loan company that appeared to be related to the $366 per month debt, but the debt remained on the credit report, and the lender did not verify that the debt was no longer owed.

The mortgage credit analysis worksheet indicated a 35 percent housing ratio, and a 35 percent total debt ratio. Considering the child support and auto loan the total debt ratio should have been 58.4 percent, which far exceeds HUD's limit of 41 percent.

Further, the underwriter underestimated the monthly hazard insurance cost on the mortgage credit analysis worksheet when calculating the housing payment. According to the HUD-1 settlement statement, the insurance escrow was $129 per month ($79 more than estimated). Using the $129 per month, the housing payment increases from $805 per month to $884 per month. This further increases the financial ratios to a housing ratio of 38.3 percent and the total debt ratio becomes 61.9 percent.

The lender noted on the mortgage credit analysis worksheet that the borrower had a few late payments while off work due to an illness but that he had since been on time with payments. This is not a compensating factor justifying excessive financial ratios. The lender also noted that the borrower's housing expense was not increasing, but this was an invalid compensating factor. The mortgage credit analysis worksheet and loan application showed that the borrower was paying $550 per month in rent. The borrower's new housing expense was to be $805 per month, a $255 per month increase using the lender's housing payment or a $333 per month increase using the actual monthly cost of hazard insurance. Further, the borrower had no reserves, claiming only $4 in cash assets.

HUD Requirements – Appendix C
Handbook 4155.1, REV-5, chapter 2, section 2-11 paragraph A (Criteria 27)
Handbook 4155.1, REV-5, chapter 2, section 2-12 (Criteria 29)
Handbook 4155.1, REV-5, chapter 2, section 2-13 (Criteria 30)

Questionable Employment History
The lender did not verify a two-year work history or explain a six-month gap in employment. The borrower's application stated the borrower worked at employer A from January 1999 through January 2003, then worked for employer B for 1.5 years, as of June 30, 2004 (which indicates a start date of January 2003). The verification of employment for employer B showed that the borrower did not start employment until July 28, 2003. Therefore, there was no documentation supporting employment between February 2003 and July 27, 2003.

HUD Requirements – Appendix C
Handbook 4155.1, REV-5, chapter 2, section 2-6 (Criteria 22)

Case number: 291-3089848 Insured amount: $81,216

Section of Housing Act: 203(b) Status upon selection: Defaulted on 3rd payment

Date of loan closing: April 3, 2003 Underwriter type: Manual

Unsupported Income

The lender overstated monthly income by $400 per month when approving the loan. The lender used $3,508 in monthly income to qualify the borrowers. The lender calculated the borrower's $2,252 monthly income using the yearly earnings from 2001 and 2002 and the year-to-date income as of January 15, 2003. However, the borrower's verification of employment showed a $4,972 (17 percent) decrease in income from 2001 through 2002. Averaging the two years of income when income significantly decreased overstated the monthly income for qualifying purposes. Using only the income from 2002 and year-to-date 2003, the average monthly income is $2,046, or $206 per month less than the amount used to qualify the borrower.

In addition, the lender used the hourly rate and a full-time schedule of 40 hours per week to compute the coborrower's $1,256 monthly income. The verification of employment stated that the coborrower worked only 34 hours per week, and it did not address the likelihood of the continuance of commission income. The coborrower showed evidence of receiving commissions for about six months, but the lender did not use commissions earned in computing the income. However, the coborrower did not have a history of two years of commission income. Based on the verification of employment, the coborrower's supported income was $1,062 per month, or $194 less than the amount used to qualify.

Using only the supported income of $3,108 per month, the total debt ratio increases above HUD's guidelines. According to the lender's calculations, the total debt ratio was 40.29 percent, but should have been 45.46 percent. The revised total debt ratio of 45.46 percent does not consider potential underreported liabilities (see below).

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2 (Criteria 4)
Handbook 4155.1, REV-4, chapter 2, section 2-7, paragraph A (Criteria 8)
Handbook 4155.1, REV-4, chapter 2, section 2-12 (Criteria 15)

Underreported Liabilities

The lender did not adequately identify recurring liabilities considered when approving the loan. The borrower's loan application, mortgage credit analysis worksheet, and credit report listed different amounts for total recurring liabilities. It is unclear what the underwriter included as recurring liabilities in the $797 per month used to qualify the borrowers. Also, education loans appeared on the credit report, but it is unclear whether the lender included any of these loans in evaluating debts. The credit report indicated that the loans were in deferment but did not indicate when repayment was to begin. There were no documents in the loan file stating when the borrower must begin repayment.

An underwriter note on the mortgage credit analysis worksheet stated, "auto less than 10 months," which indicates that the underwriter did not include the borrower's $343 monthly auto debt in the recurring liabilities. However, the outstanding balance of the auto debt was 10.4 months of payments owed. The $343 auto payment significantly affected the borrower's ability to make the mortgage payments during the months immediately after loan closing. When including the auto payment, the borrowers' debt ratio increases to 56.5 percent. The borrowers' reserves were minimal - only $375. The lender did not identify compensating factors.

The coborrower may have had a recurring housing expense that the lender did not consider in the financial ratios. The coborrower indicated on the loan application that she would not be occupying the subject property. The coborrower did not appear on any loan documents processed in January and February 2003 but initially appeared in March 2003 on an addendum to add the coborrower to the sales contract. If the coborrower was a nonoccupying owner, then her personal housing expense should have been included in the liabilities.

HUD Requirements – Appendix C
Handbook 4155.1, REV-4, chapter 2, section 2-11, paragraph A (Criteria 13)
Handbook 4155.1, REV-4, chapter 2, section 2-11, paragraph C (Criteria 14)

Unsupported Assets
The lender did not use current borrower financial information when approving the loan. The lender listed assets available of $2,794 on the mortgage credit analysis worksheet. The coborrower had an individual retirement account that contained $3,872, but the statement was from March 2002, which was not within 120 days of closing as required. In addition, the coborrower's bank account of $96 was not allowable because the bank statement was from February 2002, a year before closing. The lender adequately supported only $375 in assets available. The borrowers needed only $122 in cash to close the loan, which is supported, but the unsupported assets claimed significantly affected the lender's calculated reserves of $2,785.

HUD Requirements – Appendix C
Handbook 4155.1, REV-4, chapter 2 section 2-12 (Criteria 15)
Handbook 4155.1, REV-4, chapter 2 section 2-13 (Criteria 16)
Handbook 4155.1, REV-4, chapter 3, section 3-1 (Criteria 17)
Handbook 4155.1, REV-4, chapter 3, section 3-1, paragraph F (Criteria 18)

Case number: 291-3092637

Insured amount: $97,727

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 4th payment

Date of loan closing: May 7, 2003

Current Status:
First legal action to commence foreclosure (July 1, 2005)

HUD costs incurred:
Partial claim of $7,140

Underwriter type: Manual

Unsupported Income

The lender overstated income when approving the loan. The lender approved the loan with the borrower's income at $2,037 per month on the mortgage credit analysis worksheet. According to the verification of employment, the borrower's income was $1,946 per month, including overtime. If all borrower income for 2001, 2002, and year to date 2003 is averaged, it equals $1,868 per month.

Using the verification of employment information, the lender overstated income by $91 per month. The reduced income increases the housing ratio from 28.65 percent to 29.7 percent and the total debt ratio from 43.96 percent to 45.5 percent. These ratios exceed HUD's limits. There were no compensating factors listed on the mortgage credit analysis worksheet. The borrowers had no cash assets and had negative reserves. All funds needed to close the loan were from a nonprofit gift and seller concessions. Also, the borrower's housing expenses were increasing significantly, from $225 per month to $787 per month.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2 (Criteria 4)
Handbook 4155.1, REV-4, chapter 2, section 2-12 (Criteria 15)

Case number: 291-3183919

Insured amount: $103,274

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 6th payment

Date of loan closing: September 12, 2003

HUD costs incurred: Loan modification of $1,000

Underwriter type: Manual

Underreported Liabilities

The lender underreported recurring liabilities. It did not include a $14,356 auto loan shown on the credit report. The $347 monthly payment significantly affected the financial ratios. The borrower's bank statements from March 2003 through August 2003 supported payments made to the auto loan creditor. In addition, according to the mortgage credit analysis worksheet, the housing payment was to be $794 per month (including an estimate of $75 per month for taxes). However, the lender significantly underestimated monthly tax payments. The HUD-1 settlement statement showed that taxes from January 1 to September 12, 2003, were $1,216, or $146 per month.

The financial ratios significantly increase when all liabilities are included. The financial ratios, according to the mortgage credit analysis worksheet, were 28.7 percent and 31.7 percent. When including the auto loan and using the correct housing payment, the ratios are 32.6 percent and 48.2 percent, which exceed HUD's ratio limits of 29 percent and 41 percent.

The underwriter noted a compensating factor of "borrower has good job stability with retirement." A retirement statement, dated June 30, 2003, showed the borrower had $5,646 in retirement funds available. Using only 60 percent of the balance would provide the borrower with three months of housing payments, which was not sufficient to offset the excessive total debt ratio.

HUD Requirements – Appendix C

Handbook 4000.4, REV-1, CHG-2, chapter 2 section 2-5 (Criteria 3)
Handbook 4155.1, REV-4, chapter 2 section 2-3, paragraph B (Criteria 6)
Handbook 4155.1, REV-4, chapter 2 section 2-12 (Criteria 15)
Handbook 4155.1, REV-4, chapter 2 section 2-13 (Criteria 16)
Mortgagee Letter 00-28 (Criteria 35)

Case number: 291-3224520 Insured amount: $65,964

Section of Housing Act: 203(b) Status upon selection: Defaulted on 7th payment

Date of loan closing: December 18, 2003 HUD costs incurred: Partial claim of $9,113

Underwriter type: Manual

Unsupported Income

The lender overstated income by $434 per month. The lender used a monthly income of $2,184 to qualify the borrower ($1,983 base pay + $201 other income). The base pay of $1,983 came from a verification of employment showing the borrower made $11.44 per hour on a full-time basis. However, the calculated base pay was not consistent with the year-to-date earnings on the pay stubs, nor did the borrower have a history of earning $1,983 per month. The most recent pay stub, dated November 14, 2003, was approximately six weeks before closing and provided the most current monthly income of $1,750. The borrower's 2002 income was only $1,395 per month.

The lender also included $201 in bonuses per month in monthly income. The year-to-date wages of $18,372 as of November 14, 2003, included all overtime and bonuses for 2003. Therefore, the most recent monthly average of $1,750 (including overtime and bonuses) was already less than the lender's calculated base pay of $1,983, before adding $201 per month in bonus income. Further, the verification of employment showed the borrower worked an average of 46 hours per week, but the six pay stubs for the pay periods immediately before closing averaged only 42.47 hours per week. The pay stubs also did not support the full-time (40 hours) pay of $1,983 per month.

The borrower's ratios, according to the mortgage credit analysis worksheet, were 24.3 percent for a housing ratio and 43 percent for a total debt ratio. The borrower's actual ratios were 30.5 percent and 53.7 percent for the housing and total debt ratio respectively. The underwriter noted the following compensating factors:

- "Good employment" - This is not a valid compensating factor as the borrower's work history does not support a steady or reliable income.
- "Good verification of rent" - This is not sufficient to offset the correct debt ratio of 53.7 percent.
- "Not increasing housing over 125 percent" - This is incorrect because current housing is $400 per month and a 125 percent increase is $500. The borrower's housing expenses are actually increasing by 133 percent. A 33 percent increase in housing expenses is not minimal, making this an invalid compensating factor.

HUD Requirements – Appendix C

Handbook 4155.1, REV-4, chapter 2, section 2 (Criteria 4)
Handbook 4155.1, REV-4, chapter 2, section 2-12 (Criteria 15)
Handbook 4155.1, REV-4, chapter 2, section 2-13 (Criteria 16)

Case number: 291-3226284 Insured amount: $63,995

Section of Housing Act: 203(b) Status upon selection: Defaulted on 8th payment

Date of loan closing: March 19, 2004 Current status: First legal action to commence foreclosure (August 1, 2005)

Underwriter type: Manual

Unsupported Assets

The lender did not verify all funds needed to close the loan. The mortgage credit analysis worksheet showed that the borrower needed $1,976 to close the loan, but a nonprofit gift was to cover nearly all required closing costs. However, the HUD-1 settlement statement showed that the borrower paid $1,091 in personal funds (in addition to the nonprofit gift). The mortgage credit analysis worksheet showed the borrower had personal assets of $654. The borrower's bank statements of February 29, 2004, showed an ending balance of $1,145, but there was an unexplained deposit of $1,000 on February 27, 2004. The daily balances on the bank statements did not support a history of the borrower having adequate funds to close the loan with personal assets. Without an acceptable explanation of the large deposit, the lender could not be assured that the funds came from an allowable source.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-10 (Criteria 24)
Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph B (Criteria 25)

Questionable Credit History

The lender approved the loan even though the borrower had a questionable credit history. The borrower had insufficient credit for the credit agencies to report a credit score. The borrower's credit report listed only derogatory accounts for utilities and one judgment from a previous landlord. The judgment was paid off at closing. The lender obtained a letter of credit from the borrower's life insurance company; however, no payment history was provided to show timely payment of premiums. The lender also obtained a history of rental payments, which supported rent payments of $300 per month, but the borrower claimed rental costs of $460 per month on the loan application. Using the rental history of $300 per month, the borrower's monthly housing expense was increasing by 73 percent to $518 per month.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-3 (Criteria 19)

Unallowable Charges

The HUD-1 settlement statement reflects an underwriting fee of $214. This fee is prohibited.

HUD Requirements – Appendix C

Handbook 4000.4, REV-1, CHG-2, chapter 1, section 1-11 (Criteria 2)

Case number: 291-3232527 Insured amount: $82,702

Section of Housing Act: 203(b) Status upon selection: Defaulted on 9th payment

Date of loan closing: January 23, 2004

Current status: First legal action to commence foreclosure (August 1, 2005)

Underwriter type: Automated

Unsupported Income

The lender overstated income by $108 per month. The borrower was paid twice monthly, and the earnings on two consecutive pay stubs (check dates of December 15, 2003, and December 31, 2003) were $1,589 per pay period. This equates to an annual salary of $38,136 and a monthly salary of $3,178. The lender used monthly income of $3,286 to qualify the borrower. It is unclear how the lender calculated the $3,286 per month. The last paycheck for the year (dated December 31, 2003) showed gross pay of $37,799, which is $3,150 per month. At most, the borrower's supported monthly income was $3,178 per month.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-6 (Criteria 22)

Unsupported Assets

The Desktop Underwriter automated approval findings report reflected assets of $12,448 used to evaluate the borrower for loan approval, but the lender did not adequately support the assets. Of the $12,448, only $7,027 was verified. The lender adequately verified two stock accounts of $4,989 and $1,895 but verified only $143 of $200 claimed in the borrower's bank account. The remaining $5,364 in stock funds was not adequately verified because the account statement was not current. The statement was dated June 30, 2003, and the loan closed more than six months later on January 23, 2004.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph B (Criteria 25)
Handbook 4155.1, REV-5, chapter 3, section 3-1 (Criteria 31)

Underreported Liabilities

The lender did not consider all recurring liabilities when gaining loan approval from an automated system. The Desktop Underwriter finding report showed monthly obligations of $721 used to approve the borrower. The lender excluded a $400 debt with a monthly payment of $52. Because the debt had more than nine payments left before it is paid off, it could have affected the borrower's ability to repay the mortgage in the months immediately following the loan closing. This is especially true considering the $175 (39 percent) monthly increase in the housing expense.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-3, paragraph A (Criteria 20)
Handbook 4155.1, REV-5, chapter 2, section 2-11, paragraph A (Criteria 27)
Mortgagee Letter 99-26 (Criteria 34)

Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans, dated July 2002, chapter 2, paragraph 3 (Criteria 36)

Excessive Ratios

The total debt ratio, according to the mortgage credit analysis worksheet, was 42.55 percent. Using only supported income of $3,178 per month, and including the $52 monthly payment, the total debt ratio becomes 44 percent, which exceeds HUD's limit of 41 percent.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-12 (Criteria 29)
Handbook 4155.1, REV-5, chapter 2, section 2-13 (Criteria 30)

Questionable Credit History (subsequent to bankruptcy)

The lender used rental payments to establish credit history, but the rental receipts reflect sporadic/late payments. Also, the borrower's housing expenses were increasing from $450 per month to $625 per month (39 percent).

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-3, paragraph A (Criteria 20)

Case number: 291-3241230 | Insured amount: $89,294

Section of Housing Act: 203(b) | Status upon selection: Defaulted on 7th payment

Date of loan closing: February 27, 2004 | Underwriter type: Manual

Questionable Gift Funds

The lender did not adequately verify gift funds used to close the loan. The HUD-1 settlement statement reflected gift funds to the borrower of $4,050. However, the gift letter indicated a gift of $4,500 ($450 more), as did a canceled check from the donor. As evidence that the donor could provide the gift funds, the donor's bank provided a letter stating the bank account was sufficient for the donor's check to clear the account, as of February 11, 2004, but the bank did not provide a bank statement or activity report showing account activity. Therefore, the lender did not verify that the donor had a history of funds sufficient to provide the gift, and that the funds did not come from an unallowable source.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph C (Criteria 26)

Questionable Employment History

The lender did not verify a two-year work history for the coborrower. The verification of employment, dated February 24, 2004, showed that the coborrower had been employed for six months at that time (indicating a hire date in August 2003). According to the loan application, the previous job ended on September 19, 2002. One year of gaps in employment history was not explained: two months from April 2002 through May 2002 and 10 months from October 2002 through July 2003. The loan application indicated that the coborrower may have been a student from August 1999 through May 2003, but the lender did not verify that the borrower was a student by obtaining transcripts or other acceptable evidence.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-6 (Criteria 22)

Unallowable Charges

According to the HUD-1 settlement statement, the borrower was charged the following prohibited fees, totaling $845:

- Tax service fee $75
- Courier fee $25
- Underwriting fee $395
- Commitment fee $350

The loan was not a refinance loan, and the loan file did not contain a written agreement serving as the interest rate lock-in/loan discount points agreement. Without the written agreement, there is no evidence that the lender made the commitment for a guaranteed interest rate and/or discount points for a certain period of time and properly charged the commitment fee.

HUD Requirements – Appendix C

Handbook 4000.2, chapter 5, section 5-2, paragraph O (Criteria 1)
Handbook 4000.4, REV-11, CHG-2, chapter 1, section 1-11 (Criteria 2)
Handbook 4330.1, REV-5, chapter 4, section 4-12, paragraph B (Criteria 32)
HUD Homeownership Center Reference Guide, chapter 2, Mortgage Credit Guidelines, page 2-15, “Closing Costs and Other Fees,” (Criteria 38)

Case number: 291-3245514 Insured amount: $90,074

Section of Housing Act: 203(b) Status upon selection: Defaulted on 8th payment

Date of loan closing: March 26, 2004 Underwriter type: Manual

Unsupported Assets

The lender did not verify that the borrower had sufficient funds to close the loan. The lender estimated the funds needed to close at $3,396. The mortgage credit analysis worksheet identified an expected nonprofit gift of $2,802 and borrower personal assets of $1,812. The verification of deposit for the borrower's bank account supported assets of only $202 and an average balance over the prior 60 days of only $107. The lender did not obtain borrower bank statements. Without bank statements, the lender could not review for large unexplained deposits.

The HUD-1 settlement statement showed a nonprofit gift of $2,802 and indicated the borrower paid $2,601 in personal funds to close the loan. The borrower had also paid a $500 earnest deposit. A loan application in the lender's loan file indicated the borrower received an insurance settlement of $4,000. However, there was no documentation to support receipt of the funds, or the availability of the funds used to pay closing costs. Therefore, the lender did not verify the source of borrower funds paid on the loan.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-10 (Criteria 24)
Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph B (Criteria 25)

Excessive Ratios

The lender approved the loan with an invalid compensating factor when the borrower's total debt ratio exceeded HUD's limit of 41 percent. The lender calculated the total debt ratio at 43.23 percent. The only compensating factor identified was "not increased housing." The lender did not identify the present housing cost or obtain evidence that the borrower was previously incurring a housing expense. Further, the credit report did not identify a landlord or indicate payment of rent. The lack of a current housing expense makes the compensating factor invalid.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-12 (Criteria 29)
Handbook 4155.1, REV-5, chapter 2, section 2-13 (Criteria 30)

Derogatory Credit

The lender approved the loan even though the borrower had defaulted on significant debts in the year before the loan closed. The borrower's credit report showed three large accounts (totaling $3,500) charged off in the previous year.

HUD Requirements – Appendix C

Handbook 4155.1 REV-5, CHG-1, chapter 2, section 2-3 (Criteria 19)

Case number: 291-3248743 Insured amount: $129,862

Section of Housing Act: 203(b) Status upon selection: Defaulted on 3rd payment

Date of loan closing: March 12, 2004 Current status: First legal action to commence foreclosure (August 1, 2005)

Underwriter type: Manual

Unsupported Income

The lender did not adequately support the income claimed to qualify the borrower. The only support for the borrower's income was a verification of employment. The file did not include pay stubs, Internal Revenue Service Forms W-2, or tax returns to validate the information on the verification of employment.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 3, section 3-1 (Criteria 31)

Unsupported Assets

The lender did not verify that borrower assets needed to close the loan were from an allowable source. The mortgage credit analysis worksheet showed that at the time of loan approval, the borrower needed $4,279 to close the loan. The borrower expected a nonprofit gift of $3,957; therefore, the lender needed to verify at least $322 in personal assets. The borrower claimed assets of $1,552, and the lender obtained a verification of deposit that supported the assets. However, the lender did not obtain bank statements to review for unexplained deposits that could have indicated assets obtained from an unallowable source.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-10 paragraph B (Criteria 25)

Unallowable Charges

The HUD-1 settlement statement showed that the borrower was charged $395 for an underwriting fee and $75 for a tax service fee. Neither of these fees is allowed.

HUD Requirements – Appendix C

Handbook 4000.4, REV-11, CHG-2, chapter 1, section 1-11 (Criteria 2)
Handbook 4330.1, REV-5, chapter 4, section 4-12 paragraph B (Criteria 32)
HUD Homeownership Center Reference Guide, chapter 2, Mortgage Credit Guidelines, page 2-15, "Closing Costs and Other Fees," (Criteria 38)

Case number: 291-3264571 | Insured amount: $155,312

Section of Housing Act: 203(b) | Status upon selection: Defaulted on 4th payment

Date of loan closing: July 7, 2004 | Underwriter type: Automated

Unsupported Income

The lender overstated the borrower's employment income by $689 per month and did not verify that $637 in monthly rental income was likely to continue in the months following the loan closing. The mortgage credit analysis worksheet showed monthly income of $4,117 was used to qualify the borrower. The borrower claimed $3,480 in monthly employment income, but the lender did not support this amount. Using 2004 year to date income from the verification of employment, the borrower's monthly income was $3,380. Using the hourly wage income from the verification of employment and pay stubs, the monthly income was $3,369. Averaging the 16.25 months of 2003 through May 6, 2004, the monthly income was $3,429. Averaging the 2003 and 2004 income is the most prudent way to calculate the income. Therefore, employment income was overstated by $689.

The loan was for a two unit dwelling and the borrower planned to live in one of the units and rent the other unit. The lender qualified the borrower by using rental income of $637 per month in addition to the borrower's employment income. The lender's loan file contained a lease agreement for one unit, but the lease was to expire within 60 days of the loan closing, and there was no indication that the renter was renewing the lease.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-6 (Criteria 22)
Handbook 4155.1, REV-5, chapter 2, section 2-7 (Criteria 23)
Handbook 4155.1, REV-5, chapter 3, section 3-1 (Criteria 31)
Mortgagee Letter 99-26 (Criteria 34)
Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans, dated July 2002, chapter 2, paragraph 3 (Criteria 36)

Underreported Liabilities

The lender did not include a $205 auto loan in the borrower's liabilities, but the borrower disclosed the debt on the loan application, and the debt appeared on his credit reports. The auto loan had a balance of $5,639, which was more than 10 months of payments. The lender indicated in the automated underwriting system used to gain loan approval that the auto loan would be paid off before the loan closed, but there was no documentation in the file verifying the payoff, nor was there evidence on the HUD-1 settlement statement that the loan was paid off at closing.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-3, paragraph A (Criteria 20)
Handbook 4155.1, REV-5, chapter 2, section 2-11, paragraph A (Criteria 27)
Mortgagee Letter 99-26 (Criteria 34)
Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans, dated July 2002, chapter 2, paragraph 3 (Criteria 36)

Excessive Ratios

The overstated income and the underreported liabilities significantly affect the ratios. Recognizing only supported income and all applicable liabilities causes housing and total debt ratios of 33.69 percent and 57.22 percent respectively, which far exceed HUD's limits of 29 percent and 41 percent.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-12 (Criteria 29)
Handbook 4155.1, REV-5, chapter 2, section 2-13 (Criteria 30)

Case number: 291-3270679 | Insured amount: $168,430

Section of Housing Act: 203(b) | Status upon selection: Defaulted on 1st payment

Date of loan closing: May 3, 2004 | HUD costs incurred:
Acquisition costs of $175,328. Property has not yet been sold (as of September 2005).

Underwriter type: Manual

Unsupported Assets

The lender did not verify the source of funds used to pay off significant debts before the loan closing. On April 30, 2004, just before the loan closed, the borrowers paid $2,442 to three creditors to settle credit accounts in collection status. Neither the loan application nor the mortgage credit analysis worksheet identified funds available to the borrowers. Instead, the mortgage credit analysis worksheet showed negative assets of $92. The lender was aware of the substantial payments to clear collection debts before the loan closed but did not obtain bank statements or an explanation of the source of the funds used to pay off the collection items. Although a nonprofit gift and broker credit covered all costs of the loan closing and no cash was required of the borrowers, the lender should have verified the source of the funds used to pay off the collection accounts to ensure that they were not from an unallowable source.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph B (Criteria 25)

Unsupported Income

The lender used the monthly income from the coborrower's previous employer instead of the current employer when processing the loan. According to the loan application, the coborrower had been employed at the current job for only one month. The lender obtained a verbal verification of employment for the current job, but the verification did not confirm the hire date, hours worked per week, or rate of pay. The lender did not obtain a pay stub for the current employment. The only pay stub present was from a previous job, which the lender used as the income to calculate the financial ratios.

The lender used $1,733 in coborrower monthly income in approving the loan. According to the pay stub from the most previous employment, the borrower's monthly income was $1,470. Internal Revenue Service Forms W-2 show the coborrower's income was decreasing from prior years, as follows:

2004 $1,470 per month, as of March 16, 2004
2003 $1,650 per month
2002 $1,816 per month

Using the current monthly income of $1,470, the borrowers' total monthly income was $3,439, which makes the housing ratio 36 percent and the total debt ratio 44.8 percent, both of which far exceed HUD limits.

The mortgage credit analysis worksheet showed that the lender calculated financial ratios above HUD's limits (34.48 percent housing ratio and 42.92 total debt ratio) but did not identify compensating factors for exceeding the limits.

HUD Requirements – Appendix C
Handbook 4155.1, REV-5, chapter 2, section 2-6 (Criteria 22)
Handbook 4155.1, REV-5, chapter 2, section 2-12 (Criteria 29)
Handbook 4155.1, REV-5, chapter 2, section 2-13 (Criteria 30)
Handbook 4155.1, REV-5, chapter 3, section 3-1 (Criteria 31)

Questionable Credit History
The lender obtained a verification of rent, but a loan officer signed the verification of rent as the "authorized representative" and identified himself as the "owner" of the property on the rent document. It appears that the verification of rent was not received directly from the landlord, making the verification of rent questionable.

HUD Requirements – Appendix C
Handbook 4155.1, REV-5, chapter, section 2-3, paragraph A (Criteria 20)

Unallowable Charges
The lender charged the borrower two prohibited charges, according to the HUD-1 settlement statement. A $75 tax service fee paid to the lender is not allowed, nor is a $50 e-mail/courier fee paid to the title company. This was not a refinance loan.

HUD Requirements – Appendix C
Handbook 4000.2, chapter 5, section 5-2, paragraph O (Criteria 1)
Handbook 4330.1, REV-5, chapter 4, section 4-12, paragraph B (Criteria 32)

Case number: 291-3281528 | Insured amount: $45,534

Section of Housing Act: 203(b) | Status upon selection: Defaulted on 5th payment

Date of loan closing: June 29, 2004 | HUD costs incurred: Acquisition costs of $46,009. Property has not yet been sold (as of September 2005).

Underwriter type: Automated

Questionable Gift Funds

The lender did not adequately verify gift funds used to meet closing costs. The borrower's fiancé appears to have provided a $450 gift to the borrower. The lender obtained a gift letter from the fiancé and a copy of a $450 cashier's check purchased by the fiancé and made payable to the mortgage company. The lender also included a $450 "other liquid asset" as borrower assets in the automated underwriting system when gaining loan approval. However, the lender did not obtain donor bank statements, a verification of deposit, or withdrawal or deposit slips to confirm that the donor had the funds available and that she transferred the funds to the borrower.

Further, the lender noted that the cashier's check was a gift to pay for the property appraisal, but the HUD-1 settlement statement showed that the $400 appraisal was paid from the seller's funds. The HUD-1 settlement statement did not credit the borrower with a gift, only a $400 earnest deposit. The real estate contract also reflected the $400 earnest deposit. Therefore, the inclusion of a $450 gift to qualify the borrower is questionable.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph C (Criteria 26)
Mortgagee Letter 99-26 (Criteria 34)
Mortgagee Letter 00-28 (Criteria 35)
Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans, dated July 2002, chapter 2, paragraph 3 (Criteria 36)

Unsupported Assets

The lender did not adequately verify the source of funds needed to close the loan. The mortgage credit analysis worksheet and the Desktop Underwriter findings report showed that the lender counted $1,416 as asset available to the borrower when obtaining an automated loan approval. At the time of loan approval, the borrower needed $1,388 to close the loan, and the HUD-1 settlement statement showed the borrower paid $979 in cash to close. However, the lender did not obtain bank statements but instead obtained a bank activity report of April 12 through May 25, 2004. The report reflected a large, unexplained deposit of $1,206 on April 12, 2004, about two months before the loan closing. It appears the bank account was opened with this deposit.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-10 (Criteria 24)
Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph B (Criteria 25)
Mortgagee Letter 99-26 (Criteria 34)
Desktop Underwriter Government Underwriter Service User's Guide for Federal Housing Administration Loans, dated July 2002, chapter 2, paragraph 3 (Criteria 36)

Case number: 291-3292555 Insured amount: $155,759

Section of Housing Act: 203(b) Status upon selection: Defaulted on 2nd payment

Date of loan closing: July 20, 2004 Underwriter type: Manual

Unsupported Assets

The lender did not adequately verify the source of personal assets used in closing the loan. The mortgage credit analysis worksheet showed that the borrower needed $5,331 to close the loan. The borrower expected to receive a nonprofit gift of $4,710 so the borrower needed to provide $621 in personal assets. The lender did not obtain bank statements but instead obtained a bank report similar to a verification of deposit. The report showed a balance of $3,075 on July 19, 2004 (the day before the loan closing), but no beginning balance or detailed transactions. Using only the bank report, the lender could not review for large, unexplained deposits that could indicate funds from an unallowable source. In addition, the HUD-1 settlement statement reflected that the borrower paid $1,999 to close the loan, considerably more than the lender's initial estimate of $621.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-10 (Criteria 24)
Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph B (Criteria 25)

Underreported Liability

The lender did not adequately assess all recurring liabilities when approving the loan. The borrower's pay stubs showed a weekly deduction of $320, or $1,387 per month. There was no explanation for the deduction from either the lender or the borrower. The pay stub indicated the deduction was paid to a credit union, which could be a periodic savings transfer but could also be an undisclosed liability. The lender should have verified the purpose of the liability to ensure that it did not affect the loan approval.

HUD Requirements – Appendix C

Handbook 4000.4, REV-1, CHG-2, chapter 2, section 2-5 (Criteria 3)
Handbook 4155.1, REV-5, chapter 2, section 2-11, paragraph A (Criteria 27)

Case number: 291-3300350

Insured amount: $113,474

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 4th payment

Date of loan closing: September 3, 2004

Underwriter type: Manual

Underreported Liabilities

The lender did not adequately evaluate the borrower's recurring liabilities. The loan application, mortgage credit analysis worksheet, Loan Prospector findings report, and credit report showed different amounts for total liabilities, as follows:

- Loan application shows $74 per month.
- Mortgage credit analysis worksheet shows $0 per month.
- Loan Prospector findings report shows $1,067 per month.

The credit report shows:

- Numerous student loans (at least 23 loans with monthly payments of $1,815), but duplicates are possible.
- No monthly payments due.
- No repayment start dates.
- A total of $245,616 owed in installment debt + $7,173 in revolving debt.

The lender obtained a deferment letter from the Department of Education stating that the largest student loan ($20,952) was in deferment until at least 2006, but no other evidence of loan deferments for the remainder of the loans was provided.

According to the mortgage credit analysis worksheet, the borrower's housing ratio and total debt ratio were 31.2 percent because the lender included no recurring liabilities. If the $1,815 in monthly loan repayments was to begin within one year of the loan closing, the borrower's total debt ratio would increase to 91 percent, requiring nearly all of the borrower's current monthly income.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-11, paragraph C (Criteria 28)

Unsupported Assets

The lender did not adequately verify borrower assets when giving loan approval. The mortgage credit analysis worksheet showed that the borrower needed $12,423 to close the loan and lists $13,777 in borrower assets. The HUD-1 settlement statement indicated the borrower paid $12,122 in cash at closing. To support the availability of borrower assets, the lender obtained a verification of deposit showing that the borrower had $13,777 in a checking account, but the lender did not obtain bank statements. In addition, the verification of deposit was a bank report obtained from an Internet Web site, which did not contain the borrower's name, a beginning or ending balance, or detailed transaction activity. Without detailed bank statements, the lender could not have been assured that the borrower was the owner of the funds or that the funds were from an allowable source and could not review for large, unexplained deposits or recurring liabilities not disclosed.

HUD Requirements – Appendix C

Handbook 4155.1, REV-5, chapter 2, section 2-10, paragraph B (Criteria 25)