



Issue Date July 17, 2006
Audit Report Number 2006-LA-1014

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

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: KB Home Mortgage Failed to Ensure Underwriting Certifications for Federal Housing Administration Loans Were Accurate

HIGHLIGHTS

What We Audited and Why

We performed an audit of KB Home Mortgage Company (KB) after a prior HUD Office of Inspector General (OIG) audit found indications that KB underwriters inaccurately certified that they underwrote certain Federal Housing Administration loans. The objective of the audit was to follow up on this potential violation and determine the extent to which it occurred.

What We Found

KB failed to ensure underwriter certifications for Federal Housing Administration loans were accurate. In an estimated 206 of 543 HUD loans targeted for review, KB's underwriters certified that they personally underwrote the loans when they did not. As a result, HUD has no assurance that these loans were properly underwritten to ensure they were eligible for Federal Housing Administration mortgage insurance; therefore, HUD was exposed to unnecessary insurance risk for these loans.

What We Recommend

We recommend that HUD's assistant secretary for housing require KB, for any current or future FHA loan operations for which KB may exercise management control, to ensure that underwriter certifications for HUD-insured loans are only executed by direct endorsement underwriters after personally reviewing the appraisal, credit application, and all associated documents and using due diligence in underwriting the mortgage.

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 report.

Auditee's Response

We provided KB a draft report on June 8, 2006. We offered to hold an exit conference to discuss the finding in detail, yet KB declined this offer. KB provided written comments on June 26, 2006. The complete text of KB's response, along with our evaluation of that response, can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVES

The U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration provides mortgage insurance on home loans made by its approved lenders.¹ This insurance provides lenders with protection against losses if the homeowner defaults on the loan.

KB Home Mortgage Company (KB) originated Federal Housing Administration, U.S. Department of Veterans Affairs, and conventional loans primarily for customers purchasing newly constructed homes from its parent company, KB Home. Until recently, KB operated 11 branch offices in nine states and regional operations centers (for processing and underwriting) in Las Vegas, Nevada, and San Antonio, Texas. KB's corporate office was located at 10990 Wilshire Boulevard, Los Angeles, California. KB has been a HUD-approved lender since April 15, 1965, and was authorized to originate loans under HUD's direct endorsement program.

KB was a wholly owned subsidiary of the builder/developer KB Home. However, the assets of KB have been sold to Countrywide Home Loans, and a new joint venture company named Countrywide KB Home Loans was formed by KB Home and Countrywide Home Loans to make residential loans to KB Home (builder) customers.

Our audit objective was to determine whether KB underwriters inaccurately certified that they underwrote certain Federal Housing Administration loans. This audit was performed after a prior HUD Office of Inspector General (OIG) audit (audit report number 2005-LA-1011) found potential problems in this area.

¹ The Federal Housing Administration mortgage insurance program is authorized under Title II, Section 203(b), of the National Housing Act and is governed by regulations in 24 CFR [*Code of Federal Regulations*], Part 203.

RESULTS OF AUDIT

Finding 1: KB Failed to Ensure Underwriter Certifications for Federal Housing Administration Loans Were Accurate

KB failed to ensure underwriter certifications for Federal Housing Administration loans were accurate. Based upon statistical sample testing, we found that in an estimated 206 of 543 HUD loans targeted for review, KB's underwriters certified that they personally underwrote the loans when they did not. As a result, HUD has no assurance that these loans were properly underwritten to ensure they were eligible for Federal Housing Administration mortgage insurance; therefore, HUD was exposed to unnecessary insurance risk for these loans. This problem occurred because KB failed to implement adequate policies and procedures to ensure HUD's underwriting requirements were followed.

HUD Relies upon Lenders to Underwrite HUD-Insured Loans

Lenders approved to originate HUD-insured loans, known as direct endorsement lenders, underwrite and close individual mortgage loans without any detailed technical underwriting review performed by HUD. Therefore, HUD relies upon the lenders and their underwriters to determine the homebuyers' credit and capacity to repay the mortgage and to ensure the loans meet HUD's insurance program requirements. The lenders' underwriters must sign a certification (HUD form 92900A) that they personally reviewed the loan documents and used due diligence in underwriting the mortgage. The underwriting review by approved lenders is a critical component of HUD's home loan insurance program and is needed to limit HUD's risk of losses due to foreclosures or collection difficulties on the loans it insures. Additionally, HUD collects data to monitor the performance of the direct endorsement underwriters, and, therefore, it is important that HUD has correct data indicating which underwriter performed the underwriting analysis and made the decision on the loans it insures.

206 of 543 Loans Were Inaccurately Certified by KB Underwriters

Based upon statistical sample testing, we determined an estimated 206 HUD-insured loans originated by KB contained inaccurate underwriter certifications. The statistical sample testing included a review of 104 HUD loans selected from a targeted group of 543 loans originated by KB during the period September 1,

2002, through August 31, 2003. These 543 loans were selected for review because HUD's automated records listed a different underwriter than KB's automated records indicating the information submitted to HUD may not be accurate. For each of the sample loans, we reviewed the underwriter's certification form (HUD form 92900A), KB's underwriter conditions sheet, and the mortgage credit analysis worksheet and interviewed the underwriters who signed the underwriter certification forms.²

In 35 of the 104 loans reviewed (projected to 206 of the 543 loans targeted for review), KB's underwriters signed the underwriter certification form but stated they did not fully underwrite the loans as required. In these cases, the underwriters stated they only performed a limited or cursory review that included clearing remaining underwriting conditions (if any) and signing off of the loan without a complete review of the loan file as required. Accordingly, KB failed to ensure that the underwriter certifications for these Federal Housing Administration loans were accurate.

KB Failed to Implement Adequate Policies and Procedures

Most of the underwriters interviewed stated it was company practice for underwriters to sign off on loans for other underwriters, who had left the company or who were out of the office temporarily, without performing a thorough underwriting review. Some of the underwriters interviewed stated they were asked by KB management to not reunderwrite the loans but, rather, only to clear any remaining conditions before signing the underwriter certifications. Some of the underwriters interviewed stated they were routinely given underwriter certification forms and asked to sign them without seeing the loan file.

Inaccurate Certifications Increased HUD's Insurance Risk

Because KB's underwriters signed underwriting certification forms without personally underwriting the loans, HUD has no assurance that these loans were properly reviewed to ensure they were eligible for Federal Housing Administration mortgage insurance. Therefore, HUD was exposed to unnecessary insurance risk for these loans. Also, since the affected loan files did not correctly indicate which underwriter performed the underwriting analysis and made the decision, HUD's ability to monitor the performance of these underwriters was limited.

² The statistical sample testing is explained further in the "Scope and Methodology" section of this audit report.

Conclusion

KB failed to ensure underwriter certifications for Federal Housing Administration loans were accurate for an estimated 206 of 543 HUD loans targeted for review. This was caused by KB's failure to follow HUD's underwriting requirements and resulted in additional insurance risk to HUD for the affected loans. It also limited HUD's ability to monitor underwriters' performance.

Recommendations

We recommend that the assistant secretary for housing - federal housing commissioner

1A. For any current or future FHA loan operations for which KB may exercise management control, require KB to ensure that underwriter certifications for HUD-insured loans are only executed by direct endorsement underwriters after personally reviewing the appraisal, credit application, and all associated documents and using due diligence in underwriting the mortgage.

SCOPE AND METHODOLOGY

Our audit testing related to underwriter certifications (finding 1) generally covered the period from September 1, 2002, through August 31, 2003. During this period, KB originated 5,970 Federal Housing Administration loans for amounts totaling approximately \$853 million.

The objective of the audit was to determine whether KB underwriters accurately certified that they underwrote certain Federal Housing Administration loans. To accomplish our audit objective, we

- Selected and reviewed a statistical sample of HUD loans underwritten by KB to determine whether underwriter certifications were accurate.
- Interviewed former KB underwriters and managers.
- Reviewed data obtained during a recent HUD OIG audit related to KB loan originations.

We also performed audit steps to determine whether KB allowed ineligible loan settlement fees. This was another potential problem area identified during the prior HUD OIG audit of KB loan origination procedures (audit report number 2005-LA-1011). This area will be separately addressed at a later date.

The following statistical sampling procedures were used to obtain the projected number of inaccurate underwriter certifications (finding 1). We identified 543 Federal Housing Administration loans with underwriter approval dates on and between September 1, 2002, and August 31, 2003, for which HUD's automated records indicated a different underwriter than KB's automated records. The period reviewed was determined based upon testing conducted during a prior HUD OIG audit of KB, which identified potential problems with the underwriter certifications. We separated the 543 loans into two groups according to the reported underwriter approval date (416 sample loans approved before April 16, 2003, and 127 approved on or after this date). We pulled a statistical sample that included 104 of the 543 loans (59 sample loans approved before April 16, 2003, and 45 approved on or after this date), obtained related documents from KB's loan files, and interviewed all but one of the underwriters associated with these loans. One underwriter associated with 9 of the 104 (8.7 percent) sample cases selected refused our request for an interview. Rather than selecting replacement sample cases for these nine loans, we counted these untested sample items as valid and correct underwriter certifications when projecting the sample results. The confidence level for the sample was 90 percent, and the overall sampling error was 7.8 percent. The sample testing results for each stratified group (59 sample loans approved before April 16, 2003, and 45 approved on or after this date) were projected separately and then combined.

We performed our fieldwork from September 2005 through April 2006. We performed our audit in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, 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

No testing of controls was performed during this followup audit since KB no longer originates any loans and the purpose of this followup review was to develop the nationwide monetary impact and possible penalties for past management control weaknesses. Although we did not perform any tests of controls, we did find KB's parent company, KB Home Mortgage operations, to some extent, are continuing as they have been assumed by another entity and remain partially under the same ownership. Accordingly, we are reporting the significant control weakness noted below.

Significant Weaknesses

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.

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

- KB's controls were not adequate to ensure underwriter certifications for Federal Housing Administration loans were accurate (see finding 1).

FOLLOWUP ON PRIOR AUDITS

Prior Report Title and Number

We issued audit report number 2005-LA-1011 on September 26, 2005. The report contained one finding that KB did not originate 19 loans in compliance with HUD requirements and prudent lending practices. This prior audit, related to KB's loan origination process, also found indications that 1) KB allowed ineligible loan settlement fees, and 2) KB underwriters inaccurately certified that they underwrote certain Federal Housing Administration loans. The current audit was performed to follow up on these potential problems.


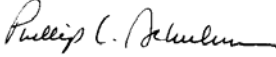
APPENDIXES

Appendix A

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

 Kirkpatrick & Lockhart Nicholson Graham LLP	1601 K Street, N.W. Washington, DC 20006-1600 202.778.9000 Fax 202.778.9100 www.klmg.com
June 26, 2006	Phillip L. Schulman 202.778.9027 Fax: 202.778.9100 pschulman@klmg.com
<u>VIA FEDERAL EXPRESS</u>	
Ms. Joan S. Hobbs Regional Inspector General for Audit U.S. Department of Housing and Urban Development Office of the Inspector General Region IX, 9DGA 611 West 6th Street Suite 1160 Los Angeles, CA 90017-3101	
Re: KB Home Mortgage Company HUD OIG Draft Audit Report	
Dear Ms. Hobbs:	
Kirkpatrick & Lockhart Nicholson Graham LLP represents KB Home Mortgage Company ("KBHMC") in connection with the above-referenced matter. KBHMC is in receipt of the Draft Audit Report, dated June XX, 2006, from the Office of the Inspector General for Audit ("OIG"). Enclosed please find four copies of KBHMC's written reply to the report. After the report is finalized, we would appreciate it if the OIG would provide us with a copy of the final version. If you have any questions, please contact me at (202) 778-9027.	
Thank you for your consideration.	
Sincerely,  Phillip L. Schulman	
Enclosures	
cc: Ben Hirst, EVP and Chief Legal Officer, KB Home	



June 23, 2006

VIA ELECTRONIC MAIL AND FEDERAL EXPRESS

Ms. Joan S. Hobbs
Regional Inspector General for Audit
U.S. Department of Housing
and Urban Development
Office of the Inspector General
Region IX, 9DGA
611 West 6th Street
Suite 1160
Los Angeles, CA 90017-3101

**RE: KB Home Mortgage Company
HUD OIG Draft Audit Report**

Dear Ms. Hobbs:

KB Home Mortgage Company ("KBHMC" or "Company") received the Draft Audit Report ("Report"), dated June XX, 2006, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of the Inspector General ("OIG"). The Report is based on a limited review of the Company following a prior OIG audit of the Company's former Tempe, Arizona branch office, report number 2005-LA-1011 (the "2005 Audit").

The OIG provided the Company with an opportunity to submit written comments for inclusion in the final report. This response summarizes KBHMC's history and operations and addresses the Report's finding. We appreciate this opportunity to comment on the OIG's finding and recommendation.

I. SUMMARY

In the Report the OIG alleges that KBHMC underwriters did not fully review documentation before signing certifications in 35 loans originated between September 1, 2002 and August 31, 2003 and, from that assertion, extrapolates this finding to a universe of 206 loans. The Report neither (a) identifies the 35 loans to which it refers, nor (b) provides the number, identity or statements of the underwriters on whose interviews the Report's finding is based. Therefore, KBHMC is unable to provide a substantive response to the Report's allegations related to the 35 loans or to analyze in a meaningful way the OIG's statistical methods employed to extrapolate those findings to 206 loans. Further, at the time the loans at issue were originated, KBHMC's policies and procedures complied with FHA guidelines. To the extent that individual underwriters acted contrary to FHA requirements in reviewing loan file documentation and executing certifications, these individuals did so in contravention of Company policy and the OIG identifies no evidence to the contrary in the Report. Therefore, the Company requests that (a) the final report address only those loans actually reviewed by the OIG and (b) any allegations that KB failed to implement adequate policies and procedures be removed from the final report.

KB HOME 10990 WILSHIRE BLVD LOS ANGELES, CA 90024
TEL 310 231 4000 FAX 310 231 4222 KBHOME.COM

The Report recommends that HUD require KBHMC, to the extent that the Company's operations continue and have been assumed by a joint venture between KB Home and Countrywide Home Loans Inc. ("Countrywide"), to ensure that underwriter certifications for FHA-insured loans are only executed by Direct Endorsement underwriters after personally reviewing all relevant documentation and using due diligence in underwriting the mortgage. KBHMC has no control over the day-to-day management or underwriting policies, procedures or safeguards implemented by Countrywide, as the manager of the joint venture. Therefore it cannot implement the Report's proposed recommendation. Thus, the Company also requests that this recommendation be removed from the final report.

II. BACKGROUND

At the time the loans at issue in this expanded audit were originated, KBHMC operated through its home office in Los Angeles, California and eleven additional registered branch offices, and employed over 500 individuals. The Company maintained approval as a Federal Housing Administration ("FHA") lender for nearly 40 years and received Direct Endorsement ("DE") authority when the DE program was initiated almost 20 years ago. KBHMC was also an approved lender for Fannie Mae, Freddie Mac, Ginnie Mae, and the Veterans Administration. The Company's primary investors included Washington Mutual, CitiMortgage, Countrywide, and Chase Manhattan Mortgage Corporation.

In 2005, Countrywide purchased substantially all of KBHMC's assets and the Company ceased operations as a mortgage banking entity. On December 31, 2005, the Company voluntarily terminated its authority to participate in the FHA program.

KB Home currently has an ownership interest in The Countrywide KB Home Loans Series of Countrywide Mortgage Ventures, LLC ("CKBHL"), which is a joint venture owned by KB Home and Countrywide, formed in September 2005.

III. RESPONSES TO THE FINDING

The OIG conducted this expanded audit after the 2005 Audit, identified potential problems in the underwriter certifications reviewed in that audit.¹ The 2005 Audit covered only 19 loans originated in 2002 by the Company's former Tempe, Arizona office. All 19 of these loans were originated by a single errant underwriter who had been terminated by KBHMC two years before the OIG undertook its review of the Company. Moreover, the loan sample chosen for the OIG audit represented less than one half of one percent of the FHA loans originated by KBHMC during the audit period. Notwithstanding the unrepresentative nature of the loans reviewed during the 2005 Audit, the OIG used its findings in these cases as the basis to expand the scope of its review to additional underwriting documentation from loans originated during that period.

¹ The OIG issued a report of findings in the 2005 Audit on September 26, 2005. That report alleged that the Company did not originate 19 loans in compliance with HUD requirements or prudent lending practices. In comments submitted on August 17, 2005, in addition to setting forth the substantial quality control and underwriting improvements the Company had made prior to the sale of its assets, KBHMC took strong exception to the allegations set forth in the 2005 Audit report. We understand that the OIG submitted these comments to the Department in full upon its submission of the 2005 Audit report to HUD.

To that end, in its most recent review, the OIG reviewed 104 loans selected from a targeted group of 543 loans originated by KBHMC between September 1, 2002 and August 31, 2003. These 543 loans were selected because the underwriter listed in HUD's automated records differed from the underwriter listed in KBHMC's records, which the Report suggests indicated that the information submitted to HUD may not have been accurate. For each of the 104 loans, we understand that the audit included a review of the underwriter's certification on the Addendum to the Uniform Residential Loan Application, Form HUD-92900-A ("Addendum"), KBHMC's internal underwriter conditions sheet, and the Mortgage Credit Analysis Worksheet ("MCAW"), as well as interviews of the underwriters who signed the underwriter certifications in these cases.

Based on this review, the Report contains one finding, in which it alleges that the Company did not ensure that underwriter certifications for FHA loans were accurate. Specifically, the Report asserts that, in 35 of the 104 loans it reviewed, Company underwriters signed the underwriter certification, but performed only a limited or cursory review rather than a full review required to properly underwrite the loan. Based on statistical sampling, the Report projects that these deficiencies occurred in an estimated 206 of the 543 loans initially targeted in this expanded review. The Report concludes that, based on these underwriters' cursory reviews, HUD had no assurance that the loans were properly underwritten and, as a result, HUD was exposed to unnecessary insurance risk.

A. KBHMC Cannot Respond to the Substance of the Report's Individual Allegations and Objects to the OIG's Statistical Extrapolation

While the Report asserts that a review of loan documentation and underwriter interviews identified 35 cases involving inaccuracies regarding underwriter certifications, the Report does not provide the borrower name, FHA Case Number, or other information enabling the Company to determine to which loans the Report refers. Without such information, KBHMC could not independently review the loan documentation to verify the Report's finding. Moreover, all of the Report's assertions are based on interviews of the underwriters who signed the Addendum in these 35 cases. The Report, however, does not indicate whether it identified one, two, or several underwriters who acknowledged signing certifications without reviewing all relevant file documentation. Thus, it is unclear whether the Report's allegations reflect an isolated incident or affected the Company's overall procedures. In addition, the Report does not provide the names of these individual underwriters or the specific statements on which the OIG relied in preparing the Report. As a result, the Company could not contact the individuals to question the statements on which the Report's finding is based. The Report also states that certain underwriters asserted that members of KBHMC's management may have condoned the practices alleged in the Report. Without any indication as to which loans were at issue or which underwriters made such assertions, the Company could not question any managers or attempt to determine the veracity of these statements.

The Report alleges that inaccurate underwriter certifications occurred in approximately 206 loans. This estimate is an extrapolation of the 35 loans in which actual reviews and underwriter interviews were conducted. According to the Report, this number was derived from statistical sampling procedures in which the OIG projected the number of inaccurate underwriter certifications from 35 out of 104 loans actually examined to 206 of the 543 loans with potential

Comment 1

Comment 2

certifications issues that were targeted for review. This statistical sample is very small and, as indicated in the Scope and Methodology section of the Report, represents only a 90% certainty that 206 underwriter certifications were inaccurate, hardly a firm confidence level. Moreover, the Company takes issue with the fact that 171 of the 206 loans identified in the Report are based on a statistical sample, rather than an actual finding of inaccuracies or violations of FHA guidelines after a thorough review. We therefore request that the Report be revised to include only those loans in which the OIG's review in fact identified underwriter certification inaccuracies.

Finally, we note that, although this review was conducted between September 2005 and April 2006, all 543 of the loans referenced in the Report were originated in 2002 and 2003, over three years ago. Based on HUD guidelines, KBHMC was no longer required to retain the loan documentation examined during this expanded review. See HUD Handbook 4000.2 REV-3, ¶ 5-8(A). Therefore, the allegations set forth in the Report are stale. Moreover, KBHMC is no longer actively engaged in the origination of mortgage loans. The Company has sold its assets, no longer originates or underwrites FHA loans, and has terminated the employment of all underwriters. We note that the Company's termination of its FHA approval as a result of its asset sale and its exit from the mortgage origination business effectively resolves any deficiencies identified in the Report.

Without specific information regarding the loans at issue, or the number, identity or statements of the underwriters on whose interviews the Report's finding is based, KBHMC is unable to conduct its own review of the loan files or interview the individuals referenced in the Report and cannot respond to the substantive allegations in this case.

B. KBHMC's Overall Underwriting Policy Complied with HUD Guidelines

The Company objects to the OIG's allegations in the Report that the Company did not ensure that underwriter certifications for FHA loans were accurate and that it was Company practice for underwriters to sign off on loans for other underwriters without performing a full underwriting review.

The OIG's justification for the expanded audit, and its underlying allegations in the Report, are based on the assumption that because a different underwriter signed the MCAW, internal KBHMC commission sheet and/or Addendum, the underwriter's certification was inaccurate. HUD, however, does not require that the same underwriter execute these documents. The Report states that different signatures in these loans often resulted from underwriters leaving the Company after a loan was originated, but before closing. These employment changes also explain differences in the underwriter listed in HUD's and the Company's automated loan records. These circumstances do not per se signify inaccurate underwriter certifications or a lack of review of loan documentation prior to making an underwriting determination. In fact, the Report does not assert that any of the cases cited were ineligible for FHA insurance.

KBHMC respectfully disagrees with the Report's findings that KBHMC's underwriting procedures failed to comply with HUD guidelines. We refer the OIG to the Company's response to the 2005 Audit report, in which the Company demonstrated that at all times during its operation, the Company required its underwriters to thoroughly review all employment and

Comment 3

credit documents, as well as the appraisal and any documentation verifying the source of funds necessary to close the loan. The Company required this thorough review and analysis by the underwriter prior to his or her signing of the MCAW or the relevant portions of the Addendum in all cases.

The statements made by the underwriters referenced in the Report demonstrate their contravention of Company policy as well as HUD requirements. For example, to the extent the individual underwriters did not receive any employment, credit and source of funds documentation prior to loan approval, the underwriters should have, according to KBHMC requirements, placed an asterisk next to the missing items on the condition sheets in these cases and ensured that these conditions were satisfied prior to signing the certification. Additionally, in any case in which an underwriter signed an Addendum in connection with a loan underwritten by another individual, that underwriter should have, at a minimum, reviewed all critical file documentation in compliance with Company policy. To the extent the underwriters referenced in the Report did not, their actions violated Company procedure.

Moreover, the Report states that the underwriters indicated that they were "given underwriter certification forms and asked to sign them without seeing the loan file." KBHMC has already addressed this allegation in its response to the 2005 Audit. These comments suggest that some other individual was responsible for assuring that the underwriters received all relevant information regarding the loan before signing any approval documents. This is not the case. Rather, as the Direct Endorsement underwriter, per HUD's express guidelines the underwriter was responsible for "the decisions relating to the acceptability of the appraisal, the inspections, the buyer's capacity to repay the mortgage and the overall acceptability of the mortgage loan for HUD insurance." HUD Handbook 4000.4 REV-1, CHG-2, ¶ 2-4. In each case in which the underwriter ignored his or her obligation to review all relevant documentation and make a reasoned, objective decision prior to signing the Addendum, these decisions were contrary to both Company policy and FHA guidelines.

As discussed in its response to the 2005 Audit report regarding its former Tempe office, KBHMC terminated the employment of at least two underwriters for acting contrary to Company policy in this regard. Since the Report does not identify the underwriters to whom it refers in this Report, KBHMC cannot comment on the disciplinary actions it may have taken in connection with these individuals. Nevertheless, KBHMC has demonstrated its responsibility in identifying and handling the circumstances surrounding the loans cited in the Report during its operation. As such, we believe that the Report should be revised to remove allegations concerning KBHMC's overall underwriting procedures.

C. KBHMC Cannot Implement the Report's Recommendation

The Report recommends that, to the extent that the Company's operations continue and have been assumed by CKBHL, HUD ensure that underwriter certifications for FHA-insured loans are only executed by Direct Endorsement underwriters after personally reviewing all relevant documentation and using due diligence in underwriting the mortgage.

KBHMC cannot implement this recommendation. KBHMC no longer originates mortgages. KB Home's role in the joint venture with Countrywide is as an investor. KB Home is not involved in the day-to-day operations of that venture, does not participate in the

Comment 4

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management or supervision of that entity or its employees, and is not responsible for implementing or enforcing policies and procedures regarding mortgage lending or FHA compliance. Countrywide has agreed with KB Home that it will manage CKBHL to cause it to comply with federal and state requirements regarding mortgage financing, as well as FHA guidelines. KB Home has no reason to believe Countrywide is failing to abide by that commitment. Nevertheless, as an investor in that entity, KB Home has no ability to ensure that the venture complies with the recommendation proposed in the Report. As KB Home cannot execute this recommendation, we request that it be removed from the final report.

IV. CONCLUSION

KBHMC generally complied with FHA underwriting requirements, made loans to qualified FHA borrowers, and established effective management supervision and controls. The Report does not provide specific allegations in each of the 35 cases cited and extrapolates the findings in these cases to assert inaccuracies in an estimated 206 loans originated three to four years ago based on statistics and not a review of the actual loan documentation. Despite the limited information provided in the Report, our review of the finding indicated that, at the time the loans at issue were originated, KBHMC's policies and procedures complied with FHA guidelines. To the extent that individual underwriters acted contrary to FHA requirements in reviewing loan file documentation and executing certifications, these individuals did so in contravention of Company policy. Moreover, while the Company is willing to cooperate with the Department to ensure that all concerns in these cases are resolved, based on the current status of KBHMC, the proposed recommendation made in the Report is not possible.

We hope the OIG will consider this response and supporting documentation. We trust that, after reviewing these materials, you will agree that certain of the Report's recommendations in connection with the cited loans are unwarranted. We respectfully request that the OIG revise its recommendations to fit the facts of this case and remove allegations regarding KBHMC's procedures and the current recommendation from the Report.

If you have any questions concerning the matters discussed herein, please contact the undersigned, at (310) 231-4122, or KBHMC's Washington counsel, Phillip L. Schulman, at (202) 778-9027.

Thank you for your consideration.

Sincerely,



Nancy S. Schwappach
Vice President, Associate General Counsel
KB Home

DC-826196 v1 0307048-0100

cc: Phillip L. Schulman, Esq.

OIG Evaluation of Auditee Comments

Comment 1 KB's response states they were unable to conduct their own review of the loan files referenced in the report or interview the associated underwriters. KB was provided a copy of the draft report and HUD OIG offered to hold an exit conference to discuss the findings in detail, yet KB declined this offer. Also, KB was provided a list of the 104 sample loans, accessed the loan file records and provided OIG the FHA loan file documents needed for OIG's audit procedures. Therefore, KB had copies of all of the documents reviewed and had knowledge of which KB underwriters were involved in the testing. KB could have contacted any or all of these 15 underwriters to discuss the sample loans. KB's decision not to perform its own testing on the sample loans, however, does not affect the validity of the results described in the audit report.

For clarification, HUD OIG interviewed 14 of the 15 underwriters associated with the 104 sample loans and found 10 of these underwriters signed certifications without fully underwriting the loans.

Comment 2 KB's Response questions the use of statistical sampling procedures and notes that a 90% confidence level is "hardly a firm confidence level". HUD OIG disagrees with this opinion and finds the use of a 90% confidence level is a generally accepted method for extrapolating statistical sample results and was fully appropriate for the audit objectives in this case. The statistical procedures are disclosed in the scope and methodology section of the audit report. It should be noted that HUD OIG pursued a statistical sampling methodology only after KB refused OIG's request to provide loan file documents for all of the 543 loans selected for review claiming it would be too burdensome to retrieve these documents. Furthermore, while arguing that providing records for all 543 loans would be too burdensome, KB agreed that the sample of 104 loans would be sufficient to draw conclusions. In an email message dated October 7, 2005 from a KB representative to HUD OIG, KB stated the following:

The provision of these three documents in 104 cases will fulfill the purpose of reviewing a statistical sample of loans originated by KBHMC. Reviewing these documents should provide the OIG with sufficient information to draw any conclusions. Thus, while KBHMC would agree to provide the three above-referenced documents in each of the 104 cases listed in the OIG's sample, the Company does not intend to provide any additional information in these 104 cases or in the remaining cases identified in the OIG's initial list of 543 loans unless compelled to do so.

Comment 3 KB's response notes that its official company policy was to comply with HUD requirements for signing underwriter certifications. As presented in the audit report finding, the practices at KB did not always adhere to such a policy. The audit report notes that most of the underwriters interviewed stated it was company

practice for underwriters to sign off on loans for other underwriters, who had left the company or who were out of the office temporarily, without performing a thorough underwriting review.

Comment 4 KB's response states KB can not implement the report recommendation since its current role is that of an investor and not as an active participant in the day-to-day operations of its new joint venture mortgage company. This new joint venture arrangement is noted in the audit report. We revised the report recommendation based upon KB's comments. The purpose of the recommendation is to place KB on notice of the violations and ensure any current and/or future FHA loan activities of KB do not result in recurrence of the problems noted in the report.