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Audit Report Number
2007-AT-1002

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

James D. McKay

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

SUBJECT: Pine State Mortgage Company, Atlanta, Georgia,
Did Not Always Comply with Federal Housing Administration
Underwriting and Quality Control Requirements

HIGHLIGHTS

What We Audited and Why

We audited loans Pine State Mortgage Company (Pine State) underwrote at its Atlanta, Georgia, branch office. Pine State is a nonsupervised direct endorsement lender with headquarters located in Atlanta, Georgia. We selected the Atlanta branch office because its default rate was significantly higher than the Georgia average.

Our audit objective was to determine whether Pine State acted in a prudent manner and complied with U.S. Department of Housing and Urban Development's (HUD) regulations, procedures, and instructions in the underwriting process for cash assets, income, and general creditworthiness of its Federal Housing Administration-insured mortgages.

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What We Found

Pine State did not always follow HUD's underwriting and quality control requirements for Federal Housing Administration-insured loans. It improperly underwrote 21 of the 108 loans reviewed. The improperly underwritten loans contained deficiencies that affected the insurability of the loans, including improper assessment of borrowers' income, debts, credit histories, and eligibility for interest rate buydowns. As a result, HUD insured 21 loans that placed the Federal Housing Administration insurance fund at risk for $151,687 in questioned costs and $713,495 in funds to be put to better use. Pine State also did not maintain proper quality controls over its underwriting process. The inadequate quality control procedures placed HUD's insurance fund at risk for an additional 15 loans. Our assessment of Pine State's quality control reviews showed these loans involved material violations not recognized by Pine State and reported to HUD. The violations affected the loans' insurability. These conditions exposed HUD's insurance fund to unnecessary risk of default, claims, and foreclosure.

What We Recommend

We recommend that the assistant secretary for housing-federal housing commissioner take appropriate administrative action against Pine State based on the information contained in this report. This action should, at a minimum, require Pine State to reimburse or hold HUD harmless against any losses for the 21 improperly underwritten loans in finding 1 that involve $151,687 in questioned costs and $713,495 in funds to be put to better use, and any of the 15 loans in finding 2 that involve material violations.

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

Auditee's Response

We discussed the findings with Pine State officials during the audit. We provided a copy of the draft report to Pine State on August 10, 2006, for their comments and discussed the report with the officials at the exit conference held on August 28, 2006. Pine State provided written comments on August 28 and September 6, 2006.

Pine State generally disagreed with our findings and case studies. The complete text of Pine State's response (minus exhibits); along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

Pine State Mortgage Corporation (Pine State) is a nonsupervised direct endorsement lender, which operates from its home office in Atlanta, Georgia. The company has been approved to originate loans since February 11, 1993. At the time of our audit, Pine State did not sponsor any loan correspondents. Pine State had 12 Federal Housing Administration-approved branch offices and is approved to operate in Georgia, Florida, Alabama, Tennessee, and South Carolina. It also did business as Bowen Family Mortgage at two of its branch offices.

We audited loans Pine State underwrote at its Atlanta branch office for properties located in the metropolitan Atlanta area for the period August 1, 2003, through July 31, 2005. The Atlanta branch originated 42 percent of Pine State's 4,163 loans but accounted for 52 percent (183/349) of the company's defaults. The branch had a 10.54 percent two-year default rate compared to Pine State's overall 8.4 percent rate. The 183 Atlanta branch defaults included 81 loans that defaulted with six or fewer payments on mortgages that totaled $11.5 million. The branch also had a 223 percent compare ratio. The branch compare ratio exceeded the 200 percent level generally used by HUD to identify branches that warrant further assessment or sanctions.

Our audit objective was to determine whether Pine State acted in a prudent manner and complied with the U.S. Department of Housing and Urban Development's (HUD) regulations, procedures, and instructions in the underwriting process for cash assets, income, and general creditworthiness of its Federal Housing Administration-insured mortgages.

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RESULTS OF AUDIT

Finding 1: Pine State's Atlanta Branch Office Did Not Fully Comply with HUD's Underwriting Requirements

Pine State did not follow HUD requirements when underwriting 21 of the 108 Federal Housing Administration-insured loans reviewed. The loans contained deficiencies that affected the credit quality (insurability) of the loans. The loan underwriting deficiencies occurred because Pine State's underwriters did not adequately assess borrower eligibility. As a result, HUD insured 21 loans that placed the Federal Housing Administration insurance fund at risk for $151,687 in questioned costs and $713,495 in funds to be put to better use.

Scope of Review

We reviewed 108 loans. The audit focused on early payment default loans and loans that involved interest rate buydowns. The loans included 16 of 81 early payment default loans originated by Pine State's Atlanta branch office from August 1, 2003, to July 31, 2005. In addition, we examined 92 of 217 defaulted temporary interest rate buydown loans[1] originated by Pine State, without regard to office location, between January 1, 2003, and December 31, 2004. We limited the review to 92 loans that had defaulted and had a debt to income ratio equal to or greater than 41 percent. We identified significant underwriting violations for 11 of the 16 loans reviewed for underwriting compliance and 10 of the 92 loans reviewed for temporary interest rate buydowns.

Loans Not in Compliance with HUD Requirements

Pine State underwrote 21 loans that contained significant loan underwriting deficiencies. The deficiencies primarily involved

[1] We expanded the review to include the interest rate buydown loans due to violations noted in loans selected for underwriting review. We only reviewed these loans for compliance with underwriting requirements associated with the borrower's eligibility for the buydowns.

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Deficiency	Number of loans
Interest rate buydown not properly assessed	11[2]
Income not properly assessed	5
Debts not properly assessed	6
Credit not properly assessed	4
Quitclaim transfers	2
Gifts not properly verified	7
Other	6

These conditions occurred because underwriters did not adequately evaluate borrower information for compliance with requirements before approving the loans.

Each loan contained one or more significant deficiencies that are summarized below. Appendix C summarizes the loan deficiencies for the 11 problem loans reviewed for overall underwriting, and appendix F contains a detailed case study for each of these loans. Appendix D summarizes the 10 loans reviewed for compliance with buydown requirements.

Interest Rate Buydowns Not Properly Assessed

Pine State inappropriately approved interest rate buydown loans for 11 borrowers (discussed in appendixes C and E). The files for the 11 borrowers did not show or document that Pine State assessed the borrowers' eligibility for the buydowns to assure that the eventual increase in mortgage payments would not adversely affect the borrowers and likely lead to default. The borrowers did not meet the buydown criteria. Thus, Pine State inappropriately used the bought down monthly mortgage amount rather than the full mortgage payment to qualify them for their loans. Each of the 11 borrowers defaulted on their loans. The following two examples demonstrate the conditions identified during the review.

- 105-0981353 - Pine State said they approved the buydown because the borrower demonstrated an ability to devote a greater portion of income to housing expense and the potential for increased income. The credit report showed the borrower was over $20,000 delinquent on child support payments. That was not consistent with Pine State's justification for the buydown. Pine State based the borrower's increased earning potential on overtime pay. Pine State did not assess or document that the potential increased

[2] This number includes one loan listed in appendix C, reviewed for overall underwriting compliance, and the 10 loans in appendix D, reviewed for borrower eligibility for temporary interest rate buydowns.

overtime pay would be enough to pay the buydown increments.

- 105-1953205 - Pine State claimed the borrower was qualified based on increased earning potential. We determined that Pine State incorrectly estimated the borrower's future earnings. The income we projected for 2004 was less than the borrower earned in 2003. Thus, the borrower did not demonstrate the potential for increased earning needed to pay the buydown increments.

HUD Handbook 4155.1, REV 5, paragraph 2-14B(2), provides that the lender must establish that the eventual increase in mortgage payments will not affect the borrower adversely and likely lead to default. The underwriter must document that the borrower meets one of four criteria that require borrowers to have (a) potential for increased income that would offset the scheduled payment increases, (b) demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expenses, (c) substantial assets available to cushion the effect of the increased payments, or (d) cash investment made that substantially exceeds the minimum required.

Although this issue was discussed in HUD's February 2004 Quality Assurance Division report, Pine State did not correct the documentation problem for temporary interest rate buydown loans. Four of the ten problem loans noted in appendix D closed after HUD completed its 2004 review[3].

Income Not Properly Assessed

Pine State did not properly assess income for five borrowers (105-1380870, 105-2032130, 105-17491989, 105-2020030, and 105-1548492). As a result, it overstated the borrowers' monthly income. The following two examples demonstrate the conditions identified during the review.

- For case 105-2020030, Pine State overstated the borrower's monthly income by $688. The overstatement included $478 for overtime pay and $210 for child support. The overtime was not allowable because the borrower had been employed at the job for only 10 months before the loan closing and because Pine State did not verify or document verification that the overtime would continue. The $210 child support was not allowable because Pine State did not properly verify the amount and resolve discrepancies

[3] Effective August 2004, HUD changed its rules to no longer allow lenders to qualify borrowers at bought down mortgage amounts. HUD changed the rule because this category of loans experienced a higher rate of default than other loans.

associated with the payments before it approved the loan. Adjustments for these and other items resulted in a 58.28 percent debt-to-income ratio compared to the 40.61 percent rate Pine State calculated.

- For case105-1741989, Pine State overstated the borrower's monthly income by at least $907. The overstatement included $627 in supplemental Social Security income and $280 for commission income. The supplemental Social Security income ended about 18 months after the loan closed because the borrower's income exceeded the eligibility limit for the benefits. Pine State did not verify the likelihood that the income would continue, and it inappropriately increased the $545 monthly payment shown on the verification by 15 percent to $627. It did not document a reason for the increase. It also overstated the borrower's 2002 monthly commission income by $280 because it did not deduct expenses that offset the commission. In addition, Pine State overstated the borrower's 2003 commission income by an undetermined amount due to its failure to document and deduct commission expenses. Adjustments for the $907 resulted in a 55.43 percent debt-to-income ratio compared to the 46.34 percent rate Pine State calculated.

Handbook 4155.1, REV 5, provides that 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 will not continue may not be used in calculating the borrower's income ratios.

Debts Not Properly Assessed

Pine State did not consider and/or properly assess borrower debts before approving six loans (105-1380870, 105-1769305, 105-1741989, 105-1587099, 105-1524517, and 105-1728585). The following examples demonstrate this condition.

- For case 105-1769305, Pine State's loan file contained no evidence that it asked the borrower to explain a credit inquiry that resulted in an additional $306 monthly debt for an automobile loan. The borrower made the loan in March 2004, the same month Pine State closed the borrower's home loan. The additional debt was shown on a credit report Pine State obtained during its quality control review, but the reviewer did not detect and report the debt during the quality control review. Adjustment for the debt and other items

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resulted in a 60.93 percent debt-to-income ratio compared to the 47.34 percent rate Pine State calculated.

- For case 105-1524517, Pine State's loan file contained no evidence that it asked the borrower to explain a credit inquiry that resulted in an additional $211 monthly debt. The borrower made the loan in October 2003. Pine State closed the borrower's home loan on November 7, 2003. The additional debt was shown on a credit report Pine State obtained during its quality control review. Adjustment for the debt resulted in a 53.42 percent debt-to-income ratio compared to the 47.36 percent rate Pine State calculated.

HUD Handbook 4155.1, REV-5, paragraph 2-3B, provides that the lender must determine the purpose of any recent debts. The borrower must explain in writing all inquiries shown on the credit report in the last 90 days.

Credit Not Properly Assessed

Pine State did not consider and/or properly evaluate borrower credit history before approving four loans (105-1380870, 105-2032130, 105-2020030, and 105-1531395). Each loan involved borrowers whose credit reports showed deragatory credit histories that involved collections, judgements, and/or delinquent accounts. The following case demonstrates this condition.

- 105-2032130 - Pine State did not adequately consider the borrower's past disregard for child support payments. The credit report showed the borrower had accumulated $58,143 in delinquent child support. The file contained an "order/notice to withhold income for support," dated July 22, 2003. The loan closed on August 13, 2004; thus, the order was not current, and Pine State did not followup or document followup to determine whether the order had been modified. Pine State should have reviewed and considered this matter before it approved the loan.

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that 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. 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.

Quitclaim Transfers

Pine State submitted two loans (105-1728585 and 105- 1817383) for insurance endorsement despite knowledge that at loan closing one or more of the coborrowers transferred their interest to individuals who were not listed on the loan applications. The borrowers used quitclaim deeds to make the transfers to individuals whose income, debts, and credit were required to be but were not assessed and approved to have ownership interest in the property.

HUD Handbook 4155.1, REV-5, paragraph 3-10 (lender responsibility at closing), provides that the lender is required to resolve all problems regarding title to the real estate. The loan must close in the same manner in which it was underwritten and approved. Additional signatures on the security instruments and/or mortgage note of individuals not reviewed during mortgage credit analysis may be grounds for withholding endorsement. Paragraph 2-2A states that HUD does not permit an individual to take an ownership interest in the property at settlement without signing the mortgage note and all security instruments.

Gifts Not Properly Verified

Pine State did not properly verify gift funds paid to closing agents for seven borrowers (105-1380870, 105-1769305, 105-1587099, 105-1524517, 105-1531395, 105-1728585, and 105-1548492). In each case, the borrowers received gifts from nonprofit donors. Pine State subsequently verified receipt of the gift funds by obtaining copies of the wire transfers submitted by the nonprofit donors to the closing attorneys. However, the verification does not relieve Pine State of its responsibility to verify the transfer of gift funds to the closing attorneys before loan closing. The missing documentation was required to provide assurance that the gifts were paid by the nonprofit organizations and not by other interested parties to the loan transactions.

HUD Handbook 4155.1, REV-4, paragraph 2-10C, requires that if the gift funds are not deposited to the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

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Other Less Significant Deficiencies

Pine State also underwrote five loans that contained less significant underwriting deficiencies. The deficiencies involved some of the same violations cited for the cases discussed above. However, we considered the deficiencies less significant because they did not affect the overall credit quality (insurability) of the individual loans. Thus, the deficiencies would not support indemnification of the defaulted loans or repayment of losses on claims. This fact does not relieve Pine State from following all facets of HUD requirements when originating Federal Housing Administration loans. We provided details of these deficiencies to Pine State during our review. Appendix C summarizes the less significant deficiencies for the five loans.

Conclusion

Pine State's underwriters did not adequately evaluate information presented by borrowers for compliance with requirements before approving 21 loans. This resulted in Pine State approving 21 loans that did not meet HUD requirements and submitting them to HUD for Federal Housing Administration endorsement. As a result, HUD insured 21 loans that placed the Federal Housing Administration's insurance fund at risk for $151,687 in questioned costs and $713,495 in funds to be put to better use.

Recommendations

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

1A. Take appropriate administrative action against Pine State for not complying with HUD requirements.

1B. Require Pine State to indemnify $713,495 for 17 defaulted loans.

1C. Require Pine State to reimburse HUD $66,425 for actual loss sustained on two claim-terminated loans that HUD sold.

1D. Require Pine State to reimburse HUD the actual losses incurred on two claim-terminated loans that HUD has not resold. We estimate $85,262 for the losses.

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Finding 2: Pine State Did Not Effectively Implement Quality Controls for Early Payment Default Loans

Pine State did not implement effective quality controls over early payment default loans despite HUD's prior findings on this issue. HUD requires all nonsupervised lenders to implement an effective quality control system to retain their HUD approval. Pine State's management did not take proper action to ensure compliance with this requirement.

We assessed Pine State's quality controls and found that it did not properly

- Assess and classify the severity of its quality control findings,
- Report material quality control findings to HUD,
- Document resolution of its quality control findings,
- Prepare and assess trends to identify areas that warranted expanded coverage,
- Assess underwriters with high default rates, and
- Assess branch offices with high default rates.

These issues hampered Pine State's ability to identify and correct performance issues and contributed to the high 10.54 percent default rate at its Atlanta branch. The conditions also allowed underwriting problems to continue without adequate measures to identify and correct them. For instance, 23 loans from Pine State's quality control findings involved violations that should have been but were not reported to HUD. We reviewed eight of the loans as part of our sample discussed in finding 1. The remaining 15 loans involved $1.3 million in unpaid principal for defaulted loans, a $155,000 claim payment, and $155,000 in losses HUD incurred on foreclosed properties.

Conditions Noted in HUD's Past Reviews

HUD Handbook 4060.1, paragraph 6-1, provides that all Federal Housing Administration-approved lenders must implement and continuously have in place a quality control plan for the origination of insured mortgages as a condition of receiving and maintaining Federal Housing Administration approval. Quality control must be a prescribed and routine function of each lender's operations, whether performed by a lender's staff or an outside source.

HUD reviewed Pine State's quality controls in February 2004. During our audit, we identified several violations of the same type as those identified during HUD's

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2004 review. The repeat issues include Pine State's failure to (a) classify the severity of its quality control findings, (b) take and document corrective actions, (c) prepare and use trend results to determine the focus of quality control work, and (e) expand its quality control review to follow up on commonalities in the review.

We reviewed Pine State's quality controls over loans that defaulted with six or fewer payments (early default loans). We primarily focused on activity for Pine State's Atlanta branch office and its overall assessment of patterns and trends to identify areas that might require increased quality control attention. We assessed all Pine State quality control report findings for all early payment default loans reviewed between May and December 2005. We noted that Pine State had improved its quality control reviews of early payment default loans since HUD's 2004 review. We found that Pine State was conducting the required reviews and had gone back and performed recent reviews of older loans not reviewed in the past.

Severity of Quality Control Violations Not Identified

Pine State did not classify the severity of violations identified by its quality control reviews as recommended by HUD. HUD's Quality Assurance Division mentioned this matter in its 2004 report, but Pine State had not implemented corrective action. The classification would identify violations that required (a) reporting to HUD, (b) management action to address decline in the quality of loans, and (c) prompt corrective action. Pine State did not report material violations to HUD and had not taken adequate measures to identify patterns and trends from its quality control reviews nor adequately correct violations noted during its quality control reviews.

HUD Handbook 4060.1, REV-1, paragraph 6-4, recommends that quality control reports to lender management include an assessment of risks to enable a lender to compare one month's sample to previous samples so the lender may conduct trend analysis. Management can also use this tool to respond quickly to a sudden decline in the quality of its loans and help identify and correct the problem. Lenders may consider a ratings system such as (a) "low risk" for loans with no or minor problems, (b) "acceptable risk" for loans that do not involve issues material to creditworthiness or insurability, (c) "moderate risk" for loans that contained significant unresolved questions or missing documentation, and (d) "material risk" for loans that involve material violations of Federal Housing Administration or lender requirements and represent an unacceptable level of risk. Lenders must report material risk loans, in writing, to HUD.

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Material Violations Not Identified and Reported to HUD

Pine State did not identify and report to HUD material violations included in its quality control reports. In some instances, Pine State's quality control reports noted that major violations were found, but the reports did not reference specific case violations. We met with Pine State officials in January 2006, and they acknowledged they had not self-reported any loans to HUD. HUD officials also stated that Pine State had not self-reported any violations detected by the company's quality control reviews. As of April 2006, Pine State had not identified and reported any material violations to HUD.

We examined Pine State's quality control findings and observed material violations for 23 loans that warranted reporting but were not reported to HUD (appendix E). The violations were included in quality control reports for early payment default loans for all Pine State offices conducted from May through December 2005. We examined eight of the loans during our underwriting review. The review confirmed the existence of the type of violations Pine State detected for seven of the loans, although in most instances, our review detected additional issues and details. We did not audit the other 15 loans to validate Pine State's review findings. The 15 loans involved more than $1.3 million in unpaid principal for 10 loans, one claim totaling $155,193, and four loans resold by HUD at a loss that totaled $155,402. The violations associated with the 23 loans consisted of

- Ten loans with overstated or understated income that increased the debt-to-income ratios to levels that adversely affected the insurability of the loans;
- Seven loans with quitclaim deeds executed at closing to individuals who were not subjected to assessment of their income, debts, and creditworthiness; and
- Six loans with omitted liabilities or understated housing costs that increased the debt-to-income ratios to levels that adversely affected the insurability of the loans.

This condition occurred because Pine State management did not meet its responsibility to identify and report material violations to HUD. This condition exposed HUD to increased risk for loans with violations that impacted their eligibility for insurance. In response to our assessment, Pine State officials commented that they did not agree with their quality control finding results for 11 of the 23 loans.

HUD Handbook 4060.1, paragraph 6-3(J), provides that findings of fraud or other serious violations must be referred, in writing (along with the supporting documentation), to the appropriate director of the Quality Assurance Division in the HUD Homeownership Center. A lender's quality control program must ensure that findings discovered by employees during the normal course of business and by quality control staff during reviews/audits of Federal Housing Administration loans are reported to HUD within 60 days of the initial discovery.

Corrective Action Not Properly Taken on Quality Control Findings

Pine State did not take or document adequate action to address and resolve findings included in its quality control reports. The reports did not contain or give reference to the required corrective actions and timetables for completing corrective actions. Although this information was requested, Pine State could not produce adequate written records supporting proper action to resolve quality control findings. In some instances Pine State officials stated that they took informal and/or undocumented actions such as sending e-mails advising staff to be alert for certain conditions detected by its quality control reviewer. They also stated that they discussed some of the issues with their staff. We found limited documentation of these discussions.

Handbook 4060.1, paragraph 6-3(I), provides that review findings must be reported to the lender's senior management within one month of completion of the initial report. Management must take prompt action to deal appropriately with any material findings. The final report or an addendum must identify actions being taken, the timetable for their completion, and any planned followup activities.

Trending Not a Consistent Part of the Quality Control Process

Pine State did not consistently identify patterns and commonalities among participants for early payment defaults that required further assessment to identify the cause and any needed corrective action and or targeted coverage in future quality control reviews. We only found two trend assessments by Pine State. One was dated August 2005; however, the other one was not dated, and we could not determine when Pine State performed the assessment. The assessments identified

- Two high default rate underwriters at its Atlanta branch office (dated August 2005) and

- A 39 percent default rate for loans that involved temporary interest rate buydowns. As discussed in finding 1, Pine State did not properly document and review borrowers' eligibility for interest rate buydowns. It produced no evidence that it initiated action to identify the cause for this high default rate and initiated action to resolve the matter.

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These conditions occurred because Pine State did not require and commit staff to identify and follow up on patterns and trends. Pine State officials said they considered patterns in informal one-on-one meetings and decided the patterns did not warrant further assessment or followup. Thus, Pine State missed the opportunity to identify and correct, in a timely manner, underwriting problems such efforts may have identified. Pine State's failure to address the issues allowed underwriting problems to continue unabated.

Inadequate Action to Identify and Address the Cause for High Underwriter Defaults

Pine State did not assess the performance of two of its highest default rate underwriters to determine why their default rates were so high and take action to address the matter.

Underwriter	Loans closed between	Total loans	Loans defaulted within two years	Default percentage	Mortgages on defaulted loans
A	Dec. 2003 and June 2004	217	55	25.35	$7,430,248
	July 2004 and Dec. 2004	143	29	20.28	3,701,148
	Jan. 2005 and June 2005	66	8	12.12	1,052,043
Subtotal		426	92	21.60	12,183,439
B	Dec. 2003 and June 2005	93	26	27.96	$3,116,226
Total		519	118	22.74	$15,299,665

Underwriter A continued to underwrite for Pine State at the time of our review. The personnel file showed no record of concern about the underwriter's high default rate. Underwriter B left Pine State to work for another lender. The personnel file showed the underwriter left Pine State in good standing. The file showed no record of concern about the underwriter's high default rate.

Pine State's owner stated the high default rates were due to a higher risk market rather than poor quality underwriting. The data we obtained from HUD's Neighborhood Watch system coupled with our file reviews did not support Pine State's assessment. The system showed an 8.25 percent default rate for loans in Georgia that correspond to Pine State's market. The default rate is 2.29 percent lower than the 10.54 default rate for Pine State's Atlanta branch where most of the underwriter's default activity occurred. Furthermore, the 8.25 Georgia default rate was 17.10 percent lower than the highest default rate for Underwriter A and 19.71 percent lower than the default rate for underwriter B.

Further, the underwriting violations detected by our review (appendixes C and D) show poor underwriting performance contributed to the underwriters' high default rate. For instance, we identified 21 loans with underwriting violations that impacted insurability. Underwriter A underwrote six or 28.6 percent of the loans, and Underwriter B underwrote three or 14.2 percent of the loans. The violations contributed to the underwriters' high default rates. Pine State did not focus extra quality control attention on these underwriters to identify the cause for the high defaults and to initiate corrective measures where appropriate.

HUD handbook 4060.1, paragraph 6-5C, provides that lenders must identify patterns of early defaults by location, program, and loan characteristic. Lenders must identify commonalities among participants in the mortgage origination process to learn the extent of their involvement in problem cases. For instance, loans involving underwriters who have been associated with problems must be included in the review sample.

Inadequate Action to Identify and Address the Cause for High Branch Office Defaults

Pine State's quality control process did not assess or document its assessment of performance by its Atlanta branch office, which had a high 10.54 percent default rate. The high default rate caused a 223 percent compare ratio for the Atlanta branch. The compare ratio exceeded the 200 percent benchmark used by HUD to consider branch offices for possible sanction. The branch had 183 defaults for the period August 1, 2003, through July 31, 2005, underwritten by 16 different underwriters. Underwriters A and B, discussed above, underwrote 116 or 63.3 percent of the defaulted loans.

Underwriter	Total branch defaults	Defaults by underwriter	Percentage of defaults by underwriter	Mortgage amounts associated with the underwriter defaults
A	183	72	39.34	$ 9,897,155
B	183	44	24.04	6,573,135
Total		116	63.38	$16,470,290

Pine State's owner stated the high branch default rate was due to its primary focus on higher risk loans for new construction. However, our assessment shows other factors also played a part. For instance, as of September 30, 2005, the branch had an 11.55 percent default rate for new construction loans. That rate exceeded Pine State's overall 9.03 percent rate and the 8.83 percent default rate for all HUD-insured new construction loans in Georgia. As previously mentioned, the high default rate was due in part to the underwriting activity by underwriters A and B. Pine State did not review and assess the reason for the underwriters' high default activity. The explanation Pine State provided was not consistent with the underwriting violations we noted for loans the two underwriters approved.

Regulations at 24 CFR [*Code of Federal Regulations*] 202.3 provide that lenders are responsible for monitoring their default and claim rate performance. The HUD secretary may notify a lender that its origination approval agreement will terminate 60 days after notice is given, if the lender had a rate of defaults and claims on insured mortgages originated in an area, which exceeded 200 percent of the normal rate and exceeded the national default and claim rate for insured mortgages. Further, HUD Handbook 4060.1, paragraph 6-5C, provides that lenders must identify patterns of early defaults by location, program, and loan characteristic. They must identify commonalities among participants in the mortgage origination process to learn the extent of their involvement in problem cases. For instance, loans involving underwriters who have been associated with problems must be included in the review sample.

Conclusion

Since HUD's 2004 review, Pine State has not implemented effective quality controls for early payment default loans. Pine State conducted the required reviews but it did not (a) classify quality control violations based on risk, (b) report material risk loans to HUD, (c) properly take and document actions to resolve quality control findings, (d) conduct frequent trending to identify patterns that warrant followup in its quality control reviews and corrective action, (e) conduct expanded reviews of high default rate underwriters, and (f) review and assess the reason for the high default rate at its Atlanta branch. Thus, Pine State's quality controls were not adequate to identify and correct problems that adversely affected the quality of its loans. These conditions contributed to the violations discussed in finding 1 and to the high default rate for Pine State's Atlanta branch office.

Recommendations

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

2A. Take appropriate administrative action against Pine State for not implementing proper quality controls over its early payment default loans. This action is justified based on Pine State's failure to correct or document corrective action on identified quality control findings, risk rank quality control findings, report material violations to HUD, and conduct and consider trending in the performance of its quality control reviews.

2B. Require Pine State to implement proper quality controls over its early payment default loans.

2C. Require Pine State to reimburse HUD for losses or claims and/or indemnify HUD for any of the loans listed in appendix E that involve material violations Pine State should have reported to HUD.

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SCOPE AND METHODOLOGY

We performed the audit between October 2005 and May 2006. We conducted the audit fieldwork at Pine State's Atlanta, Georgia, office and HUD's Office of Inspector General (OIG) and program offices in Atlanta, Georgia. The audit covered the period August 1, 2003, through July 31, 2005, but we extended the period as necessary. We conducted the audit in accordance with generally accepted government auditing standards.

To achieve our objective, we reviewed HUD's rules, regulations, and guidance for proper origination and submission of Federal Housing Administration loans. We also reviewed previous HUD reviews of Pine State and HUD case binders. In addition, we interviewed HUD staff to obtain background information on HUD requirements and Pine State.

We interviewed Pine State's management and staff to obtain information regarding its policies, procedures, and management controls. We reviewed Pine State's written policies and procedures to gain an understanding of how its processes are designed to function. We also reviewed Pine State's quality control review of early payment defaults related to our scope. Additionally, we reviewed Pine State's case binders for 16 of 81 early-payment default loans and 92 of 217 cases Pine State approved for interest rate buydowns. We limited the review to 92 loans that had defaulted and had a debt-to-income ratio equal to or greater than 41 percent. We obtained origination default and other loan information from HUD's Neighborhood Watch system for loans included in our review.

The amounts shown for questioned costs and funds to be put to better use apply only to loans reviewed during the audit. The ineligible cost represents the actual loss HUD incurred on the resale of affected properties. The unsupported cost represents 29 percent of the claim paid based on information provided by HUD. We estimated funds to be put to better use at 29 percent of the unpaid principal balance. HUD provided information that shows its loss on sales average 29 percent of the claim paid. We also used 29 percent of the unpaid principal balance because HUD had not paid claims for these loans.

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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 Weaknesses

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

- Pine State did not follow HUD requirements when underwriting 21 Federal Housing Administration-insured loans.

- Pine State did not implement its quality control plan in accordance with HUD requirements.

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APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1B			$713,495
1C	$66,425		
1D		$85,262	

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, federal, state, local policies or regulations. The amount shown represents the actual loss HUD incurred when it sold the affected properties.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures. In this instance, we estimated unsupported cost to be 29 percent of the claim paid based on information provided by HUD.

3/ "Funds to be put to better use" are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings. In this instance, we estimated funds to be put to better use at 29 percent of the unpaid principal balance. HUD provided information that shows its loss on sales averages 29 percent of the claim paid. We used 29 percent of the unpaid principal balance because HUD has not paid claims for these loans.

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Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

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September 6, 2006

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VIA FEDERAL EXPRESS

Mr. James D. McKay
Regional Inspector General for Audit
U.S. Department of Housing
and Urban Development
Office of the Inspector General
Region 4
Richard B. Russell Federal Building
75 Sprint Street, SW
Room 330
Atlanta, Georgia 30303-3388

Re: Pine State Mortgage Corporation
HUD OIG Draft Audit Report

Dear Mr. McKay:

Kirkpatrick & Lockhart Nicholson Graham LLP represents Pine State Mortgage Corporation ("Pine State") in connection with the above-referenced matter. As indicated in my email of September 6, 2006 regarding the Draft Audit Report from the Office of the Inspector General for Audit ("OIG"), enclosed please find two copies of the supplemental response and supporting documentation, which Pine State has submitted via electronic mail. 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

Phillip L. Schulman

Enclosures

cc: Robert Motley, Chairman, Pine State

DC-845357 v1 0306906-0100

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September 6, 2006

VIA ELECTRONIC MAIL AND FEDERAL EXPRESS

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Office of the Inspector General
Region 4
Richard B. Russell Federal Building
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Room 330
Atlanta, Georgia 30303-3388

RE: **Pine State Mortgage Corporation**
HUD OIG Draft Audit Report

Dear Mr. McKay:

Pine State Mortgage Corporation ("Pine State" or "Company") is in receipt of the Draft Audit Report ("Report"), dated August 9, 2006, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of Inspector General ("OIG"). The Report is based on a review of the Company's Atlanta, Georgia branch office conducted between October 2005 and May 2006. The audit covers 108 loans originated by the branch office during the period August 1, 2003 through July 31, 2005, and was extended to review certain additional loans involving early-payment defaults and interest rate buy-downs.

The Report states that its primary objective was to determine whether Pine State originated HUD-insured loans in accordance with prudent lending practices and HUD requirements. The Report contains two findings, alleging underwriting deficiencies in 21 cases and improper Quality Control procedures that placed HUD at risk in 15 additional loans. Based on these findings, the Report recommends that HUD require Pine State to: (1) indemnify it in connection with 21 loans involving underwriting findings; (2) implement proper quality controls over its early payment default loans; and (3) indemnify the Department in connection with any of the 15 additional loans that involve material violations that should have been reported to HUD.

DC-841070 v2 0306906-0100

Comment 1

The OIG provided Pine State with an opportunity to submit written comments for inclusion in the final report. This response summarizes Pine State's history and operations, including several improvements the Company has made to its Quality Control procedures, and addresses the individual findings in the Report. We appreciate this opportunity to comment on the OIG's findings and recommendations. That being said, we understand that final audit reports routinely include auditors' comments about the audited lender's written response, but that the company is not provided an opportunity to respond to these additional comments. Often, these comments include substantive allegations or statements that were not a part of the draft audit report provided to the company. To the extent that the OIG makes such additional substantive comments in this instance, we respectfully request an opportunity to respond to these additional statements to ensure that a full picture of the audited issues is presented in the final Report.

I. BACKGROUND

Pine State was incorporated in January 1990. It received approval as a participant in the Department's Federal Housing Administration ("FHA") loan programs in 1994 and as a Direct Endorsement underwriter in 1995. Headquartered in Atlanta, Georgia, Pine State operates through thirteen FHA-approved branch offices in five states and employs approximately 280 individuals. Pine State sells all loans that it originates into the secondary market on a servicing-released basis, and its primary investors include Washington Mutual and Fannie Mae. The Company enjoys excellent relationships with both consumers and its investors, and Pine State's employees consistently strive to produce high quality loans in compliance with HUD/FHA standards.

FHA lending constitutes approximately 35-40% of Pine State's business operations. Because FHA lending represents a substantial portion of Pine State's overall production, the Company is committed to its relationship with the Department and takes its responsibilities under the FHA program seriously. We are dedicated to working with HUD to extend credit to qualified FHA borrowers, and we would never knowingly violate FHA requirements nor endanger the reputation of the Company or its employees. In addition, Pine State is dedicated to customer service. We aim to make the lending process as simple as possible for borrowers and work closely with each individual applicant to ensure that he or she receives the type of financing that best fits his or her needs. Throughout our existence, we have endeavored to provide dependable and professional service and have repeatedly demonstrated our commitment to borrowers and allegiance to the FHA program.

Comment 2

Comment 3

II. RESPONSE TO THE FINDINGS

The Report contains two findings, including several sub-findings, in which it alleges that Pine State did not originate 21 loans in accordance with HUD requirements or prudent lending practices, and did not fulfill HUD guidelines regarding Quality Control. Upon receipt of the draft Report, Pine State conducted a thorough review of the findings and loan files, as well as examined applicable HUD/FHA guidelines and internal Company procedures at the time these loans were originated in an effort to provide pertinent information and documentation with this response. Our review indicated that several of the findings in the Report are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability. While we recognize that there is always room for improvement, at no time did the Company intentionally disregard HUD guidelines or knowingly misrepresent information to the Department. Where a deficiency existed, we have acknowledged it and strengthened our policies and procedures to assure compliance with HUD's requirements. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate Pine State's general compliance with HUD/FHA requirements and adherence to prudent lending standards. Below we reply to the individual matters raised in the Report, evidence our adherence to FHA requirements in connection with the findings and cited loans, and set forth our opposition to the manner in which the recommendations are presented in the Report.

A. FINDING 1 – PINE STATE COMPLIED WITH HUD's UNDERWRITING REQUIREMENTS

Finding 1 of the Report asserts in six sub-findings that the Company did not originate 21 of the 108 loans reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) interest rate buy-down assessments; (2) income documentation; (3) debt assessment; (4) credit analysis; (5) quitclaim transfers; and/or (6) gift fund verification.[1] We address each of these individual allegations in turn below.

1. Interest Rate Buy-downs

In 12 loans involving temporary interest rate buy-downs, the Report contends that the loan files did not contain evidence that the borrower met at least one of the four

[1] We note that a chart on page six of the draft Report summarizing the allegations in Finding 1 indicates that six loans contained "other," less significant deficiencies; however, Appendix C, which identifies these loans, includes only five cases. As Pine State addressed these issues throughout the OIG's review, and the auditors determined that these findings do not warrant further action by HUD, we have not provided individual responses to these cases herein.

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Comment 4

Comment 4

buy-down criteria to demonstrate that the scheduled mortgage payment increase would not adversely affect the borrowers' risk of default. As a result, the Report asserts that, in all 12 loans, the qualifying ratios exceeded HUD maximum amounts. Pine State respectfully disagrees with these allegations.

As you know, at the time the 12 loans at issue were originated, interest rate buy-downs were permissible in connection with FHA-insured loans provided that, among other factors, the lender established that the eventual increase in mortgage payments would not affect the borrower and likely lead to default.[2] See HUD Handbooks 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4) and 4155.1 REV-5, ¶ 2-14(B)(2). Specifically, HUD guidelines required that the underwriter document that the borrower met one of the following criteria: (1) potential for increased income that would offset the scheduled payment increases, as indicated by job training or education in the borrower's profession or by a history of advancement in the borrower's career with attendant increases in earnings; (2) a demonstrated ability to manage financial obligations in such a way that a great portion of income may be devoted to housing expense, or in cases where long-term debt will not extend beyond the term of the buy-down agreement; (3) the borrowers have substantial assets available to cushion the effect of the increased payments; or (4) the cash investment made by the borrower substantially exceeds the minimum required. See id. (emphasis added).

As demonstrated below, in each of the 12 cases listed in the Report, the loan file contained documentation to support the borrowers' ability to sustain the eventual increase in mortgage payments without an increased likelihood of default. While the underwriter may not have noted each of these criteria on the Mortgage Credit Analysis Worksheet ("MCAW") in every loan, in each instance Pine State took into account the criteria in determining the borrower's eligibility for the buy-down interest rate, and included evidence of such criteria in the loan file. The Company properly used a mortgage payment amount that reflected the buy-down rate to underwrite these loans, and reasonably determined that the borrowers qualified for FHA financing in each of these cases. Therefore, Pine State respectfully maintains that the Report's recommendation of indemnification would be inappropriate in these 12 loans and requests that the allegations regarding buy-downs be removed from the Report. We address each loan in turn below.

[2] As you know, in August of 2004, HUD issued Mortgagee Letter 04-28, in which it changed its guidelines to require lenders to consider the interest rate reflected on the note when determining whether an individual was qualified for FHA financing, even if the borrower would receive a buy-down interest rate. Upon notice of this change, Pine State amended its policies and procedures to ensure compliance with the revised guidance. Nevertheless, as discussed herein, the Company complied with the provisions in place at the time the 12 loans cited in this sub-finding were underwritten.

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Comment 4

a. – FHA Case No. 105-1380870

In the loan, contrary to the allegation in the Report, the loan file contained evidence indicating that the scheduled mortgage payment increase would not adversely affect the borrowers and likely lead to default. While Pine State acknowledges that the compensating factors present in this case should have been noted on the MCAW, and has reminded its employees of their obligation in that regard, loan file documents supported the borrower's potential for increased income that would offset the scheduled payment increases, one of the express criteria set forth by the Department. See HUD Handbook 4155.1 REV-5, ¶ 2-14(B)(2). Specifically, the borrower's income documentation indicated that he was likely to earn both overtime and bonus income **(Exhibit A-1)**. The borrower's employer also indicated that the borrower was scheduled to receive an increase in pay within a year of loan closing **(Exhibit A-1)**. In addition, the loan file contained a letter from the co-borrower's employer, indicating that the co-borrower had recently been promoted to shift manager, and very likely would soon be promoted to the position of assistant manager **(Exhibit A-2)**. The co-borrower's employer indicated that the anticipated promotion would give her the opportunity to increase her income **(Exhibit A-2)**. Neither the borrower's overtime or bonus income, nor the co-borrower's potential increased earnings as an assistant manager, were included in the borrowers' effective income. Thus, this income demonstrated the potential for increased income that would be adequate to offset the borrowers' scheduled payment increases in this case. Pine State complied with HUD requirements in this case and this loan should be removed from consideration in this sub-finding.

Comment 5

b. – FHA Case No. 105-1587099

In this case, Pine State maintains that the loan file documentation indicated that the scheduled mortgage payment increase would not adversely affect the borrowers and likely lead to default. Contrary to the assertions in Appendix F to the Report, the loan file supported the borrowers' potential for increased income that would offset the scheduled payment increases, one of the express criteria set forth by the Department. See HUD Handbook 4155.1 REV-5, ¶ 2-14(B)(2). Specifically, the borrower was employed as a nursing assistant and had received prior pay increases in that position **(Exhibit B-1)**. While the borrower's last pay increase was only $.10 per hour, the loan file also contained evidence that the borrower had taken nursing assistant courses in the past that were to be supplemented by certified course work **(Exhibit B-2)**. This job training further supported the borrower's potential for increased earnings within her profession, which HUD guidelines recognize as a factor to consider when determining whether a borrower will be able to absorb an increased mortgage payment. See HUD Handbook 4155.1 REV-5, ¶ 2-14(B)(2). With regard to the co-borrower, the loan file

Comment 5

indicated that he was to receive a pay increase within four months of closing **(Exhibit B-3)**, and received regular overtime income **(Exhibits B-3, B-4)**, which was not used to qualify the borrowers for FHA financing **(Exhibit B-5)**. Although the co-borrower's overtime year-to-date earnings totaled only $284 **(Exhibit B-4)**, the co-borrower clearly was earning overtime income and the employer indicated that such income was likely to continue **(Exhibit B-3)**.

Comment 5
Comment 6

Both the borrower's and co-borrower's income documentation indicated that they had the potential for increased earnings above the wages reflected in the effective income. The Report suggests that, because the reflected earnings increases did not correspond exactly to the borrowers' increased earning payment, HUD requirements were not met. Pine State respectfully disagrees. HUD guidelines state that lenders must determine the potential for increased earnings, not that the borrowers are guaranteed to earn a certain amount of additional income during the buy-down period. In this instance, the loan file documented several sources of additional earnings by both the borrower and co-borrower, which evidenced their ability to manage the scheduled payment increases in connection with the interest rate buy-down. See HUD Handbook 4155.1 REV-5, ¶ 2-14(B)(2). Thus, this allegation should not be included in the Report.

Comment 7

c. – FHA Case No. 105-1953205

In the loan, contrary to the assertion in the Report, the loan file evidenced that the borrower had the potential to earn additional income that could be used to offset the increased mortgage payments. Importantly, the borrower's Verification of Employment ("VOE") and pay stub indicated that she earned overtime income that was likely to continue **(Exhibits C-1, C-2)**. This overtime income was not used to qualify the borrower and therefore could have been used to offset the additional future mortgage payments **(Exhibit C-3)**. Moreover, contrary to the Report's assertion that the borrower's income had decreased from 2003 to 2004, the loan file documentation indicates that the borrower's earnings had in fact increased. The borrower's W-2 form for 2003 reflected monthly wages of $3,542 **(Exhibit C-4)**. Even without the $572 earnings adjustment reflected on the borrower's April 16, 2004 pay stub, the borrower had monthly earnings for the first 3.5 months of 2004 of $3,745 **(Exhibit C-2)**, which was more than the underwriter included in effective income **(Exhibit C-3)**. Moreover, analyzing the borrower's additional income demonstrates that her income was increasing from year to year. Assuming the borrower earned the same $37,086 in base pay in 2003 as reflected on the VOE for her base pay in 2004 **(Exhibit C-1)**, her additional earnings would have averaged $452 per month.[3] The borrower's

[3] This amount was calculated by subtracting the $37,086 base pay reflected on the VOE **(Exhibit C-1)** from the borrower's total 2003 earnings of $42,509, as reflected on the 2003 W-2 form **(Exhibit C-4)**, and

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pay stub reflected total year-to-date additional earnings of $2,293 for the first 3.5 months of that year **(Exhibit C-2)**, which averages to $655 per month. This increasing additional income demonstrates that the borrower's earnings had in fact increased over the past two years, as well as that the borrower had the potential of additional increased income in the future. At the time this loan was approved, the underwriter reasonably determined that the borrower met at least one of the buy-down criteria and properly approved this borrower for FHA financing based on the buy-down rate. Thus, this allegation should be removed from the final Report.

Comment 8
Comment 6

d. – FHA Case No. 105-1956571

In this case, contrary to the allegation in the Report that the borrower's income only slightly increased in past years, the loan file demonstrated the borrower's potential for increased earnings. While the borrower's income increases in past years may have been small, the borrower's employer expressly stated in a letter to Pine State that the borrower was "an excellent employee and his outlook for increasing his income is promising" **(Exhibit D)**. The employer also indicated that the borrower was "a hard working man, well thought of and there is potential for increasing his income" **(Exhibit D)**. This documentation clearly evidenced his potential for increased income, which HUD guidelines expressly recognize as a factor to consider when determining whether a borrower will be able to absorb an increased mortgage payment. See HUD Handbook 4155.1 REV-5, ¶ 2-14(B)(2). In the loan, the borrower met this criterion, and the underwriter properly approved this loan using the buy-down rate. Therefore, this allegation should be removed from the final Report.

Comment 9

e. – FHA Case No. 105-1386555

In the loan, the Report asserts that the Company did not document the borrower's potential for increased earnings to offset a higher mortgage payment after the buy-down period expired. Pine State respectfully disagrees with this allegation. The loan file contained documentation from the borrower's employer in this case indicating that he would earn overtime wages and be paid various bonuses **(Exhibit E)**. While the amount of such bonuses was not included in the employer's letter, the information that was reflected clearly demonstrated that the borrower had the potential for increased income and thus satisfied HUD guidelines for qualifying this borrower using the buy-down rate. See HUD Handbook 4155.1 REV-5, ¶ 2-14(B)(2).

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multiplying the resulting number of $5,423 by 12 months, which resulted in a monthly average of $452 in additional income.

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Moreover, although the Report notes that the borrower had been on the job for a short time as a trainee, and questions the job and income stability of the borrower, HUD guidelines in place during the relevant period did not require lenders to establish these factors when analyzing whether a borrower met the Department's buy-down criteria. As indicated above, to determine whether a borrower will be able to absorb a higher mortgage payment, HUD requirements dictated that lenders must determine the potential for increased earnings. See id. The borrower's position as a trainee supported the fact that, as he progressed in his current position, he would move from trainee status to a higher position with increased wages. This potential for upward movement within his current job evidenced the possibility for increased earnings in compliance with HUD guidelines regarding buy-down criteria. Pine State complied with these requirements and properly determined that the borrower qualified for FHA financing in this case. As a result, we respectfully request that this allegation be removed from the Report.

Comment 10

f. – FHA Case No. 105-1606248

In the loan, the Report alleges that the borrowers' long-term debts would extend beyond the term of the buy-down agreement and, therefore, takes issue with the Company's determination that the borrower met at least one of the Department's buy-down criteria.

Pine State respectfully disagrees with this assertion. HUD guidelines provide that lenders may establish a borrower's ability to absorb an increased mortgage payment in a buy-down loan if a borrower has a demonstrated ability to manage financial obligations, which may include borrowers whose long-term debt will not extend beyond the term of the buy-down agreement. See HUD Handbook 4155.1 REV-4, CHG-1 ¶ 2-14(A)(4). In this instance, the borrowers had two outstanding debts **(Exhibit F-1)**. As acknowledged in the Report, one of these debts, which had a monthly payment of $145, would have been satisfied within approximately 10 months after closing **(Exhibit F-1)**, which was well before the interest rate buy-down period expired **(Exhibit F-2)**.[4] Thus, the borrowers would have these funds available to use toward the

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[4] With regard to this outstanding debt, although not raised in the Report or relevant to the determination of whether the borrower met the applicable buy-down criteria, Appendix D takes issue with the Company's calculation that this debt had less than ten payments remaining. The Report asserts that this debt should have been included in the borrower's qualifying ratios, which would have increased to an unacceptable level. The Company understands and appreciates that, when calculating a borrower's qualifying ratios, it must include all debts extending ten months or more. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-11(A). Pine State complied with this requirement in the loan. Appendix D asserts that merely dividing the $145 payment into the $1,381 outstanding balance reflected on the credit report does not account for interest payments due and, when considering interest, this debt would not be satisfied for at least 10 months. Pine State agrees with this assessment; however, the Appendix

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increased mortgage amount at the time the first adjustment was made pursuant to the buy-down agreement **(Exhibit F-2)**. With regard to the second debt of $291, while the debt would have extended a few months past the expiration of the buy-down agreement, the second adjustment under the agreement increased the borrowers' mortgage payment by only $86 **(Exhibit F-2)**. Additionally, the borrowers' tax return information from the IRS indicated that both their wages and total taxable income had increased from 2001 through 2002 **(Exhibit F-4)**. Thus, the loan file indicated that the borrower had the potential for increased earnings, which satisfied another of HUD's express buy-down criteria, and that the borrowers could have used this additional income to offset this relatively small mortgage payment increase. Moreover, the borrowers would have had the additional $291 in funds available to satisfy this small increase within a few months of the expiration of the buy-down period **(Exhibit F-1)**. For these reasons, Pine State maintains that the loan file documented that the borrowers met at least one of the buy-down criteria, and that the underwriter approved the borrowers in this case in compliance with HUD guidelines. We therefore respectfully request that this finding be removed from the final Report.

g. – FHA Case No. 105-1696401

Here, contrary to the allegation in the Report that the borrower did not demonstrate potential for increased earnings, Pine State satisfied at least one of the Department's buy-down criteria. With regard to the potential for increased earnings, while the borrower's income did not increase from 2002 to 2003, the loan file demonstrated that the borrower was a 22-year-old police officer who had begun this career only nineteen months earlier **(Exhibit G-1)**. Based on this information, the underwriter reasonably determined that this new police officer, who was just starting a career in a profession known to have routine advancement opportunities, had the potential for increased earnings as he progressed in his field and satisfied this buy-down criterion. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). Moreover, the borrower's credit report indicated that at least one of the borrower's long term debts, which had a minimum payment of $242, would be satisfied within approximately 20 months of closing and, as a result, would not extend beyond the term of the buy-down agreement **(Exhibit G-2)**. Thus, the borrower satisfied an additional buy-down criterion. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). As the loan file demonstrates

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calculates the time necessary to pay off the debt at issue from the date of the credit report, which was issued on September 8, 2003 **(Exhibit F-1)**. This loan did not close until October 24, 2003, almost two months after the credit report was issued **(Exhibit F-3)**. At that time, the borrowers would have made at least one, if not two, additional payments toward this debt and would have had less than ten payments left **(Exhibit F-1)**. For this reason, Pine State properly excluded the $145 debt from consideration of the borrowers' eligibility for FHA financing. As Pine State complied with HUD guidelines in this instance, this allegation should be removed from the Report.

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that the borrower qualified for the buy-down rate in this instance, indemnification would be inappropriate and we request that this assertion be removed from the Report.

Comment 12

h. – FHA Case No. 105-1072865

In this instance, contrary to the assertion in the Report that the borrower did not meet the applicable buy-down criteria, the loan file indicated that the borrower had demonstrated an ability to manage financial obligations in such a way that a greater portion of his income could be devoted to housing expenses. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). Loan file documentation indicated that the borrower's housing expenses actually decreased as a result of the FHA loan **(Exhibits H-1 and H-2)**. Thus, the underwriter reasonably determined that the funds saved in monthly housing costs, as well as the tax benefits of homeownership, allowed this borrower to devote a greater portion of his income to the increased mortgage payments. While the borrower's credit report reflected certain collection accounts, the Report acknowledges that these were paid prior to closing and, as a result, allowed the borrower to contribute additional funds to his housing expenses. Although the borrower had past credit issues, he had resolved these accounts prior to closing and had demonstrated his ability to use a greater portion of his income to satisfy housing expenses. For these reasons, the underwriter reasonably determined that the borrower qualified for FHA financing, and this allegation should be removed from the Report.

Comment 13

i. – FHA Case No. 105-0981353

Although Finding 1 takes issue with the borrowers' ability to absorb the increased mortgage payments, Pine State maintains that the borrowers in this case met at least one of the four buy-down criteria established by HUD.

The loan file indicates that the underwriter qualified the borrowers for this loan using monthly income of $3,605 **(Exhibit I-1)**. The borrower's pay statement, however, indicates that the borrower earned overtime not used for loan qualification, and reflected monthly earnings of $3,885 **(Exhibit I-2)**. While such overtime income was not documented for a two-year period and, as a result, could not be included in the effective income, the loan file clearly demonstrated that the borrower was earning overtime income and that he had the potential to continue to do so in the future. Contrary to the suggestion in the Report, HUD guidelines do not require lenders to document overtime earnings for a two-year period purposes of satisfying the Department's buy-down criteria. In this case, in compliance with HUD guidelines, the underwriter determined that the borrower had the potential for increased income based on the overtime reflected in the loan file, thus satisfying one of the four buy-down criteria set forth in HUD guidelines. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4).

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Moreover, during the OIG's audit, Pine State indicated that, in this case, the borrower's child support obligations would expire within a few years of closing, allowing the borrowers to devote a greater portion of their income to housing expenses. In response, the Report asserts that the borrower had over $20,000 in delinquent child support payments, and questioned the borrowers' ability to manage financial obligations. The loan file, however, contained a letter from the borrower's attorney indicating that these arrearages resulted from failure to properly notify the borrower of his child support obligations at the correct address and that he was in the process of filing a motion to vacate the judgment against the borrower in this regard **(Exhibit I-3)**. As the loan file indicated that any failure to make timely child support payments was a result of a miscommunication and not the borrower's inability to manage financial obligations, the underwriter reasonably determined that the borrower would be able to responsibly manage his finances and devote his additional overtime income and future funds not required for child support obligations to meet his increased housing expenses. Pine State complied with HUD requirements and reasonably determined that the borrowers in this case met at least one, if not two, of the Department's buy-down criteria. Thus, this finding should be removed from the Report.

j. – FHA Case No. 105-1751832

Comment 12

In the . loan, contrary to the assertion in the Report that the borrower did not meet the applicable buy-down criteria, the loan file indicated that the borrower had demonstrated an ability to manage financial obligations in such a way that a greater portion of his income could be devoted to housing expenses. <u>See</u> HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). The loan file documented that the borrower experienced only a minimal $50 housing expense increase as a result of this FHA loan **(Exhibit J-1)**, and had made timely payments of the comparable rent for the past 10 months **(Exhibit J-2)**. Moreover, as a result of the mortgage interest tax deduction, the borrower would have more funds available for housing costs as a result of homeownership. Therefore, the underwriter reasonably determined that this borrower could devote a greater portion of his income to the increased mortgage payments at the end of the buy-down period. <u>See</u> HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4).

While the Report acknowledges these facts, it questions certain insufficient funds checks issued by the borrower and take issue with the borrower's explanation regarding the reasons for the bounced checks. While the auditors may question the reasonability of the borrower's explanation, the underwriter exercised the discretion delegated by HUD to determine that any past issues regarding issuing checks resulted in confusion about pay dates rather than any intent to mismanage his funds. Moreover, any past confusion in this instance was resolved prior to closing. Thus, the underwriter reasonably concluded that the insufficient check issue in this case would not affect the

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borrower's ability to meet his housing obligations, especially when considering that the borrower's minimal housing payment increase and the tax benefits of homeownership would allow him to devote greater portions of his income to housing obligations. Pine State maintains that it complied with HUD guidelines in this case and that indemnification of this loan would be inappropriate.

Comment 14

k. – FHA Case No. 105-1644709

In the loan, contrary to the allegation that the borrower did not meet at least one of the Department's buy-down criteria, the loan file demonstrated that the borrower had the potential for increased income that would offset the scheduled payment increases. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). First, contrary to the assertion in the Report that the borrower's 2003 monthly earnings income had decreased by $436 from the previous year, the borrower's income had in fact increased. The borrower's 2002 W-2 form and VOE indicated earnings of $27,635 during the ten months the borrower was employed at his current job, which results in a monthly earnings average was $2,763 **(Exhibits K-1, K-2)**. The borrower's pay stub indicates $26,112 in year-to-date base earnings as of the end of September 2003 **(Exhibit K-3)**. This base income reflects average monthly income of $2,901 in that nine-month period. Thus, the loan file demonstrated that the borrower's base income was increasing and that he had the potential to continue to increase his earnings. Moreover, the pay stub reflected that the borrower earned additional overtime income **(Exhibit K-3)**, which further supported his potential to increase earnings to offset future mortgage payment increases. For these reasons, the underwriter reasonably determined that this individual met at least one of HUD's buy-down criteria, and properly underwrote the FHA loan in this case. As a result, this allegation should be removed from the final Report.

l. – FHA Case No. 105-1969307

Comment 12

Finally, in the case, contrary to the assertions in the Report, Pine State maintains that the borrower met at least one of the buy-down criteria set forth in HUD requirements. As acknowledged in Finding 1 and reflected in the loan file, the borrower's income had increased by $902. While Appendix D asserts that this additional income was insufficient to meet the total increase to the mortgage payment,

Comment 6

we are not aware of any requirement in HUD guidelines that a lender account for every dollar of the increased mortgage payment through additional income or assets. Rather, HUD requirements state the lenders must identify the "potential for increased earnings that would offset the scheduled payment increase." HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). Pine State did so in this case. The steady income increases that the borrower had experienced in past years evidenced his potential to continue expanding his income in the future, which would have assisted in offsetting the eventual

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mortgage payment increases in this case. In addition, the borrower's pay stub indicated that he received an automobile allowance **(Exhibit L-1)**, which Pine State did not use to qualify the borrower for FHA financing **(Exhibit L-2)**. Furthermore, the loan file documented that the borrower experienced only a minimal $18 housing expense increase as a result of this FHA loan **(Exhibit L-2)**, and as a result of the mortgage interest tax deduction, the borrower would have more funds available for housing costs. Based on these factors, the underwriter in this case reasonably determined that the additional funds received by the borrower through increasing income, the automobile allowance, and the tax benefits of homeownership demonstrated the borrower's potential for increased earnings that could be devoted to the eventual mortgage payment increases. The loan file documented that the borrower in this case met one of the Department's buy-down criteria, and the underwriter properly approved this borrower for the FHA loan pursuant to HUD requirements. Thus, indemnification in this case is unwarranted.[5]

2. **Income Documentation**

Comment 16

In five of the loans audited by the OIG, the Report contends that the Company overstated the borrowers' income. Pine State respectfully disagrees with the allegations in three of the cases included in this sub-finding. Our individual responses to these cases are set forth below.

a. – FHA Case No. 105-1380870

Comment 16

In the loan, this sub-finding alleges that the Company approved the borrower for FHA financing based on an effective income of $1,734; however, the borrower had held the position for only five months after a four-month employment gap, which was less than the required six months and not long enough to support stability of the income amount.

Comment 15

[5] Although not raised in the Report or relevant to the determination of whether the borrower met HUD's buy-down criteria, Appendix D indicates that a $142 debt payment was not used to calculate the borrower's qualifying ratios and "brings into question whether the loan should have been approved." While inclusion of an additional $142 debt would have increased the borrower's back-end ratio, the loan file evidenced several compensating factors that would have offset this higher-than-average ratio. For instance, as discussed above, the borrower was receiving additional income through an automobile allowance that was not included in the effective income, and had a minimal increase in housing expenses **(Exhibits L-1, L-2)**. HUD has recognized both of these items as factors that would compensate against higher qualifying ratios. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13. Therefore, Pine State maintains that, even if the referenced obligation had been included in the borrower's qualifying ratios, this individual nevertheless would have qualified for FHA financing.

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With regard to income documentation, Pine State understands and appreciates that a lender must verify the borrower's employment for the most recent two full years and obtain an explanation for any gaps in employment of a month or more. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-6. The Company also appreciates that, in cases in which a borrower has recently returned to work after an extended absence, the lender must confirm that the borrower has been employed in his or her current job for six months or more and document a two-year work history prior to the absence from the work force. Id. It is Pine State's policy and practice to comply with these requirements in all FHA loans, and we maintain that the Company did so in the loan.

Comment 16

Based on the allegations in this case, it appears that the Report is suggesting that the borrower's four-month gap in employment constituted an "extended absence" and that Pine State was required to comply with HUD's more stringent employment documentation requirements in this case. The Company respectfully disagrees with this suggestion. HUD guidelines anticipate that borrowers may experience short-term gaps for a few months at a time due to factors such as a relocation, familial commitments, or career changes. In these short-term circumstances, HUD guidelines require lenders to obtain explanations for these gaps and ensure that they are reasonable and supported by the loan documents; however, the Department does not impose the more stringent employment documentation requirements unless a borrower has been out of the work force for an extended period of time. See id. The example of such an extended absence given by HUD involves "a nurse that took several years off to raise children and is not returning to the nursing profession." Id. (emphasis added). Based on this provision, which uses the term "extended absence" to refer to a period of several years of unemployment, the Company has consistently understood that these additional requirements must only be met in situations in which borrowers have recently returned to work after a year or more of unemployment. As these facts were not present in the instant loan, the Company properly followed HUD's standard income documentation requirements to determine the borrower's income in this case.

Comment 16

Here, Pine State obtained a VOE from the borrower's current employer, which indicated that he had only been employed with that company since March of 2003 **(Exhibit A-1)**. To document the borrower's two-year employment history, the Company obtained a verbal VOE from the borrower's previous employer, Blockbuster, which demonstrated that he had been employed with that entity from August of 1998 through November of 2002 **(Exhibit M-1)**. Because these documents reflected a four-month gap in employment, Pine State obtained an explanation of this employment gap from the borrower. In that document, the borrower indicated that he and his wife had relocated from Maryland to Georgia to care for a seriously ill family member **(Exhibit M-2)**. This documentation established the borrower's two-year employment history in compliance with HUD guidelines. Under these requirements, the Department expressly

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states that it does not "impose an arbitrary minimum length of time a borrower must have held a position to be eligible." HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-6. Based on this directive, and the fact that the borrower's VOE indicated that his current employment was likely to continue, Pine State reasonably included $1,734 in monthly income on the MCAW **(Exhibit M-3)**, based on the earnings reflected on the VOE **(Exhibit A-1)**. Pine State complied with HUD guidelines in documenting and evaluating the borrower's income in this case, and this allegation should be removed from the final Report.

b. – FHA Case No. 105-2032130

Comment 16

In this case, the Report alleges that the co-borrower's income of $1,343 should not have been included in the effective income because the co-borrower had an unstable employment history and had worked for the employer less than three months. The Report further asserts that, although the VOE indicated that overtime was likely to continue, the VOE did not state that the co-borrower's employment was likely to continue and the Company should have obtained a response from the employer to this question prior to loan approval. The Report concludes that, without this income, the borrowers' qualifying ratios increased to an unacceptable level.

Comment 16

As discussed above, with regard to income documentation, Pine State understands and appreciates that a lender must verify the borrower's employment for the most recent two full years. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-6. Pine State did so in this case. As indicated in the Report, the Company obtained a VOE and pay stub from the borrower's current employer, which indicated that he had been employed as a sheet metal worker for approximately three months prior to closing **(Exhibit N-1)**. To document the borrower's two-year employment history, the Report acknowledges that the Company obtained evidence that the borrower had been employed by a department store and as an assistant manager of a restaurant for the remainder of the two-year period, except for approximately a month of unemployment between these positions **(Exhibit N-2)**. HUD requirements expressly state that "*income* stability takes precedence over *job* stability." HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-6 (emphasis in original). Based on this guidance and Pine State's review of the borrower's employment documentation, the Company determined that it had sufficiently documented the borrower's current and previous income stability.

Comment 16

With regard to the likelihood of the co-borrower's continuance in his current position, the Company appreciates that the employer did not complete the section of the VOE entitled "Probability of Continued Employment." This practice is common among employers, however, as companies are often concerned that completion of this information will imply a guarantee of employment to its employees. Nevertheless, the Report does not allege, and there is no evidence to suggest, that the co-borrower's

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employment was not likely to continue. In fact, the VOE indicated that he was eligible for a salary increase in August of 2004 and that overtime income was likely to continue **(Exhibit N-1)**. These factors indicated that the borrower would continue to hold this position after loan closing. Based on this information, the underwriter reasonably determined that the co-borrower had established a two-year job history and that his current income was likely to continue. Thus, the Company properly included this individual's earnings in the effective income **(Exhibit N-3)**, and the qualifying ratios were not overstated in this case.

Comment 16

In addition to the allegations regarding the co-borrower's job stability, the Report also indicates two minor issues with the loan file documentation. With regard to the borrower's overtime income in this case, although Pine State used a conservative $389 per month figure to qualify the borrowers when the loan file supported $415 in monthly overtime, the Report asserts that the loan file should have contained support for the actual overtime amount Pine State used to approve the loan. The Company understands and appreciates the importance of accurately portraying all information in the loan file and including explanations for all figures used to qualify a borrower for FHA financing. We have counseled our employees on the importance of providing accurate information on all loan documents and including written support for all calculations in the file. Nevertheless, any inaccuracy in this instance resulted in, at worst, harmless error, as the borrower earned a higher amount of overtime income than was used to qualify the loan applicants in this case. Finally, the Report asserts that, with regard to another co-borrower, the Company included $1,504 in effective monthly income, but did not confirm that this income was likely to continue. As discussed above, employers often do not provide such information to lenders or their employees. Nevertheless, there was no indication in the loan file that this co-borrower's employment was unlikely to continue, and the co-borrower had been employed by the same company for the past nineteen months **(Exhibit N-4)**. Therefore, we believe that Pine State complied with HUD requirements and properly included these earnings in the effective income in this case **(Exhibit N-3)**.

Comment 16

In summary, Pine State complied with HUD requirements in analyzing and documenting the borrowers' income in the Therefore, the allegations regarding income assessment in this case should be removed from the final report.

c. – FHA Case No. 105-2020030

Comment 16

In this case, the Report alleges that the borrower's effective income was overstated by $688, which includes: (1) $478 in improperly included overtime earnings from a position held by the borrower for only ten months without evidence that such earnings were likely to continue; and (2) $210 in child support income that was not documented, as the loan file did not contain a final divorce decree or other agreement

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setting forth the legal basis for the payments or an explanation regarding the sporadic payment history of the child support income evidenced in the file. Without the $688 in effective income, the Report asserts that the borrower's qualifying ratios increased to an unacceptable level. We address each of these issues below.

i. Overtime Income

Comment 16

With regard to the borrower's overtime income, Pine State respectfully disagrees with the allegation that such income should not have been used to qualify the borrower in this case. HUD guidelines generally permit the use of overtime income to qualify a borrower when these earnings can be documented for the past two years. See HUD Handbook 4155.1 REV-5, ¶ 2-7(A). While the loan file does not document a two-year history of overtime income in this case, the loan file contains evidence of consistent overtime income for ten months between the borrower's start date of August 12, 2003 **(Exhibit O-1)**, and the settlement date of July 30, 2004 **(Exhibit O-2)**. HUD guidelines permit lenders to consider overtime income earned for periods of less than two years, provided that the underwriter adequately justifies and documents his or her reason for using the income for qualifying purposes. Id. In this instance, the loan file contained substantial evidence that the borrower had received regular overtime income in her employment with All Medical Personnel, and would continue to do so. The letter from the borrower's employer indicated that the borrower had been extended an offer of permanent employment with the company and was in the process of completing the paperwork to make that transition **(Exhibit O-3)**. The verbal VOE contained in the loan file also indicated that the borrower's probability of continued employment was "good" **(Exhibit O-4)**. With regard to overtime in this position, the employer's letter indicated that the borrower earned overtime at a rate of $18 per hour **(Exhibit O-3)**. In addition to this evidence of overtime and its probability of continuance, the borrower's pay stubs reflected that she in fact earned such income on a regular and consistent basis. Each of the seven pay stubs included in the loan file indicate that the borrower earned approximately $150 in overtime income on a weekly basis **(Exhibit O-5).**

Comment 16

Based on this documentation, the borrower earned approximately $600 in overtime income on a monthly basis **(Exhibit O-5)**. As the borrower had only been employed in this position for ten months, the underwriter used a conservative estimate of $487 in overtime to qualify the borrower **(Exhibit O-6)**. Pine State acknowledges that the underwriter should have documented on the MCAW the reasons for using the overtime income, which included the facts that this income: (1) was evidenced in the employer letter and on every pay stub included in the loan file; (2) was likely to continue; and (3) was typical for this type of employment **(Exhibit O-4)**. These factors, however, were clearly evidenced in the loan file. Thus, while the overtime income was not documented for a period of two years, Pine State complied with HUD guidelines in this

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case and was justified in using the borrower's overtime income to qualify him for the loan. This allegation should therefore be removed from the Report.

ii. Child Support Income

Comment 16

With regard to child support income, FHA guidelines require lenders to document such income by obtaining: (1) a copy of the divorce decree, legal separation agreement or voluntary payment agreement; and (2) evidence that the payments have been received during the last twelve months. See HUD Handbook 4155.1 REV-5, ¶ 2-7(F). In this case, the loan file contained statements from the Suffolk Support Collection Unit evidencing that the borrower received payments of approximately $296 in child support every month for seventeen months prior to closing **(Exhibit O-7)**. The seventeen months of timely payments evidenced the payor's ability and willingness to make the child support payments in this case. For this reason, the underwriter determined that it was reasonable to include this child support income in the borrower's effective earnings. As the most recent payments had been for $210, the underwriter used this more conservative amount to qualify the borrower for FHA financing **(Exhibit O-6)**. Nevertheless, Pine State acknowledges that the loan file did not contain a copy of the court order or other legal document requiring the payor to make these monthly child support payments or an explanation regarding the fluctuation in the payment amount. The Company has reminded its employees of their obligation to obtain such documentation and we are confident that any oversight in this regard will not recur. That said, the loan file evidences that the borrower had in fact received consistent child support income for seventeen months prior to loan closing, and there was no reason to question that the borrower would not continue to receive such funds. Thus, any oversight in this case was harmless.

Comment 16

Moreover, even if the $210 child support payment had not been included in the effective income, the borrower in this case would have qualified for FHA financing. Without the child support income, the borrower's qualifying ratios would have increased to 44%/44% **(Exhibit O-6)**. While these ratios would have been in excess of HUD guidelines, the loan file evidenced significant compensating factors to offset these higher-than-average ratios. Importantly, the borrower used proceeds from the sale of her prior home **(Exhibit O-8)** to make a $39,177 downpayment in this case **(Exhibit O-2)**, and had over $8,000 in reserves after closing **(Exhibits O-6, O-8)**. The Department has recognized both significant downpayments toward the purchase of the property and substantial cash reserves after closing as compensating factors. See HUD Handbook 4155.1 REV-5, ¶ 2-13. Moreover, as a result of the substantial downpayment, the loan-to-value ratio in this case was only 83% **(Exhibit O-6)**. The loan file also evidenced that the borrower had been employed in the same industry for the two years prior to closing **(Exhibit O-9)**. Based on these significant compensating factors, even if the child

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support had been excluded from effective income, the borrower would have qualified for the FHA loan. Therefore, the request for indemnification of this case should be removed from the final Report.

3. Debt Assessment

Comment 16

In six cases, the Report alleges that the Company did not consider and/or properly assess borrower debts prior to loan approval. Pine State respectfully disagrees with the allegations and recommendations in four of the cases included in this sub-finding. Our individual responses to these cases are set forth below.

a. – FHA Case No. 105-1380870

Comment 16

In the loan, the Report asserts that the loan file did not include explanations for two inquiries on the borrowers' credit report at the time of loan approval that resulted in two new loans, one with a $358 monthly payment and another with a $21 monthly payment.

Comment 16

With regard to analyzing a potential borrower's credit, Pine State understands and appreciates that it must obtain an explanation from the borrower regarding all inquiries shown on a credit report obtained prior to closing. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3(B). It is the Company's policy and procedure to do so, and we have reminded our employees of the importance of this analysis in response to the OIG's audit. Nevertheless, any oversight in this case regarding the lack of explanations for the two referenced debts constituted, at worst, harmless error. As acknowledged in the Report, the $358 monthly payment reflected a car loan that replaced a previous car loan reflected on the borrowers' credit report at the time of loan approval **(Exhibit P)**. Pine State used the monthly debt amount reflected for the initial car loan, which was $462, to qualify the borrowers in this case. As that monthly payment of $462 was more than the $358 monthly payment on the new car loan, the resulting loan would have caused the borrowers' qualifying ratios to decrease **(Exhibit A-1)**. Moreover, the second new debt resulted in a $21 monthly payment. Had Pine State obtained an explanation for this credit inquiry and included the resulting debt in the calculation of the borrower's ratios, the ratios would have only slightly increased to 27%/45%. While the back-end ratio would have slightly exceeded HUD guidelines, the loan file demonstrated compensating factors that would have offset this higher-than-average ratio. As discussed above, the borrowers had the potential for increased earnings that were not included in the effective income **(Exhibits A-1, A-2)**. Moreover, the underwriter noted on the MCAW that the borrowers had acceptable credit scores, which HUD has recognized as a compensating factor **(Exhibit M-3)**. See Mortgagee Letter 97-26. For these reasons, we believe that indemnification is inappropriate and request that this recommendation be removed from the Report.

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b. – FHA Case No. 105-1769305

Comment 16

In this loan, the Report alleges that the Company did not obtain an explanation from the borrower regarding a credit inquiry made in December of 2003 which resulted in an additional $306 monthly debt for a car loan, which was reflected on a credit report Pine State obtained in 2005 during its Quality Control review process. The Report asserts that inclusion of this debt in the borrower's debt-to-income ratios would have raised these figures to unacceptable levels.

Comment 16

Pine State understands and appreciates that based on the requirements in place at the time this loan was approved, it was responsible for obtaining a written explanation from the borrower regarding all inquiries shown on the credit report in the last 90 days, which would have included the credit inquiry at issue. See HUD Handbook 4155.1 REV-5, ¶ 2-3(B). In connection with loans underwritten by automated underwriting systems, however, FHA guidelines state that the lender is accountable for documentation aspects not addressed in the user's guides provided by the automated underwriting system's creator. See Mortgagee Letter 99-26. The loan was underwritten using Fannie Mae's Desktop Underwriter ("DU"). The user's guide for DU dictated the credit-related documentation lenders must obtain in loans underwritten with this system. See Fannie Mae Desktop Underwriter Guide, CH. 2. Verification messages are provided on the Fannie Mae Underwriting Findings report requiring the specific credit documentation required in each case. Based on these directives, in loans underwritten by DU, Pine State obtained the documentation indicated in the verification messages provided in the Underwriting Findings Reports.

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The loan received an Approve/Eligible recommendation from DU, indicating that the loan met both credit risk and eligibility requirements. Pine State complied with the verification messages on the Underwriting Findings report with regard to credit documentation, which indicated that "new debts resulting from material inquiries listed on the credit report" must be included in the debt ratios, but that "no explanation of these inquiries is required" **(Exhibit Q-1)**. Because the new debt at issue was not established until after closing **(Exhibit Q-2)**, it was not required to be included in the qualifying ratios prior to loan approval, and the Underwriting Findings Report did not require Pine State to obtain an explanation regarding the inquiry from the borrower. Therefore, the loan file contained all necessary credit documentation in accordance with DU requirements. Nevertheless, the Company understands and appreciates the importance of obtaining explanations from borrowers regarding all credit inquiries, regardless of whether the DU system required such documentation. Thus, it is Pine State's current policy to obtain such explanations prior to closing for all credit inquiries. Nevertheless, as noted above, the debt referenced in the Report was not issued until after loan closing **(Exhibit Q-2)**. Therefore, even if Pine State had obtained an

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explanation from the borrower, that document likely would have indicated that no additional debt had been accumulated prior to closing, and the borrower's qualifying ratios would have remained the same as those reflected on the MCAW **(Exhibit Q-3)**.

Comment 16
Comment 18

In summary, Pine State maintains that it complied with applicable HUD guidelines and DU instructions at the time of loan approval in this case. Thus, the Company believes that indemnification would be unwarranted and requests that the allegations in this loan be removed from the final Report.

c. – FHA Case No. 105-1587099

Comment 16

In the case, the Report asserts that the loan file did not include an explanation for one credit inquiry that resulted in an additional $39 monthly debt prior to closing, as confirmed by a credit report obtained during Pine State's Quality Control review process.

Comment 16

With regard to analyzing a potential borrower's credit, as indicated above, Pine State understands and appreciates that it must obtain an explanation from the borrower regarding all inquiries shown on a credit report obtained prior to closing. <u>See</u> HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3(B). It is the Company's policy and procedure to do so, and we have reminded our employees of the importance of this analysis in response to the OIG's audit. Nevertheless, any oversight in this case constituted, at worst, harmless error. As acknowledged in the Report, the new debt resulted in a $39 monthly payment. Had Pine State obtained an explanation for this credit inquiry and included the resulting debt in the calculation of the borrower's ratios, the ratios would have only slightly increased to 35%/48% **(Exhibit B-5)**.[6] While these ratios exceeded HUD guidelines, the loan file demonstrated compensating factors that would have offset this higher-than-average ratio. As discussed above, the co-borrower earned overtime income that was not included in the effective income **(Exhibit B-4)**. HUD guidelines state that income not reflected in the borrower's effective income but directly affecting the ability to pay the mortgage may compensate for higher-than-average qualifying ratios. <u>See</u> HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13. Moreover, the underwriter noted on the MCAW that the borrowers had acceptable credit scores, which HUD has recognized as a compensating factor. <u>See</u> Mortgagee Letter 97-26. For these reasons, we believe that indemnification is inappropriate and request that this recommendation be removed from the Report.

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[6] As discussed above, Pine State maintains that it properly underwrote the loan at the buy-down interest rate and, therefore, disagrees with the qualifying ratio cited in Appendix F of the Report. The MCAW indicates that the borrowers' back end ratio was 47%, and the addition of the $39 debt would have minimally increased this ratio to 48% **(Exhibit B-5)**.

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d. – FHA Case No. 105-1728585

Comment 16

In this loan, the Report alleges that: (1) the borrower's monthly debts were understated by $680, which would have resulted in a back-end ratio of 44%, because the Company omitted debts or did not use the most recent payment terms in its calculations; and (2) that the borrowers had experienced some credit problems, including a delinquent account and judgment that the Company required to be paid prior to closing.

Comment 16

With regard to the calculation of a borrower's debts, the Company consistently has required its underwriters to examine all of a borrower's outstanding liabilities, such as installment loans, revolving charge accounts, child support and student loans, extending ten months or more from closing when determining whether a particular borrower qualifies for FHA financing. See HUD Handbook 4155.1, REV-5, CHG-1, ¶ 2-11(A). To the extent that the underwriter did not consider all of the borrower's current debts in this case, such practice was against Company policy, and Pine State has reminded all of its underwriters of the importance of ensuring that all of a borrower's current debts and payment amounts are considered and used to calculate the qualifying ratios in each FHA loan underwritten by Pine State. We are confident that any issues identified in the Report have been resolved. That said, with regard to the loan, any oversight with regard to analyzing the borrowers' debt resulted in, at worst, harmless error. The Report indicates that including the additional debts would have increased the borrowers' back-end ratio to 44% **(Exhibit R-1)**. The loan file demonstrates, however, that significant compensating factors present in this case would have offset this higher-than-average ratio. For instance, the MCAW indicates that obtaining the FHA loan reduced the borrowers' monthly housing obligation by over $150 **(Exhibit R-1)**. FHA requirements state that a minimal increase in the borrower's housing expense also compensates against higher qualifying ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(F). Here, the transaction actually provided housing payment relief to the borrowers. The MCAW also demonstrated that the borrower had stable income **(Exhibit R-1)**. These compensating factors more than offset the higher qualifying ratios that would have resulted from inclusion of the additional debt in the borrowers' ratios.

Comment 16

With regard to the past credit issues reflected in the loan file, Pine State understands and appreciates that lenders are required to analyze a borrower's past credit record to determine whether past derogatory items resolved from a disregard for, or an inability to manage, financial obligation, or to factors beyond the control of the borrower. See HUD Handbook 4155.1 REV-5, ¶ 2-3. It is Pine State's policy to carefully scrutinize a borrower's credit history and to examine the borrower's overall

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pattern of credit behavior. See HUD Handbook 4155.1 REV-5, ¶ 2-3. Contrary to the Report's suggestion, Pine State complied with this requirement in the loan.

Comment 16

In this case, while the borrower's credit report evidenced a delinquent account and judgment, the nature of the debt and the total amount outstanding did not suggest that the borrower was a credit risk. Specifically, the accounts were incurred in 2000 **(Exhibit R-2)**, which was over four years prior to loan closing on January 15, 2004 **(Exhibit R-3)**, and amounted to only $1,794 in outstanding debt. The borrower also indicated that she had a serious accident in 2002 and was unable to work for a period of time, which may have contributed to the delinquent account reflected on the credit report **(Exhibit R-4)**. Based on the small outstanding balance and age of these accounts, the underwriter reasonably determined that these items did not reflect the borrower's current ability to manage her finances. Moreover, although HUD does not require that a borrower satisfy delinquent accounts prior to closing, see HUD Handbook 4155.1 REV-5, CHG-1, ¶ 2-3, the underwriter in this instance required the borrower to pay off these two accounts to demonstrate her ability to take responsibility for outstanding obligations. As acknowledged in the Report, the borrower satisfied both of these accounts in full at closing **(Exhibits R-4, R-5)**, evidencing her commitment to honor her financial responsibilities.

Comment 16

In summary, any oversight with regard to calculation of the borrowers' recurring debts in this case was harmless, as any additional debt only slightly increased the housing ratios, which were more than offset by compensating factors documented in the loan file. Moreover, although the borrowers' had experienced certain past credit issues, the underwriter reasonably determined that the borrower had taken responsibility for her obligations, corrected any past issues prior to closing, and demonstrated an acceptable credit risk. For these reasons, Pine State respectfully requests that the indemnification recommendation in this instance be removed from the final Report.

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4. Credit Analysis

In four loans, the Report takes issue with the Company's evaluation of the borrowers' creditworthiness, and indicates that each of the borrowers' credit histories involved collections, judgments, and/or delinquent accounts.

Pine State respects the importance of analyzing a borrower's credit performance and examining his or her attitude towards credit obligations. It is Pine State's policy and practice, with respect to every FHA applicant, to scrutinize the applicant's credit record and reasonably determine the potential borrower's creditworthiness. Given the potential risks not only to the Department, but to the Company, of making a poor credit decision, the Company's management endeavors to monitor underwriting performance and provide ongoing training to employees on the issue of credit analysis. Pine State's

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employees take their underwriting responsibilities seriously and understand that they will face severe consequences for unsatisfactory analysis of borrower credit. Pine State never would knowingly jeopardize the Company's stability or its relationship with the Department.

That being said, we note that HUD delegated to FHA lenders the responsibility for analyzing a borrower's credit and determining an individual's creditworthiness. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3; see also HUD Handbook 4155.1 REV-5, ¶ 2-3. While HUD has established specific guidelines, credit analysis remains largely subjective. For example, where derogatory credit items are present, lenders have discretion to consider the borrower's unique circumstances and determine whether financing is appropriate. As the Department has recognized that underwriting is more of an art than a science and requires the careful weighing of the circumstances in each individual case, it is Pine State's policy to carefully scrutinize a borrower's credit history to obtain any documentation or explanation necessary to assess a borrower's credit risk. See Mortgagee Letters 00-24 and 95-07; see also HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3; HUD Handbook 4155.1 REV-5, ¶ 2-3. While two underwriters may make different decisions about a borrower's credit in the same case, both underwriters may have complied with FHA requirements and made reasonable underwriting decisions. Pine State takes its underwriting responsibility seriously and would never knowingly approve a loan to an unqualified borrower.

Comment 16

In the cases cited in the Report, Pine State complied with FHA guidelines by examining the borrowers' overall pattern of credit behavior and reasonably determining that the borrowers qualified for FHA financing. The Company properly considered each borrower's previous housing obligations, recent and/or undisclosed debts, collections, judgments, and bankruptcies, and Pine State underwriters reasonably determined that past derogatory items did not reflect a current disregard for financial obligations. The loan files contain required documentation and Pine State prudently exercised the discretion granted to it by the FHA. As discussed below, the borrowers in these cases generally were hard-working individuals who took responsibility for their financial obligations. As a result, Pine State adhered to FHA requirements by reasonably determining that the borrowers were creditworthy and qualified for FHA loans. We address a representative sample of the cited loans below.

a. – FHA Case No. 105-1380870

Comment 19

In the loan, Finding 1 alleges that the loan file did not contain an explanation regarding five insufficient funds checks that appeared on the borrower's bank statement in June 2003, when the borrower had been employed for only five months after a four-month gap to care for sick family members. Based on a review of the borrower's credit history after closing, which indicated that the borrower filed for

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bankruptcy and cited excessive obligations as the reason for default, the Report suggests that the borrower may have bought the house before fully recovering from the employment gap.

Comment 16

In this loan, the underwriter analyzed the totality of the borrower's credit history in accordance with HUD guidelines and the discretion afforded in such cases. As you know, when analyzing the borrower's credit record, a period of financial difficulty in the past does not necessarily equate to an unacceptable credit risk. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3; see also HUD Handbook 4155.1 REV-5, ¶ 2-3. When delinquent accounts are present, a 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. Id.

Comment 19

With regard to the borrower's credit history in this case, Pine State obtained two explanations regarding the derogatory credit items in the loan file **(Exhibits M-2, S)**. Contrary to the assertion in the Report, one of the borrower's letters did contain an explanation for the insufficient funds checks **(Exhibit M-2)**. In that communication, the borrower indicated that the insufficient funds checks resulted from fraudulent activity in his checking account, which he reported to his banking institution and resolved prior to closing **(Exhibit M-2)**. With regard to the gap in employment and additional derogatory items, as discussed above and acknowledged in the Report, these circumstances resulted from the borrower's relocation to care for sick relatives. Based on this information, the underwriter reasonably determined that the derogatory items resulted from circumstances outside of the borrower's control, rather than a lack of financial discipline. Moreover, the borrowers provided detailed explanations of their efforts to resolve all outstanding derogatory issues and maintain stable finances prior to closing **(Exhibits M-2, S)**. Based on the information available at the time of loan approval, the underwriter reasonably determined pursuant to HUD guidelines that the borrowers in this case had resolved past credit issues and qualified for FHA financing.

Comment 16

To the extent that the borrower suffered financial setbacks after closing that led to bankruptcy, the underwriter made a sound decision at the time of loan approval that such circumstances were not likely. Nevertheless, the Report asserts that a short four-month gap in employment, which the underwriter had thoroughly analyzed prior to loan approval, should have predicted the borrowers' subsequent filing for bankruptcy. Based on this allegation, it appears that the Report is attempting to hold Pine State responsible for actions that occurred after closing that were not foreseeable at the time of underwriting. HUD guidelines do not hold lenders subject to such "hindsight" analysis, but rather require lenders to review the entire loan file and make a determination based on their judgment and experience whether the borrower is creditworthy and has the willingness and capacity to repay the FHA loan. See HUD Handbook 4155.1 REV-4,

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CHG-1, ¶ 2-3. Pine State complied with these directives in this instance and to hold the Company responsible for the borrower's post-closing actions would be contrary to HUD guidelines and the spirit of the FHA program. Therefore, this allegation and the recommendation for indemnification of HUD in connection with this loan should be removed from the final Report.

b. – FHA Case No. 105-2020030

Comment 16

In this case, the Report asserts that the Company did not assess the borrower's poor credit performance following a release from bankruptcy in May of 2001, and the borrower opened three accounts between January and June of 2001 that were delinquent when the Company pulled the borrower's credit report. Although Pine State required the borrower to satisfy these three accounts, which totaled $1,556 in outstanding debt, Finding 1 alleges that the loan file did not document compensating factors that the Company considered to offset the borrower's poor credit performance.

Comment 16

It is Pine State's policy to carefully scrutinize a borrower's credit history and to examine the borrower's overall pattern of credit behavior. <u>See</u> HUD Handbook 4155.1 REV-5, ¶ 2-3. In this case, while the borrower's credit report evidenced three delinquent accounts, the nature of the debt and the total amount outstanding did not suggest that the borrower was a credit risk. Specifically, although these accounts were opened subsequent to a bankruptcy in 2001, the accounts were incurred over three years prior to loan closing on July 30, 2004 **(Exhibit O-6)**, and amounted to only $1,556 in outstanding debt. Based on the small outstanding balance and age of these accounts, the underwriter reasonably determined that these items did not reflect the borrower's current ability to manage her finances. Moreover, although HUD does not require that a borrower satisfy delinquent accounts prior to closing, <u>see</u> HUD Handbook 4155.1 REV-5, CHG-1, ¶ 2-3, the underwriter in this instance required the borrower to extinguish these three accounts to demonstrate her ability to take responsibility for outstanding obligations. As acknowledged in the Report, the borrower satisfied all three of these accounts in full at closing **(Exhibit T)**, evidencing her commitment to honor her financial responsibilities.

Comment 16

In addition, contrary to the allegation in Finding 1, the loan file contained other evidence of compensating factors that supported the underwriter's determination of creditworthiness in this case. As discussed above, the borrower used proceeds from the sale of her prior home **(Exhibit O-8)** to make a $39,177 downpayment **(Exhibit O-2)**, and had over $8,000 in reserves after closing **(Exhibits O-6, O-8)**. The Department has recognized both significant downpayments toward the purchase of the property and substantial cash reserves after closing as compensating factors. <u>See</u> HUD Handbook 4155.1 REV-5, ¶ 2-13. Moreover, as a result of the substantial downpayment, the loan-to-value ratio in this case was only 83% **(Exhibit O-6)**. The loan file also evidenced that

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the borrower had been employed in the same industry for the two years prior to closing **(Exhibit O-9)**. Based on these significant compensating factors, and the fact that the borrower had no recent delinquent accounts and had satisfied her older delinquent debts, the underwriter reasonably determined that any past credit problems did not pose

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a risk to the borrower's ability to make regular mortgage payments. Thus, we believe that indemnification is not appropriate in this loan and that this case should be removed from the Report.

5. <u>Quitclaim Transfers</u>

Comment 20

In this sub-finding, the Report alleges that, in two loans, the Company submitted loan files for FHA insurance endorsement when it knew or should have known that the borrowers had inappropriately quitclaimed their interest in the property to individuals not listed on the loan application or evaluated for purposes of FHA loan qualification. These two cases are: (1) **– FHA Case No. 105-1817383**; and (2) **– FHA Case No. 105-1728585**. Although the Report acknowledges that Pine State did not have knowledge of the property transfers at or before closing, Finding 1 asserts that the Company should have determined that these transfers occurred between loan closing and submission of the case binder to HUD for insurance endorsement.

Comment 20

Pine State understands and appreciates that FHA lenders are required to resolve all problems regarding title to the real estate and to review all documents to assure compliance with all conditions of the commitment prior to submitting the loan to HUD for FHA insurance endorsement. <u>See</u> HUD Handbook 4155.1 REV-5, ¶ 3-10. It is the Company's policy and practice to ensure that the settlement agent closes all FHA loans in the same manner in which Pine State underwrote and approved the loans, and does not permit additional signatures on the security instruments of individuals who were not reviewed during the underwriting process. <u>See</u> <u>id.</u> Pursuant to HUD requirements, Pine State does not allow an individual to take an ownership interest in the property secured by an FHA loan at settlement without signing the mortgage note and all security instruments. <u>Id.</u> ¶ 2-2(A).

Comment 20

To ensure compliance with these requirements, the Company's closing instructions expressly instruct the settlement agent to close the loan in compliance with HUD guidelines, which set forth the above directives. In both of the loans at issue, the Company's closing instructions set forth the following directions for the closing agents:

> You [the settlement agent] are to close in accordance with existing Federal and State Laws pertaining to Real Estate transactions, regulations of the Insuring or Guarantee agencies, conditions of said agencies commitment and our specific loan closing instructions. The Federal and

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State laws before mentioned include, but are not limited to … the Department of Housing and Urban Development.

Comment 20

Based on these directions, the settlement agents were prohibited from allowing the borrowers and other individuals in the two referenced cases from executing quitclaim deeds. To the extent that such deeds were executed and included individuals who were not listed on the loan application or analyzed during the underwriting process, the settlement agent did so in contravention of Pine State's express instructions to close the loan pursuant to HUD requirements and without the Company's knowledge or consent. Had Pine State been aware of this behavior on the part of the settlement agent, it would not have permitted that entity to close these FHA transactions. However, the Company was unaware of the settlement agent's actions in these two cases at the time of closing, and could not control that entity's actions other than through the express closing instructions it provided, which the settlement agent appears to have ignored.

Comment 20

To the extent that the Company received evidence of the quitclaim deeds after closing and prior to submission of the case binder to HUD for FHA insurance endorsement, these documents would have been handled by the Company's post-closing processors and shippers. While these individuals' responsibilities include ensuring that all documents required by HUD for insurance endorsement are contained in the case binder, at the time the two loans at issue were originated, these employees were not skilled in identifying documents, such as quitclaim deeds, submitted by third-party settlement agents that would raise questions regarding the loan's eligibility for FHA insurance. In these two cases, while these employees may have received the quitclaim deeds from the settlement agent, they did not recognize these items as problematic and no member of the Company's underwriting department or senior management team was aware that the quitclaim deeds at issue had been executed or included in the loan files. In fact, in these two cases, Pine State was not aware that these documents existed until its third-party Quality Control reviewer, AMN Mortgage Services, LLC ("AMN"), notified the Company's internal Quality Control department during a routine Quality Control review of these files. In response to these findings, Pine State has provided training to its post-closing processors and shippers regarding the impermissibility of such quitclaim deeds in FHA loan files and instructed these individuals to halt processing of the case binder and notify Company management in the event that such documents are identified in future FHA loan files. Nevertheless, in the two cases at issue, the Company's management, underwriting staff and Quality Control department had no knowledge regarding the execution of the quitclaim deeds either at closing or prior to submission of the case binder to HUD for insurance endorsement. For these reasons, we believe that indemnification in these two cases would be inappropriate.

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That said, in response to these findings, Pine State has contacted the settlement agent responsible for closing these two loans, informed that entity of the Company's disapproval of such practices, and requested an explanation regarding these two closings **(Exhibit U-2)**. Pine State has also put this settlement agent on notice of possible indemnification due to the actions taken in these two cases. In an effort to ensure that such contravention from the Company's written directives does not recur in FHA settlements, Pine State has also revised its closing instructions to expressly state that the closing agent "shall not allow borrowers to execute a Quit Claim or Warranty Deed on the subject property without written approval from Lender. FHA prohibits a borrower from relinquishing all or partial title if that person is not on the mortgage note" **(Exhibit U-3)**. Finally, as indicated above, Pine State has provided training to its post-closing processors and shippers regarding the impermissibility of such quitclaim deeds in FHA loan files. These individuals have been instructed to halt the shipment of a case binder to HUD in the event that such a document is contained in the loan file, and to inform Pine State's management regarding the presence of such documentation so that any issues regarding title can be resolved prior to submission of the case binder for FHA insurance endorsement. We are confident that these steps will ensure that any oversights in connection with the two loans cited in this sub-finding do not recur.

6. Gift Transfer Documentation

Finally, in seven cases, Finding 1 asserts that the loan files did not contain proper verification that gift funds had been paid to closing agents.

As you know, FHA guidelines require a lender to verify and document the transfer of gift funds used by a borrower. When a borrower receives a traditional gift from a relative, HUD requirements instruct lenders to obtain either evidence that funds have been deposited into a borrower's account before closing or a verification of receipt of the funds from the settlement agent. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-10; see also HUD Handbook 4155.1 REV-5, ¶ 2-10(C). In all seven of the cases referenced in this sub-finding, however, the borrower's obtained "gifts" in the form of downpayment assistance. At the time the loans at issue were originated, Page 2-11 of HUD's Single Family Reference Guide ("Guide") expressly stated that, with respect to gifts provided by a nonprofit or municipality through a downpayment assistance program, "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." In each of the loans cited in Finding 1 in which downpayment assistance was provided, the HUD-1 Settlement Statement ("HUD-1") documents the transfer of the funds. It was not until HUD issued Mortgagee Letter 2004-28 that the Department's guidelines expressly required lenders to obtain and keep the documentation of the wire transfer in its mortgage loan application binder in connection with downpayment assistance gift transfers. For these reasons, Pine State maintains that the

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documentation contained in its loan files for these seven cases fully complied with HUD requirements in place at the time these loans were originated.

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Nevertheless, in response to the auditors' requests, the Company contacted each settlement agent in the seven referenced cases and obtained evidence that the funds identified on the HUD-1s were in fact transferred to the agent at settlement. These loans are as follows:

	Borrower	FHA Case No.	Evidence of Transferred Funds
1.		105-1380870	**Exhibit V-1**
2.		105-1769305	**Exhibit V-2**
3.		105-1587099	**Exhibit V-3**
4.		105-1524517	**Exhibit V-4**
5.		105-1531395	**Exhibit V-5**
6.		105-1728585	**Exhibit V-6**
7.		105-1548492	**Exhibit V-7**

Comment 16

The attached documentation demonstrates, in addition to the HUD-1 reference to the gift funds, that each of the seven borrowers at issue in this sub-finding in fact received the downpayment assistance gift from the nonprofit provider. That said, as Pine State

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fully complied with HUD guidelines in place at the time these loans were closed, the Company maintains that this allegation and any requests for indemnification in connection with this sub-finding be removed from the Report.

7. Recommendations

Comment 21

In addition to opposing several of the individual allegations contained in the Report, Pine State disagrees with certain aspects of the recommendations made in connection with the loans referenced in Finding 1. As you know, Finding 1 of the Report recommends, among other things, that the Department require the Company to: (1) indemnify HUD for potential losses of $713,495 in connection with 17 active loans; (2) reimburse HUD for actual losses it has sustained in two loans terminated by claims to HUD in which the Department has sold the underlying property; and (3) reimburse HUD for the actual losses that HUD will ultimately paid on two additional claim-terminated loans once the underlying properties have been sold, which the OIG estimates will be $85,262. To derive the estimated losses in connection with the 17 active loans and the two unfinalized claims, the Report indicates that it included 29% of the unpaid principal balance in these cases. According to Appendix A, this multiplier was selected based on information provided by HUD showing that its losses on sales average 29 percent of the claim paid.

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Pine State does not take issue with the OIG's inclusion of the Department's actual losses in connection with loans for which claims have been made, and acknowledges that using the 29% multiplier represents a fair potential loss in loans in which claims have been made, but actual losses are unknown at the time of the Report's issuance. The Company does, however, take strong exception to inclusion of the $713,495 in estimated losses in the 17 remaining loans. First, we note that the $713,495 figure does not represent a payment that the Report recommends Pine State pay to HUD, but rather reflects a mere estimate of the losses the Department could incur if these 17 loans ultimately result in claims to HUD. All 17 of the loans, however, remain active. In most cases, these loans are performing and the borrowers are consistently making payments. Pine State appreciates that these 17 loans may have entered default at some point; however, none of these 17 loans have been foreclosed, terminated, or resulted in insurance claims to the Department. To date, HUD has not incurred any loss in connection with these cases and there is no reason to believe that the Department will incur losses in these cases. Moreover, in the event that HUD does pay a claim in any of these loans, there is no guarantee that the Department will sustain monetary loss, as HUD may be able to recoup the claim amount in the sale of the underlying property.

Comment 21

Notwithstanding these facts, the Report suggests that the Department will experience losses in the amount of 29% of the unpaid principal balance of each one of these 17 loans, and lists the financial risk to the Department, which it defines as "funds to be put to better use," as $713,495. This calculation assumes that every one of the 17 active loans will go into foreclosure and result in a claim to HUD. Such an assumption would be supportable if 100% of the loans that enter default resulted in claims to HUD; however, that percentage is significantly lower. In fact, with regard to the branch office audited by the OIG, not one of the loans that went into default during the audit period resulted in a claim to HUD **(Exhibit V-8)**. Based on this fact, there is no reason to believe that any of these loans, let alone all 17 of them, will result in a claim or financial loss to the Department. HUD has collected its insurance premium in each of these cases, which continue to perform as active FHA loans. Based on these facts, absent evidence that the 17 loans at issue will result in an actual claim to the Department, the over $700,000 potential loss figure is greatly inflated and does not paint an accurate picture of the risks associated with this matter. It appears that inclusion of such an inflammatory figure in the final Report serves only as an attempt to justify the costs of the audit of this Company, rather than portray the precise amount of the potential losses that HUD may incur in connection with these 17 loans.

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Moreover, this arbitrary monetary figure is included with a mere recommendation to the Department to require the Company to indemnify it in connection with certain loans. Upon receiving the final Report, the Department will have an opportunity to

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independently review the audit findings and make an independent determination of whether indemnification is warranted in any of these cases. As discussed at length earlier in this response, Pine State disagrees that the vast majority of the findings set forth in the Report warrant indemnification. HUD may also disagree with the Report's assertions and decide not to pursue indemnification in some or all of the 17 cases. Notwithstanding the fact that these findings are preliminary, the OIG's recommendations assume that HUD will accept each allegation and pursue indemnification in each case.

In addition, while the audit process is still ongoing at the time the OIG issues its "final" report, the Report and the OIG's recommendations are made public on the OIG website. As a result, a lender's investors and peers are able to access the preliminary recommendations of the OIG before a final assessment as to their merit can be made by the Department. These entities often misinterpret the OIG's recommendations to be final actions by the Department, and also frequently misunderstand the potential losses cited to be the actual financial penalties assessed by HUD on the audited FHA lender. Under these circumstances, making these preliminary recommendations public and including an inflammatory potential loss figure that is based on the unsupported assumption that every single loan at issue will result in a claim to HUD will have a material, adverse effect on the business of the audited FHA lender. If the OIG's goal is to present the reader with a full and accurate disclosure of the audit and its implications to the audited lender, the Report should include the following disclosure on the first page in bold, capitalized lettering:

THE REPORT FINDINGS REFLECT THE VIEWS OF THE OFFICE OF INSPECTOR GENERAL AND DO NOT CONSTITUTE A FINAL DETERMINATION OF THE MATTERS RAISED HEREIN BY THE U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT. THE FINAL DETERMINATION IN THIS MATTER WILL BE MADE BY THE REPORT'S ADDRESSEE, THE HUD ASSISTANT SECRETARY FOR HOUSING – FEDERAL HOUSING COMMISSIONER, WHO WILL ULTIMATELY DECIDE WHETHER TO ACCEPT THE REPORT'S RECOMMENDATIONS IN WHOLE OR IN PART OR REJECT THEM.

The above discussion demonstrates that the over $700,000 estimated loss figure is unrepresentative of the Department's actual loss risk in connection with the 17 active loans cited in Finding 1. Inclusion of this overstated figure in the Report unfairly represents the loss exposure to HUD, and ultimately the Company, as a result of this audit. <u>Therefore, Pine State strongly opposes the inclusion of this figure in the final Report and requests that it be removed or amended to portray a more accurate picture of the potential losses in the active FHA loans cited in the Report</u>. As the recommendation regarding these loans is that the Company indemnify HUD, the Report should merely state this recommendation without including estimated losses that are

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difficult, if not impossible, to predict accurately in these loans. At the very least, if the final Report continues to include the average claim loss paid for these 17 loans as the potential financial risk to HUD and the Company, the Report should also clarify the percentage of defaulted loans that result in a claim to HUD and include the potential losses based on this significantly reduced number of loans. This figure would present readers with a more accurate and fair picture of the financial risks associated with the loans identified in the Report.

B. FINDING 2 – PINE STATE COMPLIED WITH HUD's QUALITY CONTROL GUIDELINES

Comment 23

In Finding 2, the Report alleges that the Company did not implement effective quality controls over early payment default loans despite HUD's recommendations that Pine State implement more effective controls in an earlier audit of the Company by the Department's Quality Assurance Division. Specifically, the Report asserts that the Company did not properly: (1) assess and classify the severity of its Quality Control findings; (2) report material Quality Control findings to HUD; (3) document the resolution of its Quality Control findings; (4) prepare and assess trends to identify areas that warranted expanded coverage; and (5) assess underwriters and branch offices with high default rates. The Report asserts that these issues hampered the Company's ability to identify and correct performance and resulted in the non-reporting of issues in 23 loans, eight of which the Report cited in Finding 1, involving violations that should have been conveyed to the Department. As a result, Finding 2 recommends that HUD: (1) require the Company to implement proper Quality Control over its early payment default loans and; (2) to the extent that the Department determines the violations in any of the 23 loans involve material violations of HUD guidelines, require the Company to indemnify HUD in those cases.

Comment 23

Pine State practices strict Quality Control and adheres to a detailed Quality Control Plan. See HUD Handbook 4160.1 REV-1, ¶ 6-1. We communicate Pine State's policies and procedures regarding FHA loans to our employees on a regular basis via email, and are in the process of upgrading Pine State's intranet to allow all employees direct access to all of the Company's policies and procedures. Attached for your review we have included a sample of the types of policy and procedure notifications Pine State routinely provides it employees **(Exhibit W-1)**. We continuously strive to improve the Company's Quality Control department and have taken significant steps to enhance our Quality Control review procedures to ensure full compliance with HUD guidelines and to allow Pine State's management to quickly identify and remedy any issues that may affect loan quality or performance.

Comment 23

To that end, the Company has routinely added staff to its Quality Control department to assist in the oversight of employee guidance and overall compliance and

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has hired and promoted experienced personnel to manage the QC department's operations and reviews. Pine State has also added a Career Development Officer to its ranks and has established a training division to counsel employees on proper loan origination and underwriting procedures. The managers of the Company's training, operations and QC departments work together to ensure that Pine State's employees operate at the highest level of loan origination and underwriting. With regard to Quality Control reviews, the Company has retained a third-party company, to perform these reviews **(Exhibit W-2)**, and has changed companies in the past to ensure that it receives reports in a timely fashion. We discuss additional steps the Company has taken to improve its Quality Control review procedures in response to the Report's specific allegations below.

Comment 23

The Company began implementing many of these procedures and practices as a result of the 2004 HUD Quality Assurance Division review referenced in the Report. To the extent that the Company had not fully implemented the Department's recommendations at the time of the OIG's review, Pine State has intensified its efforts to ensure that its Quality Control review procedures fully adhere to HUD guidelines. The Report recognizes Pine State's progress in this regard, noting that the Company has improved its Quality Control reviews of early payment default loans since HUD's 2004 review and indicating that it found that Pine State performs timely reviews in cases in this loan category.

Comment 23

Nevertheless, the Report takes issue with four general areas of Pine State's Quality Control review procedures for early payment default loans. Contrary to these assertions, we believe that Pine State consistently complied with HUD guidelines regarding its Quality Control procedures, reviewed its QC reports to identify risks, and reported material risks to HUD. In addition, the Company has used its Quality Control findings to analyze underwriter performance and has conducted underwriter training where necessary to ensure improved quality in its FHA loans. We hope the above information demonstrates the Company's compliance with HUD guidelines, as well as its continued efforts to ensure full compliance with FHA requirements and enhanced loan quality. Below, we respond to each of these individual allegations, as well as set forth our disagreement with the indemnification recommendation in Finding 2.

1. <u>Assessment and Classification of Quality Control Findings</u>

Comment 23

Finding 2 of the Report asserts that the Company did not classify the severity of violations identified by its Quality Control reviews as recommended in HUD guidelines, which caused the Company not to report material violations to HUD, adequately correct violations noted during the reviews, or take sufficient measures to identify patterns and trends.

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Comment 23

With regard to classification of the severity of issues identified in Quality Control reports, HUD guidelines regarding Quality Control indicate that "[t]he Department recommends that Quality Control reports to mortgagee management include an assessment of risks ... on the basis of the severity of the violations found during the review." HUD Handbook 4060.1 REV-1, ¶ 6-4 (emphasis added). While the Department has set forth a risk ratings system that suggests lenders place each QC report into one of four categories of risk, from low to material, HUD requires only that "[m]ortgagees may consider [the] ratings system" set forth in this Handbook. Id. (emphasis added).

Comment 23

These provisions make clear that, while HUD prefers that mortgagees include a risk rating system in their Quality Control procedures, such a rating system is not required by the Department at this time. Moreover, the Handbook indicates that, while the low to material risk designation provides one potential format for such a system, mortgagees may develop their own system for evaluating Quality Control samples on the basis of the severity of the violations found during the review. Id. Nevertheless, in accordance with these recommendations, Pine State has consistently asked the independent, third-party Quality Control company that conducts its Quality Control reviews to include such risk ratings in their Quality Control reports and included this requirement in the contract between Pine State and the external Quality Control company **(Exhibit W-2)**. Pursuant to this request, and contrary to the assertion in Finding 2 of the Report, at the time of the OIG's review, Pine State received risk classifications based on the severity of the issues raised during its early payment default Quality Control reviews. As indicated by the early payment default review summaries prepared for April and May of 2004 and January of 2005, the third-party reviewer provided a break-down of issues by branch office and indicated whether these findings constituted "major errors" **(Exhibit W-3)**. Moreover, even in those instances in which a risk rating was not written on the Quality Control report, Pine State analyzed each QC report and differentiated between minor and material findings. While this determination may not have been expressly identified in the QC report or loan file, the Company took appropriate action in response to each of the findings based on its assessment of the degree of risk that such findings presented to the Company and to HUD.

Comment 23

Furthermore, although HUD merely recommends that FHA lenders implement the risk rating system referenced in the Report, and although Pine State had a rating system in place that complied with this recommendation at the time of the OIG's review, the Company has begun to rate the issues identified in its Quality Control reviews based on the four categories of risk set forth in HUD Handbook 4060.1. We are confident that this additional step satisfies any of the OIG's outstanding concerns with regard to raking

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the severity of Quality Control findings and will ensure full compliance with the Department's Quality Control directives.

2. Reporting of Material Quality Control Findings

Comment 23

In this sub-finding, the Report asserts that the Company did not identify and report to HUD material violations included in its Quality Control reports. Finding 2 asserts that a review of Quality Control findings in 23 loans identified in Appendix E, eight of which are cited in Finding 1, demonstrates that material violations that warranted reporting were not conveyed to HUD. The Report acknowledges that the OIG did not independently audit the loan files in the remaining 15 cases, but relied on the Quality Control findings to recommend indemnification for the "material" violations identified in Appendix E.

Comment 23

Comment 24

As indicated above, although the risk rating system referenced in the Report is merely recommended by the Department's guidelines, Pine State nevertheless analyzes each QC report and differentiates between minor and material findings. To the extent that these reviews identify "material risks," it is the Company's policy and practice to promptly report such findings to the Department. Based on HUD's informal guidance and industry practice, the Company has always understood "material risk" to mean findings of fraud or other significant program deficiencies, such as evidence of a real estate brokerage participating in a straw-buyer scheme, that would threaten the FHA Insurance Fund. Where Pine State identifies instances of fraud, such as document fabrication, inflation of assets or omission of liabilities, the Company immediately reports these findings to the Department in compliance with HUD guidelines. See HUD Handbook 4060.1 REV-1, ¶ 6-3(J).

Comment 24

HUD guidelines do not, however, suggest that the Department's intent in requiring the reporting of significant violations requires lenders to report every instance in which its Quality Control procedures identified underwriting issues such as debt-to-income ratio miscalculations, understated housing costs due to taxes and insurance, etc. The types of violations identified as "material" in the Report and Appendix E include overstated income and omitted liabilities or understated housing costs that would have increased a borrower's qualifying ratios to an unacceptable level. The Company has never understood its obligation to inform HUD of material findings to include the reporting of these types of deficiencies or differences of opinion between an underwriter and Quality Control reviewer regarding the acceptability of compensating factors. HUD has delegated the authority to exercise discretion in the underwriting of FHA loans to mortgagees, see HUD Handbook 4155.1 REV-5, ¶ 2-3, and we would hope that the Department intends lenders to use that discretion to distinguish between the types of underwriting issues cited in the Report and more serious and material

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Comment 24

findings of fraud or program abuse that warrant the attention of the Department. With regard to the later, the Company has diligently reported such issue to HUD in the past, as evidenced by the attached communication with HUD representatives **(Exhibit W-4)**.

Comment 24
Comment 23

That said, if HUD informs us that it would like the Company to report every instance of ratio miscalculation or other such finding, in addition to the fraud reports the Company already provides, and makes this intent clear to the Company, Pine State would conform to this requirement. We believe, however, that this level of reporting would not be efficient for either the Department or Pine State. For these reasons, Pine State has taken steps to ensure that its Quality Control reports include a risk rating that conforms to the recommendations for such a ratings system in HUD guidelines and will continue to report any instances of fraud that it identifies during its Quality Control process.

Comment 25

Pine State also takes issue with the auditing procedures implemented by the OIG in this sub-finding. As indicated above, the Report acknowledges that, in 15 cases, the OIG did not conduct an independent audit of the loan file to verify the issues identified in the Quality Control report. As Pine State pointed out to the auditors, and as is reflected in both the text and Appendix E of the Report, Pine State disagreed with several of the findings made by the Quality Control reviewers. During the Quality Control process, Pine State examines the third-party Quality Control reviewer's initial findings and often disagrees with that entity's conclusions. Part of the Quality Control review process includes Pine State providing the third-party reviewer with additional information to explain the underlying circumstances in particular loan files and, often, the Quality Control reviewer removes initial findings from the QC reports it issues to Pine State. Notwithstanding these circumstances, <u>the Report ignores the possibility that the Quality Control findings may be inaccurate, fails to verify the findings with its own independent review, and relies on the untested Quality Control findings to determine that the findings constituted material violations that warrant indemnification</u>. We question whether basing such a harsh recommendation for such a large number of loans, which the Report acknowledges involves $1.3 million in outstanding principal balances, constitutes prudent auditing procedures.

Comment 24
Comment 25

In summary, Pine State takes strong exception to the overly expansive definition of "material" violation employed in the Report, as well as the questionable review practices that led to the Report's recommendation of indemnification in 15 loans identified in this sub-finding. For these reasons, the Company maintains that indemnification of the 23 cited loans is unwarranted and the allegations in this sub-finding should be removed from the Report.

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3. Documentation of Corrective Actions

The Report also alleges that the Company did not document the corrective actions it took to address and resolve findings included in the Quality Control reports it received.

Comment 23

Pine State understands and appreciates that final Quality Control reports must identify actions being taken, the timetable for their completion, and any planned follow-up activities the lender will take to ensure corrective action based on Quality Control findings. See HUD Handbook 4060.1 REV-1, ¶ 6-3(I). It has consistently been Pine State's policy and procedure to examine all Quality Control reports, identify issues that required follow-up responses and corrective action, and provide counseling and training to Company employees where necessary. While Pine State consistently has taken such corrective actions in response to Quality Control findings, the Company acknowledges that it did not always diligently explain such action in its Quality Control records in every instance. As a result of this review, the Company has reminded its Quality Control staff and management of the importance of documenting all corrective actions taken in response to QC findings, and has increased its efforts to ensure that such findings are well-documented in the loan files. Attached please find an example QC report that includes a description of the corrective action taken in each case reviewed **(Exhibit W-5)**. Pine State will continue to improve upon its procedures for documenting such actions, and we believe that any outstanding concerns raised in the Report have been resolved.

4. Preparation and Assessment of Trends and High Default Rate Patterns

Finally, the Report alleges that the Company did not identify patterns and commonalities among participants in its early payment default Quality Control reviews and, as a result, was unable to identify the areas in which corrective actions were necessary. In addition, the Report asserts that the Company did not assess the performance of underwriters and branch offices with higher default rates or take action to address the underlying reasons for the increased defaults in these areas.

Comment 23

Pine State understands and appreciates that FHA lenders must identify patterns of early defaults by location, program and loan characteristic, as well as commonalities among participants in the mortgage origination process, and take additional steps to monitor and correct the underlying causes for patterns and trends identified. See HUD Handbook 4060.1 REV-1, ¶ 6-5(C). It has been Pine State's policy and practice to do so. While the Company has performed some tracking and trending analyses in the past **(Exhibit W-6)**, we continue to develop and expand this area of our Quality Control process through technology and increased staff. Additionally, on January 1, 2006, the

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Comment 23

Company added an addendum to its contract with , the Quality Control company, requiring it to perform trending and pattern analysis of the risk ratings and provide this information with the Quality Control reports it produces **(Exhibit W-2)**. We are also expanding our internal trending reporting capabilities to track the performance of underwriters and loan officers, as well as closing and processing staff. In addition to these overall trending and tracking improvements, the Company will continue to take necessary steps on an individual basis to ensure that any issues identified in QC reports are resolved. For instance, where Pine State identifies issues with a particular underwriter, the Company will continue to provide one-on-one meetings to discuss Quality Control findings, decrease the number of FHA-insured loans this individual underwrites until it confirms that all issues have been resolved, and provide training regarding HUD underwriting requirements. We are confident that our continuation of this individualized response, as well as our expansion of overall trending and tracking reports to isolate issues before they affect loan quality, effectively resolve any outstanding issues raised in the Report.

Nevertheless, Pine State respectfully disagrees with two of the specific assertions made in this portion of the Report regarding the Company's response to findings of increased defaults in loans approved using buy-down rates and its analysis of the reasons for a high default rate at the audited branch office. We address each of these issues in turn below.

a. Corrective Actions Taken In Connection with Buy-Down Loans

The Report asserts that, although Pine State conducted an assessment identifying that a high percentage of defaults involved temporary interest rate buy-downs, the Company did not initiate action to resolve the matter.

Comment 26

Pine State respectfully disagrees with this allegation. The Company reviews HUD Neighborhood Watch reports on a monthly basis, and examines each of its underwriters' and branch offices' performances during these reviews. As a result of these reviews, the Company identified that a high percentage of loans originated by the audited branch office involved interest rate buy-downs. In response to this determination, the Company tightened its underwriting guidelines with regard to loans involving this feature. Specifically, the Company amended its internal underwriting guidelines to prevent approval of loans involving interest rate buy-downs where certain other risk factors were present **(Exhibit W-7)**. Pursuant to these amended guidelines, the Company stopped approving loans involving buy-down rates if: (1) the borrowers ratios exceeded 31%/43%; (2) the borrower's minimum credit score was less than 525; or (3) the borrower had deferred student loans and a credit score of less than 550 **(Exhibit W-7)**. Pine State implemented these increased standards for approval of buy-

Comment 26

down loans in March of 2004, several months before HUD issued Mortgagee Letter 04-28 in which it required lenders to use the ultimate interest rate to qualify borrowers even when the borrower receives a buy-down rate **(Exhibit W-7)**. The attached documentation evidences that, contrary to the Report's assertion, Pine State analyzed the Company's default rates, determined that a significant percentage involved buy-down rates, and took corrective action to prevent further defaults involving the identified commonality. As Pine State complied with HUD guidelines in this regard, the allegations regarding these issues should be removed from the final Report.

Comment 16

b. Analysis of Branch Office Default Rate

Finally, with regard to the assertion that the Company did not assess the performance of its Atlanta branch office, which had a higher-than-average default rate during the audited period, Pine State respectfully disagrees. During the OIG's audit process, the Company informed the auditors that it did in fact identify a higher-than-average default rate for this location and examined the underlying causes for the increased percentage. Although the Report indicates that Pine State's owner identified that cause as "a higher risk market," the Report ignored the fact that this "higher risk market" involved loans secured by new construction, which have a higher default rate than loans secured by existing construction or refinance transactions. Instead, the Report selects other reasons for the higher-than-average default rate of 10.54% after comparing the branch office's default rate to the Company's overall default rate during that period of 8.4% and the default rate of 8.25% for all HUD-insured loans originated in Georgia "involving Pine State's market."

Comment 27

Based on conversations with the auditors, Pine State understands that, to compare Pine State's branch office default rate to the overall default statistics for the geographic markets of the Company and the state of Georgia, the OIG removed loans secured by refinance transactions and condominiums. The Report's analysis, therefore, included percentages that reflect FHA-insured loans secured by properties with the following characterizations: (1) existing home, previously occupied; and (2) existing home, not previously occupied, which would include new construction. As these percentages include loans secured by previously occupied homes, the Report's statistics do not represent the "higher risk market" that Pine State identified as the cause of the branch office's higher-than-average default rate. As indicated above, FHA loans secured by new construction, which would fit into HUD's category of "existing home, not previously occupied," have a significantly higher default rates on average than loans secured by existing homes. Pine State's analysis of the branch office at issue in the Report identified that, during the relevant period, approximately 80% of that office's FHA originations were secured by loans that fit into the "existing home, not previously occupied" category **(Exhibit W-8)**. As these loans have a higher instance of

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default, the Company reasonably concluded that this riskier "new construction" market was the reason underlying the branch office's higher-than-average default rate during the audit period. Moreover, we note that during the same period, only approximately 20% of the FHA-insured loans originated in the Atlanta Field Office jurisdiction were "existing home, not previously occupied" **(Exhibit W-8)**. This statistic further evidenced that the Company's higher-than-average default rate was due to a larger number of these higher risk loans.

Comment 27

Comment 28

Comment 16

While the OIG may disagree that this higher risk market represented the cause for this branch office's increased default rate during the audited period, the allegation in the Report is that the Company did not examine the default rate to determine the underlying reasons. The above discussion demonstrates that, contrary to this allegation, Pine State in fact identified the higher default rate, examined the underlying reasons for these percentages, and determined that the higher instance of defaults was due to the fact that this branch office originated a significantly high number of loans that fit into the "existing home, not previously occupied" category, which experience a higher default rate than loans secured by previously occupied properties. Pine State complied with HUD guidelines in diligently examining the underlying reasons for higher-than-average default rates of its branch offices as part of its monitoring and Quality Control process. Therefore, we respectfully request that this allegation be removed from the final Report.

III. <u>CONCLUSION</u>

Comment 16
Comment 2

Pine State takes the matters raised in the draft Report seriously. Because FHA lending comprises a significant portion of Pine State's overall business operations, the Company is committed to educating and training its employees on issues regarding FHA compliance and to assuring their adherence to HUD's rules and regulations. As discussed above, Pine State substantially complied with FHA underwriting requirements and made loans to qualified FHA borrowers. Pine State's thorough review of the findings set forth in the Report indicated that many of the findings are at variance with the facts, do not constitute violations of HUD/FHA requirements on the part of Pine State, or do not affect the underlying loans' insurability. Pine State at no time misrepresented information it submitted to the Department. Moreover, since the loans cited in the Report were originated, the Company has made several improvements to its Quality Control procedures and has continued to enhance its underwriting practices. The Company identified and responded to operational and underwriting concerns, and it has exercised responsible management supervision.

Comment 2
Comment 16

We believe that this response and accompanying exhibits demonstrate 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

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facts of this case and remove allegations from the Report in those instances in which Pine State has demonstrated its compliance with HUD requirements.

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

Sincerely,

Robert Motley
President

cc: Phillip L. Schulman, Esq.

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OIG Evaluation of Auditee Comments

Comment 1 We provided Pine State the opportunity to informally respond to our tentative finding during the course of the audit. We considered its comments and revised our conclusions where appropriate. We then prepared the final draft report and provided Pine State an opportunity to respond to the report in writing. We included its written response (minus supporting exhibits) in this report along with our assessment of the response. Pine State will have further opportunity to provide comments and supporting documentation to HUD program staff, who will work with Pine State and our office to resolve the audit recommendations.

Comment 2 We revised the report in several instances to reflect valid issues raised by Pine State. See comments 3, 4, and 27. However, the revisions did not materially affect the overall accuracy of the report.

Comment 3 We revised the number shown in the summary schedule of finding 1 for cases with less significant deficiencies to agree with the number of loans listed in appendix C.

Comment 4 We assessed and accepted Pine State's position that 1 of the 12 questioned buydown cases met requirements (case number 105-1380870). We revised the report to delete all reference to this condition. The information Pine State provided did not support its claim that the remaining 11 buydown cases met requirements. Pine State's comments included substantial justification for the buydowns that it prepared in response to the audit. The justification should have been but was not prepared and documented at the time Pine State approved the buydowns.

Comment 5 Buydown for case number 105-1587099 - This buydown was not allowable for the reasons cited in the report. We agree with Pine State's reference to HUD requirements that allow lenders to consider training when assessing a borrower's potential for increased earning. In this case, the borrower obtained the training as a nursing assistant and then obtained a job in that field. We assessed the borrower's income after the indicated training and subsequent employment as a nursing assistant. Our assessment did not support an earning pattern or potential needed to justify the buydown. The file and Pine State's comments contained no support that the borrower had taken and completed any other training that would further increase her earning potential. As for the coborrower, we agree that the documents Pine State provided support a projected 2 percent raise or approximately 20 cents per hour. The borrower needed a 45-cent per hour raise to offset the first buydown increment. The file contained no documentation that the borrowers' combined earning potential was

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sufficient to pay the buydown increment.

Comment 6 Pine State did not recognize its responsibility to determine the adequacy of borrowers' earning capacity to justify buydowns. HUD's buydown requirements were designed to ensure that the eventual increase in mortgage payments would not affect the borrowers adversely and likely lead to default.

Comment 7 Buydown for case number 105-1953205 - This buydown was not justified for the reasons cited in the report. Contrary to Pine State's claim, the borrower's 2004 income was $227 less than the 2003 amount. Pine State incorrectly estimated the borrower's 2004 income. We contacted the employer and determined that our 2004 estimate was only $41 less than the 2004 amount we confirmed with the employer.

Comment 8 Buydown for case number 105-1956571 - This buydown was not justified for the reasons cited in the report. The document Pine State obtained from the employer contained a general comment that the borrower, and independent contractor, was a hard worker with a potential for increased earnings. Pine State did not determine or show how much of a pay increase the borrower would receive. Also, it did not show whether the borrower's past earning supported projected increases sufficient to pay the buydown increments.

Comment 9 Buydown for case number 105-1386555 - This buydown was not justified for the reasons cited in the report. Pine State provided a copy of the borrower's employment contract that indicated the possibility of bonuses. However, the contract only guaranteed the borrower a basic salary amount. Pine State provided no information to show when and how much of a pay increase or bonus the borrower would receive.

Comment 10 Buydown for case number 105-1606248 - This buydown was not justified for the reasons cited in the report. Pine State said it properly excluded the $145 monthly payment because the debt had less than 10 months remaining when the loan closed. Handbook 4155.1, REV-4, provides that debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make mortgage payments during the months immediately after loan closing. This was the case considering that the payment increased the borrower's debt-to-income ratio from 43.10 to 49.42 percent. Pine State also made an unsupported claim that the borrower qualified for the buydown based on increased earning. To support its position Pine State provided joint income tax data that showed the borrower's and his wife's combined income increased from 2001 to 2002. However, the borrower's wife was not a party to the loan. Thus, her income and credit were not assessed to determine eligibility for the

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loan and are not relevant to the borrower's qualification for the buydown.

Comment 11 Buydown for case number 105-1696401 - This buydown was not justified for the reasons cited in the report. The borrower had worked as a police officer for 19 months. We determined that the officer's earning rate for 2003 was less than the rate for 2002. We did not determine the reason for this condition. However, Pine State should have obtained and considered an explanation as part of its buydown assessment. HUD's Neighborhood Watch system shows the borrower defaulted due to a curtailment of income. Pine State was responsible for assessing the adequacy of potential pay increases to cover the buydown increments.

In its response, Pine State also said the borrower qualified for the buydown because of a $242 monthly debt that would be paid off within 20 months and before the buydown period ended. The liquidation of this debt 20 months into the buydown period was not relevant to the borrower's eligibility for the buydown.

Comment 12 Buydowns for case numbers 105-1072865, 105-1751832, and 105-1969307 - We assessed Pine State's comments and supporting documents. They provided no new information for our consideration. The buydowns are not justified for the reasons cited in the report.

Comment 13 Buydown for case number 105-0981353 - This buydown was not justified for the reasons cited in the report. The collection accounts, increasing housing cost, and the delinquent child support payments were not consistent with Pine State's claim concerning the borrower's ability to manage increased housing expense. We consider it unreasonable to accept that the borrower accumulated more than $20,000 in delinquent child support due to an address mix-up. The borrower was or should have been aware of the child support obligation.

In addition, Pine State claimed the borrower was qualified for the buydown because of an increased earning potential associated with overtime pay not included as effective income. We agree with Pine State's comment that HUD criteria do not require lenders to document overtime earnings for a two-year period for the purpose of satisfying the buydown requirement. However, Pine State was responsible for but did not assess or document its assessment of the adequacy of potential pay increases to pay the buydown increments.

Comment 14 Buydown for case number 105-1644709 - This buydown was not justified for the reasons cited in the report. The documents Pine State provided understated the borrower's 2002 income it used to compare against the 2003 amount. The loan file showed the borrower worked for three different employers in 2002 and earned $35,796 versus the $27,635 claimed by Pine State. The borrower worked for one employer in 2003 at an hourly pay rate that equated to $35,360 in regular pay or $436 less than the amount earned in 2002. The borrower started work for the employer in February 2002 and continued in the job through the September 2003 date reflected in Pine State's comments. The verification of employment indicated no past pay increases. The employer entered question marks in the boxes on the verification form that inquired about the projected date and amount of the next pay increase. The verification of employment did not show whether overtime would continue. The borrower's September 2003 pay stub showed only $485 in year-to-date overtime pay.

Comment 15 We disagree with Pine State's comments that compensating factors exist that would offset its omission of a $142 monthly payment from the borrower's credit assessment (FHA case number 105-1969307). The omitted debt contributed to a 47.59 debt-to-income ratio with the buydown and a 52.54 percent ratio without the buydown.

Comment 16 We disagree with Pine State's assessment that the reported violations are not valid and should be removed from the report. The report provides an accurate presentation of the conditions found and the HUD criteria designed to regulate those conditions. Pine State provided no new information for our consideration.

Comment 17 The Fannie Mae underwriting finding, item 17, required Pine State to include new debt payments resulting from material inquiries listed on the credit report in the debt ratio. Item 21 of the finding contained a similar requirement. Thus, we disagree with Pine State's assessment that it was not required to follow up on the inquiry and that we should remove this issue from the report.

Comment 18 The recommendation for indemnification was based on our consideration of all violations detected for each loan versus individual violations. We further assessed the violations giving consideration to Pine State's comments and supporting documents. We found no justification to change the recommendation.

Comment 19 We disagree with Pine State's comment that the file documented an explanation for insufficient fund charges listed on the borrower's June 2003 bank statement. The borrower's explanation, dated June 18, 2003, explained derogatory credit information listed on the credit report. However, the credit report in the file was dated July 25, 2003, over a month after the letter of explanation. Notwithstanding this discrepancy, item 6 of the explanation attributes a delinquent Blockbuster account to two returned checks that resulted from fraudulent activity in the borrower's account. The credit report did not show a Blockbuster account. The report did show two unpaid collection accounts for another video company that did not appear to be recent. The balances had been outstanding long enough to be transferred from the video company to a collection agency. Thus, the two checks mentioned did not appear to be related to the three returned checks shown on the borrower's June 2003 bank statement. The borrower's June bank statement showed no evidence of the account being frozen due to fraudulent activity. Thus, the comments and documents Pine State provided did not resolve issues we raised concerning returned checks.

Comment 20 We recognize the positive actions Pine State indicated to prevent and identify future quitclaim transfers. However, Pine State should have had such measures in place already to ensure compliance with HUD's requirements. Pine State either knew or should have known about the quitclaim transfers before it submitted the loans for HUD's endorsement. We disagree with Pine State's position that indemnification of the cases would be inappropriate.

Comment 21 We recognize Pine State's disagreement with the method we used to calculate potential losses for loans that have not been resold by HUD. The calculations represent the effect for loans that do not meet HUD's underwriting requirements whether or not they go into default. These decisions increased risk to HUD for insurance losses.

Comment 22 Pine State objected to OIG's making its report public before the Department makes a final determination on the recommendations. We recognize but disagree with Pine State's categorization of the process and the way it suggests the process works. The OIG policy requires public disclosure of issued audit reports. HUD management officials are responsible for taking action to resolve reported findings and recommendations.

Comment 23 We recognize Pine State's claimed actions to improve its quality control program. However, we disagree with its assertion that it consistently complied with HUD guidelines regarding the areas cited as violations in finding 2. The finding accurately describes the conditions detected by the audit, the HUD requirements involved, and the impact associated with the violations. Pine State did not provide adequate documentation during or subsequent to the audit to support its claimed compliance and objection to the finding.

Comment 24 Pine State's comment misrepresents the meaning of material risk defined by HUD Handbook 4060.1, REV-1, paragraph 6-4. The handbook defines material risk as material violations of FHA or mortgagee requirements and represents an unacceptable level of risk; for example, a significant miscalculation of the insurable mortgage amount or the applicant's capacity to repay, failure to underwrite an assumption or protect abandoned property from damage, or fraud. Mortgagees must report these loans, in writing, to HUD. We relied on this criterion to determine which loans Pine State should have reported to HUD. Contrary to Pine State's comments, the report never stated or implied that lenders report to HUD every underwriting issue raised by their quality control reviews. Also, if Pine State disagreed with its own quality control findings, it should have but did not document the basis for the disagreement and resolution of the disagreement(s).

Comment 25 Contrary to Pine State's claim, the issues cited in the report comply with auditing standards and provide a balanced presentation of the facts. Pine State should have but did not evaluate its quality control findings and report material risk loans to HUD. We tested the accuracy of Pine State's quality control findings for 8 of the 23 loans listed in appendix E. The review confirmed the type of violations detected by the quality control reviewer for seven of the loans (appendix E, notes a and b). We also asked Pine State to review the quality control finding, and it agreed with the results for 11 of the 23 loans. It disagreed with the results for the remaining loans even though in three cases our underwriting review confirmed the type of violations detected by the quality control review. We appropriately requested that HUD review and determine whether Pine State should indemnify the loans in appendix E.

Comment 26 Pine State provided no support for the claim that it performed monthly reviews of the Neighborhood Watch report to assess underwriter and branch office performance. It also did not provide support to show when its review identified high defaults for interest rate buydown loans. As cited in the report, Pine State produced only one instance to support trending that identified a high default rate for buydown loans. The analysis was not dated, and we could not determine when it was performed.

Furthermore, the March 2004 guidelines included in Pine State's response were not specifically designed to address buydown loans. The guidelines provided specific instructions for automated underwritten loans that warranted referral for manual underwriting. The guidelines included, among other provisions, review considerations for buydowns. The guidelines did not mention the default rate for buydown loans, nor did the guidelines require staff to document the files to include the type of information we found to be missing.

Comment 27 The report does not ignore Pine State's justification for the high default rate at its Atlanta branch office. We simply disagree with Pine State's explanation. We revised the report to clarify that Pine State primarily made loans for new construction. Pine State commented " …the Report's statistics do not represent the 'higher risk market' that Pine State identified as the cause of the branch office's higher-than-average default rate. …" We disagree. The supporting information Pine State included with its comments was dated September 30, 2004, and was not current. We updated the June 30, 2005, statistics in our report through September 30, 2005. The updated information continued to support the conditions cited in the report. The report accurately describes Pine State's loan market and how the branch office's high default rate compared to Pine State's overall default rate and the default rate associated with that market for all lenders in the state of Georgia.

Comment 28 Pine State provided no documentation to support its claim that the company's overall and its Atlanta branch's high default rates resulted solely from the company's focus on new construction loans. The data we obtained from Neighborhood Watch as of September 30, 2005, showed Pine State's Atlanta branch default rate (11.55 percent) and Pine State's overall default rate (9.03 percent) for new construction loans exceeded the Georgia average (8.83 percent). Thus, as cited in the report, the company's lack of proper underwriting practices further contributed to the high default rates.

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LOAN UNDERWRITING DEFICIENCY CHARTS

Loans with deficiencies that affected insurability

Case number	Income not properly assessed	Credit not properly assessed	Debts not properly assessed	Unauthorized quitclaims	Gifts not properly assessed	Interest rate buydown not properly assessed	Other	Total errors per loan	Questioned costs	Funds put to better use
									Ineligible	
105-1380870	X	X	X		X			4		$39,728
105-2032130	X	X						2		$46,530
105-1769305			X		X		X(1)	3*		$41,651
105-1741989	X		X				X(2)	3*		$50,516
105-2020030	X	X					X(1)	3		$45,918
105-1587099			X		X	X	X(1)	4*		$50,510
105-1524517			X		X			2*	$33,603	
105-1531395		X			X		X(1)	3		$40,309
105-1817383				X			X 1)	2		$41,171
105-1728585			X	X	X			3		$47,162
105-1548492	X				X			2		$45,641
Total	5	4	6	2	7	1	6	31	$33,603**	$ $449,136 **

* These were automated underwritten loans. The other loans were manually underwritten.

** These calculations are based on 29 percent of the insured loan amount in recognition that this is the average percentage of net loss HUD eventually experiences on loans that enter its inventory.

(1) Housing costs understated.
(2) Outdated verification documents.

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Loans with less significant deficiencies

Case number	Income not properly assessed	Credit not properly assessed	Buydown requirement met but Pine State's assessment not documented	Gifts not properly assessed	Understated housing costs	Loan application not signed by all required parties	Total violations
105-2074685	X			X		X	3
105-1353324	X	X		X			3 *
105-1565006	X			X	X		3
105-1794657	X		X		X		3
105-1676147		X	X	X	X		4
Total	4	2	2	4	3	1	16

* Loan terminated.

Not all errors pertaining to income, credit, or liabilities were considered material deficiencies. Only those errors that could have changed the underwriting decision were considered material. For instance, some errors in income or liabilities did not significantly affect the housing and debt ratios.

Appendix D

LOANS WITH TEMPORARY INTEREST RATE BUYDOWNS INAPPROPRIATELY APPROVED

The deficiencies affected insurability

	Case number	Debt-to-Income Ratio: With buydown	Debt-to-Income Ratio: Without buydown	Closing date	Questioned Cost: Ineligible cost	Questioned Cost: Unsupported cost	Funds put to better use	Notes
	Manual underwritten loans							
1	105-1953205	44.45	49.75	05/28/04		$44,503		a, b, d
2	105-1956571	44.20	48.93	06/21/04			$42,554	a, b, e
3	105-1386555	43.00	48.00	07/23/03			$28,154	a, b, f
4	105-1606248	43.10	49.42	10/02/03			$37,544	a, b, g
5	105-1696401	42.15	47.64	12/18/03			$33,323	a, b, h
6	105-1072865	43.59	49.01	04/28/03			$29,421	a, b, i
7	105-0981353	44.48	47.79	03/21/03	$32,822			a, b, j
8	105-1751832	41.64	47.40	05/24/04			$46,066	a, b, k
9	105-1644709	49.21	55.86	10/31/03			$47,297	a, b, l
	Automated underwritten loan							
10	105-1969307	47.59	52.54	07/15/04	______	$40,759	______	a, c, m
	Total				$32,822	$85,262	$264,359	

Note	
a	Pine State did not determine or document the required determinations needed to justify the use of an interest rate buydown to qualify the borrower for the loan. The file did not show or document that Pine State assessed the buydown to assure that the eventual increase in mortgage payments would not adversely affect the borrower and likely lead to default. We reviewed the file and determined that the borrower did not meet at least one of the four buydown criteria. Thus, Pine State inappropriately used the monthly bought down mortgage amount rather than the full payment to qualify the borrower for the loan. Adjustment for the buydown resulted in substantial increases in the debt-to-income ratio for each borrower. HUD Handbook 4155.1, REV 5, paragraph 2-14B(2), provides that the lender must establish that the eventual increase in mortgage payments will not affect the borrower adversely and likely lead to default. The underwriter must document that the borrower meets one of these four criteria: (a) the borrower has a potential for increased income that would offset the scheduled payment increases, (b) the borrower has a demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expenses, (c) the borrower has substantial assets available to cushion the effect of

	the increased payments, or (d) the cash investment made by the borrower substantially exceeds the minimum required.
b	The revised debt-to-income ratio exceeded HUD's limit for loan approval.
c	Pine State's inappropriate approval of the buydown caused it to enter an understated mortgage payment amount into its automated underwriting system to assess the borrower's eligibility for the loan.
d	Pine State's representative stated that the borrower had a potential for increased income to offset the increased mortgage payments required by the buydown. We determined that Pine State incorrectly estimated the borrower's future earning capacity. Based on information contained in the loan file, the borrower's projected effective income for 2004 would be $220 less than the prior 2003 income amount. Thus, the borrower did not demonstrate the potential for increased earning needed to pay either the first $1,122 or the second $1,175 annual buydown increment.
e	Pine State's representative stated that the borrower had a potential for increased income to offset the increased mortgage payments required by the buydown. Pine State stated that the borrower's historical income showed increases each year and indicated that the borrower's fiancée would contribute to paying housing expense. The borrower's fiancée was not a party to the loan, and her income was not relevant to this assessment. The loan closed in 2004. The file showed the borrower's income increased only $873 from 2002 to 2003 and deceased by $439 from 2003 to 2004. Thus, the borrower's income history did not support the potential for salary increases sufficient to pay either the first $1,071 or the second $1,131 annual buydown increment.
f	Pine State's representative stated that the borrower had a potential for increased income from bonus and overtime pay to offset the increased mortgage payments. The total effective income included the employer's confirmed standard provision for a 62.5-hour week to allow for overtime. The file showed the borrower had worked for the employer less than four months and was a trainee. That was not long enough to establish a pattern of job and income stability. The employer did not answer the question on the verification of employment concerning the borrower's prospect for continued employment. We recognize that the verification of employment showed the borrower would receive various bonuses. However, the verification did not indicate how much the payments would be or how often the payments would occur. The file did not contain sufficient evidence of job and income stability or future pay increases large enough to pay either the first $735 or the second $774 annual buydown increment.
g	Pine State's representative stated that the borrower demonstrated an ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expenses. Pine State incorrectly claimed that the borrower had one debt with a monthly payment of $291 that would not extend beyond the term of the buydown. The debt extended well into if not beyond the last term of the last buydown increment. Pine State did not verify the remaining terms of the debt with the creditor. Pine State also inappropriately excluded a $145 monthly payment from its assessment of the borrower's credit. We accept Pine State's position that the debt had less than 10 months remaining. However, the payment was high enough to affect the borrower's ability to make mortgage payments during the months immediately after loan closing. The added payment would have increased the debt-to-income ratio from 43.10 to 49.42 percent. The credit report showed the borrower had serious and recent delinquencies.
h	Pine State's representative stated that the borrower had a potential for increased income to offset the increased mortgage payments. Pine State stated that the borrower was a police officer and was likely to receive annual income increases. The loan closed in December 2003. The file showed the borrower's average monthly income decreased approximately $236 from 2002 to 2003. The file did not contain sufficient evidence of future pay increases large enough to pay either the first $871 or the second $915 annual buydown increment.
i	Pine State's representative stated that the borrower demonstrated an ability to manage financial obligations in such a way that a greater portion of income could be devoted to housing expense. Pine State also stated that the borrower would receive a tax deduction due

	to mortgage interest. The loan closed on April 28, 2003, with a 43.59 percent debt-to-income ratio. The credit report showed several collection accounts including two that were settled or paid in 2003 just prior to loan closing. The collection accounts were not consistent with Pine State's comments concerning the borrower's ability to devote a greater portion of income to housing expense. The borrower's housing cost for the new loan, giving consideration to the buydown, was slightly less than the borrower's prior rent. However, the collections accounts did not support Pine States justification for the buydown.
j	Pine State's representative stated that the borrower demonstrated an ability to manage financial obligations in such a way that a greater portion of income could be devoted to housing expense. The representative also stated that the borrower had a potential for increased income to offset the increased mortgage payments. We disagree with Pine State's assessment. The credit report showed recent collection accounts and a $20,090 delinquency on child support payments. The total mortgage payments (at the bought down amount) exceeded the borrower's prior rent amount. The collections, delinquent child support, and increased housing costs were not consistent with Pine State's claim concerning the borrower's ability to manage increased housing expense. In addition, the file did not support Pine State's claim concerning the borrower's increased earning capacity. Pine State's calculation included overtime pay based on the borrower's current pay stubs. The file did not contain documentation needed to assess overtime pay over the required two-year trend period to determine whether the amount was stable enough to warrant such consideration in projecting the borrower's future earning capacity. The file contained no verification stating whether overtime was likely to continue. We requested but Pine State could not produce documentation needed to assess the borrower's prior year income for comparison to later years. Thus, the file did not contain adequate documentation to support that the borrower would receive pay increases sufficient to pay either the first $1,307 or the second $1,380 annual buydown increment.
k	Pine State's representative stated that the borrower demonstrated an ability to manage financial obligations in such a way that a greater portion of income could be devoted to housing expense. Pine State commented that the borrower was able to make timely monthly payments with a rental expense comparable to the proposed housing expense. The loan closed on May 24, 2004. Pine State's position appeared plausible except that the file showed the borrower issued 18 insufficient fund checks between March 19 and May 5, 2004. The borrower provided a written explanation blaming the insufficient fund checks on a variation in pay dates from those the borrower was use to. The borrower's comments did not make sense. The borrower, despite any variation in pay dates, either knew or should have known the actual pay dates and should not have written any checks against funds not on deposit at the bank. Pine State's position concerning the borrower's ability to manage financial obligations was not supported by what the file showed.
l	Pine State's representative stated that the borrower had a potential for increased income to offset the increased mortgage payments. Pine State based its position on its estimate of the borrower's 2003 income that included consideration for overtime. The borrower had worked for the current employer 20 months before loan closed on October 31, 2003. The verification of employment did not identify overtime or past or future pay increases and did not contain a response to a question regarding whether overtime would continue. Based on the borrower's pay stubs, the 2003 income without consideration to overtime would be $436 less than the income for 2002. The file contained no basis for determining whether the borrower would receive salary increases sufficient to pay either the first $1,247 or the second $1,309 annual buydown increment.
m	Pine State's representative stated that the borrower had a potential for increased income to offset the increased mortgage payments. Pine State claimed that the borrower's income increased from 2001 to 2004 and that the borrower received a car allowance that was not included in effective income. Generally, Pine State's position concerning increased income appeared correct. The file showed the borrower's 2004 annual income increased by $902 without regard to the car allowance. The $902 salary increase was not sufficient to pay either the first $1,015 or the second $1,064 annual buydown increment. Pine State did not

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	document how much of the car allowance (net of expenses) represented effective income. During our assessment, we noticed that Pine State did not enter a $142 monthly revolving account debt into its automated underwriting system that assessed the borrower's eligibility for the loan. The omitted debt brings into question whether the loan should have been approved.

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Appendix E

MATERIAL QUALITY CONTROL FINDINGS NOT REPORTED TO HUD

The deficiencies could or did affect insurability

	Case number	Description	Unpaid mortgage amount	Claim paid	HUD's loss on resale	Did Pine State agree?	Notes
		Income overstated					
1	105-1187781	Debt ratio increased from 46.7 to 49 percent	$120,669			No	a, c
2	105-1428807	Debt ratio increased from 43.2 to 50 percent	99,021			No	a, c
3	105-1720581	Debt ratio increased from 38.2 to 48 percent	119,772			No	a, c
4	105-1741989	Debt ratio increased from 46.34 to 51 percent				No	b, e
		Unsupported income					
5	105-1236876	Debt ratio increased from 42.3 to 49 percent	108,863			No	a, c
6	105-0793308	Debt ratio increased from 32.6 to 60 percent	0		36,457	No	a, c
7	105-0684284	Debt ratio increased from 43.2 to 47 percent	148,271			No	a, c
8	105-0637652	Debt ratio increased from 42 to 60 percent			41,541	No	a, c
9	105-1548492	Debt ratio increased from 39.59 to 57 percent				No	b, e
10	105-1676147	Debt ratio increased from 44.43 to 47 percent					b,
		Quitclaim transfer at closing					
11	105-1530774	No underwriting assessment of transferee	149,135			Yes	a, d
12	105-1290106	No underwriting assessment of transferee	144,935			Yes	a, d
13	105-0107916	No underwriting assessment of transferee	124,268			Yes	a, d
14	105-1317601	No underwriting assessment of transferee		155,193		Yes	a, d
15	105-0306702	No underwriting assessment of transferee			23,364	Yes	a, d
16	105-1728585	No underwriting assessment of transferee				Yes	b, f
17	105-1817383	No underwriting assessment of transferee				Yes	b, f
		Liability omitted					
18	105-0365985	Debt ratio increased from 47.7 to 53 percent			54,040	No	a, c
19	105-1380870	Debt ratio increased from 43.03 to 46 percent				No	b, e
20	105-1524517	Debt ratio increased from 47.36 to 57 percent				Yes	b, f
		Housing expenses understated					
21	105-0703913	Debt ratio increased from 43.9 to 46 percent	109,734			Yes	a, d
22	105-2008495	Debt ratio increased from 44.5 to 46 percent	189,347			Yes	a, d
23	105-1769305	Debt ratio increased from 47.34 to 50 percent				Yes	b, f
	Total		$1,314,015	$155,193	$155,402		

Notes	
a	These 15 loans were not included in our audit sample.

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b	We reviewed these remaining eight loans. Our review substantiated the general finding issues raised by Pine State's reviewer for seven loans with mortgages that totaled more than $1 million (see appendix C). Our review did not substantiate the finding issue Pine State raised for the eighth loan (105-1676147).
c	Pine State reviewed the case during the course of our audit and disagreed with the finding cited in its quality control report. Pine State claimed that the borrowers' correct debt-to-income ratios were lower than cited in the quality control report and were within HUD's limit for approval. We did not audit Pine State's reassessment of its quality control results.
d	Pine State reviewed these seven loans during the course of our audit and agreed with the material findings cited in its quality control report. We did not audit Pine State's reassessment of its quality control results.
e	Pine State reviewed these three loans during the course of our audit and disagreed with the material finding cited in its quality control report. Pine State claimed that the borrowers were within HUD's requirements for approval. However, our review (appendix C) confirmed the general nature of the violations cited in the Pine State quality control report although the scope of violations we detected was broader than those indicated by the Pine State review.
f	Pine State reviewed these four loans during the course of our audit and agreed with the material findings cited its quality control report.

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Appendix F

CASE STUDIES OF IMPROPERLY UNDERWRITTEN LOANS

Case number:	105-1380870
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Date of loan closing:	July 25, 2003
Insured amount:	$141,500
Debt-to-income ratio:	43.60 percent
Status:	Reinstated
Default reason:	Excessive obligations

Credit Not Properly Assessed

The file did not contain an explanation for three insufficient fund charges shown on the borrower's June 2003 bank statement. At the time, the borrower had been employed for only five months following a four-month gap in employment to care for sick family members. HUD's system showed the borrower defaulted due to excessive obligations. The credit report Pine State obtained for the quality control review showed the borrower filed for bankruptcy protection in April 2004, about nine months after the loan closed. The bankruptcy was dismissed in July 2004, but the borrower filed for bankruptcy protection again in August 2004. These conditions indicate the borrower may have bought the house before fully recovering from the gap in employment.

HUD Requirements

HUD Handbook 4155.1, REV-4, paragraphs 2-3 and 2-3B, states that past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligation and predicting a borrower's future actions. When analyzing the borrower's credit record, it is the overall pattern of credit behavior that must be examined. The handbook further states that if the credit history reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve a loan.

Income Not Properly Assessed

Pine State approved the loan based on a $1,734 monthly effective income although the borrower had not held the job long enough to support stability of the income amount. The borrower had only been employed for five months in his job, not the required six months needed to support income stability. The employment immediately followed a four-month employment gap, during which time the file showed the borrower was taking care of sick relatives. We question whether Pine State should have included the $1,734 as effective income, but we did not deduct the amount.

HUD Requirements

HUD Handbook 4155.1, REV-4, CHG-1, section 2 provides that income from any source that is not stable may not be used in calculating the borrower's income ratios. Paragraph 2-6 provides that in some cases, a borrower may have recently returned to the workforce after an extended absence. In these circumstances, the borrower's income may be considered effective and stable, provided the borrower has been employed in the current job for six months or more.

Debts Not Properly Assessed

Pine State's loan file contained no evidence that it asked the borrower to explain two credit inquiries that resulted in two new loans. The first inquiry, dated April 21, 2003, resulted in a new loan in September 2003 with a $358 monthly payment. The second inquiry, dated May 14, 2003, resulted in a new loan in August 2003 with a $21 monthly payment. Both loans were shown on the credit report Pine State obtained more than a year later on November 7, 2004, during its quality control review of the loan. Pine State did not resolve issues related to the inquiries before it approved the loan. Pine State agreed with our adjustment to include the new $21 monthly payment. However, it stated that the $358 debt replaced a prior car loan it included in its analysis at $462 per month and that we should use the lower $358 payment in our assessment. We did not make the adjustment because Pine State's approval decision was based on information it possessed at the time and without conducting the required followup.

HUD Requirements

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-3B, provides that the lender must determine the purpose of any recent debts. The borrower must explain all inquiries shown on the credit report.

Gift Funds Not Properly Verified

The loan file contained no documentation that Pine State verified receipt of a $4,321 gift paid at closing by a nonprofit donor. Thus, Pine State allowed the loan to close without support that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The HUD-1 settlement statement shows the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction. We discussed this matter with Pine State officials, and they followed up and obtained the documents needed to confirm receipt of the gift.

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HUD Requirements

HUD Handbook 4155.1, REV-4, paragraph 2-10C, requires that if the gift funds are not deposited to the borrower’s account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

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Case number:	105-2032130
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Date of loan closing:	August 13, 2004
Insured amount:	$163,871
Debt-to-income ratio:	59.80 percent
Status:	Default
Default reason:	Curtailment of income

Income Not Properly Assessed

Pine State included $1,343 as effective monthly income although it did not establish and document the amount to be stable and likely to continue. The coborrower had worked for the employer less than three months. The employer completed the verification but entered "N/A" to the question concerning the probability of continued employment. The file contained no evidence that Pine State followed up and obtained an answer to the question. The coborrower had a history of unstable employment in different lines of work broken by periods of unemployment. The coborrower was unemployed and looking for work for more than a month and a half before finding a job as a sheet metal worker. Previously, the coborrower worked for about two months as a sales person in a department store preceded by a month of unemployment. Before the department store job, the coborrower worked for about 14 months as an assistant manager at a restaurant. HUD's system shows the default resulted from a curtailment of income. The default reason was consistent with the coborrower's inconsistent employment history. Adjustment for the $1,343 resulted in a 59.80 percent debt-to-income ratio compared to the 44.24 percent Pine State calculated.

Pine State said the verification of employment confirmed that overtime was likely to continue, and it took this to also mean that the borrower's employment was likely to continue. Confirmation that overtime will continue is not the same as confirmation of continued employment. Pine State should have obtained a response from the employer concerning the borrower's likelihood of continued employment.

We noted two other issues associated with Pine State's assessment of the borrower's income, but we did not deduct the amounts when we adjusted the debt-to-income ratio.

- Pine State allowed $389 per month for the borrower's overtime pay without documenting how it calculated the amount. When asked to explain the calculation, it provided a different $415 overtime figure and said the $389 was a conservative amount. The files should have contained support for the actual overtime amount Pine State used to approve the loan.

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- Pine State included $1,504 in monthly income for another coborrower, but it did not confirm or document confirmation with the employer that the income was likely to continue. The borrower had been employed in the position for about 19 months.

HUD Requirements

Handbook 4155.1, REV 5, section 2, provides that 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. Paragraph 2-7A states that overtime income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable, provided the lender justifies and documents in writing the reason for using the income for qualifying purposes.

Credit Not Properly Assessed

Pine State's credit analysis did not adequately consider the borrower's consistent disregard for child support obligations. The August 6, 2004, credit report showed the borrower had accumulated $58,143 in delinquent child support payments. The file contained an "order/notice to withhold income for support," dated July 22, 2003. The order required the borrower to pay $420 per month. The payment consisted of $150 for current support and $270 for past due support or $210 biweekly. The loan closed on August 13, 2004; thus, the order was not current. Pine State did not follow up or document followup to determine whether the order had been modified before it approved the loan.

Pine State officials stated they accepted the borrower's explanation concerning credit issues although it did not specifically address the child support. We considered the borrower's explanation to be inadequate.

Further, Pine State did not properly assess the borrower's poor credit performance evidenced by three other delinquent collection accounts. The credit report showed the borrower owed $4,669 on the three accounts, but the creditors were willing to settle the accounts for $2,427. Pine State required the borrower to pay off one of the collections as a condition to the loan closing. However, in view of the delinquent accounts and the delinquent child support payments, Pine State should have documented specific compensating factors to support its processing and approval of the loan. Pine State officials stated that HUD does not require collection accounts to be paid and considered the borrower to be working to improve his credit and to honor his responsibilities. We maintain that the borrower's poor credit history warranted further assessment and consideration, given the significant issues involved.

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HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that 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.

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Case number:	105-1769305
Loan purpose:	Purchase
Underwriter type	Automated underwritten
Date of loan closing:	March 19, 2004
Insured amount:	$147,175
Debt-to-income ratio:	60.93 percent
Status:	Default
Default reason:	Curtailment of income

Debts Not Properly Assessed

Pine State's loan file contained no evidence that it asked the borrower to explain a credit inquiry that resulted in an additional $306 monthly debt. The borrower made the loan in March 2004, the same month Pine State closed the borrower's home loan. The credit report showed the inquiry, dated December 17, 2003. The additional debt was for an auto loan shown on a credit report Pine State obtained on February 20, 2005, during its quality control review. However, Pine State's quality control review did not detect the additional debt. The borrower had a responsibility to report all credit obligations. However, Pine State was required to ask the borrower to explain the reason for the inquiry and whether it resulted in an additional debt. Thus, Pine State missed the opportunity to identify the debt and to input the debt into its automated underwriting system for consideration in determining the borrower's eligibility. Adjustment for the debt and housing cost (discussed below) resulted in a 60.93 percent debt-to-income ratio compared to the 47.34 percent rate Pine State calculated.

Pine State officials stated that they did not follow up on the inquiry because it occurred more than 90 days before their loan approval. Pine State's position was not consistent with the requirement to follow up on inquiries that occurred within 90 days of the credit report date.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-3B, states that inquiries shown on the credit report within the last 90 days are to be considered when analyzing the borrower's credit worthiness.

Gift Not Properly verified

Pine State's file contained no documentation that it verified a $4,395 gift paid to the closing agent by a nonprofit donor. Thus, Pine State allowed the loan to close without support that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. We discussed this matter with Pine State officials, and they followed up and obtained the documents needed to confirm receipt of the gift. However, their verification does not relieve Pine State of its responsibility to verify the transfer of gift funds before loan closing.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10C, provides that if the gift funds are not deposited to the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

Other - Understated Liabilities (Housing Cost)

Pine State understated the borrower's monthly housing cost by $59. We used the amounts reflected on the HUD-1 settlement statement for housing costs. The $59 is the net of a $72 understatement for taxes and an ($13) overstatement for insurance. The understated amount contributed to the borrower's high debt-to-income ratio. Pine State also noted this condition during its quality control review.

HUD Requirement

Handbook 4155.1, REV 5, paragraph 2-11A, provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all other additional recurring charges extending 10 months or more.

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Case number:	105-1741989
Loan purpose:	Purchase
Underwriter type:	Automated underwritten
Date of loan closing:	February 3, 2004
Insured amount:	$178,690
Debt-to-income ratio:	55.43 percent
Status:	Default
Default reason:	Other – not specified

Income Not Properly Assessed

Pine State overstated the borrower's monthly income by at least $907. The overstatement included $627 for Social Security and $280 for commissions. Pine State

- Allowed $627 in Social Security pay without verifying the likelihood that the income would continue for the first three years of the loan. We contacted the Social Security Administration and determined that it terminated the payments in August 2005, 18 months after the loan closed. It terminated the payments because the borrower's income exceeded the eligibility limit. In addition, Pine State did not document why it increased the $545 shown on the verification by 15 percent to $627. The increase was not justified based on our reconfirmation of the payment.

- Overstated the borrower's 2002 monthly commission income by $280 because it did not deduct $6,728 in expenses that offset commissions. In addition, Pine State overstated the borrower's 2003 commission income by an undetermined amount due to its failure to document and deduct commission expenses.

Pine State agreed with our assessment that the income was overstated by at least $907. Adjustment for overstatement and debts discussed below resulted in a 55.43 percent debt-to-income ratio compared to the 46.34 percent rate Pine State calculated.

HUD Requirements

Handbook 4155.1, REV 5, section 2, provides that 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. Paragraph 2-7 provides that the income 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. Paragraph 2-7D requires lenders to subtract unreimbursed business expenses from gross income. The automated underwriter findings report required Pine State to consider business expenses when underwriting the loan.

Debts Not Properly Assessed

Pine State's loan file contained no evidence that it asked the borrower to explain a credit inquiry that resulted in an additional $3,430 debt. The borrower made the loan in November 2003. The credit report showed the inquiry, dated October 22, 2003. The additional debt was shown on a credit report Pine State obtained on February 18, 2005, during its quality control review. The credit report did not show the monthly payment amount. The borrower had a responsibility to report all credit obligations. However, Pine State was required to ask the borrower to explain the reason for the inquiry and whether it resulted in or might result in an additional debt. The debt further contributed to the borrower's already high 59.47 percent debt-to-income ratio.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-3B, provides that the lender must determine the purpose of any recent debts. The borrower must explain in writing all inquiries shown on the credit report in the last 90 days. The automated underwriter finding (17) required the lender to include new debt resulting from material inquiries listed on the credit report.

Other - Outdated Income Verification

Pine State relied on an outdated February 20, 2002, verification for the borrower's Social Security income. The verification was more than 120 days old when the loan closed on February 3, 2004.

HUD Requirements

Handbook 4155.1, REV 5, paragraph 3-1, provides that all documents may be up to 120 days old at the time the loan closes (180 days for new construction). Updated, written verifications must be obtained when the age of the documents exceed these limits.

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Case number:	105-2020030
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Date of loan closing:	July 30, 2004
Insured amount:	$161,283
Debt-to-income ratio:	58.28 percent
Status:	Default
Default reason:	Other – not specified

<u>Income Overstated</u>

Pine State overstated the borrower's monthly income by $688. The overstatement included $478 for employment and $210 for child support. Pine State

- Allowed $478 in monthly overtime pay that did not meet requirements. The borrower had been employed at the job for only 10 months before the loan closing. This was not long enough to demonstrate the two-year pattern generally required to justify including overtime as effective income. Also, Pine State did not verify that the overtime was likely to continue. The file did not contain a written explanation for including overtime earned for less than the required two-year period.

- Allowed $210 per month for child support without documenting the file to show that it identified and considered discrepancies associated with the payment. The file showed the borrower had three children. The file did not contain a copy of a final divorce decree, legal separation agreement, or voluntary payment agreement, setting forth the legal basis for the payments, payment amount, which was responsible for the payment, and for how long the payments would continue. The file contained a copy of a divorce decree that dissolved a prior marriage between the borrower and the father of two of the children. The divorce decree did not mention child custody or child support and the payments received were not from the borrower's prior husband. The file did not identify the father of the third child and did not contain any documentation that stipulated an obligation for anyone to pay child support for the child. The underwriting findings requested evidence that the payments would continue for at least three years. The file contained no evidence that Pine State followed up to obtain the requested information.

  Further, for the period January 1, 2003, to May 17, 2004, the support payments varied from a low of $210 to a high of $441. The most recurring payments amounted to $280 and $210 (latest three payments), but several months had irregular highs of $350, $420, and $441. The file contained no evidence that Pine State attempted to identify why the payments fluctuated.

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We adjusted the borrower's income to omit the $688 and other amounts discussed below. The adjustments resulted in a 58.28 percent debt-to-income ratio compared to the 40.61 percent rate Pine State calculated.

<u>HUD Requirements</u>

HUD Handbook 4155.1, REV-5, paragraph 2-7, provides that 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. Paragraph 2-7A, provides that overtime income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable, provided the lender justifies and documents in writing the reason for using the income for qualifying purposes.

Paragraph 2-7F discusses child support income. The handbook provides that income in this category may be considered as effective if such payments are likely to be consistently received for the first three years of the mortgage. The borrower must provide a copy of the final divorce decree, legal separation agreement, or voluntary payment agreement, as well as evidence that payments have been received during the last 12 months. Periods less than 12 months may be acceptable, provided the payer's ability and willingness to make timely payments is adequately documented by the lender.

<u>Credit Not Properly Assessed</u>

Pine State did not properly assess or document its assessment of the borrower's poor credit performance following a release from a bankruptcy on May 29, 2001. Between January and June 2001, the borrower opened three accounts that were $1,556 delinquent when Pine State pulled its credit report. The delinquencies consisted of accounts with balances of $932, $334, and $290. Pine State required the borrower to pay off the accounts as a condition to its approval of the loan. The HUD-1 settlement statement showed the amounts were paid. However, the files did not document compensating factors Pine State considered to offset the borrower's poor credit performance.

<u>HUD Requirements</u>

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligation and predicting a borrower's future actions. It further states that 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.

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Other - Understated Liabilities (Housing Cost)

Pine State understated the borrower's monthly housing cost by $88. We used the amounts reflected on the HUD-1 settlement statement for housing costs. The understatement includes $50 for taxes and $38 for insurance. Adjustment for the understatement contributed to the borrower's high 58.28 percent debt-to-income ratio. Pine State also noted this condition during its quality control review.

HUD Requirement

HUD Handbook 4155.1, REV-5, paragraph 2-11A, provides that lenders must include the monthly housing expense and all other additional recurring charges extending 10 months or more.

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Case number:	105-1587099
Loan purpose:	Purchase
Underwriter type:	Automated underwritten
Date of loan closing:	October 20, 2003
Insured amount:	$179,200
Debt-to-income ratio:	54.14 percent
Status:	Default
Default reason:	Other

Interest Rate Buydown Not Properly Assessed

Pine State did not make or document the required determinations needed to justify the use of an interest rate buydown to qualify the borrower for the loan. The file did not show or document that Pine State assessed the buydown to assure that the eventual increased mortgage payments would not adversely affect the borrower and likely lead to default. We reviewed the file and determined that the borrower did not meet at least one of the four buydown criteria. Thus, Pine State inappropriately used the $935 monthly bought down mortgage amount rather than the full $1,162 payment to qualify the borrower. Adjustment for the buydown and the other issues discussed below resulted in a 54.14 percent debt-to-income ratio compared to the 46.97 percent ratio Pine State calculated.

HUD Requirements

HUD Handbook 4155.1, REV 4, paragraph 2-14B(2), provides that the lender must establish that the eventual increase in mortgage payments will not affect the borrower adversely and likely lead to default. The underwriter must document that the borrower meets one of four criteria that require borrowers to have (a) potential for increased income that would offset the scheduled payment increases, (b) demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expenses, (c) substantial assets available to cushion the effect of the increased payments, or (d) cash investment made that substantially exceeds the minimum required.

Pine State officials stated that the borrower and coborrowers had the potential for increased earnings to offset the buydown amount. The files did not support Pine State's position. The first monthly buydown increment amounted to $111. The file showed the coborrower was to receive a $37 per month raise. The raise was $74 less than the amount needed to offset the buydown. The borrower was to receive an unspecified raise within two months of closing. The borrower's prior raise amounted to 10 cents per hour. The file and the borrower's past pay increase provided no grounds to anticipate that the next raise would amount to the 45 cents per hour needed to offset the $74 balance of the buydown increment. Pine State also stated the coborrower earned overtime that was not counted as effective income. We did not recognize the overtime because the file did not contain documents needed to determine overtime pay for the required two-year period. The overtime paid during the past seven and a half months totaled only $284.

Debts Not Properly Assessed

Pine State's loan file contained no evidence that it asked the borrower to explain a credit inquiry that resulted in an additional $39 monthly debt. The borrower made the loan in August 2003, and Pine State closed the borrower's home loan on October 20, 2003. The credit report showed the inquiry, dated August 17, 2003. The additional $1,634 debt was shown on the credit report Pine State obtained on October 9, 2005, during its quality control review. The borrower had a responsibility to report all credit obligations. However, Pine State was required to ask the borrower to explain the reason for the inquiry and whether it resulted in an additional debt. The debt contributed to the borrower's high 54.14 percent debt-to-income ratio.

HUD Requirements

HUD Handbook 4155.1, REV-4, paragraph 2-3B, provides that the borrower must explain all inquiries shown on the credit report. Paragraph 2-11A requires the lender to consider all recurring obligations extending 10 months or more. The automated underwriter findings report required the lender to include all new debt payments resulting from material inquiries listed on the credit report.

Gift Not Properly Verified

Pine State's file contained no documentation that it verified receipt of a $5,482 gift paid to the closing agent by a nonprofit donor. Thus, Pine State allowed the loan to close without verifying that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. Pine State also noted this condition during its quality control review of the loan. We discussed this matter with Pine State officials, and they followed up and obtained the documents needed to confirm receipt of the gift.

HUD Requirements

HUD Handbook 4155.1, REV-4, paragraph 2-10C, provides that if the gift funds are not deposited to the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

Other - Understated Liabilities (Housing Cost)

Pine State understated the borrower's monthly housing insurance cost by $26. We used the insurance amount reflected on the HUD-1 settlement statement. The understatement contributed to the borrower's high 54.14 percent debt-to-income ratio.

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HUD Requirement

Handbook 4155.1, REV 4, paragraph 2-11A, provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all other additional recurring charges extending 10 months or more.

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Case number:	105-1524517
Loan purpose:	Purchase
Underwriter type:	Automated underwritten
Date of loan closing:	November 7, 2003
Insured amount:	135,600
Debt-to-income ratio:	53.42 percent
Status:	Default
Default reason:	Excessive obligations

Debts Not Properly Assessed

Pine State's loan file contained no evidence that it asked the borrower to explain a credit inquiry that resulted in an additional $211 monthly debt. The borrower made the loan in October 2003, and Pine State closed the borrower's home loan on November 7, 2003. The credit report showed the inquiry, dated September 30, 2003. The additional $6,174 debt was shown on a credit report Pine State obtained on July 29, 2005, during its quality control review. The borrower had a responsibility to report all credit obligations. However, Pine State was required to ask the borrower to explain the reason for the inquiry and whether it resulted in an additional debt. Thus, Pine State missed the opportunity to identify the debt and enter it into its automated underwriting system for consideration in determining the borrower's eligibility. Pine State's quality control review also identified the new debt. Adjustments for the debt resulted in a 53.42[4] percent debt-to-income ratio compared to the 47.36 percent rate Pine State calculated.

Pine State officials stated that they did not follow up on the credit inquiry because they did not think they were required to do so based on wording contained in the automated underwriting finding report. We reviewed the wording and determined that it intended for Pine State to follow up on the inquiry.

HUD Requirements

HUD Handbook 4155.1, REV-4, paragraph 2-3B, provides that the borrower must explain all inquiries shown on the credit report. Paragraph 2-11A requires the lender to consider all recurring obligations extending 10 months or more. Also, 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 the loan closing. The Fannie Mae underwriter findings report required the lender to include all new debt payments resulting from material inquiries listed on the report in the debt ratios.

[4] Pine State overstated the borrower's monthly housing cost by $57. We made an adjustment for the overstatement when we recalculated the debt-to-income ratio.

Gift Not Properly Verified

Pine State's file contained no documentation that it verified receipt of a $4,100 gift paid to the closing agent by a nonprofit donor. Thus, Pine State allowed the loan to close without confirming that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. Pine State obtained a copy of the wire transfer during the course of our audit. However, the later verification does not relieve Pine State of its responsibility to verify the transfer of gift funds before loan closing.

HUD Requirements

HUD Handbook 4155.1, REV-4, paragraph 2-10C, requires that if the gift funds are not deposited to the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

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Case number:	105-1531395
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Date of loan closing:	November 21, 2003
Insured amount:	$142,950
Debt-to-income ratio:	45.25 percent
Status:	Partial reinstatement
Default reason:	Excessive obligations

<u>Credit Not Properly Assessed</u>

Pine State did not properly assess or document its assessment to justify why it approved the loan despite the borrower's poor credit. The automated underwriting finding report referred the loan for manual underwriting because the loan exceeded the risk threshold for automated approval. The credit report showed that the borrower had serious delinquencies and derogatory public records or collections and that the length of time since derogatory public records or collection was too recent or unknown. Pine State did not properly assess or document its assessment of

- The borrower's collection accounts and a judgment. The credit report showed five collection accounts that totaled $2,467 and one $4,652 judgment that had been satisfied. The collection accounts each occurred within 8 to 19 months of the loan closing, and the judgment was within 11 months of closing. The file did not contain a written explanation for the judgment. Further, in some instances, the borrower's written explanation for the collections did not make sense. For instance, the borrower stated that most of the collections occurred before obtaining stable employment and salary increases. The credit report showed the judgment and four of the collection accounts occurred after July 2002. This was after the borrower started work for the employer in 2001 and established a stable earning pattern. The file showed three 2002 collections (one each in August, November, and December) resulted from insufficient fund checks. The insufficient fund checks were not consistent with the borrower's generalized explanation for the collection accounts. The file contained no evidence that Pine State questioned the inconsistencies and the missing explanation for the judgment.

- The reason for a 60-day delinquency shown on the credit report for an auto loan.

- The borrower's explanation for 16 credit inquiries (none mortgage lender related) within three months of loan closing. The borrower's letter of explanation stated, "I have not opened any new accounts." Pine State could not locate and produce the credit report it was supposed to obtain for the borrower to assess why the loan defaulted with fewer than six payments. Thus, we did not determine whether the inquiries resulted in additional debts. HUD's system showed the borrower defaulted due to excessive obligations.

HUD Requirements

HUD Handbook 4155.1, REV-4, paragraphs 2-3 and 2-3B, states that past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations. If the credit history reflects continuous slow payments, judgments, and delinquent accounts, strong offsetting factors will be necessary to approve the loan. 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 other factors beyond the borrower's control. 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, require written explanations. The explanations must make sense and be consistent with other credit information in the file. Paragraph 2-3B provides that the borrower must explain all inquiries shown on the credit report.

Gift Not Properly Verified

Pine State's file contained no documentation that it verified receipt of a $4,293 gift paid at closing by a nonprofit donor. Thus, Pine State allowed the loan to close without support that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. Pine State obtained a copy of the wire transfer during the course of our audit. However, their later verification does not relieve Pine State of its responsibility to verify the transfer of gift funds before loan closing. Pine State also noted this issue during its quality control review of the loan.

HUD Requirements

HUD Handbook 4155.1, REV-4, paragraph 2-10C, requires that if the gift funds are not deposited to the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

Other - Understated Liabilities (Housing Cost)

Pine State understated the borrower's monthly housing cost by $40. We used the amounts reflected on the HUD-1 settlement statement for housing costs. The understatement consists of $24 for taxes and $16 for insurance. Adjustment for the understatement increased the borrower's debt-to-income ratio from 44.19 to 45.25 percent.

HUD Requirement

Handbook 4155.1, REV-4, paragraph 2-11A, provides that the lender must include the monthly housing expense and all other additional recurring charges extending 10 months or more.

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Case number:	105-1817383
Loan purpose:	Purchase
Underwriter type	Manually underwritten
Date of loan closing:	March 31, 2004
Insured amount:	$146,007
Debt-to-income ratio:	34.43 percent
Status:	Default
Default reason:	Excessive obligations

Inappropriate Quitclaim

Pine State submitted the loan for insurance endorsement knowing that the coborrower had inappropriately transferred by quitclaim deed an interest in the property to his wife. The borrower's wife was not listed on the loan application, and Pine State did not identify and assess the wife's income and credit. Pine State's representatives stated they did not learn of the quitclaim until after they received the closing documents from the closing attorney. Pine State either knew or should have known about the transfer before it submitted the loan to HUD for endorsement. The loan closed on March 31, 2004. Pine State successfully completed the insurance application on May 3, 2004. It was required to resolve all problems regarding title to the real estate and to ensure that the loan closed in the same manner in which it was underwritten and approved. Pine State did not include the quitclaim in the documents sent to HUD for the Federal Housing Administration case file. HUD's system showed the borrower defaulted due to excessive obligations.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 3-10 (lender responsibility at closing), provides that the lender is required to resolve all problems regarding title to the real estate. The loan must close in the same manner in which it was underwritten and approved. Additional signatures on the security instruments and/or mortgage note of individuals not reviewed during mortgage credit analysis may be grounds for withholding endorsement. Paragraph 2-2A states that HUD does not permit an individual to take an ownership interest in the property at settlement without signing the mortgage note and all security instruments.

Other - Understated Liabilities (Housing Cost)

Pine State understated the borrower's monthly housing cost by $58. We used the amounts reflected on the HUD-1 settlement statement as the correct statement of the borrower's housing costs. The $58 is the sum of a $47 understatement for taxes and an $11 understatement for insurance. Pine State also noted this condition during its quality control review. Adjustment for the understatement increased the debt-to-income ratio from 32.68 to 34.43 percent.

HUD Requirement

Handbook 4155.1, REV 5, paragraph 2-11A, provides that the lender must include the monthly housing expense and all other additional recurring charges extending 10 months or more.

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Case number:	105-1728585
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Date of loan closing:	January 15, 2004
Insured amount:	$167,322
Debt-to-income ratio:	44.51 percent
Status:	Default
Default reason:	Excessive obligations

Inappropriate Quitclaim

Pine State submitted the loan for insurance endorsement knowing that both coborrowers had inappropriately quitclaimed their interest in the property to the borrower and her husband. The coborrowers were the borrower's mother and father. The borrower's husband was not listed on the loan application, and Pine State did not identify and assess the husband's income and credit. Pine State's representatives stated they did not learn of the quitclaim until after they received the closing documents from the closing attorney. Pine State either knew or should have known about the transfer before it submitted the loan to HUD for endorsement. The loan closed on January 15, 2004. Pine State successfully completed the insurance application on February 10, 2004. It was required to resolve all problems regarding title to the real estate and to ensure that the loan closed in the same manner in which it was underwritten and approved. Pine State did not include the quitclaim in the documents sent to HUD for the Federal Housing Administration case file.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 3-10 (lender responsibility at closing), provides that the lender is required to resolve all problems regarding title to the real estate. The loan must close in the same manner in which it was underwritten and approved. Additional signatures on the security instruments and/or mortgage note of individuals not reviewed during mortgage credit analysis may be grounds for withholding endorsement. Paragraph 2-2A states that HUD does not permit an individual to take an ownership interest in the property at settlement without signing the mortgage note and all security instruments.

Debts Not Properly Assessed

Pine State understated the borrower's monthly debts by $680 because it either omitted debts shown on credit reports or did not use the payment terms shown on the most recent credit reports. Pine State officials reviewed our calculations and said we double counted one debt with a $127 monthly payment. The credit report showed two $127 monthly payments to the same creditor for different accounts. We also observed that the credit report indicated the borrowers had experienced some credit problems. For instance, Pine State required the borrower to pay $1,794 for a delinquent account and a judgment as a condition to its approval of the loan. Adjustments for the understated debts and income (discussed below) resulted in a 44.51 percent back ratio compared to the 34.93 percent ratio Pine State calculated. HUD's system showed the loan went into default due to excessive obligations.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-11A, requires the lender to consider all recurring obligations extending 10 months or more. Paragraph 2-3 states that 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.

Income Discrepancy

Pine State did not include $804 in monthly retirement income for a coborrower. We did not add the amount because the coborrower transferred her interest in the property at closing.

HUD Requirement

HUD Handbook 4155.1, REV-5, paragraph 2-7, provides that 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 payments expected to be received in retirement.

Gift Not Properly verified

Pine State's file contained no documentation that it verified a $5,060 gift paid to the closing agent by a nonprofit donor. Thus, Pine State allowed the loan to close without support that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. Pine State obtained a copy of the wire transfer during its quality control review of the loan. However, their later verification does not relieve Pine State of its responsibility to verify the transfer of gift funds before loan closing.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10C, provides that the lender must document the transfer of the funds from the donor to the borrower. If the funds are not

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deposited to the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

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Case number:	105-1548492
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Date of loan closing:	November 21, 2003
Insured amount:	$162,300
Debt-to-income ratio:	Unknown
Status:	Default
Default reason:	Other

Unsupported Income

Pine State underwrote the loan with no support for how it calculated and verified the borrower's effective income. The file showed the borrower worked as a contractor and as an employee for different clients or employers at different times. The current employment verification showed the borrower had been employed as a contract worker for 10 weeks before loan closing and that the borrower's continued employment depended on the availability of assignments. Pine State could not support the effective income it used to approve the loan. In response to our request for support, Pine State provided a different and lower effective income that used an unsupported 25 percent factor to estimate the borrower's business expense deductions. The recalculation resulted in a 45.21 percent debt-to-income ratio compared to the 39.59 percent Pine State used to approve the loan.

Pine State should have required the borrower to provide documentation of actual business expenses incurred for determination of effective income. The borrower's 2002 federal tax return showed business expenses amounted to 66 percent of gross contract revenue. The 66 percent factor is substantially higher than the unsupported 25 percent factor Pine State used. The 66 percent factor would result in a 60.30 percent debt-to-income ratio compared to the 45.21 percent ratio Pine State calculated. However, the determination of effective income should not involve assumption. HUD does not allow income from any source that cannot be verified or will not continue. Thus, the borrower's actual debt-to-income ratio is not known. Pine State's quality control review also identified a problem with the borrower's income.

HUD Requirement

Handbook 4155.1, REV-4, CHG-1, section 2, provides 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. Paragraph 2-6 requires lenders to analyze and document the probability of continued employment and states that lenders must examine the borrower's past employment and the employer's confirmation of continued employment. Paragraph 2-7 provides that the income 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. Paragraph 2-9C discusses employee business expenses and requires determination of actual cash expenses that must be deducted from the borrower's adjusted income.

<u>Gift Not Properly Verified</u>

Pine State's file contained no documentation that it verified receipt of a $4,909 gift paid at closing by a nonprofit donor. Thus, Pine State allowed the loan to close without support that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The HUD-1 settlement statement showed the gift was paid. At our request, Pine State obtained a copy of the wire transfer. However, the later verification does not relieve Pine State of its responsibility to verify the transfer of gift funds before loan closing. The missing documentation was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction.

<u>HUD Requirements</u>

HUD Handbook 4155.1, REV-4, paragraph 2-10C, requires that if the gift funds are not deposited to the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

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