TO: Brian D. Montgomery, Assistant Secretary for Housing-Federal Housing Commissioner, H  
John W. Herold, Associate General Counsel for Program Enforcement, CE  

FROM: Heath Wolfe, Regional Inspector General for Audit, 5AGA  

SUBJECT: Colony Mortgage Corporation, Supervised Lender, Fairview Park, Ohio, Did Not Always Comply with HUD’s Requirements Regarding Underwriting of Loans and Quality Control Reviews  

HIGHLIGHTS  

What We Audited and Why  

We audited Colony Mortgage Corporation (Colony), a supervised lender approved to originate, underwrite, and submit insurance endorsement requests under the U.S. Department of Housing and Urban Development’s (HUD) single-family direct endorsement program. The audit was part of the activities in our fiscal year 2006 annual audit plan. We selected Colony for audit because of its high default-to-claim rate. Our objectives were to determine whether (1) Colony complied with HUD’s regulations, procedures, and instructions in the underwriting Federal Housing Administration-insured loans and (2) Colony’s quality control plan, as implemented, met HUD’s requirements.  

What We Found  

Colony approved 9 of 22 Federal Housing Administration loans reviewed that did not meet HUD’s requirements. The nine loans went to claim between October 1, 2003, and September 30, 2005. Further, Colony incorrectly certified to the integrity of the data supporting the underwriting deficiencies or to the due diligence used in underwriting the nine loans. During the audit period, Colony’s quality control plan  

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Issue Date  
March 26, 2007
did not fully comply with HUD’s requirements, and its quality control reviews were not adequately performed. Its deficient quality control may have contributed to the underwriting deficiencies. For the loans in question, the risk to the Federal Housing Administration fund was increased.

What We Recommend

We recommend that HUD’s assistant secretary for housing-federal housing commissioner require Colony to reimburse HUD for any future net loss once the associated properties are sold, reimburse HUD nearly $199,000 for the loss incurred on four loans already sold and for one over-insured loan, improve its existing procedures and controls to ensure that its underwriters follow HUD’s underwriting requirements, implement its revised quality control plan, and ensure that quality control reviews are performed in accordance with its revised plan. These procedures and controls should help ensure that more than $141,000 in Federal Housing Administration funds is protected from loss or misuse.

We also recommend that HUD’s associate general counsel for program enforcement determine legal sufficiency and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act against Colony and/or its principals for the nine incorrect certifications cited in this audit report.

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

Auditee’s Response

We provided the results of our underwriting and quality control reviews to Colony’s management during the audit. We also provided our discussion draft report to Colony’s president and HUD’s staff during the audit. We conducted an exit conference with Colony’s president on January 10, 2007.

We asked Colony’s president to provide written comments on our discussion draft audit report by January 19, 2007. Colony’s president provided written comments to the discussion draft report, dated January 18, 2007. Colony did not agree with finding 1, but generally agreed with finding 2. The complete text of the written comments, except for 178 pages of documentation that were not necessary to understand Colony’s comments, along with our evaluation of that response, can be found in appendix B of this report. We redacted the names of borrowers and sellers cited in the president’s comments prior to including them in this audit report. A complete copy of Colony’s comments plus the documentation was provided to the director of HUD’s Quality Assurance Division in Headquarters.
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BACKGROUND AND OBJECTIVES

Colony Mortgage Corporation (Colony) headquartered in Fairview Park, Ohio, was founded in 1984. It originates Federal Housing Administration loans through its home office and nine branch offices serving consumers, small to midsize businesses, and government entities in Ohio, Michigan, and Indiana. In January 1986, the U.S. Department of Housing and Urban Development (HUD) approved Colony as a supervised direct endorsement lender to originate Federal Housing Administration-insured loans. As a direct endorsement lender, Colony determines that the proposed mortgage is eligible for insurance under the applicable program regulations and submits the required documents to HUD without its prior review of the origination and closing of the mortgage loan. Colony is responsible for complying with all applicable HUD regulations and handbook instructions.

As of January 2007, Colony had seven loan correspondents and acted as an agent for one principal and a principal for two authorized agents. Colony sells all loans that it originates into the secondary market on a servicing-released basis. It is primarily a retail residential lender offering Federal Housing Administration, U.S Department of Veterans Affairs, and conventional mortgage financing.

We audited Colony as part of the activities in our fiscal year 2006 annual audit plan. Between October 1, 2003, and September 30, 2005, Colony originated/sponsored 2,718 Federal Housing Administration loans totaling more than $345 million in original mortgage amounts. Of these, 30 loans totaling more than $3.7 million in original mortgage amounts went to claim. Colony’s default-to-claim rate was 6.69 percent for October 2003 through September 2005.

Our objectives were to determine whether (1) Colony complied with HUD’s regulations, procedures, and instructions in the underwriting of Federal Housing Administration-insured loans and (2) Colony’s quality control plan, as implemented, met HUD’s requirements.
RESULTS OF AUDIT

Finding 1: Colony’s Underwriting of Nine Federal Housing Administration Loans Contained Deficiencies

Colony approved 9 of 22 Federal Housing Administration loans reviewed that did not fully meet HUD’s requirements. The nine loans went to claim between October 1, 2003, and September 30, 2005. The underwriting deficiencies were material as well as technical and included errors and documentation omissions clearly contrary to prudent lending practices. Further, Colony incorrectly certified to the integrity of the data supporting the underwriting deficiencies or that due diligence was used in underwriting nine loans. The problems occurred because Colony lacked adequate procedures and controls over its underwriting of Federal Housing Administration-insured loans and did not have a quality control plan that complied with HUD’s requirements (see finding 2). As a result of the improperly underwritten loans, the risk to the Federal Housing Administration fund was increased, and HUD paid more than $70,000 in claims for three loans and incurred losses of nearly $198,000 on another four loans.

Using HUD’s Single Family Data Warehouse system, we determined that Colony sponsored 2,718 Federal Housing Administration-insured loans totaling more than $345 million between October 1, 2003, and September 30, 2005. Of these, 30 loans totaling more than $3.7 million in original mortgage amounts went to claim. Six of the loans had already been reviewed by HUD’s Quality Assurance Division, and two loans had been sold under HUD’s Accelerated Claim and Asset Disposition program. Therefore, we excluded these eight loans from our universe and reviewed the remaining 22 loans for compliance with HUD’s underwriting requirements.

Colony improperly underwrote 9 of the 22 loans with a total mortgage value of nearly $1.1 million. Eight of the loans were purchases and one was a refinance loan. As of January 31, 2007, HUD had paid claims of more than $70,000 for three loans with underwriting deficiencies and incurred losses of nearly $198,000 on another four loans.

1 Prior to our sample selection, loan numbers 201-3402921 and 412-5088277 were not identified as loans reviewed by HUD’s Quality Assurance Division in HUD’s system, thus the loans were included in our universe. Since we identified similar findings as HUD during our review of the loans for compliance with HUD’s underwriting requirements; we excluded the loans from our recommendations for indemnification or reimbursement, but included the loans in our universe of loans reviewed. Further, loan number 201-340291, was also included in the recommendation for remedies under the Program Fraud Civil Remedies Act due to an incorrect certification.
Excessive Debt-to-Income Ratios

Colony improperly approved six loans (411-3737859, 413-4227951, 413-4254327, 413-4263790, 413-4288944, and 413-4315823) when the borrowers’ debt-to-income ratios exceeded HUD’s requirements, and submitted the loans for insurance without sufficient compensating factors. Paragraphs 2-12 and 2-13 of HUD Handbook 4155.1, REV-5, specify that the ratio of mortgage payments to effective income (front ratio) generally may not exceed 29 percent and the ratio of total fixed payments to effective income (back ratio) may not exceed 41 percent unless significant compensating factors are presented. The handbook allows greater latitude in considering compensating factors for the front ratio than the back ratio. For example, Colony approved loan number 411-3737859 without documenting any compensating factors on the mortgage credit analysis worksheet when the borrower’s mortgage payment-to-income ratio exceeded HUD’s maximum percentage by 9.5 percent.

Understated Liabilities

Colony did not properly assess the borrowers’ financial obligations for two loans (413-4263790 and 413-4288944). For example, Colony approved loan number 413-4263790 without including all of the borrower’s recurring debts. The borrower’s credit report, dated December 3, 2003, showed a monthly payment of $173 to Garden Financial with a balance of $1,598. Although it would not take the borrower more than 10 months to payoff the debt, we included it in our evaluation of the borrower’s ability to repay the debt. According to HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-11, debts lasting less than 10 months must be counted if the amount of the debt affects the borrower’s ability to make the mortgage payments during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing. In this instance, the borrower did not have any assets at closing.

Stability and/or Properly Verified Income Not Documented

Colony did not verify the borrowers’ income or determine income stability for loan number 413-4254327. The borrower and coborrower did not explain the gaps in their employment from July 3 through October 2, 2003, and from January 1, 2001, until October 13, 2003, respectively. HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-6, states that the lender must verify the borrower’s employment for the most recent two full years. The borrower must also explain any gaps in employment spanning one month or more.

Rental History Not Properly Verified

Colony did not properly verify borrowers’ rental histories. For loan 413-4263790, it did not verify the borrower’s rental payment history directly from the landlord or mortgage servicer or through information shown on the credit report as required in
HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-3. For loan number 413-4288944, Colony did not fully verify the borrower’s history of housing obligations covering the most recent 12-month period. The credit report indicated that the borrower’s current landlord refused residence verification. The credit report only verified a nine-month period.

Automated Underwriting Conditions Not Met

Colony did not ensure that all of the automated underwriting approval conditions for loan 413-4313543 were satisfied before the loan closed. According to the underwriting findings report, the borrower’s employment must be supported by the most recent year-to-date pay stub documenting one full month’s earnings. However, the loan file did not contain any pay documentation for the borrower. Further, the borrower had only been employed for one day before the loan was submitted through the automated desktop underwriter. Fannie Mae’s Single Family Guide to Underwriting with Desktop Underwriter, chapter 2, states that borrowers must have been employed a minimum of 30 days in their current positions to use their income for qualifying purposes.

Source of Funds Not Documented

Colony did not document the sources of borrowers’ funds to close in accordance with HUD’s requirements. For loan 413-4263790, the borrower received a gift of equity; however, there was no gift letter in the loan file. For loan number 411-3737859, the source of the borrower’s funds used at loan settlement was not disclosed. The borrower paid more than $500 at closing; however, there was no bank statement or any documentation to indicate that the borrower had enough funds to close.

Over-insured Mortgage

For loan 413-4255461, Colony overestimated the financing costs and the principal balance, thereby exceeding HUD’s maximum insurable mortgage limit as outlined in the Mortgagee Letter 2001-12 and HUD Handbook 4155.1, REV-5. The loan was funded for $160,014 instead of the maximum amount of $158,867. Therefore, the loan exceeded the HUD’s maximum mortgage limit by $1,147.

Appendixes D and E of this report provide a detailed description of all loans with underwriting deficiencies noted in this finding for which we are recommending indemnification or reimbursement.
Of the nine improperly underwritten loans, eight were underwritten manually and one was underwritten using an automated underwriting system. We reviewed the certifications for nine loans for accuracy. Colony’s direct endorsement underwriter incorrectly certified to the integrity of the data for one loan and that due diligence was used in underwriting eight loans. When underwriting a loan using an automated system, HUD requires direct endorsement underwriters to certify to the integrity of the data supplied for a lender used to determine the quality of the loans and that the loans are eligible for insurance. When underwriting a loan manually, HUD requires a direct endorsement lender to certify that it used due diligence and reviewed all associated documents during the underwriting of the loan.

Appendix C of this report provides details of the federal requirements regarding underwriting of Federal Housing Administration loans as well as a citation under the Program Fraud Civil Remedies Act.

Colony needs to improve its existing procedures and controls over its underwriting of Federal Housing Administration-insured loans by implementing its revised quality control plan (see finding 2). Additionally, it needs to ensure that underwriters continue to receive necessary training on HUD’s underwriting requirements. Such procedures and controls should ensure the accuracy of Colony’s underwriting certifications submitted to HUD.

HUD’s Quality Assurance Division performed quality assurance reviews of Colony’s branch offices and its loan correspondents in September 2003, September 2004, December 2004, September 2005, March 2006, and January 2006 (see Followup on Prior Audits in this audit report). The reviews resulted in findings related to loan origination and underwriting. The underwriting deficiencies cited in this audit report, along with the prior HUD reviews, clearly demonstrate that Colony’s existing underwriting procedures and controls need to be improved to ensure compliance with HUD’s underwriting requirements.

As previously mentioned, Colony incorrectly certified the integrity of the data or that due diligence was used in underwriting nine loans. Using the 9 loans with incorrect certifications from the 22 loans tested (nine loans that HUD paid $535,396 in claims and 13 loans where the properties were sold and HUD lost $536,316 as of February 28, 2007), we estimate the risk to the Federal Housing Administration to
be at least $141,774 for the next year if Colony does not improve its underwriting certification procedures and controls. This amount reflects that, upon sale of the mortgaged property, the Federal Housing Administration’s average loss is about 29 percent of the claim amount based upon statistics provided by HUD.

**Recommendations**

We recommend that HUD’s assistant secretary for housing-federal housing commissioner require Colony to

1A. Reimburse HUD for any future losses from the $70,543 in claims paid on three loans (413-4254327, 413-4263790, and 413-4288944) with underwriting deficiencies. The original mortgage amounts for these loans totaled more than $353,077. The estimated risk to the Federal Housing Administration fund is $20,457.

1B. Reimburse HUD $1,147 for the one overinsured loan (413-4255461).

1C. Reimburse HUD $197,625 for the actual losses it incurred on four loans (411-3737859, 413-4227951, 413-4313543, and 413-4315823) improperly underwritten since the associated properties were sold.

1D. Improve existing procedures and controls to ensure that its underwriters follow HUD’s underwriting requirements. These procedures and controls include but are not limited to implementing its revised quality control plan; continuing to provide training to its underwriters regarding HUD’s underwriting requirements to adequately resolve any discrepancies involving documentation associated with the loans, adequately supporting borrowers’ income, obtaining and reviewing documentation that adequately supports the borrowers’ income stability and expenses, and providing oversight or monitoring of its underwriting certifications before submission to HUD. These procedures and controls should help reduce the risk to the Federal Housing Administration fund by at least $141,774.

We recommend that HUD’s associate general counsel for program enforcement

1E. Determine legal sufficiency and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act against Colony and/or its principals for incorrectly certifying to the integrity of the data or that due diligence was exercised during the underwriting of nine loans.
Finding 2: Colony Did Not Fully Comply with HUD’s Quality Control Requirements

Colony did not fully comply with HUD’s quality control requirements. During the period October 1, 2003, through September 30, 2005, Colony lacked a written quality control plan that met HUD’s requirements and its quality control reviews were not adequately performed. The problems occurred because of a lack of management oversight and Colony’s quality control plan was not consistent with HUD’s requirements. As a result, Colony did not always minimize or prevent improper underwriting of loans, thus increasing the risk to the Federal Housing Administration insurance fund.

Using HUD’s Single Family Data Warehouse and Neighborhood Watch systems, we identified 100 loans totaling more than $12.5 million in original mortgage amounts that were sponsored by Colony and closed between October 1, 2003, and September 30, 2005. The borrowers defaulted within the first six payments. Of the 100 loans, we statistically selected 34 loans totaling more than $4.5 million in original mortgage amounts to review for compliance with HUD’s quality control requirements.

Colony’s quality control plan was deficient. During the period October 1, 2003, through September 30, 2005, Colony lacked a written quality control plan that fully met HUD’s requirements. HUD’s Quality Assurance Division performed a quality assurance review in September 2003 and 2004 and determined that Colony’s quality control plan did not contain all of the requirements outlined in HUD Handbook 4060.1, REV-1. Therefore, Colony revised its quality control plan. When we reviewed the revised plan, we determined that it was still deficient.

Colony did not perform adequate quality control reviews. We statistically selected 34 loans to review for compliance with HUD’s underwriting requirements. We were unable to review one of the loans because at the time of our review Colony had not reviewed the loan. Therefore of the 33 loans that Colony quality control reviewed, 32 were not performed in accordance with HUD’s quality control requirements as follows:
• Thirty quality control review sheets did not contain evidence that a reverification of the borrowers’ employment was performed;

• Twenty-four quality control review sheets did not contain evidence that a reverification of the borrowers’ income, deposits, gift letters, or other sources of funds was performed;

• Eight quality control reviews were not performed in a timely manner. The reviews were performed from 71 to 286 days after the loans went into 90-day default;

• Nine quality control review sheets did not contain evidence that a desk review of the appraisal was performed; and

• Two quality control review sheets did not contain evidence that a new credit report was ordered (except for non-Federal Housing Administration streamline refinance or automated underwriting system loans).

**Lack of Management Oversight**

Colony’s management did not ensure that its quality control plan, and the reviews performed under its plan met HUD’s requirements. As a result of its deficient plan and failure to perform adequate quality control reviews, underwriting errors were not always minimized or prevented, thus increasing the risk to the Federal Housing Administration insurance fund (see finding 1).

On November 20, 2006, as a result of the audit, Colony revised its quality control plan to comply with HUD’s requirements. We reviewed the newly revised plan and determined that it was in full compliance. While Colony has taken initial action to become compliant with HUD’s requirements, it needs to fully implement its newly revised quality control plan to ensure the accuracy, validity, and completeness of its loan origination files.

See appendix F of this report for a listing of the 34 reviewed loans.

**Recommendations**

We recommend that HUD’s assistant secretary for housing-federal housing commissioner require Colony to

2A. Implement its revised quality control plan.

2B. Ensure that reviews of its early payment defaulted loans are performed in accordance with the revised plan.
SCOPE AND METHODOLOGY

We performed our audit between April 2006 and January 2007. We conducted the audit at HUD’s Columbus field office and Colony’s Fairview Park and Westerville, Ohio, offices. The audit covered the period October 1, 2003, through September 30, 2005. We extended this period as necessary. We conducted the audit in accordance with generally accepted government auditing standards.

To achieve our objectives, we relied on computer-processed data contained in HUD’s Single Family Data Warehouse and Neighborhood Watch systems for informational purposes only. We also reviewed HUD’s Homeownership Center and Colony’s hardcopy loan files. In addition, we interviewed HUD’s and Colony’s management and staff and borrowers’ employers. Further, we reviewed HUD’s rules, regulations, and guidance for the underwriting and quality control review of Federal Housing Administration loans.

Using HUD’s data systems, we identified that Colony originated/sponsored 2,718 Federal Housing Administration loans with closing dates from October 1, 2003, to September 30, 2005. The original mortgage value of these loans totals more than $345 million. Of the total number of loans Colony originated/sponsored, HUD paid claims on 30 loans totaling more than $3.7 million in original mortgage amounts. Of the 30 loans that went to claim, we determined that HUD’s Quality Assurance Division performed a quality assurance review on eight of the loans. For the eight loans, Colony violated HUD/Federal Housing Administration requirements, paid an administrative penalty, or was currently being considered for civil money penalties for seven of the loans as of March 2007, and resolved the findings cited for the remaining loan with HUD’s Quality Assurance Division. We also determined that two loans were sold using HUD’s Accelerated Claim and Asset Disposition program. We excluded 82 of the 10 loans from our universe. We then performed a 100 percent test on the remaining 22 loans that went to claim totaling more than $2.3 million in original mortgage amounts. We also reviewed the certifications for the nine loans that were improperly underwritten for accuracy.

Using HUD’s data system and Neighborhood Watch, we identified 100 loans totaling more than $12.5 million in original mortgage amounts that were sponsored by Colony between October 1, 2003, and September 30, 2005, in which the borrowers defaulted within the first six payments. We statistically selected 34 loans totaling more than $4.5 million in original mortgage amounts from the universe of 100 loans to determine whether Colony quality control reviewed the loans in accordance with HUD’s quality control requirements. Our sampling criteria used a 90 percent confidence level, 14 percent estimated error rate, and precision of plus or minus 10 percent.

Prior to our sample selection, loan numbers 201-3402921 and 412-5088277 were not identified as loans reviewed by HUD’s Quality Assurance Division in HUD’s system, thus the loans were included in our universe. Since we identified similar findings as HUD during our review of the loans for compliance with HUD’s underwriting requirements; we excluded the loans from our recommendations for indemnification or reimbursement, but included the loans in our universe of loans reviewed. Further, loan number 201-340291 was also included in the recommendation for remedies under the Program Fraud Civil Remedies Act due to an incorrect certification.
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,
- Compliance with applicable laws and regulations, and
- Safeguarding resources.

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

Relevant Internal Controls

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

- Program operations - Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Validity and reliability of data - Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with laws and regulations - Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding resources - Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

A significant weakness exists if internal controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization’s objectives.
Based on our review, we believe the following items are significant weaknesses:

- Colony needs to implement adequate procedures and controls over the underwriting of Federal Housing Administration loans (see finding 1).
- Colony needs to implement its revised quality control plan for reviewing loans that are early payment defaults to ensure compliance with HUD’s requirements (see finding 2).
This is the first audit of Colony by HUD’s Office of Inspector General (OIG). The two most recent independent auditor’s reports for Colony covered the years ending December 31, 2004, and 2005. Both reports resulted in no findings regarding underwriting of Federal Housing Administration loans or quality control reviews.

In September 2003 and December 2004, HUD’s Quality Assurance Division performed a quality assurance review of Colony’s branch offices in Columbus and Westerville, Ohio. Further, in January 2006 and March 2006, HUD’s Quality Assurance Division performed a quality assurance review of Colony’s loan correspondents Builder’s Financial Corporation and Dominion Homes Financial Services, respectively. The reviews resulted in findings related to loan origination, quality control, underwriting, and accuracy of computerized data. All of the findings were closed as of June 2004, July 2006, June 2006, and August 2006, respectively.

Additionally in September 2004, HUD’s Quality Assurance Division performed a quality assurance review of Colony. The review resulted in findings related to underwriting, loan originations, incorrect certifications, and quality control. Based on the review, HUD considered an administrative action against Colony and civil money penalties. As a result, Colony paid an administrative fee and the findings were closed as of August 2006.

Further, in September 2005, HUD’s Quality Assurance Division performed a quality assurance review of Colony’s loan correspondent Dominion Homes Financial Services. As a result of the review, HUD was considering administrative action against Colony and civil money penalties. The review resulted in five findings that included (1) failing to ensure that the borrowers met the minimum credit requirements, (2) failing to properly verify the borrowers’ income and/or stability of income, (3) approving loans in which the fixed payment-to-income ratio exceeded HUD/Federal Housing Administration standards without adequate compensating factors, (4) failing to document the source and/or adequacy of funds for the downpayment and/or closing costs, and (5) failing to follow the standards for automated underwriting systems. All findings were still shown as open in HUD’s system as of March 2007.
APPENDIXES

Appendix A

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

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1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local policies or regulations. 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. The amount above reflects that, upon sale of the mortgaged property, the Federal Housing Administration’s average loss experience is about 29 percent of the claim amount based upon statistics provided by HUD.

3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. This includes reduction in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. Implementation of our recommendation to indemnify loans that were not originated in accordance with Federal Housing Administration requirements will reduce the Federal Housing Administration’s risk of loss to the insurance fund. The amount above reflects that, upon sale of the mortgaged property, the Federal Housing Administration’s average loss experience is about 29 percent of the claim amount based upon statistics provided by HUD.
January 16, 2007

VIA FEDERAL EXPRESS
Ms. Kelly Anderson
Assistant Regional Inspector
General for Audit
U.S. Department of Housing
and Urban Development
Region V - Office of the Inspector
General
77 West Jackson Boulevard
Suite 2649
Chicago, IL 60604-3507

RE: Colony Mortgage Corporation
HUD OIG Draft Audit Report

Dear Mr. Wolfe:

Colony Mortgage Corporation ("Colony" or "Company") is in receipt of the Draft Audit Report ("Report"), dated December 21, 2006, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of the Inspector General ("OIG"). The Report is based on a review of Colony's Federal Housing Administration ("FHA") insured loan origination and operations, which the OIG conducted between January and December 2006. The audit covers 22 loans originated by the Company during the period October 1, 2003 through September 30, 2005.

The Report states that its primary objective was to determine whether Colony followed HUD loan origination requirements, including underwriting procedures and instructions, and implemented a Quality Control plan according to HUD requirements. The Report contains two findings, alleging underwriting deficiencies in 11 cases and improper Quality Control practices. Based on these findings, the Report recommends that HUD require the Company to: (1) indemnify HUD for any future losses incurred on loans where the associated properties have not been sold; (2) reimburse HUD for claims paid on properties that have been sold; (3) improve existing procedures and controls to ensure that underwriters follow HUD's underwriting requirements; (4) implement the Company's revised Quality Control plan and perform Quality Control reviews in accordance with HUD requirements; and (5) pursue other remedies as appropriate.
The OIG provided the Company with an opportunity to submit written comments for inclusion in the final report. This response summarizes Colony’s history and operations 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 AND PRIOR AUDITS

A. COLONY MORTGAGE CORPORATION

Colony was incorporated in November 1984, and it opened for business on July 12, 1985. Headquartered in Fairview Park, Ohio, the Company originates FHA loans through its home office and nine branch offices in three states. It employs approximately 70 individuals and received approval to participate in the Department’s FHA mortgage insurance programs on August 28, 1985. It received Direct Endorsement authority on January 16, 1995. The Company sells all loans that it originates into the secondary market on a servicing-released basis, and its primary investors currently include Wells Fargo Home Mortgage, Countrywide Home Loans, Inc., SunTrust, and Citimortgage. It sponsors seven loan correspondents and acts as an agent for one principal and a principal for two authorized agents. Colony, which also is an approved lender for Fannie Mae and the Veterans Administration, has closed, on average, about 3,500 loans per year for the past three years, approximately 42% of which has consisted of FHA loans.

Colony offers a wide variety of loan products tailored to the needs of its clientele. Colony works closely with individual borrowers to ensure that their unique individual and family needs are met, and its first priority is consumer satisfaction. As a mid-size mortgage lender with a strong dedication to consumers and a substantial minority and low-income client base, Colony takes its relationship with the Department and its responsibilities under the FHA program seriously. Since its inception, Colony has endeavored to provide dependable and professional service to both loan applicants and HUD, and we are committed to educating and training our employees on issues.
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regarding FHA compliance. Colony actively monitors the Company's performance on
Neighborhood Watch, and strives to originate quality FHA loans.

B. PRIOR AUDITS

As the Company has participated in the FHA Program for over 20 years and
originated a large volume of FHA loans, the Report refers to prior audits of the
Company performed by HUD’s Quality Assurance Division. Notably, the Report states
that the Quality Assurance Division audited Colony in September 2003, December
2004, and January 2006, and has since resolved these audits. In fact, in each of these
cases, Colony thoroughly explained its compliance with FHA guidelines, and the
matters were resolved appropriately. However, the Report refers to a September 2005
audit of Dominion Homes Financial Services, one of Colony’s loan correspondents, and
states that, as a result of this audit, “HUD is considering an administrative action against
Colony and civil money penalties.” The Report then details five alleged findings and
notes that all findings remain open as of December 12, 2006.

As the Company neither has record of a September 2005 audit nor has had
opportunity to respond to the alleged open findings involving loans brokered by
Dominion Homes Financial Services, Colony believes this statement in the Report
is inaccurate. In fact, Colony responded to an inquiry from the Atlanta Quality
Assurance Division in 2006 regarding loans brokered by Dominion Homes Financial
Services, and received a letter, dated August 16, 2006, indicating that HUD accepted
the Company’s responses and closed its review (Exhibit A). If the Quality Assurance
Division inquiry received by the Company in 2005 is connected to the alleged
September 2005 audit of Dominion Homes Financial Services, contrary to the Report’s
statement above, HUD has affirmatively closed its review of Colony, and no
deficiencies were discovered.

Moreover, in connection with the prior audits cited in the Report and the body of
loans reviewed by the OIG, the Report notes that “we determined that HUD’s Quality
Assurance Division performed a quality assurance review on six of the loans and
determined that Colony violated HUD/Federal Housing Administration requirements
during the origination of insured mortgages.” Colony, however, believes this statement
to be inaccurate and an unnecessary inflammatory comment against the Company.
Notably, the mere fact of prior Quality Assurance Division audits with allegations of
underwriting deficiencies in no way means that Colony did not comply with FHA
guidelines. Instead, as the statement is included in the Report to justify the OIG’s
exclusion of six loans from its review, we respectfully ask the OIG to state only the
accurate fact that these loans were previously reviewed by HUD’s Quality Assurance
Division. It has been the Company’s policy since inception to fully implement HUD’s
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requirements and adequately train Colony employees on the origination of FHA loans. As a result, we believe that HUD’s prior audits have served to reinforce and strengthen our compliance with FHA guidelines.

II. RESPONSES TO THE FINDINGS

The Report contains two findings, including several sub-findings, in which it alleges that: (1) Colony did not originate 11 loans in accordance with HUD requirements or prudent lending practices; and (2) the Company did not fully comply with HUD’s Quality Control plan requirements. Upon receipt of the draft Report, Colony 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 Colony’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 certain recommendations presented in the Report.

A. FINDING 1 – COLONY COMPLIED WITH HUD’S UNDERWRITING REQUIREMENTS

Finding 1 of the Report asserts in several sub-findings that the Company did not originate 11 of the 22 loans reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) compensating factors; (2) debt assessment; (3) income documentation; (4) rental history verification; (5) source of funds; (6) resolution of document discrepancies; (7) three “other” areas identified in Appendix E to the Report; and (8) underwriter certifications. Finding 1 also raises concerns regarding the Company’s Quality Control process and underwriting procedures.

In connection with these sub-findings, please note that the Department has acknowledged that underwriting is more of an art than a science and requires the careful weighing of circumstances that affect the borrower’s ability and willingness to
make timely mortgage payments." Mortgagor Letter 00-24; see also Mortgagor Letter 95-07. Underwriting requires the subjective evaluation of information based on experience in determining whether a potential borrower is creditworthy. An underwriter must carefully weigh all aspects of an individual's case. Were two underwriters to review the same file, one might approve a loan where the other would deny a loan. Significantly, each underwriter may have made a reasonable and prudent underwriting decision. Thus, while it is impossible for the OIG to put themselves in the place of the Company's underwriters, given the facts of the 11 cases cited herein, we believe the Company's underwriters properly considered the borrowers' circumstances and made reasonable underwriting decisions in these cases.

Moreover, the Report refers to 2,718 FHA-insured loans originated by Colony between October 1, 2003 and September 30, 2006, totaling $345 million in original mortgage amounts. The Report also identifies a $392,000 claim paid on five of these loans, which represents less than one-half of one percent of the total origination. These statistics, however, ignore the $5,189,635.00 paid by Colony to the Department in up-front mortgage insurance premiums and an additional $3,456,757.00 paid in annual mortgage insurance premiums on these loans. With HUD's receipt of over $9 million in mortgage insurance premiums from the Company, a $392,000 claim on five loans hardly demonstrates that Colony's underwriting and origination practices put HUD's insurance fund at risk.

The Company also takes issue with the OIG's review of two of the 11 loans cited in the Report. The Report specifically states that the OIG excluded six loans from the final 22 loans reviewed for the purposes of this audit because HUD's Quality Assurance Division performed a quality assurance review on these loans. The Report, however, fails to exclude two additional loans that were reviewed by the Quality Assurance Division and HUD's Mortgage Review Board (MRB) and determined to contain no deficiencies.

First, the Atlanta Quality Assurance Division audited the [redacted] loan (FHA Case No. 201-3402821) in connection with its review of Dominion Homes Financial Services, one of the Company's sponsored loan correspondents (GIAID File No. 18852). After reviewing Colony's response to the allegations raised in the [redacted] loan, as well as others, Mr. Verlon Shannon, Director of the Quality Assurance Division, sent a letter to the Company, dated August 16, 2006, stating that Colony's response was acceptable and that HUD's review was closed (Exhibit A). Second, following an audit by the Philadelphia Quality Assurance Division, HUD's MRB issued a Notice of Violation to the Company alleging underwriting deficiencies in connection with nine loans, including the [redacted] loan (FHA Case No. 412-5088277) (Docket No. 05-5057-MR). After receiving
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Colony's response to the MRB's allegations, HUD took no further issue with the case and did not request indemnification in connection with the loan. Thus, in each of these cases, HUD has already reviewed the Company's underwriting and determined that Colony complied with FHA guidelines. The OIG's subsequent review of these cases and the allegations raised in the Report amount to gratuitous "double jeopardy," and Colony vehemently disagrees with the Report's findings in these two cases. We address the Report's allegations in connection with each of the sub-findings in turn below.

1. Compensating Factors

In the first sub-finding, the Report asserts that, in seven cases, Colony approved the loans when the borrowers' debt-to-income ratios exceeded HUD's requirements and the underwriter did not provide sufficient compensating factors to justify approval. As discussed above, the Department has acknowledged that "[i]nderwriting is more of an art than a science and requires the careful weighing of circumstances that affect the borrower's ability and willingness to make timely mortgage payments." Mortgagee Letter 00-24; see also Mortgagee Letter 95-07. Underwriting requires the subjective evaluation of information based on experience in determining whether a potential borrower is creditworthy. An underwriter must carefully weigh all aspects of an individual's case, and where two underwriters review the same file, one might approve a loan where the other would deny a loan. Significantly, each underwriter may have made a reasonable and prudent underwriting decision.

Furthermore, the Department expressly permits a mortgagee to approve FHA financing to a borrower with qualifying ratios that exceed the benchmark guidelines of 28% and 41% when significant compensating factors justify loan approval. See, e.g., HUD Handbook 4155.1, REV-6, ¶¶ 2-12, 2-13. The Department has professed that the "FHA does not set an arbitrary percent by which ratios may be exceeded but rather FHA relies on the underwriter to judge the overall merits of the loan application and to determine what compensating factors apply and the extent to which these factors justify exceeding the ratios." Mortgagee Letter 00-24 (emphasis added). Thus, where a potential borrower's qualifying ratios are high, an underwriter has to consider all relevant circumstances and exercise discretion in deciding whether to approve or reject a loan. This discretion is particularly important when the same loans underwritten manually could be submitted through an automated underwriting system and approved with much higher qualifying ratios. With different standards for varying types of underwriting, the Department must rely on underwriters to adequately analyze a borrower's financial circumstances and take into account all relevant factors, including the range of acceptable levels in qualifying ratios.

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It is Colony’s policy to carefully consider each borrower’s circumstances and document significant compensating factors in the “Remarks” section of the Mortgage Credit Analysis Worksheet (“MCAV”) in compliance with HUD guidelines. This policy has been in place since the Company’s inception, and we regularly remind our employees of the importance of ensuring that debt-to-income ratios in excess of HUD’s guidelines are justified by significant compensating factors. As an illustration of the Company’s policy, we respond to the Report’s allegations in each of the seven cases below.

a. [Redacted] – FHA Case No. 201-3402921

In the [Redacted] case, the Report alleges that Colony did not document that the borrower met the requirements for an interest rate buydown or document the borrower’s ability to sustain the mortgage payment once the buydown agreement expired. Moreover, the Report asserts that the underwriter overstated the borrower’s income and understated the liabilities, which altered the borrower’s qualifying ratios. Specifically, the Report claims the borrower was receiving short-term disability at the time of application, which reduced the borrower's income from $17.83 per hour to $9.50 per hour. In addition, the Report claims that the borrower’s credit report identified an open account with a monthly payment of $325 to Brown Forman employee credit union with a balance of $1,498. Although it would not take the borrower more than 10 months to pay off the debt, the Report claims the payment should have been included in the underwriter’s evaluation of the borrower’s ability to repay the debt and make the mortgage payment, as the borrower only had $104 in available assets at closing. If the reduced income had been used to qualify the borrower and the Brown Forman debt had been included in the borrower’s liabilities, the Report alleges the fixed payment-to-income ratio, using the buydown rate, would have been 49.31%. The Report acknowledges the underwriter provided two compensating factors, including “income not used” and “low ratios,” but the Report asserts these factors were not valid.

With regard to the borrower’s buydown of the interest rate in this case, FHA guidelines require that a buyer meet one of four criteria to establish that an increase in mortgage payments from an interest rate buy down will not adversely affect the borrower and likely lead to default. See HUD Handbook 4155.1 REV-4, ¶2-14(A)(4); HUD Handbook 4155.1 REV-5, ¶2-14(B)(2). A lender must establish one of the following: (i) a 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; (ii) a demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expense; (iii) the
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borrowers have substantial assets available to cushion the effect of the increased payments; or (iv) the cash investment made by the borrower substantially exceeds the minimum required. [4] Here, the underwriter demonstrated the borrower's ability to absorb the payment increases by documenting a substantial increase in the borrower's pay. Specifically, as demonstrated by the borrower's pay stubs from his current employment, the borrower's hourly pay rate increased on a consistent basis, and was regularly paid shift income and overtime (Exhibit B-1). Thus, as this income was not used to qualify the borrower for the loan, the underwriter sufficiently documented the borrower's potential for increased income that would offset the scheduled payment increases.

Moreover, with regard to the borrower's income, contrary to the allegations in this case, the underwriter did not overstate income. While the borrower's pay stubs documented one week of short-term disability income (Exhibit B-1), the underwriter understood that the borrower returned to work full-time prior to closing. We acknowledge that the underwriter should have documented this understanding in the file, and we have reminded Company employees of the importance of fully documenting the borrower's circumstances prior to closing. Nevertheless, the Company contacted the borrower's employer in preparation for this response, and the borrower, in fact, returned to work full-time on September 12, 2004 (Exhibit B-2), which was more than two weeks prior to closing (Exhibit B-3). Thus, there was no reason in this case to reduce the borrower's qualifying income to the short-term disability rate. In addition, the borrower's income documented on the MCAW was actually an understated amount. As acknowledged in the Report, based on an hourly rate of $17.93, the underwriter could have qualified the borrower with $3,107 in monthly income, but, instead, used a more conservative calculation of $2,840 (Exhibit B-4). Based on these facts, the underwriter properly calculated the borrower's income in this case and did not overstate the borrower's earnings.

Furthermore, with regard to the borrower's liabilities, contrary to the allegations in the Report, the borrower satisfied this debt prior to closing, and Colony had no reason to include this liability or believe the obligation would affect the borrower's ability to make the mortgage payment. Notably, the borrower's pay was deducted on a monthly basis to satisfy this obligation, and the credit report, dated May 13, 2004, reported the balance on this account as of February 2004 (Exhibit B-5). Thus, between February 2004 and the date of the credit report, the borrower made three additional payments on this account, with only a June and July payment remaining to satisfy this debt. Moreover, as of the September 28, 2004 date of closing (Exhibit B-3), the borrower's July and August 2004 pay stubs demonstrated that the credit union account had been
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paid in full (Exhibit B-1). With a $0 balance remaining on this account prior to closing, Colony was fully justified in excluding the debt from the borrower's recurring liabilities.

Ultimately, therefore, the underwriter in this case properly calculated the borrower's qualifying income and recurring liabilities, and the ratios were 23.15% and 39.95%, which are well within HUD's benchmark guidelines of 29% and 41% (Exhibit B-4). That being said, even if the underwriter had been required to provide compensating factors to justify approval of the loan, both the MCAW and the loan file documented significant compensating factors. First, as indicated in the "Remarks" section of the MCAW, the borrower earned other documented overtime income that was not used to qualify the borrower for the loan (Exhibits B-1 and B-4). Second, the borrowers had substantial cash reserves at the time of closing (Exhibit B-4), and maintained a stellar rental payment history for nearly six years (Exhibit B-4). As the Department has expressly recognized all of these items as significant factors that would justify approval of a loan to a borrower with qualifying ratios that exceed the benchmark guidelines, if compensating factors had been necessary in this case, the underwriter prudently approved the borrower in this instance based on these factors. See HUD Handbook 4155.1 REV-5, ¶ 2-13. Indemnification, therefore, is not appropriate in this case. As HUD's Quality Assurance Division has already reviewed this loan, we respectfully request that the OIG remove this finding from the final audit report.

In the [redacted] case, Finding 1 alleges that Colony approved this loan without documenting its assurance that the borrower's unemployment income was reasonably expected to continue for the first three years of the mortgage loan as required by FHA guidelines. The Report, thus, asserts that the borrower's unemployment income should have been used only as a compensating factor. When this income is excluded from the borrower's effective monthly income, the Report alleges the borrower's qualifying ratios exceeded the benchmark guidelines by 23.3% and 17.3%.

Contrary to the allegations in this case, the co-borrower received aid for her two dependent children, rather than unemployment income, and the Company sufficiently verified that the borrowers would continue to receive this assistance after closing. As these payments were provided by the county, Colony understands and appreciates that FHA guidelines consider government assistance income to be acceptable, as long as the lender obtains documentation from the paying agency and the income is expected to continue for at least three years. See HUD Handbook 4155.1, REV-5, ¶ 2-7(L). In accordance with these guidelines, Colony obtained a statement from the Adams County Department of Job & Family Services to document the co-borrower's receipt of monthly aid for her children during the previous year (Exhibit C-1). Moreover, as the borrowers
listed their dependent as ages 13 and 14 at the time of loan application (Exhibit C-2), the Company believed the child assistance payments would continue until the age of 18, which is more than the required three years. Thus, as the co-borrower had consistently received child assistance payments in the previous year and would continue to receive them until the children became of age, Colony sufficiently verified that the co-borrower’s government aid for her dependent children would continue. The Company also properly calculated the income as part of the borrowers’ qualifying income and the amount should not have been excluded as a mere compensating factor. As a result, we request that the indemnification recommendation in this case be removed from the Report.

That being said, even if the co-borrower’s aid for her dependent children was excluded from the borrowers’ income calculation, the borrowers still were eligible for FHA financing with an increase in the qualifying ratios. Notably, the Company documented sufficient compensating factors to justify the higher-than-average qualifying ratios. First, the borrowers demonstrated a conservative attitude towards the use of credit, which the Department recognizes as a significant compensating factor. See HUD Handbook 4155.1, REV-5, ¶ 2-13(C). As discussed above, the borrowers, in this case, had zero debt or monthly obligations and had remained debt free since the mid-1990s (Exhibits C-3 and C-4). Second, the borrowers had the potential for increased earnings, as their social security income increased on an annual basis (Exhibit C-5). As the Department specifically identifies this as a compensating factor, the Company reasonably relied on increased earnings to justify approval of the loan. Thus, had the aid for dependent children been excluded from the borrowers’ qualifying income in this case, considering the significant compensating factors, the borrowers were eligible for FHA financing and Colony properly approved this loan.

c. [Blank] – FHA Case No. 413-4227951

Finding 1 alleges, in the [Blank] loan, that the underwriter did not document that the borrower met the requirements for an interest rate buydown and did not establish that the borrower would be able to afford the mortgage payments once the buydown agreement expired. The Report notes that the borrower’s qualifying ratios were 29.52% and 40.36%, but alleges there was no documentation in the file to show that the borrower would have the ability to sustain the mortgage payment once the buydown agreement expired and the mortgage payment increased. Finding 1 also states that the borrower defaulted after only four payments.

Moreover, the Report emphasizes that the Company verified the borrower’s weekly income of $500 plus commissions, but the VOE did not state the amount of the commission or the frequency. Because the borrower had been employed only one
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month prior to closing and had not received commission income in the past, the Report
alleges that the underwriter should have documented the borrower’s ability to sustain
the increase in the mortgage payment. In addition, without an increase in income
during the two years of the buydown period, Finding 1 alleges that the borrower’s
qualifying ratios would be 34.99% and 45.81%. However, the Report asserts that the
only compensating factor provided to justify these ratios was “low credit use,” which
Finding 1 alleges is not adequate.

First, with regard to the buydown allegation, the borrower in this case
demonstrated an ability to offset the payment increases of the buydown program and
Colony established that the eventual increase in mortgage payments would not
adversely affect the borrower. As you know, FHA guidelines require that a buyer meet
one of the four cited criteria set forth in Paragraph 2-14(B)(3) of the Mortgage Credit
Analysis Handbook. Here, contrary to allegation in this finding, the underwriter
demonstrated the borrower’s ability to absorb the payment increases by documenting a
substantial increase in the borrower’s pay.

Specifically, as demonstrated by the VOEs from the borrower’s previous and
current employers, the borrower’s base pay increased from $13.00 per hour, or $520
per week, to $500 per week, with the opportunity for commissions (Exhibits D-1 and D-
2). While the Report suggests the borrower’s commission income should not have been
a factor in the underwriter’s analysis, whether the borrower had yet to receive
commission income at the time of closing and whether the employer disclosed exact
commission amounts was irrelevant to the underwriter’s analysis. According to FHA
guidelines, an underwriter is only required to document the amount and receipt of
commission income if he or she uses it to qualify the borrower for the loan. See HUD
Handbook 4155.1, REV-4, CHG-1, ¶ 2-7(D). In this case, the underwriter only used the
borrower’s employer-verified opportunity for commission income in her analysis of the
borrower’s financial circumstances. As HUD grants underwriters the discretion to weigh
a borrower’s individual circumstances in approving FHA loans, the underwriter, in this
case, properly considered the borrower’s opportunity for commission income as a
reasonable factor and documented the borrower’s potential for increased income that
would offset the scheduled payment increases.

In addition to this factor, the underwriter also noted the borrower’s conservative
use of credit to justify the buydown agreement. The borrower had only $282 in monthly
debt (Exhibit D-3), which consisted solely of a monthly car payment (Exhibit D-4).
Thus, with minimal monthly obligations, the underwriter documented the borrower’s
ability to devote a greater portion of his income to housing expenses. Moreover, the
Report emphasizes that the borrower defaulted after only four payments on this loan.
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As the default occurred during the buydown period, contrary to the implications in this sub-finding, the actual buydown, which was reasonably approved by the Company, did not operate as a factor in the borrower’s default. Ultimately, the underwriter prudently determined that the eventual increase in mortgage payments would not adversely affect the borrower, and Colony complied with FHA requirements in this case.

Second, with regard to the allegation that the borrower’s qualifying ratios should have been 34.96% and 45.81%, nothing in the loan file demonstrates that the borrower would not receive an increase in income during the two years of the buydown period. In fact, as discussed above, the borrower’s employer projected the borrower to have a long and prosperous career with the company (Exhibit D-5), which reasonably suggests the borrower had the potential for future increases in income. Nevertheless, even if a buydown was not used in this loan, the borrower still would have qualified for FHA financing with 34.96% and 45.81% ratios. Not only did the underwriter, in this case, document a significant compensating factor on the MCAW, as acknowledged by the OIG, the loan file documented additional factors that justified loan approval in the Balsamo case. Specifically, the borrower’s housing expenses increased by only $117 (Exhibit D-3). See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13(G). Moreover, the loan file documented alternative sources of the borrower’s credit, which demonstrated the borrower’s timely payment of all rental expenses, as well as credit for certain household goods, for over two years (Exhibit D-6). The Department expressly has recognized that “if the borrower over the past 12-24 months has met his or her housing obligation as well as other debts, there should be little reason to doubt the borrower’s ability to continue to do so despite having ratios in excess of those prescribed.” HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13(A). Furthermore, the borrower had only $282 in recurring monthly debt (Exhibit D-3), which demonstrated a conservative attitude towards the use of credit. As the Department has expressly recognized all of these items as significant factors that would justify approval of a loan to a borrower with qualifying ratios that exceed the benchmark guidelines, the underwriter prudently approved the borrower in this instance based on these factors. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13.

Ultimately, the Company documented sufficient factors to support the buydown in this case, as well as to justify approval of the loan. Indemnification, therefore, is not appropriate, and these allegations should be removed from the Report.

d. [Redacted] — FHA Case No. 413-4254327

In this case, the Report alleges that Colony did not document that the borrower met the requirements for an interest rate buydown or document the borrower’s ability to sustain the mortgage payment once the buydown agreement expired. The Report
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notes that the borrower’s mortgage payment, under the buydown agreement, was scheduled to increase from $1,097 to $1,249. Without an increase in income through the two years of the buydown assistance, the Report alleges the borrower's qualifying ratios would have increased from 24.03%/30.57% to 30.99%/43.76%.

First, with regard to the buydown allegation, the borrower in this case demonstrated an ability to offset the payment increases of the buydown program and Colony established that the eventual increase in mortgage payments would not adversely affect the borrower. As you know, FHA guidelines require that a buyer meet one of the four cited criteria set forth in Paragraph 2-14(B)(2) of the Mortgage Credit Analysis Handbook. Here, contrary to allegation in this finding, the underwriter demonstrated the borrower’s ability to absorb the payment increases by documenting a substantial increase in the borrower’s pay. Notably, although the borrower was guaranteed $600 in weekly pay (or $31,200 annually) at his current job, the borrower’s employer verified that _______ would actually earn upwards of $34,000 in his first year with the company (Exhibit E-1). Based on this verification, the underwriter had no reason to believe the borrower would not receive pay increases during the buydown period, and the Company believes the underwriter sufficiently documented the borrower’s potential for increased income that would offset the scheduled payment increases.

Second, with or without the buydown in this case, the borrower’s qualifying ratios were excellent. When using the reduced interest rate, qualifying ratios of 24.03% and 30.57% are well below HUD’s benchmark guidelines of 26% and 41%. With only $299 in monthly recurring obligations and $4,696.50 in gross monthly income, the underwriter had no reason to question that the borrowers would be able to make their monthly mortgage payment (Exhibit E-2). In addition, even without the buydown in this case, the Company still considers qualifying ratios of 30.99% and 43.76% to be excellent. While these numbers only slightly exceed HUD's guidelines in effect in 2003, under current FHA guidelines, these ratios would meet the allowable 31% and 43% qualifying ratios. See Mortgagee Letter 2005-16. Furthermore, if this loan had been underwritten using Fannie Mae’s Desktop Underwriter, the system would have permitted significantly higher qualifying ratios. Thus, considering the borrower’s opportunity for increased earnings (Exhibit E-1), the borrowers' low recurring monthly debts, and their $700 in cash reserves (Exhibit E-2), the borrowers were more than qualified for FHA financing, and the underwriter made a prudent decision to approve this loan. Indemnification is not appropriate in this case, and we respectfully request this finding be removed from the final audit report.
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e. FHA Case No. 413-4263790

In the case, the Report alleges that the underwriter understated the borrower's liabilities. According to the Report, the credit report showed a monthly payment of $173 to Garden Financial with a balance of $1,598. Although it would not take the borrower more than 10 months to satisfy this debt, the Report alleges that it should not have been excluded from the borrower's liabilities because it affects the borrower's ability to make the mortgage payment. The Report claims that if this debt had not been excluded, the mortgage payment-to-income and fixed payment-to-income ratios would have been 37.07 and 52.50 percent. While the Report acknowledges that the underwriter provided two compensating factors (low debt use and low housing), the Report asserts these factors were not adequate to support these ratios.

First, contrary to the allegations in the Report, Colony properly excluded the borrower's Garden Financial debt. FHA guidelines permit a lender to exclude a borrower's debt from the calculation of debt-to-income ratios if fewer than 10 months of a recurring charge remain on the borrower's account. See HUD Handbook 4155.1, REV-4, CHG-1, ¶ 2-11(A). However, if the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing, the debt should be counted as part of the borrower's liabilities. Id. Here, Colony had no reason to believe the Garden Financial debt would impede the borrower's ability to make the mortgage payment. In fact, the borrower only had $43 in other monthly recurring obligations and grossed nearly $1,350 in monthly income (Exhibit F-1). Regardless of the borrower's assets at closing, with a mere $519 mortgage payment and $962 in total monthly expenses, nothing in the file suggested the borrower would be unable to pay these expenses plus the remaining nine payments on the Garden Financial account. Thus, we believe the underwriter in this case excluded this liability in accordance with FHA guidelines.

Having said that, even if the Garden Financial debt had been included in the borrower's qualifying ratios, Colony documented significant compensating factors to justify approval of the loan. As acknowledged in the Report, in accordance with FHA guidelines, the underwriter in this case, noted two significant compensating factors in the "Remarks" section of the MCAW. First, the borrowers demonstrated a conservative attitude towards the use of credit, which the Department recognizes as a significant compensating factor. See HUD Handbook 4155.1, REV-4, CHG-1 ¶ 2-13. Even if the $173 Garden Financial debt were included, the borrower maintained only $216 in monthly recurring obligations, which the underwriter donated with "low debt use" (Exhibit F-1). Second, the borrower's mortgage payment increased less than $200, and the borrower maintained an excellent rental history (Exhibits F-1 and F-2). The
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Department has specifically recognized a borrower's timely satisfaction of his or her housing obligation as a significant compensating factor despite ratios in excess of HUD's guidelines. See id. Finally, the borrower's credit report evidenced zero delinquent payments on the borrower's installment and revolving credit accounts, which demonstrated the borrower's ability to pay his monthly obligations (Exhibit F-3). Thus, although we believe the underwriter properly excluded the Garden Financial debt from the borrower's qualifying ratios, Colony sufficiently documented compensating factors to justify approval of the loan. Indemnification, therefore, is not appropriate in this case, and we request this finding be removed from the final audit report.

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f. FHA Case No. 413-4288844

In this case, Finding 1 alleges that the borrower's mortgage payment-to-income and fixed payment-to-income ratios were 28.4% and 48.7% after the Company entered into a buydown agreement with the borrower. The Report asserts that Colony did not identify any compensating factors on the MCAV to justify the 48.70% ratio during the buydown period, and the underwriter did not establish that the borrower would be able to afford the mortgage payments when the buydown agreement expired. Contrary to the allegations in this case, Colony documented significant compensating factors in the loan file, and the borrower in this case demonstrated an ability to offset the payment increases of the buydown program. The Company understands and appreciates HUD's requirement that qualifying ratios in excess of the 29%/41% benchmark guidelines be justified by certain explicit compensating factors and recorded in the "Remarks" section of the MCAV. See HUD Handbook 4155.1 REV-5, ¶ 13. Thus, in accordance with these guidelines, the underwriter, in this case, documented significant compensating factors to justify the high back-end ratio. Colony also established that the eventual increase in mortgage payments would not adversely affect the borrower.

First, the borrower had substantial cash reserves after closing of $2,385.71, thereby demonstrating an ability to accumulate savings (Exhibit G-1). See HUD Handbook 4155.1 REV-5, ¶ 13(C), (G). Second, the borrower worked as a supervisor in the medical field and attended college part-time to further his profession (Exhibits G-2 and G-3). In light of the borrower's education, he demonstrated the potential for increased earnings, which HUD explicitly recognizes as a substantial compensating factor. Id., ¶ 13(f). Finally, the borrower consistently earned overtime income that was not calculated as part of the borrower's qualifying income (Exhibit G-3). This additional documented income directly affects the borrower's ability to repay the mortgage and qualifies as a significant compensating factor. See id., ¶ 13(G). The underwriter, therefore, reasonably approved the borrower in this instance based on these factors.
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Although the Company acknowledges that the underwriter should have noted these compensating factors in the "Remarks" section of the MCAW, Colony properly obtained documentation to support these factors and approval of the loan.

Moreover, the borrower in this case demonstrated an ability to offset the payment increases of the buydown program and Colony established that the eventual increase in mortgage payments would not adversely affect the borrower. As you know, FHA guidelines require that a buyer meet one of the four cited criteria set forth in Paragraph 2-14(B)(2) of the Mortgage Credit Analysis Handbook. Here, the borrower met the first of these criteria, as she had "potential for increased income that would offset the scheduled payment increases." See HUD Handbook 4155.1 REV5, ¶ 2-14(B)(2)(a).

Specifically, in addition to the fact that the borrower attended the Ohio State University in an effort to further her career (Exhibit G-4), the borrower's employment documentation evidenced an increase in the borrower's annual pay from $27,698.89 in 2001 to $29,119.70 in 2002 (Exhibit G-5) to a projected $30,492.80 at her current job (Exhibit G-6). Moreover, the borrower consistently earned overtime income, which was not used to qualify the borrower for the loan (Exhibit G-3). The underwriter, therefore, documented the borrower's potential for increased income that would offset the scheduled payment increases. For these reasons, we maintain that lumpsumification would be inappropriate and respectfully request that this allegation be removed from the final report.

g. FHA Case No. 413-4315623

In the above case, the Report alleges that Colony did not document that the borrower met the requirements for an interest rate buydown or document the borrower's ability to sustain the mortgage payment once the buydown agreement expired. Moreover, the Report alleges the mortgage payment-to-income ratio when using the reduced interest rate was 35.33%, and it claims the underwriter did not document any compensating factors to justify approval of the loan. In connection with the buydown allegation, the Report also suggests that the borrower's projected income for 2004 was $21,360, which represented a 12% increase from 2003, but the VOE did not indicate there would be an increase in income through the two years of the buydown period. Finally, the Report notes that the loan was approved when the borrower would experience payment shock of 72% after the expiration of the buydown.

First, with regard to the 35.33% mortgage payment-to-income qualifying ratio cited in the Report, this allegation is entirely inaccurate. Instead, as documented by the MCAW in this case, the fixed payment-to-income ratio equaled 35.33% when using the reduced interest rate, which is well within HUD's 41% benchmark guideline (Exhibit H-1). Moreover, even if the underwriter was required to provide compensating factors to
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justifies this ratio, Colony complied with the Department’s requirements. Notably, although the compensating factors were not detailed in the MCAW, the loan file documented additional income that was not fully calculated into the borrower’s qualifying monthly income. The borrower worked every other Saturday, which increased her gross pay during those weeks by $75 each week (Exhibit H-2). However, the $1,604 used to qualify the borrower did not take into account this additional income (Exhibit H-1). In fact, this income is understated, as the borrower’s gross monthly pay Monday through Friday equaled $1,760 ($408.25 weekly x 52 weeks / 12 months = $1,720 per month) (Exhibit H-2). Thus, the additional Saturday income directly affected the borrower’s ability to repay the mortgage and qualifies as a significant compensating factor. See HUD Handbook 4155.1 REV-5, ¶ 2-13(E).

The borrower also had only $15 in monthly debt (Exhibit H-1), which demonstrated a conservative attitude towards the use of credit, and the borrower consistently paid her rental obligation on time for the previous few years (Exhibit H-3). As the Department has expressly recognized all of these items as significant factors that would justify approval of a loan to a borrower with qualifying ratios that exceed the benchmark guidelines, the underwriter, in this case, had more than sufficient compensating factors had they been needed to approve the loan. See HUD Handbook 4155.1 REV-5, ¶ 2-13.

Second, with regard to the buydown in this case, the borrower demonstrated an ability to offset the payment increases of the buydown program and Colony established that the eventual increase in mortgage payments would not adversely affect the borrower, despite any alleged “payment shock.” As you know, FHA guidelines require that a buyer meet one of the four cited criteria set forth in Paragraph 2-14(B)(2) of the Mortgage Credit Analysis Handbook. Here, regardless of the borrower’s projected 12% increase in income, the borrower met the second of these criteria, as she had a “demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expense.” See HUD Handbook 4155.1 REV-5, ¶ 2-14(B)(2)(b). Specifically, although the borrower’s bankruptcy was discharged in January 2002, the borrower had only $15 in monthly debt at the time of closing, which demonstrated her conservative use of credit and ability to devote a greater portion of her income to housing expenses (Exhibits H-1 and H-4).

Moreover, although Colony was not required to document more than one criterion, please note that the underwriter qualified the borrower for the loan without calculating additional Saturday income (Exhibit H-2). The loan file documented that the borrower’s extra Saturday income was likely to continue (Exhibit H-2) and demonstrated that such income would have provided the borrower with an extra $150
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per month (Exhibit H-2). Thus, notwithstanding the borrower’s 2003 and 2004 pay, the underwriter demonstrated the borrower’s ability to absorb the payment increases by documenting additional income to be applied to housing expenses. Indemnification in this case is not warranted, and, as Colony fully complied with HUD’s requirements, we ask that the OIG remove this allegation from the final audit report.

2. Debt Assessment

In this sub-finding, the Report alleges that Colony did not properly assess borrowers’ financial obligations in three cases. Colony disagrees with the allegations in each of these cases, and our individual responses are set forth below.

a. [Redacted] – FHA Case No. 201-3402921

In this case, the Report alleges that Colony understated the borrower’s recurring debts. Specifically, the Report notes that the borrower’s credit report identified an open account with a monthly payment of $325 to Brown Forman employee credit union with a balance of $1,498. Although it would not take the borrower more than 10 months to pay off the debt, the Report claims the payment should have been included in the underwriter’s evaluation of the borrower’s ability to repay the debt and make the mortgage payment, as the borrower only had $104 in available assets at closing.

Colony understands and appreciates the Department’s requirement that a borrower’s debts lasting less than ten months must be counted in a borrower’s debt-to-income ratios if the amount of the debt affects the borrower’s ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing. See HUD Handbook 4155.1, REV-5, ¶2-11(A). However, contrary to the allegations in the Report, the borrower satisfied this debt prior to closing, and Colony had no reason to believe the obligation would affect the borrower’s ability to make the mortgage payment.

Notably, the borrower’s pay was deducted on a monthly basis to satisfy this obligation, and the credit report dated May 13, 2004, reported the balance on this account as of February 2004 (Exhibit B-5). Thus, between February 2004 and the date of the credit report, the borrower made three additional payments on this account, with only a June and July payment remaining to satisfy this debt. Moreover, as of the September 20, 2004 date of closing (Exhibit B-3), the borrower’s July and August 2004 pay stubs demonstrated that the credit union account had been paid in full. With a $0 balance remaining on this account prior to closing, Colony was fully justified in excluding the debt from the borrower’s recurring liabilities. As the Company had no reason to
believe the credit union account would affect the borrower's ability to repay the mortgage, we respectfully request this finding be removed from the final audit report.

b. [Redacted] – FHA Case No. 413-4263750

In the [Redacted] case, the Report alleges that the underwriter understated the borrower’s liabilities. According to the Report, the credit report showed a monthly payment of $173 to Garden Financial with a balance of $1,598. Although it would not take the borrower more than 10 months to satisfy this debt, the Report alleges that it should not have been excluded from the borrower’s liabilities because it affects the borrower’s ability to make the mortgage payment and the borrower did not have any assets at closing.

As noted above, FHA guidelines permit a lender to exclude a borrower’s debt from the calculation of debt-to-income ratios if fewer than 10 months of a recurring change remain on the borrower’s account. See HUD Handbook 4155.1, REV-4, CHG-1, ¶2.11(A). However, if the debt affects the borrower’s ability to make the mortgage payment during the months immediately after loan closing, the debt should be counted as part of the borrower’s liabilities. Id. Contrary to the allegations in this case, Colony had no reason to believe the Garden Financial debt would impede the borrower’s ability to make the mortgage payment. In fact, the borrower only had $43 in other monthly recurring obligations and grossed nearly $1,350 in monthly income (Exhibit F-1).

Regardless of the borrower’s assets at closing, with a mere $516 mortgage payment and $562 in total monthly expenses, nothing in the file suggested the borrower would be unable to pay these expenses plus the remaining nine months of the Garden Financial account. Thus, we believe the underwriter in this case excluded this liability in accordance with FHA guidelines. Indemnification in this case is not appropriate, and we respectfully request this allegation be removed from the final audit report.

c. [Redacted] – FHA Case No. 413-4288844

In the [Redacted] case, the Report alleges that Colony did not include all of the borrower’s liabilities when evaluating the borrower’s ability to repay the debt. Specifically, the Report asserts that the credit report showed two student loans in deferment status with a total monthly payment of $307; however, it claims the file contained no documentation to show that the deferment period would last at least 12 months beyond the closing date of the mortgage or that the borrower requested and received an additional forbearance for the loans. The Report also alleges that the underwriter excluded three recurring obligations with a total monthly payment of $101, but there was no documentation to show that the accounts had been satisfied. Moreover, the Report asserts that if Colony had not excluded the two student loans and
other recurring obligations, the total fixed payment-to-income ratio using the buydown rate would have been 60.64% (or 65.87% excluding the buydown). The Report acknowledges that the underwriter noted “credit” as a compensating factor, but alleges this factor was inadequate to support the higher-than-usual qualifying ratio.

Contrary to the allegations in this case, documentation in the loan file verified the Company’s proper exclusion of the student loans and three other recurring debts from the calculation of recurring monthly obligations. Notably, despite the dates of repayment shown on the credit report for the borrower’s student loans (Exhibit I-1), the borrower provided the Company with documentation of her college transcript and explained her part-time status, which, at the time of closing, would have included two and half more years of classes (Exhibit G-4). This transcript and written explanation was sufficient documentation to evidence the deferment of the borrower’s student loans for a period of time longer than 12 months from the date of closing. Moreover, in preparation of this response, Colony obtained an additional verification of the borrower’s dates of attendance at the Ohio State University (Exhibit I-2). As the borrower attended school from March 28, 1999 until June 12, 2005, the borrower’s student loans, in fact, were deferred, and the Company properly excluded these loans from the borrower’s monthly debt. Furthermore, with regard to the borrower’s obligation at Bally’s Total Fitness (which is included in the $101 in monthly payments), prior to closing, the borrower paid down this debt by $421.57, which left a balance the borrower would satisfy within 10 months of closing (Exhibit I-3). Colony, therefore, was not required to include this debt in its monthly calculation, and the borrower’s back-end qualifying ratio would not have reached 60.64%.

With regard to the Household Finance Corporation and Providian Financial monthly debts, the Company received information that these debts would be paid in full prior to closing; however, Colony has been unable to locate documentation of these payments in the loan file. We, thus, have reminded Company employees of the importance of maintaining complete documentation of all of the borrower’s liabilities, as well as evidence these debts have been paid in full. That being said, even if Colony had included the $40 Household Finance Corporation debt and the $23 Providian Financial debt in the borrower’s total monthly debt obligations, the borrower’s qualifying ratio would have increased only slightly and the loan file still contained compensating factors to justify approval of the loan.

Notwithstanding the underwriter’s notation of “credit” in the “Remarks” section of the Mortgage Application, as noted above, the underwriter in this case obtained documentation of several additional compensating factors. First, the borrower had substantial cash reserves after closing of $2,385.71, thereby demonstrating an ability to accumulate
savings (Exhibit G-1). See HUD Handbook 4155.1 REV-5, ¶ 2-13(C), (G). Second, the borrower worked as a supervisor in the medical field and attended college part-time to further this profession (Exhibits G-2 and G-4). In light of the borrower's education, demonstrated the potential for increased earnings, which HUD explicitly recognizes as a substantial compensating factor. See id., ¶ 2-13(i). Finally, the borrower consistently earned overtime income that was not calculated as part of the borrower's qualifying income (Exhibit G-3). This additional documented income directly affects the borrower's ability to repay the mortgage and qualifies as a significant compensating factor. See id., ¶ 2-13(f). Thus, while the Company believes the underwriter properly excluded the student loans and other recurring debts from the borrower's total liabilities, the loan file contained significant compensating factors to justify higher-than-usual qualifying ratios. Although the Company acknowledges that the underwriter should have noted these compensating factors in the "Remarks" section of the MCAV, Colony properly obtained documentation to support these factors, and the underwriter reasonably approved the borrower in this case.

3. Income Documentation

In this sub-finding, the Report alleges, in three cases, that Colony did not verify borrowers' income or determine income stability. Colony disagrees with the allegations in each of these cases. It is Company policy to verify a borrower's employment history for a full two-year period and require borrowers to explain any gaps in employment that span one month or more. See HUD Handbook 4155.1, REV-5, ¶ 2-6. This policy has been in place since the Company's inception, and we regularly remind our employees of the importance of verifying a complete employment history for all borrowers. As an illustration of the Company's policy, we respond to the Report's allegations in two cases below.

Please note that one of the two loans is the [redacted] loan, which HUD's MRB previously reviewed. In 2005, HUD made the identical gap in employment allegation and ultimately accepted Colony's response and explanations. Thus, as HUD has already determined the [redacted] loan contains no material deficiencies, the OIG's inclusion of this finding in the Report is excessive and prejudicial. Nevertheless, in an effort to emphasize Colony's compliance with FHA guidelines in this case, we respond to the Report's findings below.

a. [redacted] – FHA Case No. 411-3737859

In this case, the Report alleges that Colony approved the loan without documenting assurance that the borrower's unemployment income was reasonably expected to continue for the first three years of the mortgage loan.
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As discussed above in response to the Report's compensating factors allegations, contrary to the assertions in this case, the co-borrower received aid for her two dependent children, rather than unemployment income, and the Company sufficiently verified that the borrowers would continue to receive this assistance after closing. As these payments were provided by the county, Colony understands and appreciates that FHA guidelines consider government assistance income to be acceptable, as long as the lender obtains documentation from the paying agency and the income is expected to continue for at least three years. See HUD Handbook 4155.1, REV-5, ¶ 2-7(L). In accordance with these guidelines, Colony obtained a statement from the Adams County Department of Job & Family Services to document the co-borrower's receipt of monthly aid for her children during the previous year (Exhibit C-1). Moreover, as the borrowers listed their dependents as ages 13 and 14 at the time of loan application (Exhibit C-2), the Company believed the child assistance payments would continue until the age of 18, which is more than the required three years. Thus, as the co-borrower had consistently received child assistance payments in the previous year and would continue to receive them until the children became of age, Colony sufficiently verified that the co-borrower's government aid for her dependent children would continue. This allegation, therefore, should be removed from the Report, and indemnification is inappropriate.

b. [redacted] FHA Case No. 412-5088277

In the [redacted] case, the Report alleges that Colony did not obtain an explanation from the borrower to document the gap in employment from November 1, 2002 through May 26, 2003.

Contrary to the allegations in this case, no gaps existed in the borrower's employment and Colony documented the required two-year employment history. Specifically, the borrower was employed with Land America/Endress during the dates in question; however, the dates appearing on the URLA for the borrower's prior employment are inverted and incorrect. As reflected on the initial URLA, the borrower indicated that she started this prior job in November 2002 and ended the employment in May 2002 (Exhibit J-1). It appears that the borrower mistakenly wrote May 2002, rather than May 2003, as her ending date. Instead of correcting these dates on the final URLA, a Colony employee inadvertently copied and inverted the incorrect dates to read May 2002 to November 2002 (Exhibit J-2). We recognize that the final URLA should have contained the correct employment dates as we understood them, and it is Colony's policy and practice to ensure the information reflected on the URLA is accurate and complete. Nevertheless, in connection with HUD's review of this loan in 2005, we re-verified the borrower's dates of prior employment with Land America/Endress Title.
As shown on the attached VOE, the borrower, in fact, worked at this prior job until May 2003 (Exhibit J-3).

Thus, in accordance with FHA guidelines, Colony verified a consecutive 28-month employment history for the borrower, as demonstrated by the VOEs obtained from Krispy Kreme, Land America/Endress Title, and Pat Boyle Realty (Exhibits J-4 and J-3). HUD’s MRB has already determined that indemnification in this case is unwarranted, and we respectfully request that the OIG remove this finding from the final audit report.

4. **Rental History Verification**

   In this sub-finding, the Report alleges, in three cases, that Colony did not properly verify borrowers’ rental histories by obtaining appropriate documentation or reviewing a complete 12-month history. It is Colony’s policy to verify a borrower’s rental history directly from the landlord, through a borrower’s credit report, or through cancelled checks covering the most recent 12-month period. See HUD Handbook 4155.1, REV-6, ¶ 3-1. This policy has been in place since the Company’s inception, and we regularly remind our employees of the importance of obtaining the proper documentation. As an illustration of the Company’s policy, we respond to the Report’s allegations in two cases below.

   a. [Redacted] – FHA Case No. 413-4263790

      In this case, the Report alleges that Colony did not verify the borrower’s rental payment history directly from the landlord or mortgage servicer, or through information shown on the credit report. The Report asserts that the Verification of Rent ("VOR") was faxed from the borrower’s employer, and there is no indication in the file that Colony received the original VOR letter.

      Contrary to this allegation, Colony obtained the borrower’s rental verification directly from the landlord. Notably, after the VOR letter, dated December 3, 2003, was faxed to Colony, the underwriter in this case noticed a discrepancy in the dates of the borrower’s rental and contacted the landlord for a corrected VOR. The following day, Colony obtained a second VOR letter from the landlord (Exhibit F-2). Although Colony has been unable to locate a copy of this VOR letter in the file, we are confident the underwriter obtained this verification prior to closing. In fact, in preparation for this response, we contacted the borrower’s landlord and asked him to fax a copy of the letter he provided to the Company in 2003. While we have reminded Company employees of the importance of ensuring all borrower documentation is maintained in the file after closing, in accordance with FHA guidelines, Colony properly verified the
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borrower's rental history in this case with a document provided by the landlord. Thus, we believe that indemnification is inappropriate and that this case should be removed from the final report.

b. [Redacted] FHA Case No. 413-428944

In the [redacted] case, the Report alleges that Colony did not fully verify the borrower's rental history. Specifically, it alleges the credit report indicated the borrower's current landlord refused residence verification. The Report also asserts that the credit report verified a nine-month rental period, and the underwriter did not determine the borrower's payment history covering the most recent 12-month period.

While the credit report in this case indicates that the borrower's landlord refused to verify the borrower's payment of rent for the three months she resided at the Kingshill Drive address, contrary to the allegations in the Report, Colony verified a total of three and a half years of the borrower's timely rental payments. Specifically, the credit report indicates that the borrower's previous landlord at Mallard Landing Apartments verified one year of timely rental payments, while another previous landlord, verified an additional two and a half years of timely rental payments (Exhibit I-1). With such an extensive and stellar rental history, the underwriter in this case had no reason to believe the borrower's three-month payment history to her current landlord was less than timely. That being said, the Company acknowledges the underwriter should have taken additional steps to verify the three months rent not reflected on the borrower's credit report. It is our policy to verify a borrower's current rental history in every case, and we have reminded Company employees of the importance of this policy. In this case, however, the lack of a current three-month verification was harmless error. In accordance with HUD's requirements, the borrower's credit report sufficiently verified an extensive record of timely housing payments. Indemnification, therefore, is not warranted in this case, and this allegation should be removed from the final audit report.

5. Source of Funds

In this sub-finding, the Report alleges, in two cases, that Colony did not document the sources of borrowers' funds for closing in accordance with FHA guidelines. Colony disagrees with the allegations in each of these cases. Our individual responses to the two cases are set forth below.
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a. [Redacted]  
FHA Case No. 413-4263790

In the [Redacted] case, the Report alleges that the borrower received a gift of equity, but the loan file did not contain a gift letter in that case. The Report alleges that without the gift of equity, the borrower did not have sufficient funds to close the loan.

Colony understands and appreciates the Department's requirement that a lender document an outright gift of cash or a gift of equity with evidence of the transfer of funds and a gift letter that specifies the dollar amount, is signed by the donor and the borrower, states that no repayment is required, and shows the donor's name, address, telephone number, and relationship to the borrower. See HUD Handbook 4155.1, REV-4, CHG-1, ¶ 2-10(C). It is the Company's policy to obtain this documentation in every case where the borrower receives a valid gift, and we have reminded Company employees of the importance of verifying this information. With regard to the gift of equity in the [Redacted] case, both the purchase agreement and the HUD-1 Settlement Statement verified the required gift information (Exhibits K-1 and K-2). Notably, the purchase agreement in this case clearly documented the gift of equity between the seller and the borrower (Exhibit K-1). Like that of a gift letter, the purchase agreement specified the amount of the gift, was signed by the donor and the borrower, identified the donor as the borrower's mother, did not demand repayment for the gift, and otherwise acted as a legally-binding contract between the donor and the borrower for the sale of the property and gift of equity (Exhibit K-1). Moreover, the HUD-1 Settlement Statement verified that the gift was actually provided at the time of closing (Exhibit K-2). While the information contained in the purchase agreement does not conform to a typical gift letter, the underwriter in this case had no reason to question the source of the gift. Thus, as the borrower properly received the gift of equity and Colony documented the gift information enumerated in HUD's guidelines, indemnification in this case is unwarranted.

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b. [Redacted]  
FHA Case No. 413-4254327

In this case, the Report alleges that Colony did not obtain documentation of the source of the borrower's funds used at closing. Specifically, the Report asserts that the borrower paid $500 at closing; however, the loan file did not contain a bank statement or other documentation to indicate the borrower had enough funds to close the loan.

1 The Report refers to FHA Case No. 413-4284327. However, as no other case number cited in the Report matches this number, we assume the OIG intended to cite the Wallace case, which is FHA Case No. 413-4254327.
Contrary to the allegation in this case, the borrower did not make a $500 payment at closing. As demonstrated by the HUD-1 Settlement Statement, the borrower was responsible for $0 in funds at the closing table (Exhibit L). Thus, the allegations in this case appear to be entirely inaccurate, and the Company respectfully requests that this allegation be removed from the final audit report.

6. Resolution of Document Discrepancies

In this sub-finding, the Report alleges, in one case, that Colony did not resolve a significant documentation discrepancy before approving the loan (FHA Case No. 412-608327). Specifically the Report alleges the appraisal of the subject property identified that the property owner was not the seller who signed the sales contract. However, the Report claims the seller entered into a sales agreement with the borrower on July 30, 2003, when public records indicated that a deed for the property was transferred from the owner to the seller as recorded on October 2, 2003, for $28,000. The Report asserts this was the same date the loan closed and transferred the property to the borrower for $72,000. Based on these assertions, the Report alleges the property was not eligible for an FHA mortgage because the seller did not own the property for 90 days prior to transfer.

Contrary to these allegations, the seller in this case, [REDACTED], obtained proper title to the subject property by a land contract recorded in the public records on August 2, 1993 (Exhibit M-1). [REDACTED] then entered into a contract for sale with [REDACTED] on July 30, 2003 (Exhibit M-2). The seller, therefore, owned the property for more than the required 90-day period, and there was no document discrepancy to be resolved in this case. In accordance with HUD guidelines, the subject property and the borrower were eligible for FHA financing. See HUD Handbook 4000.2, REV-3, ¶ 1-7(C). Thus, we believe that indemnification is inappropriate and that this case should be removed from the final report.

7. “Other” Issues

In addition to the sub-findings discussed above, Appendix E raised concerns with “other” issues based on the OIG’s review of the loan files in these cases. Below we identify these findings and provide responses in the individual cases.

a. Credit Analysis

In four cases cited in the Report, Appendix E alleges that Colony did not properly evaluate the borrower’s creditworthiness and eligibility for FHA financing. Colony respects the importance of analyzing a borrower’s credit performance and examining his
or her attitude towards credit obligations. It, therefore, is Colony’s policy and practice to scrutinize every loan applicant’s credit record and reasonably determine his or her 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. Colony’s underwriters take their decision-making responsibilities seriously and understand that the Company will not tolerate unsatisfactory analysis of borrower credit. Colony never knowingly would jeopardize the Company’s stability or its relationship with the Department.

That being said, in evaluating several of the loans cited in the first finding, we hope the OIG will consider 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-5, §§ 2-3. While HUD has established a myriad of rules and regulations to govern the underwriting of FHA loans, it also has granted authority to FHA-approved lenders to exercise discretion in making credit decisions based on the totality of the circumstances. Credit analysis therefore remains largely subjective. 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. See Mortgagee Letters 00-24 and 95-07. While certain credit documents must be obtained, it is the underwriter's decision as to whether a particular borrower is creditworthy based on the borrower’s overall pattern of credit behavior. While two underwriters may make different decisions in the same case, both underwriters may have complied with FHA requirements and made reasonable underwriting decisions. Where derogatory items are present, lenders have discretion to consider the borrower’s unique circumstances and determine whether financing is appropriate. Colony takes this responsibility seriously and exercises its discretion carefully to ensure the extension of financing only to deserving borrowers. Below we reply to the individual findings raised in the Report with regard to four loans.

i. [redacted] – FHA Case No. 201-3403821

In this case, the Report alleges that the underwriter did not obtain an explanation from the borrowers for five insufficient funds penalty fees shown on the borrower’s bank records between February 24 and April 28, 2004 and two overdrawn fees and one return check fee shown on the co-borrower’s bank records between August 2 and September 13, 2004. The Report also alleges the borrower recently paid a judgment for a state tax lien and satisfied a judgment with 1st United Federal Credit Union. The Report further asserts that the underwriter should have considered these credit issues before loan
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approval, as the inability to make timely payments has a direct impact on the borrower's ability to meet the future housing expense of $1,012.

Please note that HUD's Quality Assurance Division made the identical credit analysis allegation in its review of the [redacted] loan and ultimately accepted Colony's response and explanations. Thus, as HUD has already determined the [redacted] loan contains no material deficiencies, the OIG's inclusion of this finding in the Report is excessive and prejudicial. Nevertheless, in an effort to emphasize Colony's compliance with FHA guidelines in this case, we respond to the Report's findings below.

With regard to the fees shown on the borrowers' bank statements (Exhibit N-1), contrary to the allegations in this case, Colony properly obtained a statement from the borrower to explain these items (Exhibit N-2), as well as a second explanation from the borrower to more than adequately document the circumstances that caused the overdrafts (Exhibit N-3). Notably, the borrower explained that he and his ex-wife borrowed a sum of money to pay for the costs of their wedding. However, when his ex-wife failed to pay the outstanding balances after their divorce, the borrower was forced to pay off the items to improve his credit prior to closing (Exhibit N-3). As FHA guidelines require a lender to examine a borrower's payment history in evaluating a borrower's creditworthiness and make no mention of isolated instances of account overdrafts, the credit statements obtained from the borrower were more than a reasonable explanation of the insufficient funds and returned checks charges in this case. See HUD Handbook 4155.1 REV-5, ¶ 2-3.

Moreover, with regard to the judgments satisfied prior to closing, Colony understands and appreciates that indication of derogatory credit, including judgments and collections, require sufficient written explanation from the borrower. See HUD Handbook 4155.1, REV-5, ¶ 2-3. In accordance with these guidelines, Colony obtained written explanations from the borrower that verified the circumstances that caused the borrower's financial difficulties. As noted above, the borrower explained that he and his ex-wife borrowed a sum of money to pay for the costs of their wedding, but the borrower was forced to pay off several of the accounts his ex-wife failed to pay prior to closing (Exhibit N-3). While the Company acknowledges that the underwriter should have asked the borrower to provide another written explanation addressing the satisfied judgments, any oversight is, at worst, harmless error. Considering the borrower's credit explanations in this case, as well as other available credit evidence, Colony made a reasonable determination as to the borrower's ability to make timely payments on his credit obligations. The borrower was eligible for FHA financing, and indemnification in this case is not appropriate.
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ii. – FHA Case No. 413-4121550

In the case, the Report alleges that the underwriter did not require an explanation from the borrower for a $85 collection account appearing on the borrower’s credit report.

With regard to this collection account, Colony understands and appreciates that indication of derogatory credit, including judgments and collections, require sufficient written explanation from the borrower. See HUD Handbook 4155.1, REV-5, ¶ 2-3. It is the Company’s policy and procedure to obtain this explanation, and we have reminded our employees of the importance of this requirement in response to the OIG’s audit. Nevertheless, any oversight in this case constituted, at worst, harmless error. Specifically, Colony documented the borrower’s worker’s compensation injury on August 17, 1993 (Exhibit O-1), and the underwriter understood the $85 collection account to be a medical account that resulted from the borrower’s injury. While the Company acknowledges that it should have obtained an explanation from the borrower for the collection account, there was no other evidence in the file to indicate the borrower was a credit risk. In fact, the borrower maintained $0 in monthly recurring obligations (Exhibit O-2) and a perfect payment history on a previous automobile loan (Exhibit O-3). Thus, as the underwriter in this case understood the collection account to have resulted from the borrower’s injury, Colony had no reason to question this account or otherwise consider the borrower uncreditworthy.

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iii. – FHA Case No. 413-4227851

In this case, Appendix E to the Report alleges that, although the borrower did not have an extensive amount of credit, he was not prudent in paying two of his three debts. The Report alleges the borrower received a misappropriated federal payment from the U.S. Department of Defense, which was sent to collections in January 2003 to ensure the borrower would repay the overpayment. The Report asserts, however, that the borrower’s credit report, dated August 20, 2003, showed the collection account had delinquent payments in April and July 2003 and had been delinquent since April 2003 for $122.

Although the Report makes no direct allegation about the Company’s credit analysis, other than stating the facts above, Colony properly determined, in this case, that the federal military debt had no effect on the borrower’s creditworthiness. Notably, the borrower explained that such debt resulted from a military bonus paid to the borrower, which was mistakenly paid and demanded to be returned (Exhibit P-1). Moreover, the delinquent payments on this account were removed from the borrower’s credit report (Exhibit D-4). Thus, the underwriter reasonably determined, in this case,
that any delinquency was of no fault of the borrower. Furthermore, neither the borrower's August 20, 2003 credit report (Exhibit P-2) nor the updated credit report obtained on August 29, 2003 evidence a \$122 balance on the Department of Defense account. The Company, therefore, properly considered these items and determined that did not pose a credit risk. Indemnification in this case is not appropriate, and the Company asks that this finding be removed from the final audit report.

iv. – FHA Case No. 413-4313542

In the Davis case, in connection with processing this loan using Fannie Mae's Desktop Underwriter ("DU"), the Report alleges that Colony should not have excluded a monthly payment to National City for \$222. The Report asserts that because the balance remaining on the loan was \$2,220, which would have resulted in 10 monthly payments, the underwriter should have resubmitted the loan.

Contrary to the allegations in this case, Colony excluded this debt in accordance with Fannie Mae's Single Family Guide to Underwriting with Desktop Underwriter. Notably, Chapter 2 to DU provides that both installment debts and revolving accounts with ten or fewer payments remaining will not be included in the qualifying ratio. See Fannie Mae Guide to Underwriting with DU, Chapter 2, Credit Documentation. Thus, as acknowledged in the Report, with 10 months remaining in payments on the National City obligation, the underwriter in this case properly excluded the debt for purposes of DU's requirements. Further, although the Report does not question the borrower's ability to make the mortgage payment in light of the National City account, we note that the underwriter neither used available overtime income to qualify the borrower nor factored in the borrower's projected pay increase in this case (Exhibit Q). While Colony was well within Fannie Mae's guidelines in excluding the National City liability, the Company also had no reason to question the borrower's ability to make the mortgage payment. Indemnification, therefore, is not appropriate in this case, and we request that this finding be removed from the final audit report.

b. Appraisal Documentation

Appendix E to the Report alleges, in the case (FHA Case No. 413-4121850), that Colony approved a loan with an appraisal date older than six months. The Report also asserts that appraisals cannot be reused during the six month period once the mortgage for which the appraisal was ordered has closed.

Colony understands and appreciates HUD's requirement that FHA appraisals on existing homes are current for six months. However, "the appraisals cannot be reused"
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during this period once the mortgage for which the appraisal was ordered has closed.  
For example, an appraisal used for the purchase of a property cannot be used again for  
a subsequent refinance even if six months has not passed. A new appraisal is required  
for each refinance transaction requiring an appraisal."  
HUD Handbook 4155.1 REV-5, §1-10(c); Mortgagor Letter 2001-12. Thus, in accordance with these requirements,  
Colony obtained a new appraisal on the subject property in connection with the  
refinance transaction. Specifically, as the original May 2, 2003 appraisal on the  
property could not be reused (Exhibit R-1), the Company obtained a second appraisal,  
dated December 4, 2003, for the refinance transaction (Exhibit R-2), which closed on  
December 22, 2003 (Exhibit R-3). Colony, therefore, complied with FHA guidelines in  
this case, and indemnification of this loan is unwarranted. We respectfully request that  
this finding be removed from the final audit report.

c. Mortgage Insurance

In one case, the [redacted] loan (FHA Case No. 413-4255461), Appendix E to the  
Report alleges that the streamline refinance loan was overinsured. Specifically, the  
Report asserts that the calculation of principal balance, plus interest (minus the  
unallowable December payment), plus closing costs and prepaid items, less the  
mortgage insurance premium refund, lowers the allowable mortgage amount to  
$158,867. The Report claims the loan was overinsured by $1,147, as the FHA insured  
the loan for $160,014.

Based on the documentation in the Company’s loan file, nothing evidences the  
alleged $158,867 maximum loan amount. Rather, the MCAW in Colony’s loan file  
demonstrates that the maximum loan amount, including up-front MIP, equaled  
$160,014, which is the exact amount of FHA insurance (Exhibit S-1). This amount was  
derived from the payoff statement also contained in Colony’s loan file, which evidenced  
a payoff amount of $154,902.30 and did not include a December payment (Exhibit S-  
2). Without additional information from the OIG, the Company believes that this loan  
was not over-insured, and we request that an indemnification recommendation be  
removed from the final audit report.

8. Underwriter Certifications and PFCRA Penalties

In addition to the loan-level allegations discussed above, the Report alleges that  
Colony’s direct endorsement underwriter incorrectly certified to the integrity of the data  
for one loan underwritten using an automated underwriting system and incorrectly  
certified that due diligence was used in underwriting 10 loans manually underwritten.  
The Report states that when underwriting a loan using an automated system, HUD  
requires direct endorsement underwriters to certify to the integrity of the data used to

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determine the quality of the loans, as well as certify that the loans are eligible for FHA insurance. With regard to a loan underwritten manually, the Report states that HUD requires direct endorsement lenders to certify that it used due diligence and reviewed all associated documents during the underwriting of the loan.

In connection with this allegation, the Report recommends that HUD determine the legal sufficiency and, if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act, 31 U.S.C. §§ 3801 et seq. (“PFCRA”), in connection with the loans cited in Finding 1. As you know, HUD is authorized to impose civil penalties under PFCRA against a person who makes a claim that the person knows or has reason to know: (1) is false, fictitious, or fraudulent, or (2) includes or is supported by a written statement that either contains a material fact that is false, fictitious, or fraudulent, or omits a material fact that the person has a duty to include and is false, fictitious or fraudulent as a result of the omission. 24 C.F.R. § 28.10. For the reasons that follow, Colony strongly disagrees with the certification allegation and the inclusion of such an inflammatory recommendation in this case.

Initially, the Report indicates that the underwriting deficiencies occurred “because Colony lacked adequate procedures and controls over its underwriting.” As demonstrated in the above discussion, however, in the 11 cases cited in connection with the underwriter certifications in Finding 1, Colony substantially complied with HUD requirements in each of these cases and the underwriter made a reasonable decision to approve the loan after exercising due diligence in examining each of the files at issue. For these reasons, Colony disagrees with the recommendation of any penalty in connection with these loans, let alone the harsh sanction of PFCRA penalties recommended in the Report.

Additionally, the Report does not allege, and there is no evidence to suggest, that Colony or its employees intended to circumvent HUD underwriting guidelines in these cases. Rather, the certifications in these 11 cases were executed by the underwriter after diligent review of the loan files in which these individuals made every effort to comply with FHA requirements. The certifications in these cases were executed in the belief that the borrowers qualified for FHA financing, which in fact they did in each case, rather than in an attempt to mislead the Department. The Report does not allege that Colony or its underwriter knowingly misrepresented facts to the Department or intentionally provided false information in the cases at issue. Before imposing penalties on FHA-approved lenders, HUD weighs a number of factors, including whether the deficiency was intentional or resulted from errors on the lender’s part, whether there was any injury to the public, and the mortgagor’s history of prior offenses. While intentional violations or a disregard for HUD requirements can lead to severe sanction,
such as PFCRA penalties, HUD usually imposes less severe consequences for deficiencies caused by unintentional error. Additionally, Colony maintains that the borrowers in all 11 cases qualified for FHA financing and, at most, Colony inadvertently left certain documentation out of the final loan file. At worst, certain of these 11 loans contained minor errors that did not affect the insurability of the loans. As indicated above, Colony believes that the final report should omit recommendation of any penalty in connection with these cases, making the recommendation of PFCRA penalties all the more severe under these circumstances.

We also note that, rather than cite new allegations, the PFCRA recommendation in Finding 1 appears to be an attempt to pile on the allegations made against Colony’s underwriting practices in this Report. Typically, OIG audit reports allege certain deficiencies in a company’s FHA operations, and the company is given an opportunity to address the materiality and accuracy of the allegations. By also adding an incorrect certification allegation to these underwriting assertions, the Department has created a situation where every misunderstanding of FHA requirements or oversight of a detail or document in a FHA loan could give rise to allegations of a false certification claim. Considering that FHA financing recently has significantly decreased in volume, such actions will create a chilling effect on lenders who want to participate in the FHA Program and endanger the longevity of the FHA Program’s future. Enforcement actions are meant to reinforce HUD’s rules and regulations, rather than discourage broad participation in FHA lending. For the sake of the Program, therefore, we believe the OIG should reconsider its approach to alleging false certifications and focus on the reinforcement of FHA rules and regulations.

Furthermore, Colony believes that it is being audited under different standards than other lenders that the OIG determined were not in compliance with HUD’s underwriting requirements. For instance, in recent years, we are aware that the OIG has issued reports alleging underwriting deficiencies in loans originated by two national lenders. See, e.g., Audit Rpt. No. 2005-AT-1014 (Sept. 15, 2005); Audit Rpt. No. 2008-NY-1001 (Nov. 18, 2005). Not one of these reports, however, recommended that the Department consider PFCRA penalties. Colony believes that the OIG should examine and make recommendations for lenders based on a similar set of standards to ensure that lenders are not audited differently by different OIG offices or disadvantaged by their geographical location in one OIG jurisdiction versus another. Here, Colony believes that it is being held to a different standard than other regional and national lenders that had underwriting concerns raised by the OIG. In fact, during the Company’s exit conference, the OIG stated that it is within its discretion to make PFCRA recommendations directly to HUD. Thus, we would hope that in a case with a mere 11 loans, the OIG would refrain from recommending such a draconian proceeding and,
instead, allow HUD to make a direct evaluation of the OIG’s allegations. We again respectfully request that the OIG use this discretion to ensure that lenders receive consistent treatment from the agency.

Finally, in a prior audit, HUD already raised the incorrect certification allegation against the Company and proposed to debar the underwriter of record on the 11 cases cited in the Report. Without any admission of wrongdoing or liability, the underwriter entered into a settlement with the Department, and HUD determined the underwriter was qualified to continue to participate in the FHA Program. All other certification allegations made against the Company also were resolved. Thus, the OIG’s attempt to resurrect allegations in this case already considered and resolved by the Department is unfair and prejudicial. Colony strongly believes the underwriter in each of the 11 cases generally complied with FHA guidelines and properly certified to her belief that each of the borrowers were eligible for FHA insurance. The recommendation of PFCRA penalties is unduly harsh, and we believe the OIG ignores the Company’s general compliance with FHA guidelines in these cases.

9. Underwriter Controls and Recommendations

In Finding 1, the Report also makes over-generalized allegations regarding the Company’s underwriting procedures and controls and recommends that Colony address these deficiencies by implementing its revised Quality Control plan, ensuring that underwriters continue to receive necessary training on HUD’s underwriting requirements, and indemnifying the Department for losses on these loans. The Report also suggests that the cited allegations when viewed against prior Quality Assurance Division audits of the Company demonstrate that Colony’s existing underwriting procedures and controls need improvement.

Colony, however, strongly disagrees with the Report’s contentsions that the Company does not maintain adequate procedures and controls to ensure prudent underwriting and compliance with FHA guidelines. First, as discussed in more detail below, Quality Control has always been a top priority for the Company, and it is Colony’s policy and procedure to fully implement its Quality Control plan and ensure that all Company underwriters and employees fully understand HUD/FHA requirements and are kept informed of changes and developments in underwriting guidelines. Colony also has required its underwriters to go above and beyond FHA requirements and instituted its own safeguards to ensure that borrowers eligible for FHA financing can actually afford the mortgage payments (Exhibit T). HUD’s prior audits of the Company merely reinforce these policies and procedures and in no way demonstrate that Colony does not engage in prudent lending practices. In fact, while Colony has taken responsibility for its mistakes when warranted, these audits have provided Colony the
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opportunity to demonstrate the competence of its underwriting staff and explain the Company’s compliance with FHA requirements.

Moreover, out of the 2,718 FHA-insured loans originated by the Company between October 1, 2003 and September 30, 2005, alleged deficiencies in the 11 loans cited in the Report hardly suggests that Colony’s underwriting procedures and controls are inadequate. This is especially true considering the Report’s allegations merely question the judgment that HUD requires underwriters to exercise when approving FHA loans. As discussed above, HUD has acknowledged that “[u]nderwriting is more of an art than a science and requires the careful weighing of circumstances that affect the borrower’s ability and willingness to make timely mortgage payments.” Mortgagee Letter 00-24; see also Mortgagee Letter 95-07. Underwriting requires the subjective evaluation of information based on experience in determining whether a potential borrower is creditworthy or otherwise eligible for FHA financing. Thus, just because the OIG does not agree with the underwriter in the 11 cases cited in the Report does not mean that Colony disregarded or did not comply with HUD’s requirements. It is more than conceivable that two underwriters could consider the same loan file and make different underwriting decisions – both in compliance with HUD/FHA guidelines. Because the Company maintains adequate underwriting procedures and controls and disagrees with the vast majority of the findings in the Report, Colony believes the OIG’s indemnification recommendations in the Report are unwarranted.

We also note that HUD will have an opportunity to make an independent determination as to whether indemnification is warranted in any of these cases. Upon review, the Department may disagree with the Report’s assertions and decide not to pursue indemnification in some or all of the 11 cases. That being said, and notwithstanding the fact that these findings are preliminary, the OIG’s recommendations still 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:


As Colony values its relationship with the Department and strives to always adhere to HUD’s requirements, we respectfully request that the OIG reconsider the quality of Colony's underwriting practices and revise its recommendations to appropriately fit the facts of this case.

III. FINDING 2 — COLONY COMPLIED WITH HUD'S QUALITY CONTROL REQUIREMENTS

In the second finding, the Report alleges that the Company did not fully comply with HUD's Quality Control requirements. Specifically, Finding 2 asserts that, during the period from October 1, 2003 through September 30, 2006, the Company’s Quality Control plan did not meet HUD's requirements. The Report also alleges that as a result of a Quality Assurance Division audit on September 22, 2003, Colony revised its Quality Control plan, but the OIG determined that this plan still did not meet HUD's requirements. While the Report acknowledges that Colony's Quality Control plan currently meets all of HUD's requirements, the Report requests that Colony implement its revised Quality Control plan to reduce the risk to HUD's insurance fund.

Furthermore, the OIG statistically selected 34 loans originated by the Company that went into early payment default during the OIG's period of review. Of the 34 loans reviewed for purposes of the Report,2 Finding 2 asserts that Quality Control reviews

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2 The 34 loans cited in Finding 2 are: (1) FHA Case No. 413-4350542; (2) FHA Case No. 413-4357245; (3) FHA Case No. 413-4435450; (4) FHA Case No. 413-4315823; (5) FHA Case No. 413-4288582; (6) FHA Case No. 413-4301665; (7) FHA Case No. 411-3622580; (8) FHA Case No. 411-3808539; (9) FHA Case No. 413-4302694; (10) FHA Case No. 413-4258827; (11) FHA Case No. 413-437912; (12) FHA Case No. 413-428225; (13) FHA Case No. 151-7538549; (14) FHA Case No. 151-7640328; (15) FHA Case No. 413-4259153; (16) FHA Case No. 413-4459174; (17) FHA Case No. 201-3125116; (18) FHA
were not performed in accordance with HUD’s Quality Control requirements. More specifically, the Report asserts that certain of the reviews were not performed in a timely manner and the files did not contain evidence that Colony conducted a desk review of the appraisal, re-verified the borrower’s employment, income, and assets, and obtained a new credit report for the borrowers. The Report attaches Appendix F, which provides a summary of these alleged deficiencies.

1. Quality Control Plan

First and foremost, contrary to the allegations in the Report, Colony never disregarded HUD’s Quality Control plan requirements, and the Company vehemently disagrees with the Report’s suggestion that Colony’s Quality Control practices resulted in poor underwriting or increased the risk to HUD’s insurance fund. Colony recognizes that its former Quality Control plan omitted certain elements required by FHA guidelines. That plan, however, did not reflect all of the Company’s policies and procedures, and Colony has strived to adhere, since its inception, to each and every Quality Control requirement in HUD’s guidelines. Moreover, as acknowledged in the Report, Colony’s current Quality Control plan meets all applicable HUD/FHA requirements and is attached as Exhibit U. Colony has fully implemented this Quality Control plan and instructed Company employees to adhere strictly to it. We will continue our longstanding practice of stringent Quality Control and trust that our response to this finding fully addresses the OIG’s concerns.

In addition, it has always been the Company’s policy to fully implement the elements of Colony’s Quality Control plan and take action where deficiencies are revealed. The Report, however, states that “Colony’s president stated that the company was aware that its quality control plan did not meet HUD’s requirements,” and that “the quality control department did not verify borrower’s information due to difficulties in obtaining re-verification documentation.” These statements are inaccurate and unfairly misleading. As stated above, it is Colony’s policy to fully comply with HUD’s Quality Control requirements, and, at no time, has Colony disregarded these requirements or intentionally implemented a deficient Quality Control plan. Moreover, as discussed in more detail below, servicers often do not report a loan’s default and borrowers’

Case No. 413-422456; (19) FHA Case No. 413-4370656; (20) FHA Case No. 412-5230164; (21) FHA
Case No. 412-521362; (22) FHA Case No. 413-4444177; (23) FHA Case No. 413-4213762; (24) FHA
Case No. 413-434362; (25) FHA Case No. 413-4286656; (26) FHA Case No. 413-4395473; (27) FHA
Case No. 201-3305349; (28) FHA Case No. 413-4226160; (29) FHA Case No. 413-4191154; (30) FHA
Case No. 201-3383897; (31) FHA Case No. 413-4380033; (32) FHA Case No. 413-4435556; (33) FHA
Case No. 413-4460222; and (34) FHA Case No. 413-4298045.
employers and financial institutions are reluctant to re-verify borrower information after the loans have closed. Colony, however, makes every effort to comply with its Quality Control plan and HUD requirements. Whether servicers, employers, and financial institutions actually provide the information to allow the Company to fully implement its plan is out of Colony’s control. Nevertheless, in accordance with its plan, Colony completes all required Quality Control reviews, and where deficiencies are identified, Colony takes the necessary action to ensure these deficiencies will not recur.

2. Quality Control Reviews

With regard to the Report’s allegations regarding the Company’s Quality Control reviews, Colony takes its Quality Control responsibilities seriously and actively ensures that the Company implements all components of its Quality Control plan. Notably, it is the Company’s policy to review 10% of all FHA-insured loans originated by Colony within 60 days from the end of the month in which the loans closed. See HUD Handbook 4020.1, REV-1, ¶ 6-6(A), (C); HUD Handbook 4020.1, REV-2, ¶ 7-6(A), (C). In addition to 10% of the loans selected for a routine quality control review, it is the Company’s policy to review all loans that go into default within the first six payments. Id., ¶ 8-6(D); 7-8(D). In both instances, it is Colony’s policy to timely complete Quality Control reviews, and the Company ensures the Quality Control reviews re-verify certain documentation and information, including the borrowers’ credit report, employment and asset documentation, appraisals, and the borrowers’ occupancy. Id., ¶ 8-6(E); 7-6(E).

First, in accordance with FHA guidelines, Colony completes a timely Quality Control review of those early payment default loans that it is aware have gone into default. The Company, however, does not service any of the loans it closes, but rather sells all loans in the secondary market on a servicing-released basis. Accordingly, Colony’s ability to monitor the default status of a loan it originates largely depends on whether the loan’s purchaser timely notifies Colony that the loan has gone into default or foreclosure and/or timely reports the default to HUD so that it is reflected in FHA Connection. Unfortunately, many servicers often fail to keep the Company and/or HUD apprised of borrowers’ payment histories, a problem that is not unique to Colony. Nevertheless, it is Colony’s policy to actively monitor Neighborhood Watch and the default status of the loans the Company originates. Thus, contrary to the allegations in the Report, Colony performs timely Quality Control reviews of early payment default loans as soon as the loans are identified as in default.

Second, in each of the 34 loans cited in the Report, the Company conducted a Quality Control review of these loans once Colony had information of the loans’ default. As noted above, depending on the length of time it takes the servicers of the loans to
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report default status directly to the Company, or to HUD through FHA Connection, it is Colony’s policy to review all loans that default within the first six mortgage payments. Moreover, it is Company policy to re-verify a borrower’s employment, obtain a new credit report from a different credit bureau, re-verify a borrower’s assets or other sources of funds, and perform a desk review of the appraisal in connection with each Quality Control review performed. The 34 loans cited in the Report are no exception. However, as a considerable amount of time often passes before Colony receives default information, it is difficult to obtain updated employment information and current asset verification during Quality Control reviews. Notably, each of the 34 loans cited herein were processed and underwritten using alternative documentation for the borrowers’ income and assets, including pay stubs, W-2 forms, and bank statements. This alternative documentation makes it less likely that employers and banking institutions will provide income and asset information in writing after the time of closing. Moreover, in preparation for its Quality Control reviews, Colony requires its borrowers to sign an IRS Form 4506T at the time of closing, so that Colony may later request income documentation for the borrowers. The borrower’s income information, however, must be ordered within 60 days of his or her signature, and this form is often outdated once Colony learns the loans are in default. Thus, in accordance with FHA guidelines and the Company’s Quality Control plan, Colony attempts to obtain a telephone re-verification of the borrower’s income and assets. Employers and banking institutions, however, often cite privacy policies to deny any verbal re-verification.

That being said, Colony has reminded Company employees of the importance of ensuring that all documentation and information re-verified in a Quality Control review is maintained in the file, and we are certain that such an oversight will not recur in the future. At the very least, the Company acknowledges that Quality Control personnel should have documented their efforts to re-verify the cited information in the 34 loans referenced in the Report. The Company is committed to the stringent Quality Control of the FHA-insured loans it originates, and we have reminded Company employees of the importance of re-verifying and documenting borrower information for all Quality Control reviews. It is always Colony’s intention to implement its Quality Control plan to comply with HUD requirements, and we believe any oversight with regard to the loans cited in the Report will not recur.

Colony has always engaged in stringent Quality Control. We consistently review and analyze Company practices and procedures, and take responsibility to ensure that FHA requirements are met. As discussed above, we have implemented a written Quality Control plan that complies with HUD/FHA requirements. Furthermore, it is our policy and practice to conduct timely Quality Control reviews and re-verify all required items. We are confident that any problems that the Company may have experienced in
the past with regard to the issues raised in the Report have been resolved, and we respectfully request that these allegations be removed from the Report.

IV. CONCLUSION

Colony takes the matters raised in the draft Report seriously. Because FHA lending comprises a substantial portion of Colony’s overall business operations (over 40%), 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, Colony generally complied with FHA underwriting requirements and made loans to qualified FHA borrowers. Colony’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 Colony, or do not affect the underlying loans’ insurability. Moreover, since the loans cited in the Report were originated, the Company has continued to enhance its underwriting practices and Quality Control standards. Accordingly, we respectfully request that the OIG revise the allegations cited in the Report based on the information and documentation provided in this response.

Finally, Colony believes that the recommendations involving PFCRA penalties are unwarranted, as they suggest intent to circumvent HUD requirements when no such intention existed in these cases. Colony values its relationship with the Department and did not, in any manner, seek to misrepresent any information to HUD. Colony believes that the various remedies available to HUD, short of the severe sanctions under PFCRA, are appropriate to resolve any deficiency identified in the Report. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate that including these recommendations in the Report is unnecessary, inappropriate, and will damage Colony’s reputation. We respectfully request that the OIG revise its recommendations to fit the facts of this case.

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,

David C. Dillen
President

cc: Phillip L. Schulman, Esq.
OIG’s Evaluation of Auditee Comments

Comment 1  We provided Colony the opportunity to informally respond to our tentative findings during the audit. We considered its comments and revised our conclusions where appropriate. We then prepared the discussion draft report and provided Colony an opportunity to respond to the draft report in writing. We included its written response (minus supporting documentation) in this report along with our evaluation of the response. Colony will have further opportunity to provide comments and supporting documentation to HUD to resolve the recommendations.

Comment 2  Since issuance of the discussion draft audit report, Colony received a copy of HUD’s September 2005 Quality Assurance Division review of its loan correspondent Dominion Homes Financial Services. The September 2005 review is independent from the review conducted by HUD’s Atlanta Quality Assurance Division in 2006. Further, in response to Colony’s comments, we revised the audit report to show why the loans were excluded from our review.

Comment 3  Colony contends that $392,000 in claims for five loans hardly demonstrate that Colony’s underwriting and origination practices put HUD’s insurance fund at risk. We disagree. During the audit, 22 of the loans were reviewed and 9 (40 percent) contained underwriting deficiencies. Further, any claim paid by HUD due to improper underwriting or loan origination practices puts HUD’s insurance fund at risk.

Comment 4  We selected our sample on May 19, 2006, prior to the loans being cited in HUD’s system. As a result, we selected and reviewed loans 201-3402921 and 412-5088277 during the audit. Loan number 201-3402921 was cited in HUD’s Quality Assurance Division’s file number 18852, dated May 24, 2006. Loan number 412-5088277 was cited in HUD’s Quality Assurance Division’s file number 16373, which was not documented in HUD’s Quality Assurance Document Library System as of March 2007.

We assessed Colony’s position that the two questioned loans previously reviewed by HUD’s Quality Assurance Division should be removed. Since loan number 412-5088277 was remedied by Colony with a payment of an administrative fee to HUD, we revised the audit report to delete all reference to this loan except for explaining our methodology regarding the loans reviewed. We also excluded loan number 201-3402921 from the recommendation for indemnification; however, because Colony’s direct endorsement underwriter incorrectly certified that due diligence was used in underwriting this loan; the loan was included in the recommendation to HUD’s associate general counsel for remedies under the Program Fraud Civil Remedies Act.

Comment 5  We disagree with Colony that for loan number 201-3402921 the borrower was qualified for the buydown because of an increased earning potential associated with shift pay and overtime pay not included as effective income. The borrower’s rate of
pay was not consistent. It ranged between $13 and $18 per hour based on assignment. Therefore, we used the year-to-date amount from the borrower’s most recent earning statement ending August 22, 2004, to determine that his monthly income totaled $2,360. The mortgage credit analysis worksheet in the borrower’s file cited low ratio and income available as compensating factors. These factors were not sufficient. The borrower earned overtime income; however, the underwriter did not provide documentation to support an average of the overtime income and establish an earnings trend to determine whether this income would more than likely continue for at least three years. Without this information, we are unable to determine if the borrower would continue to earn overtime in performing his regular job functions, and if the funds would be consistently earned during or after the buydown period expired. The borrower’s fixed payment to income ratio was already 41 percent at the buydown rate. Without attendant increases in income after the two buydown period, the fixed payment-to-income ratio would be 45.6 percent. Although HUD’s requirement does not require lenders to document overtime earnings for a two-year period for satisfying the buydown agreement, it was Colony’s responsibility to document its assessment of the borrower’s potential for increased income that would offset the scheduled mortgage payment increases.

Although the borrower may have returned to work after being on short-term disability prior to the loan’s settlement, Colony did not provide documentation showing the hourly rate the borrower received upon returning to work since the borrower’s rate of pay varied per assignment.

Additionally, we disagree with Colony that the borrower satisfied the Brown Forman debt for $1,498. The documentation Colony provided showed that the borrower satisfied a judgment for the 1st United Labor Credit Union and not the Brown Forman debt. The borrower stated in his credit explanation letter that the Credit Union was deducting 25 percent of the balance of $1,964 from of his payroll check. The borrower’s earning statement ending July 25, 2004, shows the borrower paid $1,962 for a Cr Levy. This amount coincides with the amount the borrower stated in his letter of explanation. Also in Colony’s file was an order of satisfaction, dated August 4, 2004, stating the judgment to the 1st United Labor Credit Union was paid in full and the judgment was deemed satisfied.

Further, we disagree with Colony that the underwriter properly calculated the borrower’s qualifying income and recurring liabilities based on the reasons previously mentioned. Also contrary to Colony’s assertion, the borrower did not have a substantial cash reserve at the time of closing. The mortgage credit analysis worksheet, dated September 16, 2004, a few days before the loan closed, showed the borrower paid a $250 earnest money payment and had $104 in cash assets.

Since HUD’s Quality Assurance Division had previously reviewed the loan and found similar findings, we did not request indemnification for this loan. However, we included the loan in our recommendation to HUD’s associate general counsel.
for program enforcement to pursue remedies under the Program Fraud Civil Remedies Act due to the incorrect certification.

Comment 6  We agree with Colony that for loan number 411-3737859, the borrower received aid for her two dependent children rather than unemployment income. Therefore, we adjusted our calculation of the borrower’s income to include the amount and revised the report accordingly. However, we disagree with Colony that sufficient compensating factors were documented to justify exceeding HUD’s limit for the mortgage payment expense to effective income ratio by 9.5 percent (38.5 percent). HUD Handbook 4155.1, REV-5, paragraph 2-12, states if the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total fixed payment-to-effective income exceeds 41 percent, significant compensating factors should be documented and listed on the mortgage credit analysis worksheet. The mortgage credit analysis worksheet in the borrower’s file did not contain any compensating factors.

Additionally, contrary to Colony’s assertion that the borrowers had remained debt free since the mid-1990s, a credit report, dated January 27, 2004, shows a collection account from Verizon West North for $398. The account was opened in December 2002, and the borrowers’ payments were delinquent in February and July 2003. The borrowers provided a money order receipt showing a payment in the amount of $225 on April 2, 2004, payable to the collection company for Verizon. However, the account number listed on the money order did not match the account number on the credit report. The most recent credit report provided by Colony, dated May 13, 2005, shows the account remains in collection with a past due balance of $398.

Comment 7  We disagree with Colony that for loan number 413-4227951, the borrower’s verification of employment showed his base pay increased from $13 per hour, or $520 per week, to $600 per week. Actually, the borrower’s hourly pay with his previous employer Dupont was nearly $22 or $869 per week. He was employed with Dupont from May 27, 2003, through October 12, 2003. The borrower then became employed with All American Improvements earning $600 per week on October 13, 2003, one month prior to closing. The change in employment resulted in a decrease in pay of $269 per week or $1,076 per month.

We agree with Colony’s reference to HUD requirements that the underwriter is only required to document the amount and receipt of the commission income if he or she uses it to qualify the borrower for a loan. However, Colony did not recognize its responsibility to determine the adequacy of the borrower’s earning potential to justify the buydown. After the buydown assistance period, the borrower’s mortgage payment-to-income ratio would be 35 percent, and the fixed payment-to-income ratio would be 46 percent. HUD’s buydown requirements were designed to ensure that the eventual increase in mortgage payments would not affect the borrower adversely and likely lead to default.
The underwriter did not prudently determine that the eventual increase in mortgage payments would not adversely affect the borrower. This is evident given that the borrower’s base pay decreased significantly from his previous employer to his current employer. The mortgage credit analysis worksheet in the borrower’s file listed low credit use. This factor was not sufficient in determining the borrower’s ability to handle the mortgage payment increases. The borrower’s credit report did not demonstrate his ability to manage financial obligations. When the borrower was earning more income, the credit report identified two collection accounts. One account was paid before closing and the other was not paid at the time of our review. Therefore, the underwriter did not demonstrate the borrower’s ability to manage financial obligations. Although the borrower may receive commission income, the stability and consistency of the income was not determined. Further, the receipt of the income does not indicate that the borrower had a history of career advancements or received training that would enable him for higher future earnings as required by HUD.

Further, the documentation Colony obtained from the employer contained a general comment that the employer looks forward to the borrower having a long and prosperous career. This document in of itself did not demonstrate that the borrower would receive an increase in income during the two years of the buydown period. Colony did not determine or show how much of a pay increase the borrower would receive as proper justification for the buydown agreement. Additionally, upon approval of the loan, the borrower’s housing expenses would increase by $124. This amount would be significantly more once the borrower’s mortgage payment increased.

**Comment 8** We disagree with Colony that for loan number 413-4254327 the underwriter demonstrated the borrower’s ability to absorb the payment increases by documenting a substantial increase in the borrower’s pay. The document provided by Colony, in response the discussion draft audit report, dated October 31, 2003, from the borrower’s employer included a general comment that new drivers average about $34,000. This figure was an average; therefore, the borrower can earn less than or more than the amount. It did not state that the borrower, as a new hire, would earn $34,000 per year. However, the document did note that the borrower would earn a guaranteed minimum of $600 a week. Therefore, we used this figure to determine the borrower’s monthly income of $4,030.

Further, if the borrower had received an annual salary of $34,000 a year as a truck driver, the borrower’s income would have decreased by $3,897 annually since the borrower was previously employed as a police officer with an annual salary of $37,897. In addition, the verification of employment form, dated October 3, 2003, stated the borrower was not entitled to overtime or commission income. It also did not show how much of an increase in pay the borrower would receive in the future.

Colony did not recognize its responsibility to determine the adequacy of the borrowers’ earning capacity to justify the buydown. 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. In this instance, the borrowers’ recurring debt was actually $525, instead of $299, and the borrowers’ housing expenses during the buydown totaled $1,097. However, at the note rate the borrowers’ payment would be approximately $1,249, and the borrowers’ mortgage payment-to-effective income and fixed payment to income ratios would be 31 and 44 percent, respectively. Contrary to Colony’s statement that the loan would be acceptable under Mortgagee Letter 2005-16, the loan closed in 2003 before the effective date of the Letter and the mortgage credit analysis worksheet in the loan file did not contain any compensating factors. HUD’s requirements stipulate that the mortgage payment-to-effective income and fixed payment to effective income should not exceed 29 percent and 41 percent, respectively, without sufficient compensating factors documented on the mortgage credit analysis worksheet. Since this loan was approved under a buydown agreement, Colony was required to document that the increased mortgage payments would not adversely affect the borrowers by showing that the borrowers had potential for increased income that would offset the scheduled payment increases.

**Comment 9** We disagree with Colony that for loan number 413-4263790 the underwriter properly excluded the $173 monthly payment to Garden Financial because the debt had less than 10 months remaining when the loan closed. According to HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-11, debts lasting less than 10 months must be counted if the amount of the debt affects the borrower’s ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing. The borrower did not have any assets at closing. In addition, we disagree with Colony’s comments that compensating factors existed that would offset its omission of the $173 monthly payment from the borrower’s credit assessment. The omitted debt increased the borrower’s total fixed payment-to-income ratio from 40.14 percent to 52.50 percent. HUD Handbook 4155.1, REV-5, CHG-1, chapter 2, section 5, paragraph 2-12, states if the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total fixed payment-to-effective income exceeds 41 percent, significant compensating factors should be documented and recorded on the mortgage credit analysis worksheet.

The mortgage credit analysis worksheet identified two compensating factors, low credit use and low housing. These compensating factors were not adequate to support the borrower’s qualifying ratios. For the first compensating factor, the borrower had not successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12 to 24 months. The borrower’s previous rental payment was $194 less than the new mortgage. For the second compensating factor, Colony must document the borrower had a demonstrated ability to accumulate savings and a conservative attitude toward the use of credit. The borrower only met part of the compensating factor since Colony did not provide documentation that the borrower demonstrated the ability to accumulate savings.
Comment 10 We agree that loan number 413-4288944 met HUD’s buydown requirements and revised the report accordingly. However, Colony failed to include all of the borrower’s liabilities when evaluating the borrower’s ability to repay the debt. The borrower’s credit report as of January 2004 identified two student loans with a total monthly payment of $307 that were in deferment status. The loans’ deferment was scheduled to end in July 2004 and January 2005, respectively. The loan closed in March 2004. According to HUD Handbook 4155.1, REV-5, CHG-1, chapter 2, section 4, paragraph 2-11(C), states that if a debt payment, such as a student loan, is scheduled to begin within 12 months of the mortgage loan closing, the lender must include the anticipated monthly obligation in the underwriting analysis, unless the borrower provides written evidence that the debt will be deferred to a period outside this time frame.

Therefore, contrary to requirements in HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-11, there was no documentation to show that the deferment period would last at least 12 months beyond the mortgage closing date. Colony provided the borrower’s transcript to show that the borrower was a part-time student; however, the transcript did show that the borrower requested and received an extension of forbearance for the student loans. In addition, we disagree that the borrower’s obligation to Bally’s Total Fitness should have been excluded because the borrower had 10 payments remaining on the account. HUD Handbook 4155.1, REV-5, CHG-1, chapter 2, section 4, states that when computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more. With the inclusion of the student loans and the three recurring obligations totaling $408, the borrower’s fixed payment-to-income ratio when using the reduced interest rate was 60.64 percent.

HUD Handbook 4155.1, REV-5, CHG-1, chapter 2, section 5, paragraph 2-12, states if the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total fixed payment-to-effective income exceeds 41 percent, significant compensating factors should be documented and recorded on the mortgage credit analysis worksheet. The compensating factor on the mortgage credit analysis worksheet was credit. This compensating factor was not adequate to support the borrower’s fixed payment-to-income ratio.

Moreover, we disagree that Colony sufficiently documented the borrower’s cash reserves of $2,386. The borrower’s December 2003 bank statement shows a $2,200 deposit on December 10, 2003, that was not explained by the borrower as required by HUD Handbook 4155.1, REV-5, CHG-1, chapter 2, section 3. Without the $2,200 deposit, the borrower’s balance would have been $721. Prior to the deposit on December 10, 2003, the borrower received an electronic deposit from her employer for $1,953 on December 5; it would be reasonable to question if the additional payment was from her employer, since the borrower was paid bi-weekly. In addition, the beginning balance for the December 2003 statement was less than $21. Further, on December 4, 2003, the borrower’s account was in overdraft by
less than $1 until the borrower’s payroll deposit on December 5. Because Colony did not request documentation to support the $2,200 deposit, there is no way of determining if the borrower really demonstrated an ability to accumulate savings.

We agree with Colony that loan number 413-4288944 met HUD’s buydown requirements. We revised the audit report to delete all reference to this condition (see comment 10). However, we disagree that the borrower’s undocumented overtime income directly affected the borrower’s ability to repay the mortgage and qualified as a significant factor. Colony did not provide documentation to support an average of overtime and establish an earnings trend to determine whether this income would more than likely continue for at least three years.

Comment 11 We agree with Colony that for loan number 413-4315823, the borrower’s fixed payment-to-income ratio equaled 35.33 percent. The report should have referenced the mortgage payment-to-income ratio. Therefore, we revised the report to show the borrower’s mortgage payment-to-income as listed on the mortgage credit analysis worksheet was 34.39 percent.

Contrary to Colony’s statement that the borrower worked every other Saturday and the pay should be considered additional income, we determined that the pay should not have been considered additional income but included in the calculation for effective income. The borrower’s verification of employment did not state the every other Saturday income is in addition to her effective income. Therefore, the Saturday income was reflected as effective income and we calculated it as such. Hence, the borrower did not have $150 in additional income. The borrower’s total monthly income including the Saturday pay totaled $1,775. With the inclusion of this income, the borrower’s mortgage payment-to-income ratio was 32.27 percent using the reduced interest rate. However, after the buydown, the ratio would be 39 percent. Therefore, the additional Saturday income did not directly affect the borrower’s ability to repay the debt.

Although the report should have referenced the mortgage payment-to-income ratio instead of the fixed payment-to-income, Colony’s underwriter did not document any compensating factors to support the increased qualifying ratio when the loan was approved. Therefore, Colony did not comply with HUD’s requirements as it relates to recording significant compensating factors on the mortgage credit analysis worksheet. The borrower’s annual income for 2003 was $18,955 with an expected income of $21,300 for 2004. Therefore, the borrower’s income would increase by approximately 12 percent. The borrower qualified for the loan with a mortgage payment of $573. The payment, after expiration of the buydown assistance, would be approximately $688 and assuming a 12 percent increase in income each year through the two years of the buydown agreement, the mortgage payment-to-income ratio would be approximately 31 percent. However, there was no indication on the verification of employment form or other related documentation in Colony’s file or HUD’s case binder that the borrower would receive an increase in income.
Contrary to Colony’s statement that the borrower demonstrated ability to manage financial obligations in such a way that at greater portion of income may be devoted to housing expenses, the borrower obtained an account in December 2003 with a credit limit of $49 and a balance of $49. Prior to this account being opened, the borrower filed for bankruptcy in September 2001 and the bankruptcy was discharged in January 2002. Since the discharged bankruptcy, the borrower had not yet demonstrated his ability to manage financial obligations and Colony did not consider the impact of the borrower’s $288 increase in rental expense.

Comment 12  See comment 5.

Comment 13  See comment 9.

Comment 14  See comment 10

Comment 15  See comment 6.

Comment 16  See comment 4.

Comment 17  We disagree with Colony that for loan number 413-4263790 the borrower’s rental verification was obtained directly from the landlord. In the letter that Colony provided as supporting documentation, the landlord stated he was providing a copy of the letter that he provided to the borrower. He did not state that he provided the letter to Colony. In addition, the letter conflicted with the letter in the borrower’s loan file. For instance, the letter in the loan file that was used to qualify the borrower shows the borrower began renting an apartment from the landlord on February 3, 2001. The letter Colony provided to dispute our finding shows the borrower had only been a tenant since February 2002.

Comment 18  We disagree with Colony’s position that for loan number 413-4288944 that Colony’s underwriter had no reason to believe the borrower’s three-month payment history to her current landlord was less than timely. With the previous apartments, the borrower was married and her spouse contributed to the living expenses. This was the first apartment that the borrower had since her divorce. HUD requirements state that the payment history of the borrower’s housing obligations holds significant importance in evaluating credit. Colony must determine the borrower’s payment history of housing obligations covering the most recent 12-month period.

Comment 19  We disagree with Colony that for loan number 413-4263790 the purchase agreement and HUD-1 settlement statement verified the required gift information. Neither the purchase agreement nor the HUD-1 settlement statement stated that no repayment was required. In accordance with HUD’s requirements, a gift letter from the seller must be signed by the donor and borrower that specifies the dollar amount of the gift; state that no repayment is required; show the donor’s name, address, and telephone number; and state the nature of the donor’s relationship to the borrower.
Colony did not provide any documentation to support its compliance with HUD’s requirements.

**Comment 20** The loan number referenced in the report was 413-4284327; however, the loan number was 411-3737859. We revised the audit report to show the correct loan number (See comment 6).

**Comment 21** See comment 4.

**Comment 22** We disagree that Colony properly obtained a statement from the borrower for loan number 201-3402921 to explain insufficient charges. Colony only provided documentation to explain the borrower’s overdraft fees and it did not provide an explanation from the coborrower for her overdraft or returned check fees. When analyzing a borrower’s credit history, Colony should have examined the overall pattern of credit behavior. When you consider the overdraft fees, insufficient funds penalty fees, and current judgment, these actions are not consistent with Colony’s claim concerning the borrowers’ ability to make timely payments on their credit obligations. The inability to make timely payments has a direct impact on the borrowers’ ability to meet the future housing expense of $1,012, which is an increase of $647 from the borrowers’ current housing expense.

As stated earlier in comment 4, since HUD’s Quality Assurance Division had previously reviewed the loan and found similar findings, we did not recommend indemnification for this loan; however, we recommended this loan for action under the Program Fraud Civil Remedies Act for the incorrect certification.

**Comment 23** We commend Colony for bringing this weakness to its employee’s attention in an effort to prevent this oversight from recurring in the future.

**Comment 24** As stated in the finding for loan number 413-4227951, the borrower received a misappropriated federal payment from the U.S Department of Defense. To ensure that the borrower would repay the overpayment, the account was sent to collections in January 2003. The credit report, dated August 20, 2003, showed that the collection account had delinquent payments in April and July 2003. The credit report Colony provided dated only nine days after the previous credit report did not disclose the borrower’s previous delinquencies, but showed that the $847 overpayment was past due.

We agree with Colony that the account had not been past due since April 2003 for $122. The $122 was in reference to a collection account with Insight Communication. Since both accounts were paid prior to closing, we revised the audit report to remove all reference to the U.S Department of Defense and Insight Communication collection accounts.

**Comment 25** We agree with Colony that the $222 monthly payment to National City for loan number 413-4313543 should have been excluded. Therefore, we revised the audit
report to delete all reference to this condition. However, Colony’s underwriter inputted into Fannie Mae’s desktop underwriter system $2,532 as the borrower’s income when this amount could not be supported by the borrower’s pay documentation. The borrower had only been employed for one day before the loan was approved. The verification of employment, dated March 10, 2004, revealed that the borrower was to start work on March 22, 2004, one day after the desktop underwriter run date of March 23, 2004. The loan closed on March 30, 2004, eight days after the borrower started his new employment. Fannie Mae’s Single Family Guide to Underwriting with Desktop Underwriter, chapter 2, states that borrowers must have been employed a minimum of 30 days in their current position to use the income for qualifying purposes. The borrower’s monthly pay prior to the loan closing was $1,459. With the exclusion of the $222 monthly payment and inclusion of the borrower’s previous income, the mortgage payment expense-to-effective income ratio was 55.28 percent and the total fixed payment-to-effective income was 81.65 percent when using the reduced interest rate. The underwriter should have resubmitted the loan using the borrower’s monthly income supported by the borrower’s pay documentation.

**Comment 26** We agree and removed the loan from this audit report.

**Comment 27** We disagree that loan number 413-4255461 was not overinsured. The mortgage credit analysis worksheet shows the unpaid principal balance on this loan as $154,944 when the actual unpaid principal balance was $153,707. Due to Colony’s overestimation of the borrower’s closing costs and prepaid expenses, the loan amount before the mortgage insurance premium was overstated on the mortgage credit analysis worksheet. The loan amount reported was $157,650; however, based on the HUD-1 settlement statement the loan amount was $156,520. Therefore, the financed mortgage insurance premium at 1.5 percent should have been $2,347 and not $2,364 as shown on the mortgage credit analysis worksheet.

The calculation of principal balance plus interest, plus closing costs and prepaid expenses, less the mortgage insurance premium refund, lowers the allowable mortgage amount to $158,867. The loan was insured for $160,014; therefore, the loan was overinsured by $1,147 ($160,014 minus $158,867).

We agree with Colony that this loan should not be recommended for indemnification; however, we recommended that Colony reimburse HUD $1,147 for the overinsured loan amount.

**Comment 28** Colony objected to the inclusion of a recommendation that HUD’s associate general counsel for program enforcement determine legal sufficiency and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act against Colony and/or its principals for incorrectly certifying that due diligence was exercised during the underwriting of 11 loans cited in our discussion draft audit report.
As stated in HUD Handbook 4000.4, REV-1, chapter 2-4(C), the underwriter must assume the following responsibilities: (1) compliance with HUD’s instructions, the coordination of all phases of underwriting, and the quality of decisions made under the program, (2) the review of appraisal reports, compliance inspections, and credit analyses performed by fee and staff personnel to ensure reasonable conclusions, sound reports, and compliance with HUD’s requirements, (3) the decisions relating to the acceptability of the appraisal, the inspections, the buyers capacity to repay the mortgage, and the overall acceptability of the mortgage loan for HUD insurance, (4) the monitoring and evaluation of the performance of fee and staff personnel used for the direct endorsement program, and (5) awareness of the warning signs that may indicate irregularities, and an ability to detect fraud, as well as the responsibility that underwriting decisions are performed with due diligence in a prudent manner.

Colony respectfully requested that we use our discretion in making recommendations to ensure that national lenders receive consistent treatment. Colony claims that our recommendation constitutes selective enforcement in that it believes that Colony was audited under different standards than other national lenders we determined that did not comply with HUD’s underwriting requirements. In addition, Colony states that OIG’s audit reports (audit report numbers 2005-AT-1014 and 2006-NY-1001) on other lenders cited the same underwriting related issues as cited in this report, but refrained from including a recommendation related to the Program Fraud Civil Remedies Act. We disagree with Colony’s belief of inconsistent treatment. We are consistent in the treatment of Colony and other lenders since we have discretion when making audit recommendations. Specifically, it is at OIG’s discretion to include or exclude recommendations to HUD’s Office of General Counsel related to violations of the Program Fraud Civil Remedies Act in the audit reports.

Comment 29 Colony objected to our policy of making audit reports public before HUD makes a final determination on the recommendations. Colony respectfully requested that we include a disclosure. We recognize Colony’s objection; however, we disagree with Colony’s categorization of the process and the way it suggests the process works. HUD management officials are responsible for initiating action to resolve reported findings and recommendations.

Comment 30 We acknowledged in the audit report that Colony revised its quality control plan to adhere to HUD’s requirements. However, we disagree with its assertion that it did not disregard HUD’s quality control requirements. Colony conceded that its former quality control plan omitted certain elements required by HUD’s Federal Housing Administration. The Mortgagee Approval Handbook, 4060.1, REV-1, requires all Federal Housing Administration approved lenders, including loan correspondents, to implement and continuously have in place a quality control plan for the origination and/or servicing of insured mortgages as a condition of mandatory approval. Our finding accurately describes the conditions detected by the audit and the impact associated with the violation. In addition, Colony did not provide
adequate documentation during or subsequent to the audit report to support its claimed compliance.

Comment 31  We commend Colony for bringing this weakness to its employees’ attention in an effort to prevent this oversight from recurring in the future.
Appendix C

FEDERAL REQUIREMENTS

Loan Underwriting Requirements

HUD Handbook 4155.1, REV-5, CHG-1, chapter 1, section 4, paragraph 1-12, states that HUD’s credit alert interactive voice response system need not be checked, but HUD’s limited denial of participation and the General Services Administration’s exclusion lists are still required checks for all borrowers. Chapter 2, section 1, paragraph 2-5, states that a person suspended, debarred, or otherwise excluded from participation in the Department's programs is not eligible to participate in FHA-insured mortgage transactions. The lender must examine HUD's limited denial participation list and the government wide General Services Administration's exclusion lists and document this review on the HUD 92900-WS/92900-PUR. If the name of the borrower, seller, listing or selling real estate agents, or loan officer appears on either list, the application is not eligible for mortgage insurance.

Chapter 2, section 1, paragraph 2-3, of the handbook 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. Collections and judgments indicate a borrower’s regard for credit obligations and must be considered in the analysis of creditworthiness with the lender documenting its reasons for approving a mortgage when the borrower has collection accounts or judgments. The lender must determine the borrower’s payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity-of-interest with the borrower), or verification of mortgage directly from the mortgage servicer, or through canceled checks covering the most recent 12-month period.

Chapter 2, section 1, paragraph 2-4, of the handbook states that the residential mortgage credit reports must access at least two named repositories and meet all of the requirements for the three repository-merged credit reports, and provide a detailed account of the borrower’s employment history. The report must also verify each borrower’s current employment and income (if obtainable). It also must include a statement attesting to certification of employment and date verified. If this information is not obtained through an interview with the employer, the credit-reporting agency must state why this action was not taken.

Chapter 2, section 2, of the handbook states 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.

Chapter 2, section 2, paragraph 2-6, of the handbook states that the lender must verify the borrower’s employment for the most recent two full years. The borrower also must explain any gaps in employment spanning one month or more. To analyze and document the probability of
continued employment, lenders must examine the borrower’s past employment record, qualifications for the position, and previous training and education and the employer’s confirmation of continued employment.

Chapter 2, section 1, paragraph 2-3, of the handbook states that when delinquent accounts are revealed, the lender must determine whether late payments were due to a disregard for or inability to manage financial obligations or to factors outside of the borrower’s control. Major indications of derogatory credit, including judgments or collections or recent credit problems, require sufficient written explanation from the borrower. When reviewing the borrower’s credit report, the lender must pay particular attention to recent and undisclosed debts. The lender must account for any significant debt shown on the credit report but not listed on the loan application and must obtain explanations for all credit report inquiries.

Chapter 2, section 3, paragraph 2-10, of the handbook states that all funds for the borrower’s investment in the property must be verified and documented. Paragraph 2-10c states that the lender must document the gift funds by obtaining a gift letter signed by the donor and borrower that specifies the dollar amount of the gift; states that no repayment is required; shows the donor’s name, address, and telephone number; and states the nature of the donor’s relationship to the borrower. In addition, the lender must document the transfer of funds from the donor to the borrower.

Chapter 2, section 4, of the handbook states that the borrower’s liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower’s ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing.

Chapter 2, section 5, paragraph 2-12, of the handbook states that debt-to-income ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership. If the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total fixed payment-to-effective income exceeds 41 percent, significant compensating factors should be documented and recorded on the mortgage credit analysis worksheet.

Chapter 2, section 6, paragraph 2-14, of the handbook states 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 the following criteria:

a. The borrower has a 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.

b. The borrower has demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expenses. This criterion
also may include borrowers whose long-term debt, if any, will not extend beyond the term of the buydown agreement.

c. The borrower has substantial assets available to cushion the effect of the increased payments.

d. The cash investment made by the borrower substantially exceeds the minimum required.

Chapter 3, section 1, paragraph 3-1, states that this document must be in the form of a direct verification from the landlord or mortgage servicer or through information shown on the credit report.

HUD Handbook 4000.4, CHG-2, paragraph 2-5, states that lenders are to obtain and verify information with at least the same care that would be exercised if originating a mortgage when the lender would be entirely dependent on the property as security to protect its investment. The lender must review all closing statements, certifications on the closing statements, legal instruments and other documents executed at closing, and certify to HUD that the transaction and loan meet statutory and regulatory requirements of the National Housing Act and HUD, and that the loan has been closed according to the terms and the sales price as specified in the sales contract.

Fannie Mae’s Single Family Guide to Underwriting with Desktop Underwriter, chapter 2, states that borrowers must have been employed a minimum of 30 days in their current positions to use their income for qualifying purposes.

Quality Control Requirements

HUD Handbook 4060.1, REV-1, “Mortgagee Approval Handbook,” chapter 6, requires

- The quality control plan to be in writing. Lenders must have fully functioning quality control programs from the date of their initial Federal Housing Administration approval until final surrender or termination of the approval.

- Quality control of servicing to be an ongoing function. Due to the importance of the aspects of servicing, lenders must perform monthly reviews of delinquent loan servicing, claims, and foreclosures.

- The quality control program to provide for the review and confirmation of information on all loans selected for review.

- Each direct endorsement loan selected for a quality control review to be reviewed for compliance with HUD’s underwriting requirements, sufficiency of documentation, and soundness of the underwriting.
Program Fraud Civil Remedies Act Of 1986

Title 31, United States Code, section 3801, “Program Fraud Civil Remedies Act of 1986,” provides federal agencies, which are the victims of false, fictitious, and fraudulent claims and statements, with an administrative remedy to recompense such agencies for losses resulting from such claims and statements; to permit administrative proceedings to be brought against persons who make, present, or submit such claims and statements; and to deter the making, presenting, and submitting of such claims and statements in the future.
## Appendix D

### SUMMARY OF UNDERWRITING DEFICIENCIES

<table>
<thead>
<tr>
<th>Loan number</th>
<th>Mortgage amount</th>
<th>Underwriting method</th>
<th>Insurance status</th>
<th>Amount of claim</th>
<th>Amount of loss</th>
<th>Exceed ratios</th>
<th>Credit issues</th>
<th>Overstated income/understated liabilities</th>
<th>Source of funds</th>
<th>Unsupported income</th>
<th>Automated underwriting conditions Not Met</th>
<th>Over-insured loan</th>
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* We are not requesting indemnification for this loan; however, we are requesting that this loan be remedied under the Program Fraud Civil Remedies Act for an incorrect certification.
Appendix E

NARRATIVE CASE PRESENTATIONS

Loan number: 201-3402921

Mortgage amount: $148,822

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: September 28, 2004

Status as of February 28, 2007: Claim

Payments before first default reported: Three

Claim paid by HUD: $154,383

Summary:

Colony’s underwriter (H055) failed to document that the borrower met the requirements for an interest rate buydown in accordance with HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-14, and establish that the borrower would be able to afford the mortgage payments once the buydown agreement expired. There was also no documentation in Colony’s file or HUD’s case binder to show that the borrower would have the ability to sustain the mortgage payments once the buydown agreement expired and the borrower’s monthly mortgage payment increased significantly.

In addition, the underwriter overstated the borrower’s income and understated the liabilities. The loan closed on September 28, 2004, when the borrower’s last pay stub ending August 22, 2004, showed the borrower’s year to date monthly earnings as $2,360. Additionally, the borrower’s credit report, dated May 13, 2004, showed a monthly payment of $325 to Brown Forman employee credit union with a balance of $1,498. Although it would not take the borrower more than 10 months to payoff the debt, we included it in our evaluation of the borrower’s ability to repay the debt. According to HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-11, debts lasting less than 10 months must be counted if the amount of the debt affects the borrower’s ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing. In this instance, the borrower only had $104 in available assets at closing. If the correct monthly income had been used and the Brown Forman debt had been included, the total fixed payment-to-income ratio using the reduced interest rate would have been 45.58 percent. The underwriter provided two compensating factors, including income not used and low ratio. These compensating factors would not be valid for the reasons stated previously.
Further, the borrower satisfied a judgment for a state tax lien in May 2003 and satisfied a judgment with 1st United Federal Credit Union in July 2004, the loan closed September 28, 2004. In addition, the underwriter failed to obtain an explanation for the two overdraft and one returned check fees shown on the coborrower’s bank records between August 2 and September 13, 2004. The inability to make timely payments has a direct impact on the borrowers’ ability to meet the future housing expense of $1,012, which was an increase of $647 from the borrower’s current housing expense. The underwriter should have considered these credit issues before approving the loan. The borrower defaulted after only three payments.

HUD’s Quality Assurance Division previously reviewed this loan and found similar findings; therefore, we will not request indemnification. However, we recommended that this loan be pursued under the Program Fraud Civil Remedies Act for an incorrect certification.
Loan number: 411-3737859

Mortgage amount: $67,599

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: April 27, 2004

Status as of February 28, 2007: Claim

Payments before first default reported: Three

Loss to HUD: $36,950

Summary:

Colony’s underwriter (H055) approved the loan without documenting any compensating factors on the mortgage credit analysis worksheet. The loan was approved when the mortgage payment-to-income ratio exceeded HUD’s required percentage by 9.5 percent. Paragraphs 2-12 and 2-13 of HUD Handbook 4155.1, REV-5, specify that the ratio of mortgage payments to effective income (front ratio) generally may not exceed 29 percent and the ratio of total fixed payments to effective income (back ratio) may not exceed 41 percent unless significant compensating factors are presented.

In addition, the borrower paid more than $500 at closing; however, the source of the funds was not determined as required by HUD Handbook 4155.1, REV-5, section 2-10.
Loan number: 413-4227951

Mortgage amount: $110,300

Section of Housing Act: 234(c)

Loan purpose: Purchase

Date of loan closing: November 24, 2003

Status as of February 28, 2007: Claim

Payments before first default reported: Four

Loss to HUD: $48,994

Summary:

Colony’s underwriter (H055) failed to document that the borrower met the requirements for an interest rate buydown in accordance with HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-14, and establish that the borrower would be able to afford the mortgage payments once the buydown agreement expired. The mortgage payment-to-income and fixed payment-to-income ratios when using the reduced interest rate were 29.52 and 40.36 percent, respectively. Additionally, there was no documentation in the file to show that the borrower would have the ability to sustain the mortgage payments once the buydown agreement expired and the borrower’s monthly mortgage payment increased significantly. The borrower defaulted after only four payments.

The borrower’s verification of employment showed that the borrower received commission income in addition to a weekly salary of $600. However, the verification of employment form did not state the amount or frequency of the earned commission. Since the borrower had only been employed for one month before closing and had not received commission income in the past, the underwriter should have documented the borrower’s ability to sustain the mortgage payment once the buydown agreement expired. The borrower qualified for the loan with a mortgage payment of $774. The payment after expiration of the buydown assistance would be approximately $909, and without an increase in income within the two years of the buydown agreement, the mortgage payment-to-income, and fixed payment-to-income ratios would increase to 34.96 percent and 45.81 percent, respectively. The underwriter cited low credit use as a compensating factor on the mortgage credit analysis worksheet. However, the compensating factor given was not adequate to support the mortgage payment-to-income and fixed payment-to-income ratios.
Loan number: 413-4254327

Mortgage amount: $157,731

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: November 25, 2003

Status as of February 28, 2007: Claim

Payments before first default reported: Nine

Claim paid by HUD: $23,832

Summary:

Colony’s underwriter (H055) failed to document that the borrower met the requirements for an interest rate buydown in accordance with HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-14, and establish that the borrower would be able to afford the mortgage payments once the buydown agreement expired. The borrower’s mortgage payment-to-income and fixed payment-to-income ratios using the reduced interest rate were 24.03 and 30.57 percent, respectively. Additionally, there was no documentation in the file to show that the borrower would have the ability to sustain the mortgage payments once the buydown agreement expired and the borrower’s monthly mortgage payment increased significantly.

The borrower qualified for the loan with a mortgage payment of $1,097. However, the mortgage payment after the buydown agreement expired would be approximately $1,249, and without an increase in income through the two years of the buydown assistance, the mortgage payment-to-income ratio would be 30.99 and the fixed payment-to-income ratio would be 43.76 percent.

The underwriter also approved the loan without adequately analyzing the stability of the borrower’s income. The borrower was employed by NCR Corporation from May 1, 1999, through November 1, 2002, with an annual salary of $15,819. The borrower’s title was not shown on the uniform residential loan application. The borrower then became employed as a police officer for nine months with an annual salary of $37,897 from November 1, 2002, through July 1, 2003. Two months after his employment with the police department ended, the borrower became employed as a truck driver on October 3, 2003, with an annual salary of $31,200. Due to changes in the borrower’s employment, the borrower’s income decreased from $37,897 to $31,200 for a loss of $6,697 in income.

Additionally, the borrower did not explain the gap in employment from July 3 to October 2, 2003. There was also no explanation for the gap in employment for the coborrower from January 1, 2001, to October 13, 2003. HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-6, states that the lender must verify the borrower’s employment for the most recent two full years. The borrower
also must explain any gaps in employment spanning one month or more. To analyze and
document the probability of continued employment, lenders must examine the borrower’s past
employment record, qualifications for the position, and previous training and education and the
employer’s confirmation of continued employment.

Further, the credit report, dated November 14, 2003, revealed a credit inquiry from United
Consumer Financial Services on September 8, 2003. The credit report shows that contact with the
borrower did not take place to clear the inquiry. There was no letter in the file from the borrower
explaining the inquiry. There were also four collection accounts identified on the credit report
dated from September 1999 and as recent as July 2003. All four collections were paid at closing;
however, the borrowers did not provide any written explanations for the collection accounts. The
credit report pulled during the quality control review dated June 24, 2004, shows that an account
with United was opened in September 2003 for $2,003 with a monthly payment of $55.
Loan number: 413-4255461
Mortgage amount: $160,014
Section of Housing Act: 203(b)
Loan purpose: Refinance
Date of loan closing: November 26, 2003
Status as of February 28, 2007: Claim
Payments before first default reported: One
Claim paid by HUD: $167,609

Summary:
Colony’s underwriter (H055) approved the loan when the streamline refinance was over-insured. The calculation of principal balance plus interest, plus closing costs and prepaid expenses, less the mortgage insurance premium refund, lowers the allowable mortgage amount to $158,867. The loan was insured for $160,014; therefore, the loan was overinsured by $1,147.

In addition, the underwriter did not notate on the mortgage credit analysis worksheet if the borrower had been checked against the limited denial of participation list. In accordance with HUD Handbook, 4155.1, REV-5, HUD’s Federal Housing Administration-approved lenders must examine the HUD limited denial of participation list and document the reviews on the HUD-92900-PUR or the HUD–92900-WS worksheets. If the name of any party to the transaction appears on the list, the application is not eligible for mortgage insurance. Loans processed as streamline refinances also require checks against this exclusion listing.
Loan number: 413-4263790

Mortgage amount: $67,196

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: December 5, 2003

Status as of February 28, 2007: Claim

Payments before first default reported: Three

Claim paid by HUD: $18,079

Summary:

Colony’s underwriter (H055) approved the loan without a gift letter from the seller signed by the donor and borrower that specifies the dollar amount of the gift; states that no repayment is required; shows the donor’s name, address, and telephone number, and states the nature of the donor’s relationship to the borrower in accordance with HUD Handbook 4155.1, REV-5, paragraph 2-10. The settlement statement showed that the borrower needed $4,159 to close the loan on December 5, 2003. The uniform residential loan application showed a $4,850 gift of equity as the source of funds. Without the gift of equity, the borrower did not have sufficient funds to close the loan.

In addition, the underwriter understated the borrower’s liabilities. The borrower’s credit report, dated December 3, 2003, showed a monthly payment of $173 to Garden Financial with a balance of $1,598. Although it would not take the borrower more than 10 months to payoff the debt, we included it in our evaluation of the borrower’s ability to repay the debt. According to HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-11, debts lasting less than 10 months must be counted if the amount of the debt affects the borrower’s ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing. In this instance, the borrower did not have any assets at closing. If the underwriter had not excluded the Garden Financial debt, the mortgage payment-to-income and total fixed payment-to-income ratios would have been 37.07 and 52.50 percent, respectively. The underwriter provided two compensating factors, low debt use and low housing costs. The compensating factors given were not adequate to support the mortgage payment-to-income and the fixed payment-to-income ratios. The borrower defaulted after only three payments.

Further, the underwriter failed to verify the borrower’s rental payment history directly from the landlord or mortgage servicer or through information shown on the credit report as required in HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-3. The verification of rent was faxed from
the borrower’s employer. There is no indication in Colony’s file or HUD case binder that the lender received the original letter and verified the document.
Loan number: 413-4288944

Mortgage amount: $128,150

Section of Housing Act: 234(c)

Loan purpose: Purchase

Date of loan closing: March 5, 2004

Status as of February 28, 2007: Claim

Payments before first default reported: 13

Claim paid by HUD: $28,632

Summary:

Colony’s underwriter (H055) approved the loan using a residential mortgage credit report that did not meet HUD’s requirements. Specifically, the borrower’s employment history was not included on the credit report. The underwriter also failed to include all of the borrower’s liabilities when evaluating the borrower’s ability to repay the debt. The credit report showed two student loans with a total monthly payment of $307 that were in deferment status. Contrary to requirements in HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-11, there was no documentation to show that the deferment period would last at least 12 months beyond the mortgage closing date. Neither Colony’s file nor HUD’s case binder contained any documentation that the borrower requested and received an extension of forbearance for the student loans. In addition, the underwriter excluded three recurring obligations with a total monthly payment of $101. There was also no documentation to show that the loans had been satisfied.

If the student loans and recurring obligations had not been excluded, the total fixed payment-to-income ratio using the reduced interest rate would have been 60.64 percent. The underwriter provided credit as a compensating factor. The compensating factor was not adequate to support the fixed payment-to-income ratio.

Further, the borrower’s rent was not fully verified. The credit report indicated that the borrower’s current landlord refused residence verification. The credit report only verified a nine-month period. The underwriter failed to determine the borrower’s payment history of housing obligations covering the most recent 12-month period.
Summary:

The loan was processed through Fannie Mae’s desktop underwriter with an approve/eligible rating. The income on the mortgage credit analysis worksheet shows that the borrower’s gross monthly salary was $2,532. The underwriting findings report requires the borrower’s employment be supported by the most recent year-to-date pay stub documenting one full month’s earnings. There was no pay stub in Colony’s file or HUD’s case binder.

In addition, the borrower had only been employed for one day before the loan was approved. The verification of employment, dated March 10, 2004, revealed that the borrower was to start work on March 22, 2004, one day after the desktop underwriter run date of March 23, 2004. The loan closed on March 30, 2004, eight days after the borrower started his new employment. Fannie Mae’s Single Family Guide to Underwriting with Desktop Underwriter, chapter 2, states that borrowers must have been employed a minimum of 30 days in their current position to use the income for qualifying purposes. The borrower’s monthly pay prior to the loan closing was $1,459. When using borrower’s current monthly income the mortgage payment expense-to-effective income ratio was 55.28 percent and/or the total fixed payment-to-effective income was 81.65 percent when using the reduced interest rate. The underwriter should have resubmitted the loan.
Loan number: 413-4315823

Mortgage amount: $94,242

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: July 23, 2004

Status as of February 28, 2007: Claim

Payments before first default reported: Three

Loss to HUD: $56,148

Summary:

Colony’s underwriter (H055) failed to document which of the criteria the borrower met according to the underwriting requirements listed in HUD Handbook 4155.1, REV-5, CHG-1, paragraph 2-14, and establish that the borrower would be able to afford the mortgage payments once the buydown agreement expired. The mortgage payment-to-income ratio when using the reduced interest rate was 34.39 percent. The underwriter did not document any compensating factors to support the qualifying rate when the loan was approved. In addition, there was no documentation in Colony’s file or HUD’s case binder to show that the borrower would have the ability to sustain the mortgage payment once the buydown agreement expired and the borrower’s monthly mortgage payment significantly increased. The borrower defaulted after only three payments.

The borrower’s annual income for 2003 was $18,955 with an expected income of $21,300 for 2004. Therefore, the borrower’s income would increase by approximately 12 percent. The borrower qualified for the loan with a mortgage payment of $573. The payment, after expiration of the buydown assistance, would be approximately $688 and assuming a 12 percent increase in income each year through the two years of the buydown agreement, the mortgage payment-to-income ratio would be approximately 31 percent. However, there was no indication on the verification of employment form or other related documentation in Colony’s file or HUD’s case binder that the borrower would receive an increase in income.

Paragraphs 2-12 and 2-13 of HUD Handbook 4155.1, REV-5, specify that the ratio of mortgage payments to effective income (front ratio) generally may not exceed 29 percent and the ratio of total fixed payments to effective income (back ratio) may not exceed 41 percent unless significant compensating factors are presented. The handbook allows greater latitude in considering compensating factors for the front ratio than the back ratio. However, the loan was approved when the borrower’s mortgage payments after the buydown would result in approximately 37 percent increase.
# Appendix F

## SUMMARY OF QUALITY CONTROL DEFICIENCIES USING HUD’s REQUIREMENTS

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