



Issue Date November 6, 2006

Audit Report Number 2007-KC-1003

TO: Brian D. Montgomery, Assistant Secretary for Housing - Federal Housing
Commissioner and Chairman, Mortgage Review Board, H

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

SUBJECT: PlainsCapital McAfee Mortgage, Lubbock, Texas, Did Not Follow HUD
Underwriting Requirements and Originated Loans from Unregistered Branch
Offices

HIGHLIGHTS

What We Audited and Why

We audited PlainsCapital McAfee Mortgage (McAfee Mortgage) because its two-year default rate for loans with amortization dates between December 2003 and November 2005 was 44 percent higher than the U.S. Department of Housing and Urban Development's (HUD) national average for this period. In addition, the percentage of current defaults and claims was 88 percent higher than HUD's national average.

Our objective was to determine whether McAfee Mortgage originated Federal Housing Administration single-family loans in accordance with HUD requirements, including adequately monitoring its branch offices and originating loans from only HUD-approved offices.

What We Found

McAfee Mortgage did not follow HUD regulations when underwriting 11 of the 35 loans reviewed. These loans contained material deficiencies that affected the insurability of the loans. As a result, HUD insured 11 loans with original

mortgage amounts of more than \$1 million that placed the Federal Housing Administration insurance fund at unnecessary risk.

In addition, between December 1, 2004, and December 31, 2005, McAfee Mortgage submitted 821 loans from unregistered branch offices. In November 2004, HUD notified McAfee Mortgage that it was violating branch office rules, but it continued the practice. By not registering its branch offices, the lender circumvented HUD's oversight controls and placed the Federal Housing Administration insurance fund at unnecessary risk for nearly \$75 million in loans.

What We Recommend

We recommend that the assistant secretary for housing - federal housing commissioner require McAfee Mortgage to indemnify HUD for the 11 improperly underwritten loans, including four active loans with original mortgage amounts totaling \$290,430, losses of \$82,604 incurred on sales of properties related to two defaulted loans, and future losses on five defaulted loans for which HUD has paid claims of \$454,238 but not yet sold the properties.

We also recommend that HUD take appropriate administrative action against McAfee Mortgage for not following HUD's branch office requirements, including imposing civil money penalties for all loans originated from unregistered branches from December 1, 2004, to the present.

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

McAfee Mortgage generally disagreed with our conclusions. We provided the draft report to McAfee Mortgage on August 31, 2006, and requested a response by September 27, 2006. The lender provided written comments and additional documentation on September 26, 2006. We evaluated the information and revised the report as needed. On October 23, 2006, we provided McAfee Mortgage the opportunity to respond to the revised report but the lender chose not to provide additional comments.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

PlainsCapital McAfee Mortgage (McAfee Mortgage) began as McAfee Mortgage and Investment Company in Lubbock, Texas, in April 1949. During our audit period of January 2004 through December 2005, McAfee Mortgage was a bank-owned company specializing in Federal Housing Administration, U.S. Department of Veterans Affairs, and conventional mortgage lending. The company performed its loan processing, underwriting, and closing procedures in house.

In early 2006, McAfee Mortgage's parent company, PlainsCapital Corporation, merged McAfee Mortgage with another subsidiary, PrimeLending. McAfee Mortgage's corporate office in Lubbock, Texas, was closed May 1, 2006, and PrimeLending of Dallas, Texas, took over its operations.

McAfee Mortgage became an approved nonsupervised lender for the Federal Housing Administration on July 11, 1984. The Federal Housing Administration provides mortgage insurance on loans made by approved lenders. The mortgage insurance protects lenders such as McAfee Mortgage against losses when homeowners default on their mortgage loan.

The U.S. Department of Housing and Urban Development (HUD) endorsed 3,708 McAfee Mortgage loans with Federal Housing Administration insurance between December 2003 and November 2005. Its current default and claim rate for that period was 6.34 percent, or 88 percent higher than the national average.

Our objective was to determine whether McAfee Mortgage originated Federal Housing Administration single-family loans in accordance with HUD requirements, including adequately monitoring its branch offices and originating loans from only HUD-approved offices.

RESULTS OF AUDIT

Finding 1: McAfee Mortgage Did Not Follow HUD Underwriting Requirements on 11 Federal Housing Administration Loans

McAfee Mortgage did not follow HUD requirements when underwriting 11 Federal Housing Administration loans. Its management did not implement adequate quality control procedures to ensure the loans it submitted to HUD were qualified for Federal Housing Administration insurance. As a result, the lender placed the insurance fund at unnecessary risk for more than \$1 million in loans and caused HUD to incur related claims and losses.

Loans Did Not Comply with HUD Requirements

McAfee Mortgage underwrote 11 loans that contained significant underwriting deficiencies. These deficiencies primarily involved the following:

Unsupported Income/Questionable Employment Histories

McAfee Mortgage did not properly assess income of borrowers. Borrower income was either overstated or not adequately supported. McAfee Mortgage also did not adequately assess borrowers' employment histories and income stability. Borrowers had unexplained gaps in the two-year employment history required by HUD, did not provide support for employment listed on the application, or did not provide reasonable explanations for frequent job changes. Lenders must accurately assess borrower income and employment history to make informed decisions on income stability and the borrower's ability to repay the mortgage.

For example, in case number 493-7827818, the lender did not obtain a verification of employment or pay stubs for the coborrower's current employment but used the expected base pay of \$2,167 per month from an anticipated job for qualifying the borrowers. The expected income was \$521 more than the lender could support based on prior employment. The lower income increased the financial ratios to 34.9 percent and 46.7 percent, which exceeded HUD's limits.

Unsupported Assets/Questionable Gift Funds

McAfee Mortgage did not adequately support assets (funds available to close) claimed by borrowers. HUD requires a verification of deposit and the most recent bank statement for automated underwriting approvals. If a verification of deposit is not available, additional months of bank statements are required. HUD requires two months of bank statements on manual underwriting approvals. The lender

either did not adequately document the source of funds or there was evidence that the funds came from an unallowable source.

For example, in case number 291-3239808, the assets claimed in the borrower's bank accounts included \$3,000 from the seller. The loan file included a transaction receipt from the borrower's bank showing a \$3,000 deposit. A letter from the borrower stated that the deposit was a draw against a balance due the borrower from a company contracting with the borrower for future construction work. This same company was also the seller of the property. Without the \$3,000, the borrower would not have had the funds necessary to close the loan.

Further, one common form of assets is gift funds provided to borrowers. McAfee Mortgage did not always obtain adequate gift documentation. HUD requires extensive gift documentation to ensure the gift funds are coming from an acceptable source and not from a party related to the sales transaction. McAfee Mortgage did not accurately identify donor funds as gifts. It also did not adequately verify that funds provided to the borrower were from an allowable source and did not require repayment, or verify that repayment was deferred. McAfee Mortgage also allowed gift funds from related parties.

Underreported Liabilities/Questionable Credit Histories

McAfee Mortgage did not include all applicable and significant liabilities when approving loans. Credit reports and other borrower documents reflected obligations that the underwriter did not consider when calculating borrowers' debt ratios. Underwriters must accurately assess borrower debts to make reasonable decisions on the borrowers' ability to repay the mortgage.

Also, McAfee Mortgage did not adequately assess borrower credit histories. Credit histories showed significant derogatory credit and collection items within the two years before closing. McAfee Mortgage did not document its analyses of the credit reports to explain why it approved borrowers with poor credit histories.

For example, the borrower's credit history in case number 493-7852047 included numerous late payments and a car repossession. The borrower enrolled in a debt consolidation program to pay off more than \$20,000 in debt shortly before applying for the Federal Housing Administration loan. McAfee Mortgage did not verify that the debt consolidation agency granted the borrower permission to enter into the mortgage transaction, as required by HUD.

Appendix D summarizes the significant deficiencies, and appendix E provides details of the deficiencies on each of the 11 questioned loans.

McAfee Mortgage's Inadequate Quality Control Process Caused Improper Underwriting

McAfee Mortgage had an inadequate quality control process that allowed the lender to approve and submit improperly underwritten Federal Housing Administration loans to HUD for insurance. Its formal quality control plan did not include several basic elements that HUD requires in all quality control programs, and McAfee Mortgage did not properly implement the plan it had in place. For example,

- The written quality control plan did not include numerous HUD-required elements.
- The quality control personnel did not provide the quality control results to management in a timely manner. In some cases, the results were not reported to management until six months after loan closing.
- The quality control personnel did not review 100 percent of the loans defaulting within six months of loan closing.
- McAfee Mortgage did not report review findings containing fraud or other serious violations to HUD, although the quality control reviews identified numerous loans with material risks.
- McAfee Mortgage's underwriting manager stated that she conducted on-site reviews of the branch offices but could not provide documentation to confirm that she properly conducted branch office reviews.

Without implementation of adequate quality control procedures, McAfee Mortgage was unable to ensure accuracy, validity, and completeness of its loan origination and underwriting operations. Therefore, HUD is not assured that the loans it insured were qualified for Federal Housing Administration insurance.

Insurance Status of Improperly Underwritten Loans

As of June 27, 2006, HUD systems showed that HUD had paid a claim or a claim was in process on 7 of the 11 questioned loans. Of the four remaining loans, two were in default, including one in preclaim status.

Status of loans with material deficiencies as of June 27, 2006	Number of loans	Losses incurred	Estimated future losses
Claims paid – property sold	2	\$82,604	
Claims paid – property not yet sold	5		\$131,729
Currently insured – in default	2		\$ 43,884
Currently insured – not in default	2		\$ 40,341
Totals	11	\$82,604	\$215,954

**Estimated future losses are based on HUD's average loss rate of 29 percent of claims paid from the Federal Housing Administration insurance fund for fiscal year 2005.

Conclusion

McAfee Mortgage did not comply with HUD requirements when underwriting 11 Federal Housing Administration loans. Therefore, HUD's insurance fund was placed at unnecessary risk for these loans, which had original mortgage amounts totaling more than \$1 million. HUD has paid claims on 2 of the 11 improperly underwritten loans with losses totaling \$82,604 and may incur further losses on five loans for which HUD has not sold the related properties but has paid claims of \$454,238. HUD also remains at unnecessary risk for the other four loans that are currently insured and had original mortgage amounts totaling \$290,430.

If HUD implements our recommendations for the lender to indemnify the loans, it will reduce HUD's actual and potential losses to the Federal Housing Administration insurance fund. We are not making a recommendation for HUD to take action regarding McAfee Mortgage's inadequate quality control program because McAfee Mortgage's former operations are currently managed by another lender, including the quality control process.

Recommendations

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

- 1A. Require McAfee Mortgage to indemnify HUD for four actively insured loans with original mortgage amounts totaling \$290,430. The projected loss is \$84,225, based on HUD's insurance fund average loss rate of 29 percent for fiscal year 2005 (see appendix D).
- 1B. Require McAfee Mortgage to reimburse HUD for two loans where HUD has already incurred losses totaling \$82,604 (see appendix D).
- 1C. Require McAfee Mortgage to indemnify HUD for five loans where HUD has paid \$454,238 in claims but not yet sold the properties. The projected loss is \$131,729, based on HUD's insurance fund average loss rate of 29 percent for fiscal year 2005 (see appendix D).

Finding 2: McAfee Mortgage Originated Federal Housing Administration Loans from Branch Offices Not Registered with HUD

McAfee Mortgage originated 1,928 Federal Housing Administration loans between January 2004 and December 2005 from branch offices that it had not registered with HUD. Management ignored HUD regulations regarding branch office registration despite HUD warnings of the violation. As a result, McAfee Mortgage circumvented HUD's risk management controls and placed unnecessary risk on the Federal Housing Administration insurance fund. It also avoided registration fees of \$16,500

McAfee Mortgage Did Not Register All Branch Offices with HUD

From January 2004 through December 2005, McAfee Mortgage originated almost 60 percent of its Federal Housing Administration-insured loans from branch offices not registered with HUD. Of the 3,326 loans endorsed by McAfee Mortgage during this period, 1,928 were originated (with original mortgage amounts of more than \$172 million) from 33 branches not registered with HUD. These offices performed significant loan origination activities, including

- Accepting borrower applications,
- Ordering appraisals and title searches,
- Ordering Federal Housing Administration case numbers,
- Verifying borrower information and obtaining any additional borrower information needed for loan processing, and
- Entering loan information into automated underwriting systems.

Nonsupervised lenders, such as McAfee Mortgage, are allowed to maintain branch offices but must register them with HUD. HUD assigns each branch its own identification number and collects an annual registration fee. In addition, HUD uses an automated system to monitor the performance of Federal Housing Administration lenders. The system analyzes the default and claim rates in various ways, including by branch office. HUD may terminate the approval of a lender or its branch offices to originate Federal Housing Administration loans based on excessive default and claim rates.

McAfee Mortgage circumvented HUD's risk management controls by originating loans from 33 unregistered branch offices. The unregistered branches used the branch identification numbers of registered branches to access HUD systems and submit loans for insurance endorsement. For example, McAfee Mortgage operated a HUD-approved branch office in College Station, Texas. According to HUD data, the College Station branch submitted more than 900 loans for endorsement during

the audit period. However, McAfee Mortgage's records showed that College Station originated only about 130 loans. It originated the remaining loans from 12 other branch offices using the College Station branch identification number.

In addition, McAfee Mortgage's failure to register the branch offices kept HUD from receiving the registration fees of \$16,500 for the two-year audit period.

McAfee Mortgage Ignored Branch Office Registration Requirements

McAfee Mortgage management knew HUD's branch office requirements but ignored them. In August 2004, HUD conducted a review of McAfee Mortgage's Phoenix, Arizona, branch office. HUD identified Federal Housing Administration-insured loans that McAfee Mortgage originated from three branch offices that were not registered with HUD. In November 2004, HUD notified McAfee Mortgage of the violation. However, McAfee Mortgage continued originating loans from unregistered branches despite being notified of the violation. After the HUD review, between December 1, 2004, and December 31, 2005, McAfee Mortgage submitted 821 loans with original mortgage amounts of more than \$74 million from 30 unregistered branch offices.

Conclusion

McAfee Mortgage originated Federal Housing Administration loans from branch offices that it had not registered with HUD. Without proper registration of branches, HUD's automated system cannot monitor the performance of branch offices, assess lender performance, and take appropriate actions to protect the insurance fund.

McAfee Mortgage's practice of originating loans from unregistered branches circumvented HUD's risk management controls and unnecessarily increased the risk to the Federal Housing Administration insurance fund. It also kept HUD from receiving \$16,500 in fees HUD collects to increase the insurance fund.

Recommendations

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

- 2A. Take appropriate administrative action against McAfee Mortgage, including imposing civil money penalties, for all loans originated from unregistered branches from December 1, 2004, to the present for failing to comply with HUD's requirement to register all branch offices.

- 2B. Require McAfee Mortgage to properly register all of its branch offices.
- 2C. Require McAfee Mortgage to pay HUD the \$16,500 in branch office registration fees that it would have paid if it had properly registered the branch offices.

SCOPE AND METHODOLOGY

McAfee Mortgage endorsed 3,326 Federal Housing Administration-insured loans that closed between January 1, 2004, and December 31, 2005. Of the 3,326 loans, 310 defaulted within two years of loan closing. Of the 310 loans, HUD terminated insurance and paid claims on 33 loans. HUD's Single Family Data Warehouse system showed that McAfee Mortgage had originated these loans from nine different branch offices. In addition, 98 of the 310 loans defaulted within the first six months after the loan closed (early defaults). We reviewed 22 of the 33 loans in claims status and 13 of the early defaults.

To review loan processing by multiple branch offices, we initially grouped the 33 loans by the branch office identification number in HUD's systems. We calculated the percentage of loans in claims status at each of the nine branch offices, then selected 10 loans based on each branch office's pro rata share of the 33 loans. For example, HUD's systems showed that the College Station, Texas, branch office had originated 17 of the 33 loans (51 percent). Using the pro rata share method, we selected five loans from that branch office (i.e., 51 percent of the 10 loans selected). Once we had identified the number of loans to review from each branch office, we selected the loans based on the level of risk to the Federal Housing Administration insurance fund, as follows:

- HUD incurred a loss on the sale of the foreclosed property,
- Loans with the fewest months paid before the first default
- Highest mortgage amount.

We also selected the remaining 12 loans in claims status that were identified in HUD's systems as loans originated by the College Station branch office. McAfee Mortgage's loan data showed that it had actually originated these loans from its Houston, Texas, area branch offices but had processed the loans using the HUD branch identification number for its College Station branch. McAfee Mortgage had not registered the Houston branch offices with HUD as required, and these branch offices had higher default rates than most other McAfee Mortgage branches.

We also reviewed 13 of the 98 loans that defaulted within six months of loan closing but had not reached claims status. We evaluated the distribution of loans throughout all of McAfee Mortgage's branch offices and selected the 13 loans from the three branches with the highest Federal Housing Administration loan volume. We selected the loans based on the level of risk to the Federal Housing Administration insurance fund, as follows:

- Loans with the fewest months paid before the first default
- Highest mortgage amount.

We accomplished our objective by reviewing the Federal Housing Administration and McAfee Mortgage underwriting policies and procedures and interviewing McAfee Mortgage personnel. We also reviewed the HUD and lender loan files for the 35 loans reviewed. We identified underwriting deficiencies and assessed the materiality of those deficiencies to the insurability of the loan. For significant deficiencies, we are recommending that HUD take appropriate action

on these loans. We informed McAfee Mortgage of minor underwriting deficiencies but have not recommended that HUD take action on these loans.

We reviewed McAfee Mortgage's quality control plan and reviews performed by the lender, including branch office reviews. We also analyzed reviews performed by HUD's Office of Housing, Quality Assurance Division, and interviewed HUD quality assurance staff.

We relied on computer-processed data contained in HUD's Single Family Data Warehouse and Neighborhood Watch systems. We assessed the reliability of the data, performed sufficient tests of the data, and found the data adequate to meet our audit objective. We also relied on computer data from McAfee Mortgage to identify the branch offices that originated its loans. McAfee Mortgage had not registered all branch offices with HUD but allowed its unregistered branches to originate loans using registered branch identification numbers. Therefore, no independent data were available to test McAfee Mortgage's branch office data.

In assigning a value to the potential savings to HUD if it implements our recommendations on loans for which it has not yet incurred a loss, we applied the Federal Housing Administration's average loss experience for fiscal year 2005 provided by HUD. We calculated the savings value at \$84,225 for those properties currently actively insured, which is 29 percent of the original mortgage amount of \$290,430. For loans for which HUD has paid a claim but not yet sold the related property, we calculated the savings value at \$131,729, or 29 percent of \$454,238 in claims paid.

We conducted audit work at McAfee Mortgage's former corporate office in Lubbock, Texas, and branch offices in Beaumont and Port Arthur, Texas. We conducted audit work from January through July 2006 and performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

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

Relevant Internal Controls

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

- Controls over underwriting - Policies and procedures that management has implemented to reasonably ensure that underwriting activities comply with HUD's regulations, procedures, and instructions.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weakness

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

- McAfee Mortgage's quality control program did not meet HUD requirements, and McAfee Mortgage did not properly implement the plan it had in place (finding 1).
- McAfee Mortgage circumvented HUD's oversight controls by operating unapproved branch offices (finding 2).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A		\$84,225
1B	\$82,604	
1C		\$131,729

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local policies or regulations.
- 2/ “Funds to be put to better use” are quantifiable savings that are anticipated to occur if an Office of Inspector General (OIG) recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

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 its insurance fund. The amounts above reflect 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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Comment 1



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September 26, 2006

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VIA FEDERAL EXPRESS

Mr. Ronald J. Hosking
Regional Inspector General for Audit
U.S. Department of Housing
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Office of the Inspector General
Region VII Office of Audit
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400 State Avenue
Kansas City, Kansas 66101-2406

**Re: PlainsCapital McAfee Mortgage Company
HUD OIG Draft Audit Report**

Dear Mr. Hosking:

Kirkpatrick & Lockhart Nicholson Graham LLP represents PlainsCapital McAfee Mortgage Company ("MMC") in connection with the above-referenced matter. MMC is in receipt of the Draft Audit Report, dated August 31, 2006, from the Office of the Inspector General for Audit ("OIG"). Enclosed please find two copies of MMC's written reply to the report with supporting documentation. After the report is finalized, we would appreciate it if the OIG would provide us with a copy of the final version. If you have any questions, please contact me at (202) 778-9027.

Thank you for your consideration.

Sincerely,

Phillip L. Schulman

Enclosures

cc: Todd Salmans, MMC

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Note: We redacted borrower's names from the auditee comments and substituted the applicable Federal Housing Administration loan number, as needed, to protect the privacy of the individual borrowers.



September 25, 2006

VIA FEDERAL EXPRESS

Mr. Ronald J. Hosking
Regional Inspector General for Audit
U.S. Department of Housing
and Urban Development
Office of the Inspector General
Region VII Office of Audit
Gateway Tower II – 5th Floor
400 State Avenue
Kansas City, Kansas 66101-2406

**RE: PlainsCapital McAfee Mortgage Company
HUD OIG Draft Audit Report**

Dear Mr. Hosking:

PlainsCapital McAfee Mortgage Company ("MMC" or "Company") is in receipt of the Draft Audit Report ("Report"), dated August 31, 2006, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of Inspector General ("OIG"). The Report is based on a review of MMC's Federal Housing Administration ("FHA") insured loan originations and operations, which the OIG conducted between January and July of 2006. The audit covers 35 loans originated by the Company during the period January 1, 2004 through December 2005.

The Report states that its primary objective was to determine whether MMC originated FHA-insured loans in accordance with prudent lending practices and HUD requirements, including adequately monitoring its branch offices. The Report contains two findings, alleging underwriting deficiencies in 17 cases and improper branch office registration practices. Based on these findings, the Report recommends that HUD require MMC to: (1) indemnify it in connection with 17 loans involving underwriting findings; and (2) take appropriate administrative action against the Company for not adhering to HUD's branch office requirements.

The OIG provided MMC with an opportunity to submit written comments for inclusion in the final report. This response summarizes MMC'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

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Comment 1

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

MMC was incorporated in April of 1949. It received approval as a participant in the Department's FHA loan programs on July 11, 1984. At the time of the OIG's review, the Company was a wholly-owned subsidiary of PlainsCapital Corporation. MMC operated through its home office in Lubbock, Texas and several branch and satellite offices throughout Texas and the Southern portion of the United States. In early 2006, MMC's parent company made a business decision to merge the Company with another of its parent's lender subsidiaries, PrimeLending, A PlainsCapital Company ("PrimeLending"). As a result, PrimeLending took control of MMC's operations and Quality Control processes. On May 1, 2006, MMC closed the doors of its Lubbock, Texas headquarters and ceased operations as an independent mortgage company. MMC is now managed and operated by PrimeLending.

Nevertheless, at all times during MMC's existence as an independently operated entity, the Company endeavored to provide dependable and professional service and repeatedly demonstrated its commitment to borrowers and allegiance to the FHA program. MMC would never knowingly violate FHA guidelines or endanger the reputation of the Company or its employees. FHA lending constituted a significant portion of its business and, as a result, the Company has at all times placed a premium on FHA compliance. It has consistently been careful to ensure compliance with insurer, guarantor, and investor requirements and has always taken its Quality Control responsibilities seriously. In addition, MMC has been dedicated to customer service. We consistently aimed to make the lending process as simple as possible for borrowers and worked closely with each individual applicant to ensure that he or she received the type of financing that best fit his or her needs.

II. RESPONSE TO THE FINDINGS

The Report contains two findings, including several sub-findings, in which it alleges that MMC did not originate 17 loans in accordance with HUD requirements or prudent lending practices, and did not fulfill HUD guidelines regarding branch office registration. Upon receipt of the draft Report, MMC conducted a thorough review of the

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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 MMC's general compliance with HUD/FHA requirements and adherence to prudent lending standards. Below we reply to the individual matters raised in the Report, evidence our adherence to FHA requirements in connection with the findings and cited loans, and set forth our opposition to the manner in which the recommendations are presented in the Report.

A. FINDING 1 – MMC COMPLIED WITH HUD'S UNDERWRITING REQUIREMENTS

Comment 1

Finding 1 of the Report asserts in eight sub-findings that the Company did not originate 17 of the 35 loans reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) income documentation; (2) employment documentation; (3) asset documentation; (4) gift fund documentation; (5) debt assessment; (6) credit analysis; (7) eligibility of the borrower and/or the property; and (8) four "other" areas identified in Appendix E to the Report. Finding 1 also raises concerns regarding the Company's Quality Control process. We address the Report's allegations in connection with each of these areas in turn below, as well as set forth the Company's concerns regarding the recommendations made in Finding 1.

1. Income Documentation

In this sub-finding, the Report asserts that, in four cases, the borrower's income was either overstated or not adequately supported by loan file documentation. It is MMC's policy to thoroughly review all income documentation and to qualify borrowers for FHA financing based on effective income reflected in these documents 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 a borrower's effective income is supported by the loan file documentation. As an illustration of the Company's policy, we respond to the Report's allegations in three cases below.

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Comment 2

a. [REDACTED] FHA Case No. 493-7797558

In this case, the Report asserts that the Company understated the borrower's monthly earnings by \$504, as the underwriter used a 16-month average income of \$5,705 rather than a monthly income average of \$5,201 based on the 28 months of earnings reflected on the Verification of Employment ("VOE") and did not develop an average of overtime income. The Report asserts that, without the \$504 in earnings, the borrower's qualifying ratios increased to an unacceptable level.

MMC respectfully disagrees with the assertion that the underwriter improperly used a 16-month income average to qualify the borrower for this loan. To document the borrower's income in this case, in compliance with HUD guidelines, MMC obtained VOEs (**Exhibit A-1**) several pay stubs (**Exhibit A-2**), and W-2 forms for 2002 and 2003 (**Exhibit A-3**), which indicated that the borrower had been employed by Ford Motor Company for the past four years. See HUD Handbook 4155.1 REV-5, ¶ 3-1(E). Although the VOE reflects 28 months of income history, it also evidences that the borrower's overall income increased each year and would continue to increase based on an annual cost of living allowance increase (**Exhibit A-1**). Therefore, to reflect the borrower's increased earnings over the past year and four months, the underwriter reasonably used the past 16 months of income to calculate the borrower's average monthly earnings, and included that amount of \$5,705 on the Mortgage Credit Analysis Worksheet ("MCAW") (**Exhibit A-4**).

While this income included overtime earnings, a letter in the loan file indicated that the borrower earned regular overtime income (**Exhibit A-5**), and each of the five pay stubs included in the file evidenced that the borrower routinely received regular overtime earnings, as well as shift premium income (**Exhibit A-2**), in addition to his regular income. Thus, although the VOE or W-2 forms did not reflect the overtime earnings in a way that allowed the underwriter to break out the average overtime earnings from the borrower's overall income, the loan file reflected that the borrower had earned regular overtime payments during his four year employment with this company, which is more than the two-year period required by HUD guidelines for inclusion of such earnings in a borrower's effective income. See HUD Handbook 4155.1, REV-5, ¶ 2-7(A). Therefore, the underwriter reasonably included the overtime income reflected in the earnings totals on the VOE and W-2 forms into the borrower's effective income (**Exhibits A-1, A-3, A-4**). MMC adhered to HUD requirements in calculating the borrower's effective income in this case.

Moreover, even if the lower monthly amount based on the 28 months of earnings had been used to calculate the borrower's average earnings, the borrower would have nevertheless qualified for FHA financing in this case. Although use of the lower monthly

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earnings average would have increased the borrower's qualifying ratios, the loan file documented significant compensating factors to justify approval in [REDACTED]. First, the underwriter noted on the MCAW that the borrower had cash reserves after closing (**Exhibit A-4**), and the loan file evidenced that the borrower had savings of at least \$3,000 in his 401(k) account (**Exhibit A-6**). HUD guidelines expressly recognize that substantial cash reserves after closing offset higher-than-average qualifying ratios. See HUD Handbook 4155.1, REV-5, ¶ 2-13(G). In addition, as discussed above, the borrower had excellent job stability, and had been employed by Ford Motor Company for over four years prior to closing (**Exhibit A-1**). These compensating factors demonstrate that even if the Company had used the 28-month average earnings to calculate the borrower's effective income, this individual nevertheless would have qualified for FHA financing.

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In summary, although the Report asserts that "it would have been more prudent to use the 28-month average to qualify the borrower," the above discussion demonstrates that MMC complied with HUD guidelines in calculating the borrower's income in this case based on the 16-month earnings average and that, even using the more conservative earnings suggested by the OIG, the borrower would have qualified for FHA financing. MMC complied with HUD requirements in this case and, therefore, indemnification is unwarranted. We respectfully request that this loan be removed from the final Report.

Comment 3

b. [REDACTED] FHA Case No. 493-7888318

In this loan, the Report asserts that the borrower's income was overstated by \$573, as the qualifying income of \$2,393 was not supported by the loan file. The Report alleges that the borrower's income was listed at \$10.50 per hour on the VOE, which reflected base pay of only \$1,820 and, although the loan file evidenced that the borrower earned overtime and bonus income, the loan file did not evaluate the borrower's two-year average of overtime or obtain a 2003 W-2 form to calculate monthly income. The Report concludes that without this documentation or confirmation that the overtime and bonus income will continue, this additional income cannot be included in the effective income, which would raise the qualifying ratios in this case to 41.44%/43.78%.

Contrary to the assertions in this case, MMC obtained all required documentation necessary to demonstrate the borrower's earnings history of both regular and overtime and bonus income and complied with HUD guidelines in calculating the borrower's earnings in this case. To document the borrower's employment, the Company obtained a VOE dated September 8, 2004 (**Exhibit B-1**), and pay stubs (**Exhibit B-2**) from his current employer, Building Specialists. The VOE indicated that the borrower had

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worked for that entity since September of 2002, but did not include income amounts for 2002 or 2003 (**Exhibit B-1**). Therefore, to evidence the borrower's past earnings, MMC obtained both a 2002 W-2 form and, contrary to the allegation in this sub-finding, also obtained a W-2 form evidencing his income for 2003 (**Exhibit B-3**). The W-2 forms indicated that the borrower had earned \$6,601 in 2002 and \$27,995 in 2003 (**Exhibit B-3**). HUD guidelines permit the use of overtime income to qualify a borrower when such income can be documented for the past two years. See HUD Handbook 4155.1 REV-5, ¶ 2-7(A). Although the W-2 forms did not separate base wages from overtime or bonus income, at the hourly rates reflected on the VOE for 2003 and 2004 (**Exhibit B-1**), the income amounts on these W-2 forms indicated that, during these two years, the borrower had earned income in addition to his base wages. Moreover, contrary to the assertion in the Report, the employer expressly indicated on the VOE that overtime and bonus income were likely to continue (**Exhibit B-1**), and all of the pay stubs contained in the loan file evidenced that the borrower earned regular overtime income (**Exhibit B-2**). Based on the fact that the borrower's income documentation evidenced that he had earned overtime income over the past two years and that such income was likely to continue, the underwriter properly included the overtime earnings in the borrower's effective income in this case.

In 2002, the VOE indicates that the borrower earned \$9.50 per hour (**Exhibit B-1**). Based on that hourly rate, the borrower would have averaged \$5,700 in base income over the 3.5 months he was employed with this company during that year ($\$9.50 \times 40 \text{ hours} = \$380 \times 15 \text{ weeks} = \$5,700$) (**Exhibit B-1**). The W-2 form for 2002 demonstrates that the borrower in fact earned \$6,601, which reflects earnings in addition to his base income. Similarly, in 2003, based on a pay rate of \$9.50, which the borrower earned until November 2, 2003 according to the VOE (**Exhibit B-1**), the borrower's base earnings would have been approximately \$19,760 ($\$9.50 \times 40 \text{ hours} = \$380 \times 52 \text{ weeks} = \$19,760$). The 2003 W-2 form, however, indicates that the borrower earned \$27,995 that year (**Exhibit B-3**). Based on the additional income on the W-2 forms and the overtime and bonus earnings for 2004 reflected on the VOE, the borrower averaged \$550 in overtime earnings over the 24-month period of employment ($\$901 \text{ in } 2002 + \$8,235 \text{ in } 2003 + \$4,079 \text{ in } 2004 = \$13,215 / 24 \text{ months} = \550). Had the underwriter combined with the borrower's base monthly pay of \$1,820 with the \$550 in average monthly overtime, the borrower's total monthly income would have been \$2,370, which was only \$20 less than the income reflected on the MCAW (**Exhibit B-4**).

Because the borrower's base income had increased to \$10.50 in November of 2003, the Company reasonably calculated the borrower's income by averaging the total earnings from the past 24 months. Based on file documentation, the borrower's total earnings of \$57,972 over the 24-month period reflected would result in average monthly

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earnings of \$2,415 (**Exhibits B-1, B-3**). Thus, the \$2,393 the underwriter used to calculate the borrowers' effective income in this case was more conservative than the income supported by the borrower's income documentation (**Exhibit B-4**). Based on this more conservative average, the borrowers' total fixed payment-to-income ratio was 33.29%, which is well below the 41% guidelines set forth in HUD requirements (**Exhibit B-4**). See HUD Handbook 4155.1 REV-5, ¶ 2-12. MMC complied with HUD guidelines in this case and was justified in using the borrower's overtime income to qualify the borrowers for FHA financing. Indemnification would therefore be inappropriate and this allegation should be removed from the final Report.

c. [REDACTED] **FHA Case No. 493-7827818**

[REDACTED] FHA case number 493-7827818

Comment 4

In [REDACTED], the Report alleges that the income used to qualify the borrowers was unsupported, as the co-borrower had been employed at her current position for only three weeks at closing and the only support for this employment was a letter addressed to someone other than the co-borrower; however, the Company included \$2,167 in qualifying income based on this projected employment.

[REDACTED] FHA case number 493-7827818

Comment 5

Contrary to the allegation in [REDACTED], the loan file contained sufficient documentation to support the underwriter's use of \$2,167 in monthly income for the co-borrower to qualify these borrowers for FHA financing. HUD guidelines expressly provided that "[i]f a borrower is about to start a new job and has a guaranteed, nonrevocable contract for employment that will begin within 60 days of loan closing, the income is acceptable for qualifying purposes." HUD Handbook 4155.1 REV-5, ¶ 2-7(R). Here, the loan file contained a letter from GE Equipment Services, the co-borrower's employer, indicating that she had been hired as an Equipment Inspector at an hourly rate of \$12.50 (**Exhibit C-1**). This letter, dated June 9, 2004, evidenced that the co-borrower would be starting a new position within 60 days of closing on June 30, 2004 (**Exhibit C-2**). Thus, based on HUD guidelines, the underwriter reasonably included \$2,167 in effective income for the co-borrower based on the hourly rate indicated in the employer's letter and the ratios listed on the MCAW were accurate (**Exhibit C-3**). Moreover, to further support the borrower's employment with GE, the loan file contained a VOE, pay stubs, and a W-2 form from Crown Staffing (**Exhibit C-4**), demonstrating that she had been employed in that position through a temporary employment agency for the three months prior to closing. Moreover, the co-borrower's explanation letters regarding her employment indicated that she would have started her full-time position with GE sooner, but had to fulfill her 90-day commitment to the temporary agency prior to being hired on a full-time basis directly with the employer (**Exhibit C-5**).

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Comment 3

While the co-borrower's employment letter was addressed to [REDACTED] rather than to [REDACTED], as the co-borrower's name was listed on the loan documents, several documents in the file evidence that [REDACTED] and [REDACTED] are the same individual. Explanation letters from the co-borrower signed [REDACTED] indicated that this individual was hired on a full-time basis by GE (Exhibit C-5). In addition, W-2 forms for the co-borrower's past employment demonstrated that her name was [REDACTED] indicating that the borrower's middle name was [REDACTED] (Exhibit C-6). Finally, the address for the co-borrower on the employer's letter was the same address provided as the co-borrower's current residence on the Uniform Residential Loan Application ("URLA") (Exhibits C-1, C-7). Therefore, while the underwriter should have obtained an explanation for the name difference and included it in the loan file, any oversight in this regard was harmless, as the letter clearly references employment of the co-borrower in this case. In any event, as the co-borrower provided evidence of a new position and began this new job even before loan closing on June 30, 2004, the underwriter reasonably included average monthly income based on the borrower's new position in the effective earnings in this case. MMC complied with HUD guidelines in calculating the borrowers' effective income in [REDACTED], and indemnification would be inappropriate. Therefore, we respectfully request that this allegation be removed from the final Report.

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number
493-7827818

2. Employment Documentation

In three cases, the Report contends that the Company did not obtain sufficient documentation to assess borrowers' employment histories or did not obtain explanations for gaps in employment during the two-year period prior to closing. MMC respectfully disagrees with the allegations in two of the cases included in this sub-finding. Our individual responses to these cases are set forth below.

a. [REDACTED] FHA Case No. 493-7827818

[REDACTED] FHA case number 493-7827818

In [REDACTED], this sub-finding alleges that the borrowers' employment history was not documented, as the borrower's previous income was not documented and the co-borrower two-year work history included four months of unemployment and three different jobs.

With regard to employment documentation, MMC understands and appreciates that a lender must verify a borrower's employment for the most recent two full years and obtain an explanation for any gaps in employment of a month or more. See HUD Handbook 4155.1 REV-5, ¶ 2-6. It is MMC's policy and practice to comply with these requirements in all FHA loans, and we maintain that the Company did so in [REDACTED]. With regard to the borrower's employment, the loan file contained a VOE (Exhibit

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Comment 6

D-1), several pay stubs and a payment history report (**Exhibit D-2**), and a 2003 W-2 form from the borrower's current employer, Metropolitan Transit Authority (**Exhibit D-3**). Although these documents evidenced only a 10-month employment history, the borrower indicated on the loan application that he had been self-employed in the home repair industry for over a year prior to beginning his employment with the transit authority (**Exhibit C-7**), and the Company obtained a 2002 tax return evidencing his income from this self-employment (**Exhibit D-4**). While the Company appreciates that the income evidenced on the 2002 tax return was significantly lower than that earned by the borrower at his current job, and that the underwriter should have obtained a 2003 tax return to evidence his income from self-employment during that year, the loan file does in fact document the borrower's employment history over the two-year period prior to closing in compliance with HUD guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-6. Furthermore, the borrower had stable 10-month employment in his current position at the time of closing (**Exhibit D-1**).

Comment 4

With regard to the co-borrower's income, although she had been employed in her current position for less than one month prior to closing, the loan file included a VOE, pay stubs, a W-2 form, and explanation letters from the co-borrower demonstrating that she had been employed in that position through a temporary employment agency for the three months prior to closing (**Exhibits C-4, C-5**). To document her employment before she held these positions, MMC obtained an explanation from the co-borrower, which indicated that, although she had changed jobs frequently during the prior two-month period, she had done so to increase her earnings and her hours (**Exhibit C-5**). In compliance with HUD guidelines, the Company obtained a W-2 form documenting the co-borrower's income with each of the employers listed in the co-borrower's explanation letters (**Exhibits C-6, D-5**). The co-borrower also explained that the gap in her employment history during this period resulted from a pregnancy (**Exhibit C-5**). While the co-borrower held several positions during this period and had held her current position, either as a temporary or full-time employee, for only a few months prior to closing, HUD guidelines expressly state that the Department "do[es] not impose a minimum length of time a borrower must have held a position of employment to be eligible" and requires only that "the lender must verify the borrower's employment for the most recent two full years." HUD Handbook 4155.1 REV-5, ¶ 2-6. In compliance with these directives, MMC obtained documentation sufficient to demonstrate the employment histories of both borrowers for the two years prior to closing in this case. Therefore, indemnification is unwarranted and this allegation should be removed from the Report.

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b. [REDACTED] FHA Case No. 493-7905859

Comment 4

Here, the Report asserts that the borrower's employment history was not stable, as the borrower had worked for his current employer for only eight months prior to closing and had held five different jobs in different fields in the years prior to loan application.

Comment 7

With regard to employment documentation, as discussed above, MMC understands and appreciates that a lender must verify a borrower's employment for the most recent two full years and obtain an explanation for any gaps in employment of a month or more. See HUD Handbook 4155.1 REV-5, ¶ 2-6. MMC did so in this case. To document the borrower's current income, the Company obtained a VOE (**Exhibit E-1**), and pay stubs (**Exhibit E-2**). Because the VOE indicated that the borrower had been employed in this position for only eight months prior to closing on October 29, 2004 (**Exhibit E-3**), the Company required the borrower to provide evidence that he was employed by the entities listed on the loan application (**Exhibit E-4**). In response, the borrower provided W-2 forms documenting his employment over the two years prior to closing (**Exhibit E-5**). With regard to job stability, HUD guidelines expressly state that the Department does not impose a minimum length of time a borrower must have held a position of employment to be eligible for FHA financing. See HUD Handbook 4155.1 REV-5, ¶ 2-6. The Department makes clear that, when analyzing a borrower's employment, "income stability takes precedence over job stability." *Id.* (emphasis in original). MMC adhered to these requirements in analyzing the borrower's employment history in [REDACTED]. Although the borrower had not been employed at his current position for a full two-years prior to closing, the loan file documented that he had consistently been employed during the past two years. Based on the borrower's current income and the fact that he had been employed at that job for eight months, the underwriter reasonably determined that the borrower had demonstrated sufficient job stability to warrant loan approval. MMC complied with HUD guidelines in documenting and analyzing the borrower's employment in this loan and this allegation should be removed from the final Report.

FHA case
number
493-7905859

3. Asset Documentation

The Report asserts that, in two cases, the loan files did not contain sufficient documentation of the assets used by the borrower to close the loan. MMC understands and appreciates its obligation to obtain a verification of deposit and the most recent bank statements to verify the assets used by the borrower at closing. See HUD Handbook 4155.1 REV-5, ¶ 3-1(F). At all times during its existence as an independently managed lender, it was MMC's policy and practice to strictly adhere to these requirements. To the extent that oversights were noted in the loans cited in the

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Report, the Company has merged with another lender that has taken over management and oversight of the Company and any of its remaining employees. Nevertheless, the Company respectfully disagrees with the allegations made in [REDACTED], **FHA Case No. 493-7681268**.

[FHA case number 493-7681268]

Comment 4

In [REDACTED], this sub-finding asserts that the borrower's earnest money deposit ("EMD") was not properly verified, as the \$3,150 cashier's check and \$500 personal check representing the EMD were deposited with the seller and not a disinterested third party. The Report also alleges that the source of the earnest money deposit was \$375 in monthly savings that the borrower accumulated through earnings and child support payments; however, the loan file did not adequately document the borrower's receipt of child support income. Finally, the Report notes that the borrower's monthly housing expense increased 168%, from \$550 to \$926.

With regard to the EMD deposit, the Report acknowledges that the loan file contains a copy of a cashier's check listing the borrower as the remitter in an amount of \$3,150 (**Exhibit F-1**), as well as a personal check for \$500 made payable to the seller of the property from the borrower (**Exhibit F-2**). This \$3,650 EMD was reflected on the MCAW (**Exhibit F-3**). While the Company acknowledges that this deposit should have been made to a party not interested in the sale, such as the closing agent, the loan file clearly demonstrates that the borrower in fact provided the EMD funds to the seller in this case. Therefore, any oversight with regard to the deposit of these funds constituted, at worst, harmless error, and indemnification in this instance would be inappropriate.

Comment 4

With regard to the source of the EMD, the loan file contained a letter of explanation from the borrower indicating that she had saved these funds from her regular earnings and child support payments she received (**Exhibit F-4**). Regarding the child support income, the Company acknowledges that, although the borrower demonstrated that she was entitled to receive child support payments, and in fact did receive certain payments prior to loan closing, both through the formal child support system and informally from the payor of these benefits, the loan file did not document the regular receipt of such payments to support the borrower's assertion of savings based on such income. Nevertheless, in preparation of this response, the Company revised the borrower's budget plan, based only on the income reflected on her VOE and pay stubs from her current employment (**Exhibits F-5, F-6**). Based on her documented earnings, after the borrower's stated monthly expenses, the borrower would have been able to save \$893 per month, which was significantly more than the \$375 the borrower indicated she had saved to use for the EMD (**Exhibits F-4, F-5**). Therefore, any oversight with regard to documenting the borrower's child support income was

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harmless, as the loan file clearly documented the borrower's ability to save the funds used to make the EMD in this case from her regular, documented income.

Comment 4

With regard to the borrower's increased housing expense, while MMC appreciates that the borrower's monthly housing payment increased from \$550 to \$926, this increase represented a 57%, rather than a 168% increase in housing payment. Moreover, the loan file demonstrated that the borrower had sufficient means to absorb this increased monthly expense. The loan file indicated that the borrower had no recurring debt (**Exhibit F-3**). In addition, although the child support income was not stable enough to be included in the borrower's effective income, the loan file did include some evidence of receipt of this additional income that could be used to offset the increased housing obligation. The borrower also would experience tax savings as a result of the mortgage that would increase her ability to contribute more of her income to her housing obligation. Finally, as discussed above, the borrower had demonstrated an ability to save as much as \$893 of her regular earnings even without such additional income, which would have been more than enough to meet the increased housing costs in this case. MMC maintains that the borrower in this case qualified for FHA financing and, as a result, indemnification is not warranted in this loan.

Comment 8

4. Gift Fund Documentation

In eleven loans, the Report alleges that the loan files did not contain sufficient documentation to evidence that the borrowers received gift funds used to meet the downpayment requirements in each case. MMC respectfully disagrees with the assertions in all eleven loans cited in this sub-finding. Our individual responses in each case are set forth below.

Comment 2

a. [REDACTED] FHA Case No. 161-2072802

FHA case number 161-2072802

In [REDACTED], this sub-finding asserts that the loan file did not adequately document a \$3,500 gift from a downpayment assistance organization, as the loan file did not contain support for the transfer of funds from the nonprofit organization and the title company's bank statement provided by the Company during the audit did not indicate the loan to which the deposit was credited.

MMC understands and appreciates that, to document gift funds in FHA loans, a lender must obtain a gift letter indicating that the funds are provided as a gift with no expectation of repayment, as well as evidence that the funds were actually provided by the donor to the borrower. See HUD Handbook 4155.1 REV-5, ¶ 2-10(C); Mortgagee Letter 00-28. Prior to the issuance of Mortgagee Letter 04-28, Page 2-11 of HUD's Single Family Reference Guide expressly stated that, with respect to gifts provided by a

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nonprofit or municipality through a downpayment assistance program, "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." In this case, the Report acknowledges that the loan file contained a gift letter from the Genesis Foundation, a downpayment assistance provider, indicating that it would provide the borrower with \$3,500 in downpayment assistance (**Exhibit G-1**). Moreover, on the HUD-1 Settlement Statement ("HUD-1") contained in the loan file, the settlement agent certified that the borrower in fact received a \$3,500 gift from the Genesis Foundation at closing (**Exhibit G-2**). The buyer and seller also certified on the HUD-1, under threat of criminal penalties, that funds were not obtained from an improper source (**Exhibit G-2**). These documents demonstrate that the Company fully complied with HUD guidelines in place at the time of closing to evidence the borrower's receipt of downpayment assistance in this case.

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number
161-2072802

In addition, during the OIG's audit, MMC contacted the closing agent in the [REDACTED] and obtained a copy of the title company's bank statement evidencing that the Genesis Foundation wired \$3,500 to the title agent on March 15, 2004 (**Exhibit G-3**), which was the closing date in this loan (**Exhibit G-2**). While the title company's bank records do not expressly indicate that these particular funds were used to complete the borrower's transaction, this transfer was received from the downpayment assistance foundation referenced in the file, was in the same amount as the gift funds evidenced on the HUD-1 and gift letter, and were received by the title agent on the date that this loan closed (**Exhibits G-2, G-3**). MMC complied with HUD's documentation requirements at the time of closing, and the attached information clearly demonstrates that the borrower received the downpayment assistance funds in this case. Thus, indemnification is unwarranted and this allegation should be removed from the final Report.

b. [REDACTED] FHA Case No. 161-2097168

The Report in this case asserts that, as the loan file did not contain documentation evidencing the transfer of the \$1,950 downpayment assistance grant referenced on the gift letter, the Company did not sufficiently document the gift funds in this case.

FHA case number 161-2097168

MMC respectfully disagrees with this allegation. [REDACTED] closed on May 10, 2004, prior to the issuance of Mortgagee Letter 2004-28. At that time, HUD guidelines stated that "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." HUD Single Family Reference Guide, Page 2-11. To evidence the gift funds in this case, the loan file contained a copy of the gift letter from Equity Funding, a provider of downpayment assistance, indicating that it was to provide the borrower with \$1,950 in downpayment funds (**Exhibit H-1**). The loan file also

Comment 9

contained a HUD-1 evidencing that Equity Funding in fact provided the \$1,950 at closing (**Exhibit H-2**). The buyer and seller also certified on the HUD-1, under threat of criminal penalties, that funds were not obtained from an improper source (**Exhibit H-2**). In this instance, the attached documentation demonstrates that the borrower in fact received a gift of \$1,950 from Equity Funding to be used to assist the borrower with downpayment costs. As MMC complied with HUD requirements in obtaining documentation to evidence the transfer of the downpayment assistance funds to the borrower at closing, this finding should be removed from the final Report.

Comment 2

c. [REDACTED] FHA Case No. 161-2136365

FHA case number 161-2136365

In [REDACTED], this sub-finding alleges that the Company did not adequately document \$2,145 in gift funds provided by a downpayment assistance organization, as the loan file did not contain evidence of the transfer of funds from the nonprofit organization to the borrower.

Here, the loan file contained a gift letter from Equity Funding Corporation indicating that this organization would provide the borrower with \$2,145 in downpayment assistance funds at closing (**Exhibit I-1**). The HUD-1 in this case evidenced that Equity Funding in fact provided these funds at closing on February 4, 2005, and the settlement agent certified that these funds were in fact provided in this case (**Exhibit I-2**). MMC appreciates that, for loans closed after Mortgagee Letter 04-28 became effective on August 21, 2004, lenders are required to obtain evidence of the wire transfer in the loan file. While the Company inadvertently omitted such documentation from the original loan file, in preparation of this response, MMC has obtained from the title company a copy of a cashier's check made payable to the settlement agent in the amount of \$2,145 (**Exhibit I-3**). This check is dated February 4, 2005 (**Exhibit I-3**), the same day as the loan closed (**Exhibit I-2**). The attached documentation evidences that the borrower received the necessary downpayment assistance to close the loan and such funds were received by the settlement agent from the nonprofit organization on the closing date. Indemnification of this loan would therefore be inappropriate, and we request that this allegation be removed from the final Report.

Comment 2

d. [REDACTED] FHA Case No. 493-7792016

In this case, the Report asserts that a \$5,700 gift from the borrower's relative that was the source of the \$4,876 in funds to close was not adequately documented, as the loan file did not contain evidence of the transfer of funds from the donor to the borrower or settlement agent.

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As you know, with regard to gift funds obtained from a relative, as in this case, HUD guidelines require a lender to obtain the following documents when the gift funds are in the homebuyer's account prior to closing: (1) a gift letter specifying, among other items, the dollar amount given, the donor's name, address, telephone number, and relationship to the borrower, and stating that no repayment is required; (2) a copy of the canceled check or other withdrawal document showing the withdrawal from the donor's personal account; and (3) when deposited with the settlement agent, evidence that the closing agent received the funds from the donor for the amount of the purported gift. See HUD Handbook 4155.1, REV-5, ¶12-10 (C).

As stated in the Report, the borrower received a \$5,700 gift from a relative. To evidence the gift, MMC obtained a gift letter in the amount of \$5,700 from the borrower's cousin (**Exhibit J-1**). While we recognize that documentation of the withdrawal of the funds from the donor's bank account and deposit with the settlement agent should have been maintained in the loan file, please note that the omission in this instance does not reflect Company policy or practice and was an anomaly. MMC and its current management have advised Company personnel of the findings in this case and reminded them of the documentation requirements for gifts set forth in HUD guidelines. We are confident that any deficiency in connection with this matter has been resolved and will not recur. Having said that, the donor listed on the gift letter did provide the gift funds in this case. During the course of the OIG's review, the Company obtained from the settlement agent documentation evidencing the wire transfer of \$5,700 from the donor to the closing agent (**Exhibits J-2, J-3**). This documentation demonstrates that the donor requested a wire transfer of \$5,700 to be made from his bank account to the title agent's account on May 12, 2004 (**Exhibit J-2**), and that the title agent in fact received the \$5,700 gift from the donor on May 13, 2005 (**Exhibit J-3**). The incoming wire confirmation notes that the settlement agent received the \$5,700 gift from the donor listed on the gift letter and references the borrower's name (**Exhibit J-3**). Thus, any deficiency in connection with this matter constituted, at worst, harmless error. The donor provided the gift funds and the borrower in fact received the funds used to close the loan on May 18, 2004 (**Exhibit J-4**).

FHA case number 493-7792016

During the audit, the OIG indicated that the remaining concern in [REDACTED] was the ability of the donor to make the \$5,700 gift. In response to this concern, MMC notes that HUD requirements expressly state that "[a]s a rule, we are not concerned with how the donor obtains the gift funds provided they are not derived in any manner from a party to the sales transaction. Donors may borrow gift funds from any other acceptable source provided the mortgage borrowers are not obligors to any note to secure money borrowed to give the gift." HUD Handbook 4155.1 REV-5, ¶ 2-10(C). In this case, the OIG does not allege, and there is no evidence to suggest, that the donor

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derived the gift funds from an impermissible source. The attached documentation demonstrates that the donor in fact provided the gift used to satisfy the funds needed to close this loan, and the donor expressly indicated on the gift letter that he did not expect repayment of these funds by the borrower (**Exhibit J-1**). As the enclosed documents satisfy HUD guidelines regarding gift documentation, we maintain that indemnification is unwarranted and this loan should be removed from the final Report.

Comment 2

e. [REDACTED] FHA Case No. 493-7797558

FHA case number 493-7797558
In [REDACTED] the Report alleges that the loan file did not contain sufficient documentation regarding a \$3,657 gift from a downpayment assistance organization, as no evidence of the transfer of the funds from the nonprofit organization to the settlement agent was present. The Report acknowledges that MMC provided wire transfer documentation during the course of this audit; however, indicates that this documentation did not identify that the funds were provided for this particular borrower.

FHA case number 493-7797558
MMC respectfully disagrees with this allegation. [REDACTED] closed on May 25, 2004 (**Exhibit K-1**), prior to the issuance of Mortgagee Letter 2004-28. At that time, HUD guidelines stated that "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." HUD Single Family Reference Guide, Page 2-11. To evidence the gift funds in this case, the loan file contained a copy of the gift letter from Home Gift USA, a provider of downpayment assistance, indicating that it was to provide the borrower with \$3,657 in downpayment funds (**Exhibit K-2**). The HUD-1 in this loan also evidences that Home Gift USA in fact provided the \$3,657 at closing (**Exhibit K-2**). The buyer and seller also certified on the HUD-1, under threat of criminal penalties, that funds were not obtained from an improper source (**Exhibit K-2**). These documents demonstrate that the Company fully complied with HUD guidelines in place at the time of closing to evidence the borrower's receipt of \$3,657 in downpayment assistance in this case.

In addition, during the OIG's audit, MMC contacted the closing agent in this case and obtained a copy of the title company's bank statement evidencing that Home Gift USA wired \$3,675 to the title agent on March 25, 2004 (**Exhibit K-3**), which was the closing date in this loan (**Exhibit K-1**). While the Report takes issue with the fact that this wire transfer confirmation does not list the borrower's name, the wire transfer reflects the exact amount of funds indicated on the gift letter and the HUD-1, references Home Gift USA as the provider, and evidences that the settlement agent received the funds on the date [REDACTED] closed (**Exhibits K-1 through K-3**). Moreover, the title company provided this document in response to MMC's request for evidence of the wire transfer in [REDACTED], and confirms that this documentation evidences the title agent's receipt of downpayment assistance in this particular case by listing the

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borrower's name on the cover letter to the wire transfer (**Exhibit K-3**). Based on this information, there is no reason to question that this wire transfer documentation evidences the downpayment assistance grant provided to the borrower in [REDACTED]. MMC complied with HUD's documentation requirements at the time of closing, and the attached information clearly demonstrates that the borrower received the downpayment assistance funds in this case. Thus, indemnification is unwarranted and this allegation should be removed from the final Report.

FHA case
number
493-7797558

f. [REDACTED] – FHA Case No. 493-7950103

Here, the sub-finding asserts that the loan file did not contain adequate documentation of the borrower's receipt of \$4,000 from a nonprofit downpayment assistance organization because the loan file did not include support for the transfer of funds. The Report acknowledges that MMC provided a wire transfer notification during the OIG's review, but that this document did not contain proof of receipt of funds.

FHA case number 493-7950103

The loan file in [REDACTED] contained a gift letter from Ameridream indicating that this organization would provide the borrower with \$3,665 in downpayment assistance funds at closing (**Exhibit L-1**). The HUD-1 in this case evidenced that Ameridream in fact provided these funds at closing on February 4, 2005, and the settlement agent certified that these funds were in fact provided in this case (**Exhibit L-2**). MMC appreciates that, for loans closed after Mortgagee Letter 04-28 became effective on August 21, 2004, lenders are required to maintain evidence of the wire transfer in the loan file. While the Company inadvertently omitted such documentation from the original loan file, in preparation of this response, the Report acknowledges that MMC obtained from the title company a copy of the incoming wire transfer notification evidencing that the settlement agent was credited with funds of \$3,665 by Ameridream on February 2, 2005 (**Exhibit L-3**). While the Report suggests that this documentation does not demonstrate the transfer of downpayment assistance in this case, we respectfully disagree. All information on this incoming wire transfer matches the information set forth on the gift letter in this case (**Exhibits L-1, L-2**), the wire transfer expressly identifies that these funds are to be used in connection with [REDACTED] (**Exhibit L-3**), and the settlement agent received the funds two days prior to closing in this case (**Exhibits L-2, L-3**). The wire transfer document clearly evidences that the borrower received the necessary downpayment assistance to close the loan and that such funds were received by the settlement agent from the nonprofit organization on the closing date. Indemnification of this loan would therefore be inappropriate, and we request that this allegation be removed from the final Report.

FHA case
number
493-7950103

Comment 2

Comment 2

g. [REDACTED] – FHA Case No. 493-7772874

FHA case number 493-7772874

In [REDACTED], the Report alleges that gifts from a downpayment assistance organization were not properly documented, as evidence of the transfer of funds was not contained in the loan file. This sub-finding also asserts that two \$1,000 gifts from the borrower's relatives were also undocumented, as the loan file did not contain evidence that the checks provided by the donors had cleared once deposited by the borrower.

FHA case number 493-7772874

With regard to the downpayment assistance grant, [REDACTED] closed on April 30, 2004 (**Exhibit M-1**), prior to the issuance of Mortgagee Letter 2004-28. At that time, HUD guidelines stated that "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." HUD Single Family Reference Guide, Page 2-11. To evidence the downpayment assistance funds in this case, the loan file contained a copy of the gift letter from Home Downpayment Gift Foundation, a provider of downpayment assistance, indicating that it was to provide the borrower with \$4,000 in downpayment funds (**Exhibit M-2**). The HUD-1 in this loan also evidences that Home Downpayment Gift Foundation in fact provided the \$4,000 at closing (**Exhibit M-2**). The buyer and seller also certified on the HUD-1, under threat of criminal penalties, that funds were not obtained from an improper source (**Exhibit M-2**). These documents demonstrate that the Company fully complied with HUD guidelines in place at the time of closing to evidence the borrower's receipt of \$4,000 in downpayment assistance in this case. Moreover, in preparation of this response, MMC contacted the closing agent in this case and obtained a copy of the incoming wire transfer of the \$4,000 gift from this nonprofit organization to the title agent (**Exhibit M-3**). MMC complied with HUD's documentation requirements at the time of closing to evidence the downpayment assistance grant in this case, and the attached information clearly evidences that the borrower received the downpayment assistance funds in this case.

With regard to the gifts from the borrower's relatives, as the Report states, the borrower received gift funds from two relatives that he used to close this loan. As indicated above, with regard to gift funds obtained from a relative, as in this case, HUD guidelines require a lender to obtain the following documents when the gift funds are in the homebuyer's account prior to closing: (1) a gift letter specifying, among other items, the dollar amount given, the donor's name, address, telephone number, and relationship to the borrower, and stating that no repayment is required; (2) a copy of the canceled check or other withdrawal document showing the withdrawal from the donor's personal account; and (3) the homebuyer's deposit slip or bank statement that shows the deposit of the gift funds. See HUD Handbook 4155.1, REV-5, ¶2-10 (C).

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493-7772874

MMC complied with these requirements in documenting both of the relatives' gifts in [REDACTED]. With regard to the gift from the borrower's grandmother, the loan file contains a gift letter dated April 28, 2004, indicating the donor's intent to give the borrower \$1,000 (**Exhibit M-4**). To evidence the transfer of these funds, the loan file contains a copy of the canceled check dated March 25, 2004, from the donor to the borrower (**Exhibit M-5**), and a copy of the borrower's deposit ticket from the borrower evidencing his deposit of these funds on March 25, 2004 (**Exhibit M-6**). Similarly, to document the gift from the borrower's mother, the file contains a gift letter dated March 25, 2004, from the donor indicating her intent to give the borrower \$1,000 (**Exhibit M-7**), a copy of the canceled check dated March 24, 2004, from the donor to the borrower (**Exhibit M-8**), and a copy of the borrower's deposit ticket from the borrower evidencing his deposit of these funds on March 25, 2004 (**Exhibit M-6**). The Report alleges that this documentation does not demonstrate that the donor's checks cleared once deposited into the borrower's account. We respectfully disagree. Both copies of the checks include images of the backs of the checks, which evidence that the checks were stamped by the borrower's bank, Bridge City State Bank, #15796406# (**Exhibits M-6, M-8**). This documentation satisfies HUD requirements, which indicate that copies of a donor's canceled checks are sufficient to evidence the withdrawal of the gift funds from the donor's account. MMC properly documented the receipt of gift funds in this loan.

In summary, MMC fully complied with HUD guidelines at the time this loan closed to evidence the borrower's receipt of both downpayment assistance and gifts from relatives. For these reasons, indemnification is unwarranted and this loan should be removed from the final Report.

h. [REDACTED] – FHA Case No. 493-7775178

Here, the Report asserts that: (1) the loan file does not document the \$5,000 downpayment assistance funds provided by the City of Houston; and (2) the EMD of \$500 was provided by someone other than the borrower.

FHA case number 493-7775178

With regard to the downpayment assistance funds, [REDACTED] was closed on closed on June 4, 2004 (**Exhibit N-1**), prior to the issuance of Mortgagee Letter 2004-28 and, therefore, the Company needed only to evidence the actual transfer of funds on the HUD-1. See HUD Single Family Reference Guide, Page 2-11. The HUD-1 in this case evidenced the transfer of \$5,000 from the City of Houston to the borrower in this case in compliance with that requirement (**Exhibit N-1**). Moreover, in preparation of this response, MMC obtained a copy of the cashier's check for \$5,000 made payable to the settlement agent in care of the borrower in this loan (**Exhibit N-2**). This check was issued on June 4, 2004, the same day as the loan closing (**Exhibits N-1, N-2**).

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Comment 4

With regard to the EMD, the loan file contained a money order made payable to the settlement agent in this case in the amount of \$500 (**Exhibit N-3**). While the Company acknowledges that the borrower lists a different last name on this money order, individuals of Hispanic descent often use several names and, as the borrower's last name was indicated on the money order, the underwriter determined that this was sufficient to evidence provision of the EMD funds by the borrower in this case. MMC understands and appreciates that the underwriter should have obtained a name affidavit to confirm the borrower's use of two different first names; however, we believe that any oversight in this case constituted, at worst, harmless error. The money order was provided by [REDACTED] and the title company in fact received the \$500 EMD (**Exhibit N-3**). Moreover, both the borrower and the settlement agent certified on the HUD-1, which referenced the EMD in this case, that that document accurately represented the transaction and that all funds used to close had been derived from a permissible source (**Exhibit N-1**).

In summary, the attached documentation demonstrates that the borrower received downpayment assistance in this case, and the loan file evidences that the borrower in fact provided sufficient funds to satisfy the EMD and close this loan. Therefore, we believe that indemnification would be inappropriate, and respectfully request that this loan be removed from the final Report.

Comment 3

i. [REDACTED] – FHA Case No. 493-7827818

In this loan, the sub-finding asserts that the loan file did not contain adequate documentation of the borrower's receipt of \$6,510 from a nonprofit downpayment assistance organization because the loan file did not include support for the transfer of funds.

[REDACTED] FHA case number 493-7827818 closed on June 29, 2004 (**Exhibit C-2**), prior to the issuance of Mortgagee Letter 2004-28. At that time, HUD guidelines stated that "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." HUD Single Family Reference Guide, Page 2-11. MMC complied with these requirements in this instance. The loan file contained a gift letter from Home Gift USA, a downpayment assistance provider, indicating that it would provide the borrower with \$6,510 in downpayment assistance (**Exhibit O-1**). Moreover, on the HUD-1 contained in the loan file, the settlement agent certified that the borrower in fact received a \$6,510 gift from Home Gift USA at closing (**Exhibit C-2**). The buyer and seller also certified on the HUD-1, under threat of criminal penalties, that funds were not obtained from an improper source (**Exhibit C-2**). These documents demonstrate that the Company fully complied with HUD guidelines in place at the time of closing to evidence the borrower's receipt of downpayment assistance in this case. In addition, in preparing this response,

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Comment 3

MMC contacted the closing agent and obtained a copy of the wire transfer of the \$6,510 in downpayment assistance from Home Gift USA to the settlement agent on June 29, 2004 (**Exhibit O-2**), the day of closing (**Exhibit C-2**). This wire transfer references the borrower's name (**Exhibit O-2**). MMC complied with HUD's documentation requirements at the time of closing, and the attached information clearly documents that the borrower received the downpayment assistance funds in this case. Thus, indemnification is unwarranted and this allegation should be removed from the final Report.

j. [REDACTED] – FHA Case No. 493-7905859

FHA case number 493-7905859

In [REDACTED], the sub-finding asserts that the loan file did not contain adequate documentation of the borrower's receipt of \$2,435 from a nonprofit downpayment assistance organization because the loan file did not include support for the transfer of funds. The Report also alleges that the loan file does not sufficiently document the borrower's receipt of a mortgage credit certificate, as the file contains only a commitment letter and not the certificate itself, and concludes that without this documentation, the borrower's qualifying ratios would have increased to an unacceptable level.

With regard to the downpayment assistance grant, the loan file contained a gift letter from Partners in Charity, Inc. indicating that this organization would provide the borrower with a downpayment assistance grant in this case (**Exhibit P-1**). MMC appreciates that, for loans closed after Mortgagee Letter 04-28 became effective on August 21, 2004, lenders are required to obtain evidence of the wire transfer in the loan file. While the Company inadvertently omitted such documentation from the original loan file, in preparation of this response, MMC obtained from the title company a copy of the incoming wire transfer notification evidencing that the settlement agent received \$2,435 from Partners in Charity on October 29, 2004, when this loan closed (**Exhibit P-2**). The wire transfer document clearly evidences that the borrower received the necessary downpayment assistance to close the loan and such funds were received by the settlement agent from the nonprofit organization on the closing date.

With regard to the Mortgage Credit Certificate, MMC understands and appreciates that to offset a borrower's qualifying ratios with a tax rebate subsidized by a government entity, the lender must verify the subsidy in writing. See HUD Handbook 4155.1 REV-5, ¶ 2-7(I). While the Company acknowledges that the loan file did not contain the Mortgage Credit Certificate at the time of the review, any oversight in this case was inadvertent and did not represent Company policy. Nevertheless, the absence of this document from the loan file constituted, at worst, harmless error. In preparing this response, the Company obtained a copy of the Mortgage Credit

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Certificate issued to the borrower in this case (**Exhibit P-3**). As the borrower in fact received the Mortgage Credit Certificate in this loan, the underwriter properly calculated the qualifying ratios and the borrower qualified for FHA financing.

As the attached documentation evidences that the borrower in fact received the downpayment assistance grant referenced in the loan file and also received the Mortgage Credit Certificate, indemnification of this loan would be inappropriate in this case. We therefore request that this allegation be removed from the final Report.

k. [REDACTED] – FHA Case No. 493-7908169

FHA case number 493-7908169

Finally, in [REDACTED], the Report asserts that, as the loan file did not contain documentation evidencing the transfer of the \$3,585 downpayment assistance grant referenced on the gift letter, the Company did not sufficiently document the gift funds in this case.

Comment 11

The loan file in this case documents the downpayment assistance grant with a gift letter from Home Gift USA indicating that the nonprofit organization would provide the borrower with a \$3,585 downpayment assistance grant (**Exhibit Q-1**). The loan file also contained a HUD-1 evidencing that Home Gift USA in fact provided the \$3,585 at closing (**Exhibit Q-2**). The Company appreciates that, as this loan closed after the issuance of Mortgagee Letter 2004-28, it should have retained the wire transfer documentation in the loan file. Any oversight in this regard, however, constituted at worst harmless error. The buyer and seller certified on the HUD-1, under threat of criminal penalties, that funds were not obtained from an improper source (**Exhibit Q-2**), and the Report does not allege, nor is there any evidence to suggest, that the downpayment assistance in this case was not provided by Home Gift USA. In this instance, the attached documentation demonstrates that the borrower in fact received a gift of \$3,585 from a nonprofit downpayment assistance organization to be used to assist the borrower with downpayment costs. As MMC obtained documentation to evidence the transfer of the downpayment assistance funds to the borrower at closing, we maintain that this finding should be removed from the final Report.

5. Debt Assessment

In three cases, the Report asserts that the loans were approved without consideration of all applicable and significant liabilities, as the underwriters did not include recurring debts reflected on the credit reports and other file documentation in the borrowers' qualifying ratios. MMC respectfully disagrees with these allegations in two of the cited cases. Our individual responses to each of these loans follow.

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Comment 4

a. [REDACTED] – FHA Case No. 493-7770482

FHA case number 493-7770482

In [REDACTED], this sub-finding alleges that the borrower's receipt of a deferred payment loan from a municipal downpayment assistance program was not adequately documented, as the loan file contained only a conditional commitment letter verifying the borrower's eligibility for the program and did not include documentation supporting receipt of the funds or a secondary promissory note. The Report also suggests that, if the loan payments were not deferred, the borrower's qualifying ratios of 34%/34% would have increased to an unacceptable level.

Comment 12

With regard to downpayment assistance provided in the form of secondary financing, MMC understands and appreciates that "documentation from the provider of the secondary financing must show the amount of funds provided to the borrower in each transaction and copies of the loan instruments are to be included in the endorsement binder." HUD Handbook 4155.1 REV-5, ¶ 1-13. In this case, the loan file contained a copy of the letter from the municipality's downpayment assistance program, Southeast Texas Housing Finance Corporation ("SETH"), indicating that the borrower qualified for a \$5,000 deferred payment loan (**Exhibit R-1**), as well as a copy of the SETH program guidance also indicating that the assistance would be in the form of a \$5,000 deferred forgiveness loan (**Exhibit R-2**). Moreover, contrary to the Report's allegations, the loan file properly evidenced that the borrower in fact received the \$5,000 in downpayment assistance from SETH. As discussed above, prior to the issuance of Mortgagee Letter 04-28, Page 2-11 of HUD's Single Family Reference Guide expressly stated that, with respect to gifts provided by a nonprofit or municipality through a downpayment assistance program, "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." (emphasis added). In this case, the loan closed on May 13, 2004, when this documentation requirement was in effect (**Exhibit R-3**). The HUD-1 contained in the loan file indicated that the borrower received \$5,000 in downpayment assistance from SETH, and the settlement agent certified that the borrower in fact received these funds from SETH at closing (**Exhibit R-3**). The buyer and seller also certified on the HUD-1, under threat of criminal penalties, that funds were not obtained from an improper source (**Exhibit R-3**). These documents demonstrate that the Company fully complied with HUD guidelines in place at the time of closing to evidence the borrower's receipt of the downpayment assistance in this case.

While the Company appreciates that the underwriter also should have obtained a copy of the promissory note in this case, any oversight with regard to this documentation constituted, at worst, harmless error. The documents included in the file evidenced the amount of downpayment assistance received from SETH, and the HUD-1

documents that the borrower in fact received this assistance at the time of closing. The title agent, borrower and seller certified to the accuracy of the HUD-1, and there is no evidence to suggest that the funds came from an impermissible source. Moreover, the loan file clearly indicates that the assistance funds were provided in the form of a deferred forgiveness loan (**Exhibit R-2**), which indicates that the borrower would not be responsible for repaying these funds. As a result, the underwriter properly excluded this "loan" from the calculation of the borrower's qualifying ratios in this case.

In summary, the loan file documents that the borrower received the downpayment assistance in this case from a permissible source and the assistance was in fact provided in the form of a deferred forgiveness loan that the borrower was not obligated to repay. As the loan file clearly evidences receipt of this assistance, the underwriter properly excluded the downpayment funds from the borrower's debt calculation. For these reasons, we maintain that indemnification would be inappropriate and respectfully request that this allegation be removed from the final Report.

b. [REDACTED] – FHA Case No. 493-7908169

In this case, the Report asserts that the Company did not include a projected monthly student loan obligation of \$639 in the borrowers' qualifying ratios because, although the loan was deferred until December 2005, the loan payment was significant and was scheduled to begin only 13.5 months after closing. The Report concludes that the underwriter "should have applied prudent business practices and included this payment in the qualifying ratios," which would have increased to 57%.

Comment 4

MMC takes strong exception to the assertions in this sub-finding. HUD guidelines expressly state that, "[i]f a debt payment, such as a student loan, is scheduled to begin within twelve 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." HUD Handbook 4155.1 REV-5, ¶ 2-11(C). This provision expressly permits lenders to exclude student loan payments that have been deferred for more than 12 months after closing from the borrower's qualifying ratios. In this case, the borrowers' credit report evidenced student loan obligations (**Exhibit S-1**); however, the loan file also included written evidence from the federal student loan provider indicating that the loan payments had been deferred until December 16, 2005 (**Exhibit S-2**). As this loan closed on October 28, 2004 (**Exhibit Q-2**), this loan was currently in deferment for 13.5 months after closing. Therefore, as acknowledged in the Report, the Company strictly adhered to HUD guidelines when it excluded the student loan payment from the borrowers' qualifying ratios calculation. While the Report suggests that "prudent business practices" dictated inclusion of this debt into that calculation, we are not aware

of any HUD requirement that required including this debt or suggesting that doing so would be "prudent." As an FHA-approved lender, MMC is obligated to determine a borrower's liabilities in conformance with HUD guidelines, and the Company did so in this instance. MMC properly excluded the deferred student loan payment from the borrowers' liabilities, and correctly determined that the borrowers had acceptable qualifying ratios of 30%/33% in this case (**Exhibit S-3**).

Moreover, even if the underwriter had included the deferred student debt into the qualifying ratios, the loan file evidenced significant compensating factors that would have offset the higher-than-average ratios. The credit report and the MCAW evidence that the borrowers had minimal debts at the time of closing (**Exhibits S-1, S-2**), and the loan received an "Approve/Eligible" rating from the automated underwriting system based on their debt and income (**Exhibit S-4**). The loan file documentation also indicated that the borrower was working as a pharmacy technician, and had been employed by the same company for over four years (**Exhibit S-5**). Moreover, the co-borrower was in the process of obtaining a college degree, evidencing her potential for increased income once she finished school and obtained employment based on this education (**Exhibit S-6**). These factors indicated that the borrowers would have increased income that would assist in making the loan payments once the deferment period had passed, which the Department has expressly recognized as a compensating factor that would offset higher-than-average qualifying ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(I). Finally, the loan file documented that the borrower had begun saving for retirement through his employer's profit-sharing retirement plan (**Exhibit S-7**). HUD requirements indicate that a demonstrated ability to accumulate savings also can offset higher qualifying ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C).

As evidenced by the above discussion and acknowledged in the Report, the Company strictly adhered to HUD guidelines in calculating the borrowers' qualifying ratios in this case, and they clearly qualified for the FHA loan. Moreover, to the extent that the underwriter would have included a deferred student loan payment in considering whether to approve these borrowers, the loan file evidenced significant compensating factors that would have offset this future loan payment. Indemnification of this loan is unwarranted and, as MMC fully complied with HUD guidelines in this instance, this loan should be removed from the final Report.

6. Credit Analysis

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

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MMC respects the importance of analyzing a borrower's credit performance and examining his or her attitude towards credit obligations. It is MMC's policy and practice, with respect to every FHA applicant, to scrutinize the applicant's credit record and reasonably determine the potential borrower's creditworthiness. Given the potential risks not only to the Department, but to the Company, of making a poor credit decision, the Company's management endeavors to monitor underwriting performance and provide ongoing training to employees on the issue of credit analysis. MMC's employees take their underwriting responsibilities seriously and understand that they will face severe consequences for unsatisfactory analysis of borrower credit. MMC never would knowingly jeopardize the Company's stability or its relationship with the Department.

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

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

Comment 4

a. [REDACTED] – FHA Case No. 493-7888318

[FHA case number 493-7888318]

In [REDACTED], the Report questions the borrowers' eligibility for FHA financing, as the borrowers' credit scores averaged 529 and the credit report reflected an automobile repossession less than a year before closing and collection accounts within two years of closing, including defaulted federal student loans. This sub-finding also asserts that the Company excluded six debts from the credit report in the automated underwriting system but did not document the reasons for excluding these debts.

Comment 13

With regard to the six excluded debts, contrary to the assertion in the Report, the credit report contained in the loan file clearly documents that these six accounts were either placed with collection agencies and later closed, or reflected the automobile loan that was resolved with the repossession of the vehicle securing the financing (**Exhibit T-1**). As the borrowers were no longer obligated to make payments in connection with any of these six accounts, the Company properly excluded them from consideration of the borrowers' current financial situation in the automated underwriting system (**Exhibit T-2**).

With regard to the borrower's overall creditworthiness, the underwriter analyzed the totality of the borrower's credit history in accordance with HUD guidelines and the discretion afforded in such cases. As you know, when analyzing the borrower's credit record, a period of financial difficulty in the past does not necessarily equate to an unacceptable credit risk. See HUD Handbook 4155.1 REV-5, ¶ 2-3. When delinquent accounts are present, a lender must determine whether the late payments were due to a disregard for, or an inability to manage, financial obligations or to factors beyond the control of the borrower. Id.

The loan file contained a letter from the co-borrower indicating that she had been out of work for a four-month period in the two years prior to closing, and had a difficult time finding employment until she began working at her current position with Target (**Exhibit T-3**). Based on this information, the underwriter reasonably determined that the derogatory items reflected on the credit report resulted from this period of unemployment rather than a lack of financial discipline. Moreover, the credit report reflected that, in the months prior to closing, the borrowers had resolved their derogatory credit accounts and had re-established their credit (**Exhibit T-1**). The two open accounts reflected on the credit report were current and had no delinquent payment history (**Exhibit T-1**). Moreover, the borrowers' current credit balance indicated that the borrowers had minimal current debt, evidencing their restraint in handling credit obligations (**Exhibit T-1**). Based on their current credit obligations, the borrowers received an "Approve/Eligible" rating from the automated underwriting system

(Exhibit T-2). With the information available at the time of loan approval, the underwriter reasonably determined pursuant to HUD guidelines that the borrowers in this case had resolved past credit issues and relied on the automated underwriting system approval to determine their eligibility for FHA financing.

In addition, the loan file contained other evidence of compensating factors that supported the underwriter's determination of creditworthiness in this case. As discussed above, the borrower had steady employment for the two years prior to closing, and was receiving regular overtime and bonus income **(Exhibit B-1)**. The loan file also evidenced that the co-borrower had found regular employment and was steadily earning income to contribute to the borrowers' housing payment **(Exhibit T-4)**. Moreover, the borrowers had qualifying ratios of 34%/36%, which demonstrated their ability to meet both their existing obligations and their mortgage payment **(Exhibit B-4)**. Based on these compensating factors and the fact that the borrowers' existing credit obligations were minimal and current at the time of closing, the underwriter reasonably determined that any past credit problems did not pose a risk to the borrowers' ability to make regular mortgage payments. Thus, we believe that indemnification is inappropriate and that this case should be removed from the final Report.

Comment 2

b. [REDACTED] – FHA Case No. 493-7950103

In this case, the Report asserts that the borrower had no traditional credit and, although the loan file contained a memorandum stating that the borrower used only cash and had included his utilities in his rental payments and a letter from an insurance company indicating the borrower maintained insurance on his vehicle, neither this letter nor the borrower's Verification of Rent ("VOR") provided a payment history to show timely receipt of payments.

FHA case number 493-7950103

MMC takes strong exception to the allegations made in [REDACTED]. As you know, HUD guidelines expressly state that "[n]either the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejecting the loan application." HUD Handbook 4155.1 REV-5, ¶ 2-3. In such cases, HUD requirements state that "the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider." *Id.* MMC strictly adhered to these requirements in this case. Here, the credit report and a memorandum in the loan file indicated that the borrower was not a traditional credit user **(Exhibits U-1, U-2)**. To establish a credit history, the Company obtained a letter from the borrower's vehicle insurance company, which expressly stated that the borrower maintained a "month to month policy" and that the borrower's account "no lapses in coverage for the previous 2 years" **(Exhibit U-3)**. In addition, the loan file contained a VOR that, contrary to the allegation in the Report, stated that the

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borrower had no past due payments during his five year rental history (**Exhibit U-4**). These documents clearly indicated that the borrower paid both his insurance premiums and rent in a timely manner and demonstrated the borrower's financial responsibility. As this documentation established an alternative credit history for the borrower in compliance with HUD guidelines, the underwriter made a reasonable determination that this borrower qualified for FHA financing. For these reasons, indemnification is unwarranted. We therefore request that this allegation be removed from the final Report.

Comment 3

c. [REDACTED] – FHA Case No. 493-7908169

FHA case number 493-7908169
In [REDACTED], this sub-finding alleges that the borrowers' credit scores averaged 521 and the credit report included several recent collection accounts, three of which the borrower was contesting.

While the Company acknowledges that the borrowers' credit report indicated certain derogatory items, MMC maintains that the underwriter made a reasonable decision that the borrowers qualified for FHA financing in this case. Although the credit report indicated that the borrowers had collection accounts, the majority of these were resolved more than 12 months prior to closing and, as acknowledged in the Report, the borrowers were contesting certain of the more recent accounts (**Exhibit S-1**). In addition, as discussed in detail above, the loan file contained evidence of several compensating factors demonstrating the borrowers' creditworthiness and ability to make timely mortgage payments. For instance, the credit report and the MCAW evidence that the borrowers had minimal debts at the time of closing (**Exhibits S-1, S-2**), and the loan received an "Approve/Eligible" rating from the automated underwriting system based on their debt and income (**Exhibit S-4**). The loan file documentation also indicated that the borrower had stable employment as a pharmacy technician (**Exhibit S-5**), and that the co-borrower was in the process of obtaining a college degree, which evidenced her potential for increased income once she finished school and obtained employment based on this education (**Exhibit S-6**). Finally, the loan file documented that the borrower had begun saving for retirement through his employer's profit-sharing retirement plan (**Exhibit S-7**). These factors indicated that the borrowers had taken control of their financial situation, exercised restraint with regard to their current credit obligations, and would have increased income that would assist in making regular mortgage payments. Based on the totality of the circumstances in this case, the underwriter reasonably determined that the borrowers had resolved their past credit issues and qualified for FHA financing. For these reasons, we believe that indemnification of this loan would be inappropriate and respectfully request that this loan be removed from the Report.

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7. Borrower/Property Eligibility

Comment 4

In three loans, the Report takes issue with the eligibility of the borrower or the property for FHA financing. For instance, in [REDACTED] loan, **FHA Case No. 491-8444756**, Appendix E to the Report asserts that HUD did not accurately process the loan as a HUD real estate owned ("REO") property, as the appraisal noted several repair conditions, including evidence of mold, but the loan file did not contain documentation of the repairs. In response to these allegations, MMC provided the auditors with several documents evidencing completion of the repairs noted in the appraisal. While the Report acknowledges receipt of this documentation, the Appendix continues to allege that the loan file did not contain evidence of mold remediation or a final inspection report indicating that the repairs had been completed.

Comment 14

FHA case
number
491-8444756

MMC understands and appreciates its obligation to ensure that all repair conditions noted on an appraisal are completed prior to closing in the purchase of REO property from HUD when the borrower finances the purchase with a FHA loan. See Mortgagee Letter 00-27. It is the Company's policy and practice to include documentation in the loan file evidencing the satisfaction of all repair conditions noted by the appraiser. As acknowledged in the Report, although the Company may have inadvertently neglected to retain copies of such documentation regarding the repairs in [REDACTED] MMC has provided evidence that the repairs were completed prior to closing. With regard to the mold remediation and final inspection, the Company appreciates that it should have obtained documentation evidencing that this issue had been resolved and all repairs had been completed. Nevertheless, the appraisal of this property was completed on March 22, 2004 (**Exhibit V-1**), and the Department, which was the seller of this REO property, accepted the sales contract on April 13, 2004 (**Exhibit V-2**). The underwriter in this case assumed that, as the Department accepted the contract almost a month after the completion of the appraisal and did not include mold remediation on the escrow agreement, this issue had been resolved. We note that, per the appraisal and sales contract, the original FHA Case Number for this loan was 491-672170 (which is missing one digit) (**Exhibit V-1, V-2**). Because this loan was initially processed under a different case number and because the Department accepted the sales contract without including the mold remediation issue in the escrow agreement, the Company believes that evidence of mold remediation may be included in the case file for the original case number. Therefore, we respectfully request that, before recommending indemnification in this case, the Department examine the file for that case number to determine whether evidence of mold remediation was obtained prior to execution of the sales contract on April 13, 2004.

Comment 15

8. "Other" Issues

Finally, in four loans, Appendix E raises concerns with "other" issues based on the OIG's review of the loan files in these cases. In one case, Appendix E alleges that the borrower's pay stubs were faxed from the seller and, in two additional cases, the Report asserts that the borrowers experienced payment shock in the increase of their housing obligation as a result of the FHA loan. We address these issues in turn below.

a. Faxed Documentation

In [REDACTED], **FHA Case No. 493-7770482**, the Report asserts that the borrower's pay stubs were faxed from the seller's office. As you know, borrowers often meet with loan officers outside of a lender's office in order to accommodate a borrower's work schedule, and borrowers often use fax machines made available by real estate agents or builder sales representatives, to which the borrowers would not otherwise have access, in order to deliver documents to the lender. To the best of our knowledge and recollection in this case the borrower used the builder sales representative's fax machine for this purpose. Whether the borrowers personally faxed the documents to the Company or handed the documents to an office assistant to fax, the borrowers themselves would have brought most of the documents to the corporate office for delivery to MMC. That being said, the Company understands and appreciates that, at the time this loan was originated, HUD requirements had been amended to clarify that lenders may not accept income documentation faxed through the seller's equipment. See HUD Handbook 4155.1 REV-5, ¶ 3-1. Nevertheless, we believe that any oversight in this case constituted, at worst, harmless error. The pay stubs and W-2 forms included in the loan file were computer-generated and there is no evidence to suggest that these documents were altered or amended by any party (**Exhibit W-1**). Moreover, the Company obtained a VOE, which was faxed directly from the employer, that supported the information contained on the pay stubs and W-2 forms (**Exhibit W-2**). As the loan file supported the income information used to qualify the borrower for FHA financing, we believe that indemnification would be inappropriate in this case. Therefore, we respectfully request that this assertion be removed from the final Report.

b. Payment Shock

In two loans, [REDACTED] **FHA Case No. 493-7827818**, and [REDACTED] **FHA Case No. 493-7908169**, Appendix E alleges that the borrowers' housing payments increased significantly as a result of the FHA loan.

The Company appreciates that, in each of these cases, the borrowers' housing payments in fact increased from the rental payments both borrowers were paying prior

Comment 16

Comment 3

to closing; however, in both instances, the loans received approvals from automated underwriting systems (**Exhibit X, S-4**). As a result, the Company was not required to analyze the housing payment increase as part of the underwriting decision. MMC's underwriters accurately entered the required information into the automated system in each case and relied on the automated underwriting decision in both of these loans. Moreover, the loan files in both cases evidenced that the borrowers had the ability to absorb the increased housing obligations. In [REDACTED] the borrower had recently begun a new position and was earning additional income that could be used to offset the higher housing payment in this case (**Exhibits C-1, C-5**). With regard to [REDACTED], as discussed above, the credit report and the MCAW evidence that the borrowers had minimal debts at the time of closing (**Exhibits S-1, S-2**). The loan file documentation also indicated that the co-borrower was in the process of obtaining a college degree, which evidenced her potential for increased income once she finished school and obtained employment based on this education (**Exhibit S-6**). The loan file also documented that the borrower had begun saving for retirement through his employer's profit-sharing retirement plan (**Exhibit S-7**). Finally, in both cases, the borrowers also experienced significant tax savings as a result of the mortgage interest rate deduction that increased their ability to contribute more income to the increased housing obligations. These factors indicated that, although the borrowers in both of these loans encountered increased housing payments as a result of their FHA mortgages, the borrowers had the ability to meet these increased financial obligations. Therefore, indemnification in these cases is unwarranted, and MMC respectfully requests that the allegations regarding payment shock be removed from the final Report.

FHA case
number
493-7827818

FHA case
number
493-7908169

9. Quality Control Process

In Finding 1, the Report also alleges that, during the audit period, the Company's Quality Control Plan was missing several items and was not properly implemented.

With respect to these items, while we were aware of the Department's rules and regulations concerning Quality Control during MMC's corporate existence, and while the Company diligently practiced sound Quality Control measures, we recognize that the Quality Control Plan reviewed during the OIG's audit did not reflect all of the Company's Quality Control practices in accordance with FHA requirements. That being said, as discussed above and acknowledged in the Report, the Company's operations, including its Quality Control procedures, are currently managed by another lender with which MMC had merged earlier this year. All former MMC branches are subject to PrimeLending's Quality Control policies and procedures and are monitored by that entity to ensure compliance with FHA guidelines. We believe these facts effectively resolve

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any outstanding concerns the Department may have regarding the Company's Quality Control process during the audit period.

10. **Recommendations**

In addition to opposing several of the individual allegations contained in the Report, MMC disagrees with certain aspects of the recommendations made in connection with the loans referenced in Finding 1. As you know, Finding 1 of the Report recommends, among other things, that the Department require the Company to: (1) indemnify HUD for potential losses of \$126,167 in connection with six active loans; (2) reimburse HUD for actual losses it has sustained in five loans terminated by claims to HUD in which the Department has sold the underlying property; and (3) reimburse HUD for the actual losses that HUD will ultimately paid on six additional claim-terminated loans once the underlying properties have been sold, which the OIG estimates will be \$152,793. To derive the estimated losses in connection with the six active loans and the six unfinalized claims, the Report indicates that it included 29% of the unpaid principal balance in these cases. According to Appendix A, this multiplier was selected based on information provided by HUD showing that its losses on sales average 29 percent of the claim paid.

MMC does not take issue with the OIG's inclusion of the Department's actual losses in connection with loans for which claims have been made, and acknowledges that using the 29% multiplier represents a fair potential loss in loans in which claims have been made, but actual losses are unknown at the time of the Report's issuance. The Company does, however, take strong exception to inclusion of the \$126,167 in estimated losses in the six remaining loans. First, we note that the \$126,167 figure does not represent a payment that the Report recommends MMC pay to HUD, but rather reflects a mere estimate of the losses the Department could incur if these six loans ultimately result in claims to HUD. All six of the loans, however, remain active. In at least half of these cases, these loans are performing and the borrowers are consistently making payments. MMC appreciates that these six loans may have entered default at some point; however, none of these six loans have been foreclosed, terminated, or resulted in insurance claims to the Department. To date, HUD has not incurred any loss in connection with these cases and there is no reason to believe that the Department will incur losses in these cases. Moreover, in the event that HUD does pay a claim in any of these loans, there is no guarantee that the Department will sustain monetary loss, as HUD may be able to recoup the claim amount in the sale of the underlying property.

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Notwithstanding these facts, the Report suggests that the Department will experience losses in the amount of 29% of the unpaid principal balance of each one of these six loans, and lists the financial risk to the Department, which it defines as "funds to be put to better use," as \$126,167. This calculation assumes that every one of the six active loans will go into foreclosure and result in a claim to HUD. Such an assumption would be supportable if 100% of the loans that enter default resulted in claims to HUD; however, that percentage is significantly lower. Therefore, there is no reason to believe that any of these loans, let alone all six of them, will result in a claim or financial loss to the Department. HUD has collected its insurance premium in each of these cases, which continue to perform as active FHA loans. Based on these facts, absent evidence that the six loans at issue will result in an actual claim to the Department, the over \$100,000 potential loss figure is greatly inflated and does not paint an accurate picture of the risks associated with this matter. Moreover, this arbitrary monetary figure is included with a mere recommendation to the Department to require the Company to indemnify it in connection with certain loans. Upon receiving the final Report, the Department will have an opportunity to independently review the audit findings and make an independent determination of whether indemnification is warranted in any of these cases. As discussed at length earlier in this response, MMC disagrees that the vast majority of the findings set forth in the Report warrant indemnification. HUD may also disagree with the Report's assertions and decide not to pursue indemnification in some or all of the 17 cases. Notwithstanding the fact that these findings are preliminary, the OIG's recommendations assume that HUD will accept each allegation and pursue indemnification in each case.

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

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

The above discussion demonstrates that the \$126,167 estimated loss figure is unrepresentative of the Department's actual loss risk in connection with the six active loans cited in Finding 1. Inclusion of this overstated figure in the Report unfairly represents the loss exposure to HUD, and ultimately the Company, as a result of this audit. Therefore, MMC strongly opposes the inclusion of this figure in the final Report and requests that it be removed or amended to portray a more accurate picture of the potential losses in the active FHA loans cited in the Report. As the recommendation regarding these loans is that the Company indemnify HUD, the Report should merely state this recommendation without including estimated losses that are difficult, if not impossible, to predict accurately in these loans. At the very least, if the final Report continues to include the average claim loss paid for these six loans as the potential financial risk to HUD and the Company, the Report should also clarify the percentage of defaulted loans that result in a claim to HUD and include the potential losses based on this significantly reduced number of loans. This figure would present readers with a more accurate and fair picture of the financial risks associated with the loans identified in the Report.

B. FINDING 2 –BRANCH OFFICE REGISTRATION REQUIREMENTS

Finding 2 of the Report alleges that, during the audit period, the Company originated FHA loans from 33 branch offices that were not registered with HUD, even after the Department informed the Company's management during a review of the Company's Phoenix, Arizona office in November of 2004 of issues with unregistered branches. The Report asserts that the following activities were conducted at the unregistered locations: (1) accepting borrower applications; (2) ordering appraisals and title searches; (3) ordering FHA case numbers; (4) verifying borrower information and obtaining additional borrower information; and (5) entering loan information into automated underwriting systems. Finding 2 recommends that the Department take appropriate action against MMC, including imposing civil money penalties and requiring the Company to properly register all of its branch offices.

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Comment 18

At all times during MMC's existence as an independent mortgage lender, the Company believed that it operated all of its offices in compliance with HUD requirements. MMC understands and appreciates that each branch office of the Company that engages in FHA lending activity and submits loans to HUD for insurance endorsement must be registered with the Department. See HUD Handbook 4060.1 REV-1, ¶ 1-2(A). It has always been MMC's policy and practice to receive approval from the Department for each branch office of the Company from which it intends to originate FHA loans. See HUD Handbook 4060.1 REV-1, ¶¶ 3-2, 3-4(D). With regard to the 33 offices referenced in the Report, MMC believed that these locations constituted legitimate satellite offices at the time the loans at issue were originated.¹

The Department expressly permits a mortgagee to originate FHA loans through a satellite location that is not registered with HUD so long as certain conditions are met. In Mortgagee Letter 94-39, HUD reinstated the right of approved mortgagees to operate satellite offices, subject to the same staff and facility requirements as registered branch offices. In Mortgagee Letter 94-39, the Department stated that, "[e]ffective with this Mortgagee Letter, mortgagees may operate satellite offices, under the following conditions:" (1) the satellite office is located within the jurisdiction of a HUD field office where the mortgagee has an approved branch or home office; (2) the satellite office is in a location conducive to performing mortgage lending business, is clearly identified to the public, and is separate and apart from any other entity; (3) the satellite office is staffed by an employee of the mortgagee; (4) the satellite office has no direct contact with HUD; (5) the satellite office's loans and operation are subject to the mortgagee's Quality Control; and (6) the mortgagee pays all operating expenses of the satellite office.

During the time MMC operated as an FHA-approved lender, the Company believed that all offices not registered as branch offices with the Department complied with these guidelines. The 33 offices referenced in the Report were located in the same HUD field office jurisdictions as registered branches of the Company, were situated in business offices conducive to lending operations, and maintained separate space and signage clearly identifying these offices to the public. In addition, the satellite offices were staffed by bona fide, exclusive MMC employees, were included in the Company's Quality Control reviews, and MMC paid all operating expenses of the offices. For these reasons, the Company believed that the employees located in these offices could

¹ MMC understands that, pursuant to the Department's issuance of a revised HUD Handbook 4060.1 on August 14, 2006, HUD has eliminated the use of satellite offices for taking single-family loan applications due to the expansion of the originating lending area of registered branch offices. During the audit period, however, the Department permitted lenders to originate FHA loans from satellite offices without first registering these locations with HUD. See Mortgagee Letter 94-39.

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permissibly accept borrower applications, order appraisals and title searches, and gather borrower information to be submitted to the Lubbock headquarters office for underwriting and submission to HUD for FHA insurance. The Company employed only loan officers and loan processors at its satellite offices and did not underwrite files from these locations. To the extent that employees in these offices entered information into an automated underwriting system, that information merely assisted loan officers in making initial determinations of the types of loan products for which loan applicants were eligible. All FHA loan files were fully reviewed by Direct Endorsement underwriters and underwritten at fully-approved branch offices of the Company.

That being said, the Company now understands and appreciates that HUD guidelines regarding satellite offices do not permit employees at these locations to communicate with HUD, including ordering FHA case numbers or submitting loans to HUD for insurance endorsement. See Mortgagee Letter 94-39. At all times, MMC submitted case binder to HUD for insurance endorsement from the Company's Lubbock, Texas corporate office or, after the merger process began, from PrimeLending's Dallas headquarters office. Nevertheless, employees located at the satellite offices did order FHA case numbers from the Department under the branch offices' identification numbers. While the Company acknowledges that ordering of FHA case numbers from these locations did not strictly adhere to HUD's satellite guidelines, any oversight in this regard was technical in nature. The Report does not allege, and there is no evidence to suggest, that any of the loans originated at the Company's satellite office involved fraud, misrepresentation, or any other deficiencies in the loans themselves, and all of the borrowers in these cases qualified for FHA financing. When examining branch and satellite offices, the Department typically is concerned with whether the office is a bona fide office of the Company staffed by loan officers employed exclusively by the FHA lender, or whether the office represents an impermissible "net branch" from which a third-party mortgage broker originate FHA loans under another FHA lender's approval. Such impermissible activity was not present here. All of the offices referenced in the Report were bona fide offices of MMC and the loan officers that took borrowers applications at these locations were, at all times, exclusively employed by MMC, not third-parties. Moreover, any issues regarding the Company's office registration practices have effectively been resolved by MMC's merger with another of its parent company's subsidiary lenders. Upon merging with PrimeLending in May of 2006, all of MMC's branch office locations were transferred to that entity. Upon this transfer, all of these locations were either closed or registered as branch offices of that entity with the Department. Currently, all offices of the existing entity that communicate with HUD are properly registered as fully approved branch offices with the Department.

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MMC takes strong exception to the Report's assertion that the Company's management ignored HUD's branch office requirements. While HUD auditors took issue with the registration of three of the 33 offices referenced in the Report during a routine monitoring review in 2004, at no time did the Department raise concerns with the Company's other satellite offices. Upon receiving notice that the HUD auditors had issues with three of the Company's locations, MMC informed the Department that these three offices had been closed and were no longer engaging in FHA loan origination activity. These closures effectively resolved HUD's outstanding issues regarding these locations. To our knowledge, the Department did not raise concerns with any member of the Company's management regarding MMC's remaining satellite offices. Therefore, MMC believed that its remaining offices adhered to HUD guidelines regarding satellite locations. Furthermore, during the 22 years that the Company was an FHA-approved lender, the Department's auditors did not take issue with the activities performed by, or the registration of, its branch or satellite offices. At all times, MMC and its management believe that the Company's offices complied with HUD guidelines regarding satellite locations. Therefore, we respectfully request that the allegation regarding the Company's actual knowledge of FHA guidelines be removed from the final Report and ask that the OIG reconsider its recommendation regarding civil money penalties.

In summary, we hope that the OIG will consider that MMC at no time sought to evade applicable requirements and that the Company's management was unaware that the offices cited in the Report did not fully comply with HUD guidelines regarding satellite offices. We also note that any concerns raised in Finding 2 effectively been resolved, as the Company has merged with another entity, which has taken over the management of MMC's operations. As a result, all of the offices referenced in the Report have either been closed or registered with the Department pursuant to HUD requirements. The Company's current management is fully knowledgeable of all Company operations and closely oversees FHA originations and branch office activity. Given the Company's recent merger and transfer of management, we are confident that any prior oversight in this regard has been resolved and will not recur.

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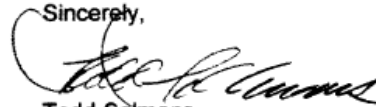
III. CONCLUSION

MMC takes the matters raised in the draft Report seriously. As discussed above, MMC substantially complied with FHA underwriting requirements and made loans to qualified FHA borrowers. MMC'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 MMC, or do not affect the underlying loans' insurability. MMC at no time misrepresented information it submitted to the Department. Moreover, since the loans cited in the Report were originated, the Company has merged with another lender and has ceased independent operations. MMC's origination, underwriting and Quality Control processes are now managed by another lender and all of the Company's offices have been closed or registered as branch offices with the Department. This new corporate and management structure effectively resolves the underwriting, Quality Control and branch office issues identified in the Report.

We believe that this response and accompanying exhibits demonstrate that many of the Report's recommendations in connection with the cited loans are unwarranted. We respectfully request that the OIG revise its recommendations to fit the facts of this case and remove allegations from the Report in those instances in which MMC has demonstrated its compliance with HUD requirements.

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

Sincerely,



Todd Salmans
Executive Vice President
PrimeLending, A PlainsCapital
Company

Attachments

cc: Phillip L. Schulman, Esq.

OIG Evaluation of Auditee Comments

- Comment 1** In response to our initial draft report, McAfee Mortgage provided written comments and additional documentation. We reviewed the information and revised the report accordingly. The final report questions 11 loans for underwriting deficiencies. We removed 6 of the initial 17 loans from the report based on information provided in McAfee Mortgage's response. After making these changes, we provided the revised report to McAfee Mortgage and gave it an opportunity to provide revised comments. McAfee Mortgage requested that we include their original comments.
- Comment 2** Based on information provided in McAfee Mortgage's response, we removed this loan from our finding.
- Comment 3** Based on the information provided in McAfee Mortgage's response, we removed this issue from a loan that remains questioned in our finding.
- Comment 4** Based on information provided in McAfee Mortgage's response, we revised the language in our report to clarify this issue.
- Comment 5** McAfee Mortgage did not adequately verify the coborrower's future monthly income used to qualify for the loan. The sole support for using the future income was a letter from the company that offered the coborrower a position, contingent upon the coborrower meeting certain requirements. McAfee Mortgage did not verify that the coborrower had met the stipulations and was guaranteed the new job before closing the loan. Further, the letter did not represent a guaranteed, nonrevocable contract for employment, as required by HUD to support using the future income for qualifying for a Federal Housing Administration loan.
- Comment 6** HUD requires lenders to obtain evidence of a two year work history to establish employment and income stability. The borrower claimed to have been self-employed for more than a year in the two years before applying for the loan. The lender supported 10 months of self-employment income in 2002 but did not obtain a 2003 tax return or other documentation to support self-employment income for five months in 2003.
- Comment 7** McAfee Mortgage did not establish that the borrower had a stable income despite the frequent changes in employment. The borrower had held five jobs in the two years before applying for the loan and the various jobs did not appear to be in a similar employment field as the borrower's most recent job. Further, McAfee Mortgage did not obtain support for three months of income claimed in 2004 and the support that the lender relied on for seven months of income in 2003 was illegible.

- Comment 8** McAfee Mortgage used an unsigned monthly budget showing that the borrower should have been able to save \$1,118 per month (or \$893 if the unsupported child support income is excluded). The borrower provided a signed statement to the lender that she was able to save about \$375 per month for nine months before applying for the loan. The lender and borrower did not establish that the borrower had actually saved more than the \$375 per month claimed as the source of her earnest deposit. The borrower's monthly housing payment was increasing by \$376, causing us to question the likelihood that the borrower would have been able to make the monthly mortgage payments.
- Comment 9** HUD Handbook 4155.1, Rev-5, chapter 2, section 2-10, revised October 2003, states that the lender is responsible for properly documenting the transfer of donor/gift funds and gives information on what documentation is acceptable. HUD issued the October 2003 version of the handbook as guidance after the HUD Single Family Reference Guide, dated November 2001. Therefore, the revised handbook was HUD's latest guidance and the guidance that McAfee Mortgage should have followed when documenting the gift transfer.
- Comment 10** In its response, McAfee Mortgage provided evidence of the transfer of funds but did not provide information on the City of Houston's assistance program. Without additional documentation, the lender and HUD cannot be assured that repayment was deferred or not expected, and that the debt was appropriately excluded when evaluating the borrower's liabilities.
- Comment 11** We maintain that the lender did not follow HUD requirements and failed to properly document the transfer of gift funds.
- Comment 12** We agree that the assistance program description indicated that repayment was deferred. However, McAfee Mortgage did not document receipt of the funds or obtain a promissory note. Without documents confirming that payments were deferred and that any deferment was for at least one year, HUD cannot be assured that the lender appropriately excluded the assistance loan when evaluating the borrower's liabilities.
- Comment 13** We agree that the six accounts either went to collection or the collateral was repossessed but disagree that this negates the borrowers' responsibility for the debts. Further, the credit report showed that two additional accounts were for defaulted federal student loans totaling nearly \$5,000. The coborrower indicated that unemployment was the cause of the financial problems but the credit report showed a significant history of poor credit and numerous bad debts before the loss of employment.
- Comment 14** McAfee Mortgage provided contractor and materials invoices/receipts of work completed on the property. However, the information did not support remediation of noted health and safety concerns or confirm that all valuation conditions noted by the appraiser were resolved. The appraiser noted

conditions of damaged plumbing and the presence of mold and lead-based paint. The lender did not obtain a final verification that the health issues and safety were resolved before or after closing the loan.

- Comment 15** McAfee Mortgage stated that the loan was originally processed under a different Federal Housing Administration case number and that evidence of mold remediation may be in that loan file. However, the borrower's loan was not processed under a different Federal Housing Administration case number. The property was a HUD real estate owned property and the previous owner had a Federal Housing Administration insured loan under the case number referenced by the lender.
- Comment 16** We maintain that the borrower's pay stubs being faxed from the seller's office was against HUD requirements and that the lender should not have relied on the pay stubs unless received from a party not related to the transaction.
- Comment 17** As standard practice, OIG reports contain amounts considered as funds to be put to better use if the recommendations are implemented. The purpose of this practice is to estimate the monetary benefit of the audit, not to claim an amount of damages for violations committed by the auditee. In the case of indemnifications, OIG and HUD have agreed that 29 percent of the loan amount is a reasonable estimate of funds to be put to better use.
- Comment 18** Using loan origination data provided by McAfee Mortgage, we identified 50 of the lender's office locations processing Federal Housing Administration loans in 2004 and 2005. A senior vice president in McAfee Mortgage's corporate office identified the 50 offices as branch offices and not satellite offices. The 33 unregistered offices were included in the list of 50 offices.
- Comment 19** We interviewed a McAfee Mortgage senior vice president and a direct endorsement underwriter in the corporate office, and various employees in two branch offices. Based on the interviews, we concluded that the lender's staff conducted activities in the 33 offices beyond those allowed in satellite offices. In addition, several staff, including a corporate direct endorsement underwriter, told us that direct endorsement underwriters reviewed only the property appraisal on loans approved by an automated underwriting system. The underwriters did not perform a full review of the automated approvals.
- Comment 20** HUD notified McAfee's Mortgage's president and chief executive officer in November 2004 that the practice the lender had in place for processing loans in its unregistered branch offices was unacceptable and violated HUD requirements. A senior vice president in the corporate office responded to HUD's letter, indicating that the situation was resolved because McAfee Mortgage had closed the branch offices. HUD adequately notified the lender's management of the improper practices and the lender should have taken action to rectify the situation in all of its offices.

Appendix C

CRITERIA

Criteria 1

HUD Handbook 4000.2, REV-3, chapter 1, section 1-7, states that property flipping is a practice whereby recently acquired property is resold for a considerable profit with an artificially inflated value, often abetted by a lender's collusion with the appraiser.

C. Resales Occurring 90 Days or Less Following Acquisition. A property acquired by the seller is not eligible for a mortgage to be insured by the Federal Housing Administration for the buyer unless the seller has owned that property for at least 90 days. If a property is resold 90 days or fewer following the date of acquisition by the seller, the property is not eligible for a mortgage insured by the Federal Housing Administration. The Federal Housing Administration defines the seller's date of acquisition as the date of settlement on the seller's purchase of that property. The resale date is the date of execution of the sales contract by a buyer intending to finance the property with a Federal Housing Administration-insured loan.

Criteria 2

HUD Handbook 4155.1, REV-5, chapter 1, section 1-7-A, states that the seller may contribute up to 6 percent of the property's sales price toward the buyer's actual closing costs, prepaid expenses, discount points, and other financing concessions. Contributions exceeding 6 percent of the sales price or exceeding the actual cost of prepaid expenses, discounts points, and other financing concessions will be treated as inducements to purchase, thereby reducing the amount of the mortgage. Closing costs normally paid by the borrower are considered contributions if paid by the seller.

Criteria 3

HUD Handbook 4155.1, REV-5, chapter 1, section 1-13-A, states that any financing (other than the Federal Housing Administration-insured first mortgage) that creates a lien against the property is considered secondary financing and not a gift, even if it is a "soft" or "silent" second (i.e., has no monthly repayment provisions) or has other features forgiving the debt.

Documentation from the provider of the secondary financing must show the amount of funds provided to the borrower in each transaction, and copies of the loan instruments are to be included in the endorsement binder. Costs incurred for participating in a downpayment assistance secondary financing program may only be included in the amount of the second lien. Permissible secondary financing arrangements include

A. Government Agencies. Federal, state, and local government agencies, as well as nonprofit agencies considered instrumentalities of government, may provide secondary financing for the borrower's entire cash investment. The second lien itself must be made or held by the eligible governmental body or instrumentality. Neither governmental units nor their established nonprofit instrumentalities may use "agents," including other nonprofits or for-profit enterprises, to make the second lien regardless of the source of those funds. In other words, even if the funds

used for the secondary financing were derived from an acceptable source such as HUD Homeownership Investment Partnership funds or from a unit of government or eligible nonprofit instrumentality, the subordinate lien must be in the name of the eligible entity; i.e., the state, county, city, or eligible nonprofit instrumentality must be the lien holder. This authority cannot be delegated to another party that is not itself permitted to provide this level of secondary financing. These other entities, however, may be used to service the subordinate lien if regularly scheduled payments are to be made by the borrower. Loans secured by secondary mortgages are subject to the conditions described below:

1. The Federal Housing Administration-insured first mortgage, when combined with any second mortgage or other junior liens from government agencies, may not result in cash back to the borrower. The sum of all liens cannot exceed 100 percent of the cost to acquire the property. The cost to acquire is the sales price plus allowable borrower-paid closing costs, discount points, repair and rehabilitation expenses, and prepaid expenses. The cost to acquire may exceed the appraised value of the property under these types of government assistance programs.
2. The required monthly payment under the insured mortgage and the second mortgage or lien, plus other housing expenses and all recurring charges, cannot exceed the borrower's reasonable ability to pay.
3. The source, amount, and repayment terms must be disclosed in the mortgage application, and the borrower must acknowledge that he or she understands and agrees to the terms.

Criteria 4

HUD Handbook 4155.1, REV-5, chapter 2, section 2-2-B, details citizenship and immigration status requirements.

- B. Citizenship and Immigration Status. When a mortgage loan applicant indicates on the loan application that he or she holds something other than U.S. citizenship, the lender must determine residency status from the documentation provided by the borrower.

Nonpermanent Resident Aliens. The Federal Housing Administration will insure a mortgage made to a nonpermanent resident alien, provided the property will be the borrower's principal residence, the borrower has a valid Social Security number, and the borrower is eligible to work in the United States as evidenced by an employment authorization document issued by the Bureau of Citizenship and Immigration Services. If the authorization for temporary residency status will expire within one year and a prior history of residency status renewals exists, the lender may assume continuation will be granted. If there are no prior renewals, the lender must determine the likelihood of renewal, based on information from the Bureau of Citizenship and Immigration Services.

Although Social Security cards may indicate work status, such as "not valid for work purposes," an individual's work status may change without the change being reflected on the Social Security card. Therefore, the Social Security card is not to be used as evidence of work status for nonpermanent resident aliens; the Bureau of Citizenship and Immigration Services employment authorization document is to be used instead.

Criteria 5

HUD Handbook 4155.1, REV-5, chapter 2, section 2-2-D, states that although the nonpurchasing spouse's credit history is not to be considered a reason for credit denial, a credit report that complies with other HUD requirements must be obtained for the nonpurchasing spouse to determine the debt-to-income ratio.

Criteria 6

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

When analyzing a borrower's credit history, the lender is to examine the overall pattern of credit behavior, rather than isolated occurrences of unsatisfactory or slow payments. When delinquent accounts are revealed, the lender must document its analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including delayed mail delivery or disputes with creditors.

While minor derogatory information occurring two or more years in the past does not require explanation, major indications of derogatory credit--including judgments, collections, and any other recent credit problems--require sufficient written explanation from the borrower.

Neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejecting the loan application. HUD also recognizes that some prospective borrowers may not have an established credit history. For those borrowers, and for those who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider. The lender must document that the providers of nontraditional credit exist and verify the credit information.

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

Criteria 7

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

Criteria 8

HUD Handbook 4155.1, REV-5, chapter 2, section 2-3-F, states that participation in a consumer credit counseling payment program does not disqualify a borrower from obtaining a Federal Housing Administration-insured mortgage, provided the lender documents that one year of the pay-out period has elapsed under the plan and the borrower's payment performance has been satisfactory (i.e., all required payments made on time). In addition, the borrower must receive written permission from the counseling agency to enter into the mortgage transaction.

Criteria 9

HUD Handbook 4155.1, REV-5, chapter 2, section 2-6, 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.

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

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

Criteria 10

HUD Handbook 4155.1, REV-5, chapter 2, section 2-7, states that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage loan. If the borrower intends to retire during this period, the effective income must be the amount of documented retirement benefits, Social Security payments, or other payments expected to be received in retirement.

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

- A. Overtime and Bonus Income. Both overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of bonus or overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. Periods of

less than two years may be acceptable, provided the lender justifies and documents in writing the reason for using the income for qualifying purposes.

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

- R. Projected Income. Projected or hypothetical income is not acceptable for qualifying purposes. However, exceptions are permitted to this rule for income from cost-of-living adjustments, performance raises, bonuses, etc., which are both verified by the employer in writing and scheduled to begin within 60 days of loan closing.

If a borrower is about to start a new job and has a guaranteed, nonrevocable contract for employment that will begin within 60 days of loan closing, the income is acceptable for qualifying purposes. The lender also must verify that the borrower will have sufficient income or cash reserves to support the mortgage payments and any other obligations during the interim between loan closing and the start of employment. However, if the loan will close more than 60 days before the borrower's employment begins, the loan is not eligible for endorsement until the lender provides a pay stub or other acceptable evidence that the borrower has begun the new job.

Criteria 11

HUD Handbook 4155.1, REV-5, chapter 2, section 2-9-B, states that the following documents are required from self-employed borrowers:

1. Signed and dated individual tax returns, plus all applicable schedules, for the most recent two years.
2. Signed copies of federal business income tax returns for the last two years, with all applicable schedules, if the business is a corporation, an S corporation, or a partnership.
3. A year-to-date profit-and-loss statement and balance sheet.
4. A business credit report on corporations and S corporations.

Criteria 12

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

Criteria 13

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

Criteria 14

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

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

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

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

Criteria 15

HUD Handbook 4155.1, REV-5, chapter 2, section 2-10-M, states that borrowers who have saved cash at home and are able to demonstrate adequately the ability to do so are permitted to have this money included as an acceptable source of funds to close the mortgage. To include such funds in assessing the homebuyer's cash assets for closing, the money must be verified--whether deposited in a financial institution or held by the escrow/title company--and the borrower must provide satisfactory evidence of the ability to accumulate such savings.

The asset verification process requires the borrower to explain in writing how such funds were accumulated and the amount of time taken to do so. The lender must determine the reasonableness of the accumulation of the funds based on the borrower's income stream, the period during which the funds were saved, the borrower's spending habits, documented expenses, and the borrower's history of using financial institutions. All other factors being equal, individuals with checking and/or savings accounts are less likely to save money at home than an individual with no history of such accounts.

Criteria 16

HUD Handbook 4155.1, REV-5, chapter 2, section 2-11-C, states that 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 timeframe.

Criteria 17

HUD Handbook 4155.1, REV-5, chapter 2, section 2-12, states that ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. The lender must compute two ratios:

- A. Mortgage Payment Expense to Effective Income. If the total mortgage payment (principal and interest, escrow deposits for real estate taxes, hazard insurance, the mortgage insurance premium, homeowners' association dues, ground rent, special assessments, and payments for any acceptable secondary financing) does not exceed 29 percent of the gross effective income, the relationship of the mortgage payment to income is considered acceptable. A ratio exceeding 29 percent may be acceptable only if significant compensating factors are documented and recorded on the mortgage credit analysis worksheet. Typically, for borrowers with limited recurring expense, greater latitude is permissible on this ratio than on the total fixed payment ratio.
- B. Total Fixed Payment to Effective Income. If the total of the mortgage payment and all recurring charges does not exceed 41 percent of the gross effective income, the relationship of total obligations to income is considered acceptable. A ratio exceeding 41 percent may be acceptable only if significant compensating factors are documented and recorded on the mortgage credit analysis worksheet.

Criteria 18

HUD Handbook 4155.1, REV-5, chapter 3, section 3-1, states that the application package must contain all documentation supporting the lender's decision to approve the mortgage loan. When

standard documentation does not provide enough information to support this decision, the lender must provide additional explanatory statements, consistent with other information in the application, to clarify or to supplement the documentation submitted by the borrower.

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

Criteria 19

HUD Handbook 4155.1, REV-5, chapter 3, section 3-1-C, states that for all borrowers, including U.S. citizens, the lender is required to document a valid Social Security number for each borrower, coborrower, and cosigner on the mortgage. All individuals eligible for legal employment in the United States must have a Social Security number. Each borrower must provide the lender with evidence of his or her own valid Social Security number as issued by the Social Security Administration. This applies to purchase money loans and all refinances, including streamline refinances. While the Social Security card is not required, the lender is required to validate the Social Security number. Lenders may use various means for validating the Social Security number, including examining the borrower's pay stubs, passport, and valid tax returns, and may use service providers including those with direct access to the Social Security Administration. The lender is also required to resolve any inconsistencies or multiple Social Security numbers for individual borrowers that are revealed during loan processing and underwriting.

Criteria 20

Mortgagee Letter 00-27 provides processing instructions for Federal Housing Administration-insured financing that involves a HUD real estate owned property.

Appraisal Type - Upon conveyance of properties to HUD's real estate owned inventory, HUD's management and marketing contractor shall obtain an as-is appraisal (not as-repaired) for each HUD real estate owned property to determine the listing price.

Utility Issues - Utilities should be on at the time the appraisal is conducted, unless there are documented extenuating circumstances. In the event of extenuating circumstances, the appraiser should note the following:

- On the uniform residential appraisal report, the appraiser will annotate "The following utilities were not on at the time the appraisal was conducted (e.g., electric, gas, and/or water) --Unable to verify their functionality."
- On the valuation condition sheet, it also should be clearly noted that "The following utilities were not on at the time the appraisal was conducted (e.g., electric, gas, and/or water)--Unable to verify their functionality." However, the appraiser should note any readily observable condition that is evident. Completion of the valuation condition sheet requires observation of 13 areas, that include but are not limited to the well and individual water supply, the septic system, structural conditions, and mechanical systems, to determine any obvious defects (i.e., exposed wiring, frayed wiring, presence of leaks, and structural damage of plumbing

fixtures). Extra attention should be given to the readily observable condition of the utility systems that are not activated at the time of the appraisal.

- HUD's management and marketing contractor shall permit entry to the purchaser(s) during the contract period to activate the utilities for the purposes of conducting a home inspection. If the HUD real estate owned appraisal was completed without the utilities being activated, the mortgage lender or purchaser(s) must complete the systems check while the utilities are activated.

Marketing Approach - A property that requires no more than \$5,000 for repairs to meet the Federal Housing Administration's minimum property requirements as determined by the appraiser is eligible to be marketed for sale in its as-is condition with Federal Housing Administration mortgage insurance available, provided the purchaser(s) establishes a cash escrow to ensure the completion of the required repairs. Purchaser(s) are permitted to include in the mortgage an amount equal to 110 percent of the estimated cost of the repairs.

When a repair escrow is required, the escrow account should be established and administered in accordance with the procedures outlined in HUD Handbook 4145.1. A completed form HUD-92300, Mortgagee's Assurance of Completion, should be included in the case binder submitted for insurance endorsement. A completed form HUD-92051, Compliance Inspection Report, must be submitted after the completion of repairs.

Criteria 21

Mortgagee Letter 04-28 requires that any resale of a property may not occur 90 or fewer days from the last sale to be eligible for Federal Housing Administration financing.

Criteria 22

Mortgagee Letter 04-28 states that HUD Handbook 4155.1, REV-5, sets forth the documentation requirements for showing the transfer of gift funds. The instructions also state that when the transfer occurs at closing, the lender remains responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source.

Since most transfers of downpayment funds from charities are by means of wire transfers, when that situation occurs, the lender must obtain and keep the documentation of the wire transfer in its mortgage loan application binder. While that document need not be provided in the insurance binder, it must be available for inspection by HUD's Quality Assurance Division when that office conducts its on-site review of lenders.

Criteria 23

Underwriting requires careful analysis of the many aspects of the mortgage. Each loan is a separate and unique transaction, and there may be other factors that demonstrate the borrowers' ability and willingness to make timely mortgage payments. There is a danger of "layering flexibilities" in assessing mortgage insurance risk, and simply establishing that a loan transaction meets minimal standards does not necessarily constitute prudent underwriting. The lender is responsible for adequately analyzing the probability that the borrower will be able to repay the mortgage obligation in accordance with the terms of the loan.

Appendix D

SCHEDULE OF MATERIAL DEFICIENCIES

Federal Housing Administration case number	Original mortgage amount	Claims paid	29% of original mortgage amount	Loss to HUD	29% of claims paid	Unsupported income	Questionable employment	Unsupported assets	Questionable gift funds	Underreported liabilities	Questionable credit history	Ineligible property or borrower	Other
161-2097168	\$63,995		\$18,559						x			x	
491-8444756	\$65,000		\$18,850									x	
493-7681268	\$86,325		\$25,034					x					
493-7770482	\$75,110		\$21,782					x				x	x
291-3239808	\$98,356	\$105,536		\$55,091		x		x			x		x
493-7888318	\$113,754	\$121,916		\$27,513							x		
493-7775178	\$65,772	\$68,780			\$19,946				x				
493-7827818	\$113,591	\$118,911			\$34,484	x	x						x
493-7852047	\$145,960	\$149,249			\$43,282		x				x		
493-7905859	\$90,972	\$94,157			\$27,306		x			x			
493-7908169	\$113,326	\$23,141			\$6,711				x	x			
Totals	\$1,032,161	\$681,690	\$84,225	\$82,604	\$131,729	2	3	3	3	2	3	3	3

Appendix E

CASE STUDIES FOR 11 QUESTIONED LOANS

<u>Case number:</u> 161-2097168	<u>Insured amount:</u> \$63,995
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Active
<u>Date of loan closing:</u> May 10, 2004	<u>Underwriter type:</u> Automated

Ineligible Property

The property was resold within 90 days of the last sale for a substantial profit. The seller of the property took ownership on December 22, 2003, paying \$38,000 for the property. The new contract was executed on March 1, 2004, for \$65,000. The seller owned the property for only 69 days before reselling. A property resold within 90 days following the date of acquisition by the seller is not eligible for a Federal Housing Administration-insured loan.

In response to the audit, McAfee Mortgage agreed with this finding.

HUD Requirements

HUD Handbook 4000.2, REV-3, chapter 1, section 1-7-C (appendix C – criteria 1)
Mortgagee Letter 2003-07 (appendix C – criteria 21)

Questionable Gift Funds

The lender did not adequately document gift funds provided by a charitable organization. The settlement statement reflected gift funds of \$1,950 to the borrower from the nonprofit and the associated funds from the seller to the same nonprofit. The HUD case binder contained the gift letter but did not include support for the transfer of funds. Without additional gift fund documentation, such as wire transfer documents, the lender could not verify that the funds came from an allowable source.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-10-C (appendix C – criteria 14)
Mortgagee Letter 2004-28 (appendix C – criteria 22)

<u>Case number:</u> 491-8444756	<u>Insured amount:</u> \$65,000
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Active
<u>Date of loan closing:</u> June 18, 2004	<u>Underwriter type:</u> Manual

Ineligible Property

The lender did not accurately process this loan as a HUD real estate owned property. The appraiser noted several repairs necessary to meet Federal Housing Administration minimum property requirements and estimated the cost of those repairs to be \$4,900. The appraiser was unable to check the plumbing system because the water was not turned on. There was no documentation that an inspection was performed once the water was activated. The appraisal

also noted the presence of lead-based paint and mold, both health hazards. Neither the HUD case binder nor the lender file contained documentation of lead paint repairs or mold remediation.

Neither a lender's assurance of completion (HUD-82300) nor a compliance inspection report (HUD-92051) was in the file. The file also did not contain support for completion of the required repairs or administration of the repair escrow. A loan information sheet prepared by the lender, dated June 23, 2004, stated that the repairs were not complete.

In response to our audit, McAfee Mortgage provided documentation to address some of the conditions noted by the appraisal. However, McAfee Mortgage did not provide evidence of paint repairs or mold remediation, a plumbing inspection, or a final inspection.

HUD Requirements

Mortgagee Letter 00-27 (appendix C – criteria 20)

<u>Case number:</u> 493-7681268	<u>Insured amount:</u> \$86,325
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Active
<u>Date of loan closing:</u> January 16, 2004	<u>Underwriter type:</u> Automated

Unsupported Assets

The lender did not adequately support funds used to close the loan or the borrower's ability to pay a substantial increase in housing costs. The borrower provided a monthly budget savings plan stating that she was able to save \$1,118 per month, or half of her monthly income. The savings plan included income of \$225 from unsupported child support. State child support records showed that she was not receiving the child support consistently. The records, dated December 9, 2003, showed that the borrower had not received any child support since March 2003. The payments recorded by the state ranged from \$34 to \$113 per month – not the \$225 used to support the borrower's ability to save and have additional income available to offset increased housing expenses.

In addition, the borrower provided a statement that she had only been able to save \$375 per month over a nine month period to accumulate the earnest money. The borrower's housing expense (principal and interest) increased \$376, from \$550 per month to \$926 per month. The lender did not adequately demonstrate that the borrower had the ability to absorb the 68 percent increase in her housing payment.

Additionally, the file contained copies of a cashier's check for \$3,150, with the borrower as the remitter, and a personal check from the borrower for \$500. The borrower deposited both checks with the seller and not a third party having no interest in the sale.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-10-B (appendix C – criteria 13)

HUD Handbook 4155.1, REV-5, chapter 2, section 2-10-M (appendix C – criteria 15)

<u>Case number:</u> 493-7770482	<u>Insured amount:</u> \$75,110
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Active
<u>Date of loan closing:</u> May 13, 2004	<u>Underwriter type:</u> Manual

Citizenship and Immigration Status

The lender did not adequately document the borrower's eligibility as a nonpermanent resident alien, nor did it adequately ensure that the Social Security number claimed by the borrower legitimately belonged to the borrower. The lender obtained a verification of employment and a memorandum from the employer indicating that the borrower was working under the H-2B visa program but did not provide his employment authorization document issued by the Bureau of Citizenship and Immigration Services. The borrower's work visa expired a month after closing, and the lender did not provide proof of a renewal history or other documentation from the Bureau of Citizenship and Immigration Services, ensuring that the borrower's work status would be renewed, thereby allowing him to legally reside in the country and be eligible for a Federal Housing Administration-insured loan.

Additionally, the lender conducted checks on the borrower's Social Security number that indicated the number was associated with someone else and was issued in Michigan. The loan file showed no indication that the lender attempted to resolve the discrepancy, which draws into question the legitimacy of the Social Security number belonging to the borrower.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, paragraph 2-2-B (appendix C – criteria 4)
 HUD Handbook 4155.1, REV-5, chapter 3, section 3-1-C (appendix C – criteria 19)

Unsupported Assets/Questionable Secondary Financing

The lender did not adequately document a deferred payment loan from a municipal downpayment assistance program. The mortgage credit analysis worksheet and settlement statement reflected \$5,000 from the program. The lender file contained a conditional commitment letter verifying the borrower's eligibility for the program, pending the borrower meeting additional conditions. The loan file did not indicate that the borrower met the additional conditions or that the funds were transferred. The lender should have also obtained a promissory note evidencing the secondary financing agreement. Without the appropriate documentation, the lender could not be assured that the funds were received on the borrower's behalf and came from an allowable source, or that repayment of the municipal loan was deferred.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 1, section 5, paragraph 1-13-A (appendix C – criteria 3)
 HUD Handbook 4155.1, REV-5, chapter 2, section 2-11-C (appendix C – criteria 16)

Inadequate Documentation

The seller faxed the borrower's pay stubs to the lender. When an interested third party handles or transmits documents critical to the underwriting process, the lender cannot be assured of the legitimacy of those documents. The lender cannot use pay stubs faxed from the seller to support income.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 3, section 5-1 (appendix C – criteria 18)

<u>Case number:</u> 291-3239808	<u>Insured amount:</u> \$98,356
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Claim - sold for loss of \$55,166
<u>Date of loan closing:</u> February 10, 2004	<u>Underwriter type:</u> Manual

Unsupported and Ineligible Assets

The seller contributed to the cash needed to close the loan. The borrower claimed his bank account balance of \$4,386 on February 5, 2004, as funds available to close. The account contained \$3,000 from the seller of the property, deposited on that same day. The deposit was supported by a letter from the seller stating that the funds were a draw against a balance owed the borrower for upcoming construction work contracted for by the seller. The settlement statement showed the borrower needed \$2,316 to close. Bank records showed the borrower had only \$1,524 on February 3, 2004. Without the \$3,000, the borrower would not have had the funds necessary to close the loan.

Additionally, other bank accounts for the borrower showed negative daily balances, multiple negative balance fees, and insufficient funds charges.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-10 (appendix C – criteria 12)

HUD Handbook 4155.1, REV-5, chapter 2, section 2-10-B (appendix C – criteria 13)

Overinsured Loan

The seller contributed more than 6 percent of the sales price for borrower closing costs. The settlement statement showed that the seller contributed \$4,339 toward borrower closing costs. The seller also provided \$3,000 directly to the borrower. The seller contributed 7.35 percent of the sales price for borrower closing costs, causing the loan to be \$1,345 overinsured.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 1, section 1-7-A (appendix C – criteria 2)

Unsupported Income and Invalid Compensating Factors

The lender overstated the borrower's income by \$94 per month. The lender incorrectly added back the self-employment tax to the adjusted gross income. The financial ratios increase to 38.6 percent with the correct effective income. Additionally, the borrower provided his 2002 and 2003 tax returns, but neither was signed. The lender also failed to obtain a year-to-date profit-and-loss statement and balance sheet for the self-employed borrower.

The borrower's mortgage payment was \$807 per month with no other liabilities listed on the mortgage credit analysis worksheet. The borrower's housing ratio significantly exceeded HUD's limit of 29 percent, and the lender listed multiple compensating factors. However, the factors were invalid, as follows:

- The lender claimed an excellent rental history, but one rent verification passed through the seller, and the seller also provided a verification of rent for a few months of the rental period.
- The lender claimed a minimal increase in housing expense, but the borrower's housing costs were increasing by 25 percent from the current rent and 80 percent from the rent paid until five months before the loan closed.
- The lender claimed that the alternative credit provided an acceptable credit history; however, the alternative credit was not sufficiently supported.
- The lender claimed the borrower had reserves after closing, but the seller provided \$3,000 to the borrower for funds to close, which effectively created the reserves.
- The lender claimed that the borrower had no recurring debt. While this may have been true, this was not sufficient to offset the other questionable issues of the loan or the high housing ratio.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-9-B (appendix C – criteria 11)

HUD Handbook 4155.1, REV-5, chapter 2, section 2-12 (appendix C – criteria 17)

Identity of Interest

The seller of the property was the borrower's landlord, and the seller had contracted with the borrower for construction services, including rehabilitating the property being insured. The seller also provided a verification of rent, which stated that the borrower paid \$650 per month from October 15, 2003, to the time of the loan application. An additional verification of rent from another party stated that the borrower's spouse paid \$450 per month from 2001 to October 15, 2003. The seller faxed the earlier rent verification to the lender.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-3-A (appendix C – criteria 7)

Questionable Credit History

The borrower had no credit scores. The only items on the borrower's credit report were two collections. Additionally, the borrower was married, but the lender did not obtain credit reports for the nonpurchasing spouse. HUD requires that credit reports be obtained for the nonpurchasing spouse to determine the debt-to-income ratio.

In addition, the lender required the borrower to obtain a nontraditional credit history. The borrower provided a letter of credit for a cell phone from a construction company. The letter indicated that the borrower paid the company a monthly fee for its use. No payment history was provided to support the legitimacy of the letter of credit. Also, the seller faxed the letter of credit to the lender.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-2-D (appendix C – criteria 5)

HUD Handbook 4155.1, REV-5, chapter 2, section 2-3 (appendix C – criteria 6)

Questionable Appraisal

Two appraisals listed the property as vacant. The borrower claimed that he had lived in the subject property for three years. The appraisals were performed 12 days apart, just before the loan closed. One listed the borrower as the purchaser, and the other listed the borrower's nonpurchasing spouse as the purchaser. Also, both appraisals said there were no sales of the property within the prior three years; however, the seller acquired the property in October 2003, according to the verification of rent.

In response to the audit, McAfee Mortgage agreed with the findings on this loan.

<u>Case number:</u> 493-7888318	<u>Insured amount:</u> \$113,754
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Claim
<u>Date of loan closing:</u> September 28, 2004	<u>Underwriter type:</u> Automated

Questionable Credit History

The credit report showed that an automobile was repossessed less than a year before loan closing and listed more than \$11,000 in collection accounts within the two years before loan closing. The collection accounts included two defaulted federal student loans totaling nearly \$5,000. The lender excluded six debts from the credit report in the automated underwriting system but did not provide documentation to explain why the items were excluded.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-3 (appendix C – criteria 6)

<u>Case number:</u> 493-7775178	<u>Insured amount:</u> \$65,772
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Claim
<u>Date of loan closing:</u> June 4, 2004	<u>Underwriter type:</u> Manual

Questionable Gift Funds

The lender did not adequately document gift funds of \$5,000 and a \$500 earnest deposit paid by parties other than the borrower. The mortgage credit analysis worksheet and settlement statement reflected funds of \$5,000 provided from the City of Houston. Neither the HUD nor McAfee Mortgage loan file contained documentation supporting these funds, nor did they include support for the transfer of funds. Without additional documentation, such as the wire transfer documents and acceptance/award letter, the lender could not verify that the funds came from an allowable source and that no repayment was required.

Additionally, the settlement statement, mortgage credit analysis worksheet, and sales contract listed an earnest deposit of \$500. The file contained a money order to the title company for \$500 from someone other than the borrower. The loan files contained no evidence that the funds came from an allowable source and that no repayment was required. Additionally, the individual that purchased the money order also signed the termite inspection and was listed as the borrower. However, the borrower that closed the loan signed an affidavit that he was not known by any

other names, and he signed the termite inspection as well, evidencing that the two names appearing on the various documents are not the same person.

In response to our audit, McAfee Mortgage provided additional documentation but no documentation regarding the City of Houston funds or a gift letter for the \$500.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-10-C (appendix C – criteria 14)
Mortgagee Letter 2004-28 (appendix C – criteria 22)

<u>Case number:</u> 493-7827818	<u>Insured amount:</u> \$113,591
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Claim
<u>Date of loan closing:</u> June 29, 2004	<u>Underwriter type:</u> Automated

Unsupported Income

The lender overstated income by \$521 per month when approving the loan. The lender used the coborrower's expected base pay of \$2,167 for qualifying. The only support for this employment at the time the lender approved the loan was a letter offering the borrower a position. The lender did not obtain a guaranteed, nonrevocable contract, as required by HUD to use future income for qualifying. Further, the coborrower had been in the new position for three weeks at the time the loan closed. The lender obtained two pay stubs from the new position but these were for work performed after the loan closed.

At the time the lender approved the loan, the coborrower was earning \$10 per hour working through a staffing agency for four months. A pay history showed that she averaged more than 37 hours per week. At that rate, her monthly income was \$1,646, which was supported by three weeks of pay stubs. The lower, supported income of \$1,646 increases the ratios to 34.9 percent and 46.7 percent.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-7 (appendix C – criteria 10)
HUD Handbook 4155.1, REV-5, chapter 2, section 2-12 (appendix C – criteria 17)

Questionable Income Stability/Employment

The lender did not establish income stability or a two year work history. It did not adequately verify the borrower's employment or education/training to fulfill the two year requirement. The loan application showed that the borrower was self-employed in the home repair business for just over a year before his current job, which began May 23, 2003. The lender did not obtain a tax return for 2003 to support the five months of self-employment income claimed.

The coborrower's two-year work history included four months of unemployment and three different jobs. The coborrower explained the gaps in employment and that she changed jobs frequently seeking better pay. According to the loan file, her income remained the same in each of the three jobs prior to employment by the staffing agency.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-6 (appendix C – criteria 9)

HUD Handbook 4155.1, REV-5, chapter 2, section 2-9-B (appendix C – criteria 11)

Additional Factors

The borrowers had no cash assets. Their bank balance was less than \$6 when verified.

<u>Case number:</u> 493-7852047	<u>Insured amount:</u> \$145,960
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Claim - property not yet sold
<u>Date of loan closing:</u> July 30, 2004	<u>Underwriter type:</u> Automated

Questionable Employment History

The lender did not establish employment stability. The borrower changed jobs frequently in the two years before applying for the loan and did not adequately support employment in the same line of work. While the verification of employment and current pay stubs supported the income used to qualify the borrower, she had been on the job for only one month. She was unemployed for the 4.5 months before the current job and provided no explanation for the gap in employment. The borrower wrote a letter stating that employment for the previous 10 years was in the procurement field, but another letter stated that in 2001 and 2002 she was unable to find a position in her career field.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-6 (appendix C – criteria 9)

Questionable Credit History

The borrower's vehicle was repossessed at the end of 2003. She had recent late payments on several accounts. The credit report showed several profit-and-loss writeoffs totaling more than \$13,000. She had enrolled in a debt consolidation program in May 2004 to pay off more than \$20,000 of debt. At the time she applied for the loan, she had been enrolled in the program for only three months--not for at least one year of the pay-out period. The file contained an authorization for automatic withdrawals from her bank account to pay the debts but no debt consolidation agreement. Additionally, the borrower did not provide written permission from the debt consolidation agency to enter into the mortgage transaction.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-3 (appendix C – criteria 6)

HUD Handbook 4155.1, REV-5, chapter 2, section 2-3-F (appendix C – criteria 8)

<u>Case number:</u> 493-7905859	<u>Insured amount:</u> \$90,972
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Claim
<u>Date of loan closing:</u> October 29, 2004	<u>Underwriter type:</u> Manual

Underreported Liabilities

The lender did not obtain a credit report for the nonpurchasing spouse. The property was in a community property state, so debts of the nonpurchasing spouse that are not excluded by state law should have been included in the qualifying ratios. The lender approved the loan with ratios of 33.78 percent and 47.68 percent.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-2-D (appendix C – criteria 5)
 HUD Handbook 4155.1, REV-5, chapter 2, section 2-3 (appendix C – criteria 6)
 HUD Handbook 4155.1, REV-5, chapter 2, section 2-12 (appendix C – criteria 17)

Questionable Employment History/Stability of Income

The borrower did not present a stable income. The borrower had worked for his current employer for only seven months. His application listed five jobs during the two years before the loan application. The application did not identify titles of each job, and none of the places of employment appeared related to his current position as a cable installer.

Employers provided Internal Revenue Service forms W-2 for some of the jobs, but not all. The tax documentation did not support two consecutive years of employment, nor did it indicate that the job changes were related to increased pay or benefits. Based on the data provided, the borrower's earnings ranged from \$746 per month to \$1,309 per month. The information did not support a trend of increasing income. The borrower's income for the seven months at his current job was significantly higher than from any of his past jobs. HUD's regulations state that income stability can be more important than job stability if the borrower changes jobs within the same line of work and continues to advance in income or benefits. The lender did not sufficiently demonstrate that the borrower met the HUD criteria.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-6 (appendix C – criteria 9)

<u>Case number:</u> 493-7908169	<u>Insured amount:</u> \$113,326
<u>Section of Housing Act:</u> 203(b)	<u>Status upon selection:</u> Claim
<u>Date of loan closing:</u> October 28, 2004	<u>Underwriter type:</u> Automated

Questionable Gift Funds

The lender did not adequately document gift funds provided by a nonprofit. The settlement statement reflected gift funds of \$3,585 from the nonprofit and the associated funds from the seller to the same nonprofit. The case binder contained the gift letter but did not include support for the transfer of funds. Without additional gift fund documentation, such as the wire transfer documents, the lender could not verify that the funds came from an allowable source.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-10-C (appendix C – criteria 14)
Mortgagee Letter 2004-28 (appendix C – criteria 22)

Underreported Liabilities

The lender did not include a projected monthly obligation of \$639 in the borrower's financial ratios. The credit report listed a deferred student loan payment of \$639 per month, which was deferred until December 2005. While HUD requires a lender to only include a recurring debt in the financial ratios that will begin within 12 months of closing, the loan payment was significant and was scheduled to begin only 13.5 months after closing. Considering the student loan payment, the total debt ratio would have been 57 percent. Further, HUD regulations state that simply establishing that a loan meets minimum standards does not necessarily constitute prudent underwriting. The lender is still responsible for analyzing the borrowers' ability to repay the mortgage.

Using the same gross earnings used by the lender, the borrower's student loan payment beginning 13.5 months after closing was 20 percent of the borrowers' combined monthly income of \$3,212. Additionally, based on the information provided regarding the coborrower's college education, her student loan payments were to begin around the same time. The coborrower had more than \$24,000 in federal student loans. Additionally, based on the loan information the coborrower provided, she should have been making monthly payments of at least \$53 for accrued interest on the loans. This amount was not included in the borrowers' recurring liabilities.

HUD Requirements

HUD Handbook 4155.1, REV-5, chapter 2, section 2-11-C (appendix C – criteria 16)
HUD Handbook 4155.1, REV-5, chapter 2, section 2-12 (appendix C – criteria 17)
HUD Handbook 4155.1, REV-5, chapter 2, section 2-5 (appendix C – criteria 23)