
AUDIT REPORT



COLBAN FUNDING, INC.
NON-SUPERVISED MORTGAGEE
LIVERPOOL, NEW YORK

2003-NY-1004

July 24, 2003

OFFICE OF AUDIT
NEW YORK/NEW JERSEY



Issue Date July 24, 2003

Audit Case Number 2003-NY-1004

TO: John C. Weicher, Assistant Secretary for Housing-Federal Housing Commissioner,
Chairman, Mortgagee Review Board, H

Garry Clugston
for

FROM: Alexander C. Malloy, Regional Inspector General for Audit, 2AGA

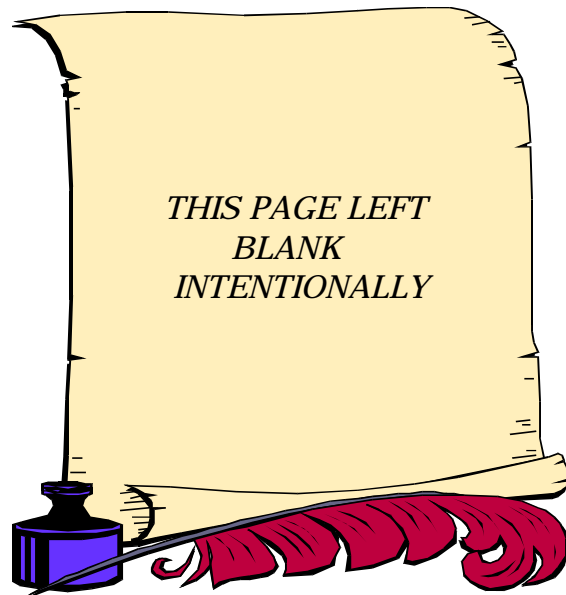
SUBJECT: Colban Funding, Inc.
Non-Supervised Mortgagee
Liverpool, New York

We completed an audit of Colban Funding, Inc. (Colban), a non-supervised mortgagee. The objectives of the audit were to: (1) determine whether Colban approved insured loans in accordance with the requirements of the U.S. Department of Housing and Urban Development/Federal Housing Administration (HUD/FHA), which require adherence to prudent lending practices; and (2) determine whether Colban's Quality Control Plan, as implemented, meets HUD/FHA requirements and whether provisions of the plan are being followed. The review covered the period between July 1, 2000, and June 30, 2002.

Our review concluded that Colban did not always adhere to prudent lending practices during the approval process of 11 of the 31 loans that we examined during our audit. In addition, we found that Colban is improperly allowing non-FHA approved entities to perform loan origination functions of HUD/FHA insured loans. Also, Colban has not documented actions taken to correct deficiencies cited as a result of quality control reviews.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide us for each recommendation without management decisions, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after report issuance for any recommendations without a management decisions. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact Garry Clugston, Assistant Regional Inspector General for Audit, on (716) 551-5755, extension 5901.



Executive Summary

We completed an audit of the branch office of Colban Funding, Inc. (Colban) in Liverpool, New York, a non-supervised mortgagee. The objectives of the audit were to: (1) determine whether Colban approved insured loans in accordance with the requirements of the U.S. Department of Housing and Urban Development/Federal Housing Administration (HUD/FHA), which require adherence to prudent lending practices; and (2) determine whether Colban's Quality Control Plan, as implemented, meets HUD/FHA requirements and whether provisions of the plan are being followed. The review covered the period between July 1, 2000 and June 30, 2002, and consisted of a review of 31 HUD/FHA insured loans that totaled \$2,560,300. A summary of the results of our review is provided below.

Eleven loans with underwriting deficiencies

We concluded that Colban did not always adhere to prudent lending practices during its approval process of the 31 HUD/FHA insured loans we reviewed. More specifically, our review disclosed that 11 of the 31 loans had at least one significant underwriting deficiency. Some of the underwriting deficiencies are as follows:

Underwriting processing deficiencies

- Minimum Investment Not Provided.
- Not Enough Funds to Close.
- Understated Debt and Underwriting Ratios.
- Insufficient Gift Information.
- Inaccurate Closing Documentation.
- Earnest Money Not Verified.
- Inadequate Property Valuation.

We believe that the underwriting deficiencies occurred because Colban personnel did not assure that the loans were approved in accordance with HUD/FHA requirements. As a result, mortgages were approved for unqualified borrowers causing HUD/FHA to assume an unnecessary risk.

Colban used non-FHA approved entities to originate FHA/HUD insured mortgages

Our review disclosed that Colban violated HUD/FHA requirements by: 1) allowing non-FHA approved (Mortgage Brokers) entities to perform certain functions during the origination of HUD/FHA insured mortgages; 2) failing to inform HUD/FHA on the Addendum to Uniform Residential Loan Application form HUD-92900-A when a FHA approved Loan Correspondent originated the loan, and; 3) allowing the use of seller contributions to pay mortgage broker fees. We attribute this to Colban's inaccurate interpretation of HUD/FHA requirements regarding the loan origination process. As such, Colban's

Weaknesses in Quality Control Plan

practices have caused HUD/FHA to assume an unnecessary insurance risk and borrowers to incur increased loan fees.

Additionally, Colban's management staff has not documented actions taken to correct deficiencies cited as a result of quality control reviews. This occurred because Colban management has not implemented all of the reporting procedures of its Quality Control Plan. As a result, Colban is not fully utilizing its quality control review plan, which is designed to enhance and maintain accuracy, validity, and completeness in its loan origination process.

Regarding the first finding, we recommend that Colban reimburse HUD/FHA for losses on 3 of the 31 loans and indemnify HUD/FHA against future losses on 8 of the 11 loans identified in Appendix A of this report. Also, Colban should provide your office with a corrective action plan containing assurances that all HUD/FHA guidelines pertaining to underwriting HUD/FHA insured loans will be followed by its underwriting staff. Regarding the second and third findings, we made specific recommendations for corrective action.

Exit conference

The results of our audit were discussed with Colban personnel throughout the course of the on-site audit work. We forwarded a copy of the draft report for review and comment to Colban on June 19, 2003, and held an exit conference on July 1, 2003 at Colban's Offices. Colban provided written comments to our draft report. We included excerpts of the comments with the findings, and provided the complete text in Appendix D of the report.

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Abbreviations

FHA	Federal Housing Administration
HOC	Home Ownership Center
HUD	U.S. Department of Housing and Urban Development
OIG	Office of Inspector General
QAD	Quality Assurance Division
REO	Real Estate Owned

Introduction

Colban Funding, Inc. (Colban) is a non-supervised mortgagee with its headquarters located in Endwell, New York. It became an authorized Direct Endorsement mortgagee on August 26, 1999. Colban has a branch office located at 7515 Morgan Road, Liverpool, New York, which was approved on November 9, 1999. This branch office is responsible for originating loans mainly in upstate New York encompassing the areas of Buffalo, Rochester, Syracuse, and Albany, New York. Colban underwrites HUD/FHA insured loans, conventional loans, and Veterans Administration insured loans.

During our audit period, from July 1, 2000 to June 30, 2002, Colban originated, under its Direct Endorsement Program, 1,133 HUD/FHA insured loans amounting to \$90,733,402 within the State of New York. At April 30, 2003, the mortgages for 31 of the 1,133 loans were in default status. HUD paid claims on six of the loans, totaling \$507,656 with losses totaling \$54,077.

Audit Objectives

The objectives of the audit were to: (1) determine whether Colban approved loans in accordance with the requirements of the U.S. Department of Housing and Urban Development/Federal Housing Administration (HUD/FHA), which require adherence to prudent lending practices; and (2) determine whether Colban's Quality Control Plan, as implemented, meets HUD/FHA requirements and whether Colban is following provisions of the plan.

Audit Scope and Methodology

The purpose of our review was to confirm the accuracy of all material information used as a basis for underwriting and closing loans. We obtained background information by:

- Reviewing relevant HUD regulations, requirements, and Mortgagee Letters.
- Examining reports and information maintained on HUD's Neighborhood Watch Early Warning System and Single Family Data Warehouse.
- Interviewing members of HUD's Quality Assurance Division.

To accomplish our audit objectives, we initially selected a sample of 19 loans from HUD's Neighborhood Watch database with a beginning amortization date between July 1, 2000 and June 30, 2002. We selected these loans because they either had gone to claim, were currently in default, or

had gone into default at least once within the first two years. Subsequently, we discovered that three of the loans selected were included in a January 2002 review conducted by HUD's Quality Assurance Division (QAD). Also, we discovered that an indemnification request has been made by HUD regarding the three loans, therefore, we removed them from our sample. Based on our survey results, we expanded our sample by selecting an additional 15 loans within our audit period. Eight of these loans were currently in default and the remaining seven were selected because they had debt-to-income ratios in excess of the HUD/FHA allowable threshold. The 31 loans in our sample were HUD/FHA insured loans that totaled \$2,560,300. The results of our detailed testing only apply to the 31 loans selected and cannot be projected to the universe of 1,133 loans.

Our file review and audit procedures included: (a) a reconfirmation of the borrowers' income, assets, and liabilities, (b) a verification of selected data on the settlement statements, and (c) inquiries with borrowers, mortgage brokers, members of HUD's, and Colban's staffs.



HUD's QAD review

HUD's QAD performed a Title II monitoring review of the Colban branch office during January 2002. The following are the violations of HUD's requirements that were detailed in the letter to Colban, dated May 6, 2002. They are discussed below:

HUD/FHA Origination Requirements

During its monitoring review, the QAD identified various violations of HUD's origination requirements involving borrowers not meeting the minimum required cash investment, borrower's income being overstated, and verifications and supporting documents passing through the hands of an interested third party. Due to the seriousness of the three findings, Colban was requested to indemnify HUD against future losses on specific loans with origination processing deficiencies.

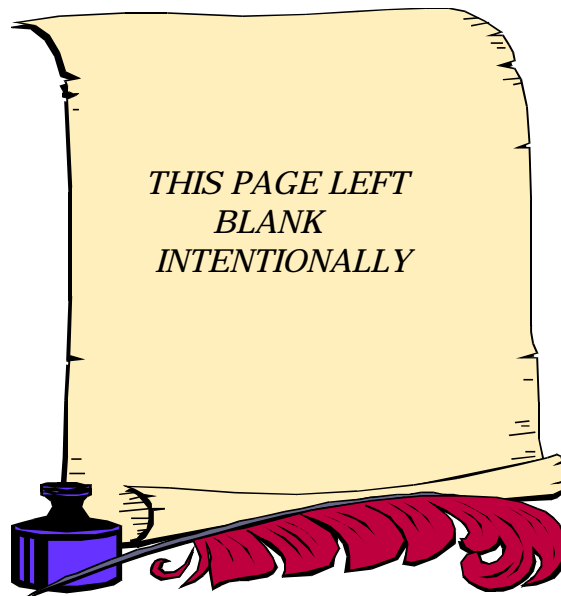
We noted similar violations regarding minimum required cash investment and documents passing through the hands of interested third parties during our audit. These violations are discussed in detail in Finding 1 and Finding 2, respectively.

Mortgagee Review Board considering administrative action and civil money penalties

The Mortgagee Review Board issued a letter on March 12, 2003 advising Colban that administrative action and civil money penalties were being considered. Also, the letter advised that any actions taken by the Board would be based on violations of HUD/FHA requirements by Colban that were discovered during a review of additional documentation received subsequent to the QAD review in January 2002. The violations of HUD/FHA requirements by Colban include: 1) failing to reconcile the HUD-1 Settlement Statement to show exactly who was paid from the loan proceeds; 2) submitting loans to HUD/FHA for endorsement that were originated by non-FHA approved mortgage brokers; and 3) falsely certifying on the Addendum to the Uniform Residential Loan Application, HUD-92900-A, that Colban complied with all HUD's requirements.

Audit Period

We performed the audit fieldwork between October 2002 and April 2003. Our audit pertained to loans originated between July 1, 2000, and June 30, 2002. As necessary, we reviewed loan activity prior and subsequent to our audit period. Our audit work was performed at Colban's Liverpool, New York office. The audit was conducted in accordance with Generally Accepted Governmental Auditing Standards.



Inadequate Loan Underwriting Practices Resulted in Approval of HUD/FHA Insured Loans for Unqualified Borrowers

Our review disclosed that Colban did not adhere to prudent lending practices when approving 11 of the 31 loans that we examined during our audit. We noted that underwriting deficiencies occurred because Colban personnel did not assure that the loans were processed in accordance with all applicable HUD/FHA requirements. As a result, mortgages were approved for unqualified borrowers causing HUD/FHA to assume an unnecessary insurance risk.

Section 2-1 of HUD Handbook 4000.4 REV-1, Single Family Direct Endorsement Program requires mortgagees to conduct its business operations in accordance with accepted sound mortgage lending practices. Also, HUD Handbook 4000.4 REV-1, Chapter 2, Section 2-5, provides that the mortgagee must obtain and verify information with at least the same care that would be exercised in originating the loan in which the mortgagee would be entirely dependent on the property as security to protect its investment.

In our opinion, Colban did not always adhere to the above requirements, as discussed below, when it underwrote 11 of the 31 loans we reviewed.

Examined 31 loans

Our examination of 31 loans approved by Colban between July 1, 2000, and June 30, 2002, disclosed that in 11 of the cases Colban either did not follow all applicable HUD requirements or did not exercise the care expected of a prudent lender in approving the loans. Consequently, we found significant underwriting deficiencies in 11 of the cases, as shown below:

<u>Deficiencies</u>	<u>Number of Loans</u>
Minimum Investment Not Provided	6 of 11 loans
Not Enough Funds to Close	2 of 11 loans
Understated Debt and Underwriting Ratios	3 of 11 loans
Inaccurate Closing Documentation	2 of 11 loans
Insufficient Gift Information	1 of 11 loans
Earnest Money Not Verified	1 of 11 loans
Inadequate Property Valuation	1 of 11 loans

When the samples for review were selected on August 8, 2002 and September 30, 2002, eight of the eleven loans with delinquencies were in default and one mortgage had

gone to claim. At April 30, 2003, the mortgages of two of the eleven loans were in default and three of the loans had gone to claim. HUD has paid \$85,964.39 and \$74,848.06 on two of the loans and completed the claim on the other loan incurring a loss of \$54,077. The total of \$214,889.45 in paid claims and losses is disallowed costs and should be reimbursed to HUD. The remaining eight HUD/FHA insured loans had delinquencies amounting to \$658,880. We are requesting indemnification for these loans (See Appendix C).

Appendix A to this report provides a summary of the loan underwriting deficiencies noted during our review, while Appendixes B-01 through B-11 provide an individual description of the underwriting deficiencies for each of the 11 loans. The deficiencies occurred because Colban representatives did not adhere to HUD/FHA requirements, nor comply with prudent lending practices. In our opinion, the deficiencies resulted in the approval of mortgages for unqualified borrowers, which have caused HUD/FHA to assume an unnecessary risk.

Auditee Comments

Colban's comments are included with the individual narrative case presentations in Appendixes B-012 to B-11

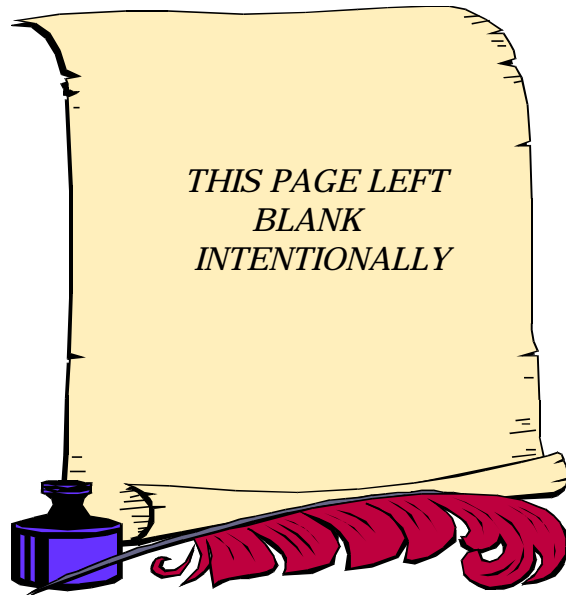
Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner, Chairman, Mortgagee Review Board require Colban to:

- 1A. Reimburse HUD for the actual loss on case number 372-3037514 and for the claims paid on case numbers 372-3025335 and 372-3007955 less all-sales revenue received.

- 1B. Indemnify HUD/FHA against future losses on eight of the loans in question (371-2856125, 371-2919310, 371-2979270, 371-2898761, 372-2995679, 371-2900728, 372-3050612, and 371-2998785).

- 1C. Provide your office with a corrective action plan to assure that all HUD/FHA guidelines regarding the underwriting of HUD/FHA insured loans are followed by its underwriting staff.



Violations Pertaining to the Participation of Non-FHA Approved and FHA Approved Entities in the Loan Origination Process

Our review disclosed that Colban violated HUD/FHA requirements by: 1) allowing non-FHA approved (Mortgage Brokers) entities to perform certain functions during the origination of HUD/FHA insured mortgages; 2) failing to inform HUD/FHA on the Addendum to Uniform Residential Loan Application form HUD-92900-A when a FHA approved Loan Correspondent originated the loan; and 3) allowing the use of seller contributions to pay the mortgage broker fees. We attribute this to Colban's inaccurate interpretation of HUD/FHA requirements pertaining to the loan origination process. As such, Colban's practices have caused HUD/FHA to assume unnecessary insurance risks and borrowers to incur increased loan fees.

For 27 loans in our sample the borrowers engaged the services of a mortgage broker

For 27 of the 31 loans in our sample, we found that the borrowers engaged the services of a mortgage broker. For 23 of those 27, there was evidence that mortgage brokers improperly participated in the origination of HUD/FHA insured mortgages. For three loans, each borrower engaged a mortgage broker who was also an authorized Loan Correspondent or an Agent of Colban. However, Colban did not inform HUD on the applications, as required by Mortgage Letter 94-56, that a FHA approved Loan Correspondent originated the loan.

Criteria

Mortgagee Letter 95-36 dated August 2, 1995, stated that the Department recognizes that there are certain loan origination functions that do not materially affect underwriting decisions that may be contracted out by mortgagees without increasing the risk to FHA. However, the underwriting and customary loan officer functions may not be contracted out. The contracting out of such loan origination functions must be with a commercial provider of the types of services being requested, and may not be contracted out to third party loan originators, real estate brokers and other similar entities. The Federal Register, dated March 1, 1999, Part IV included the Real Estate Settlement Procedures Act Statement of Policy 1999-1 which stated that HUD identified 14 services or functions normally performed in origination of a loan. The list included in part the following: taking information from the borrower and filling out the application; collecting

financial information (tax returns, bank statements) and other related documents that are part of the application process; initiating/ordering appraisals and initiating/ordering verifications of employment and deposit.

HUD's Handbook 4060.1 REV-1, Paragraph 1-2 provides that a mortgagee must be approved by HUD in order to originate, purchase, hold or sell HUD/FHA insured mortgages. Further, Paragraph 2-25 states that mortgagees may not perform only a part of the loan origination process, such as taking the loan application, and routinely transferring the underwriting package (appraisal report and/or mortgage credit package) to another mortgagee. This requirement does not apply to the relationship between a Sponsor and its Loan Correspondent(s) under the Direct Endorsement program. A Loan Correspondent may process applications and submit them to its Sponsor(s) for underwriting of the loan.

HUD Handbook 4000.4, Paragraph 2-13 laid out the rules for a Loan Correspondent participating in the Direct Endorsement program. It provided that the Loan Correspondent is responsible for all the processing. Mortgagee Letter 94-56 allowed the HUD/FHA approved Loan Correspondent type mortgagees to utilize the services of an approved Sponsor for processing their FHA insured mortgage loan. According to the Letter, it is HUD/FHA's mission to promote homeownership while continuing to manage the level of risk to the FHA insurance fund and preserve the interests of FHA mortgagors. In order to meet these goals, the Department believes it is imperative that HUD/FHA know with whom it is doing business.

Mortgage Broker performed loan origination functions in violation of HUD/FHA requirements

Colban failed to ensure that mortgage brokers were not originating loan

Colban failed to ensure that third party mortgage brokers, who were non-FHA approved entities, were not performing origination functions. Our review of the loan origination files and interviews indicated that mortgage brokers were providing mortgage origination functions in violation of HUD requirements.

Evidence that mortgage brokers took applications

Our review found indications that mortgage brokers took initial loan applications. But, Colban certified on the Addendum to the Uniform Residential Loan Application form HUD-92900-A that a full-time employee of the lender or its duly authorized agent obtained the information contained in the Uniform Residential Loan Application and the Addendum directly from the borrower. Colban contends that since each of the loan applications were marked as being received by mail, this showed that it came directly from the borrower. However, interviews with Colban personnel disclosed that Loan Application packages usually come directly from the mortgage broker.

Although Mortgagee Letter 98-15 allows for the lender to take an application by mail, the Letter maintains that the lender remains responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation, source of funds for the transaction, and the intended use of the property. Interviews with personnel at the branch office disclosed that they have very little contact with borrowers. They rely on the mortgage brokers to work with the borrowers to ensure that loan qualifications are met. During our interviews of borrowers, they claimed to have had minimal or no contact with Colban and that the information and documentation provided went through their mortgage broker. This indicates that Colban did not meet its responsibilities to perform certain origination functions that are customary loan officer functions.

Documentation passed through the mortgage broker

Also, our review found that the files contained documents, which materially supported underwriting decisions, which passed through the hands of the mortgage broker in nine of the 31 insured loans in our sample. The files of five loans contained gift letters and/or the support for the gifts that were facsimiled from the mortgage broker to Colban. In one case, the borrower stated that the mortgage broker told her that she could not use funds saved at home for her transaction. The mortgage broker instructed her to give the funds to a relative who in turn would give the money back to her in the form of a gift. Also, the files of four additional loans contained bank statements, which were used to support the borrowers' assets, that were facsimiled from the mortgage broker to Colban. Further, the files contained facsimiled income verification documents, such as W-2's, tax forms and earning statements that came from the mortgage broker. For one

loan, Colban's files contained a check for the appraisal, which the borrower made out to the mortgage broker. For many of these documents Colban certified that they were true copies of the originals, although it appeared that Colban never actually obtained the original documents.

Colban claims that any documents that were facsimiled to them and affected the credit decision were re-verified. However, there was no evidence in the case files showing that facsimiled documents were re-verified.

Mortgage brokers explained that they provided origination services

We spoke to several mortgage brokers regarding their involvement with HUD/FHA insured loans. They explained that the services they provide would be classified as origination services. Functions performed range from interviewing borrowers and taking applications to gathering documentation and submitting it to Colban. One mortgage broker indicated that she gathered all of the borrowers' information and facsimiled it to Colban. Furthermore, this mortgage broker stated that she completes the application and that she and other mortgage brokers run credit reports and prepare good faith estimates.

Each file we reviewed contained an agreement between the mortgage broker and the borrower detailing the services provided for the fee. Language in these agreements would lead one to believe that the services provided included loan origination functions. The standard language in most of the agreements included the following provision: I understand that your services may include, but are not limited to the following: 1) assistance in obtaining information required to complete the mortgage application, and 2) assistance in processing the loan application and in meeting conditions of the loan commitment.

Also, we reviewed the standard agreement that Colban entered into with their correspondents. In particular, we noted that the section pertaining to brokers without HUD correspondent approval provides the following: FHA doesn't allow a mortgage broker without a HUD Loan Correspondent designation to originate FHA loans. It further states that the broker is being paid by the borrower to provide the following services: assistance in completing a loan application package, assistance with the loan

application process, and satisfying conditions of loan commitment.

Colban's President believes that mortgage brokers are not originating loans

Colban maintains that the mortgage brokers are not originating the loans. According to Colban's President, his definition of origination is when a company takes a mortgagor's loan application, processes the mortgagor's loan, and closes the mortgagor's loan. He said that all three elements are necessary for origination to occur. He feels that since mortgage brokers don't close loans, they are not originating. However, HUD's regulations provide that application intake, processing, and closing are all parts of the origination function. Therefore, an entity performing any part of these functions is participating in the origination of the loan.

We believe that Colban has misinterpreted the intent of HUD's criteria as it pertains to loan origination and its obligations under Mortgage Letters 95-36 and 98-15. Because Colban has allowed mortgage brokers, who were non-FHA approved entities, to perform origination functions, it lacks assurance that these loans have been originated in accordance with HUD requirements. Thus, increasing the risk to the FHA insurance fund.

Loans originated by FHA approved entities not reported

Colban failed to follow HUD/FHA reporting requirements during the processing of three loans that were originated by FHA approved entities (Loan Correspondents). Mortgage Letter 94-56 provides that in order for HUD/FHA to meet its goals it is imperative that HUD knows with whom it is doing business. Accordingly, mortgagees are required to inform HUD when FHA approved Loan Correspondents originate approved HUD/FHA insured loans. Contrary to this, Colban did not inform HUD on the final Addendum to Uniform Residential Loan Application form HUD-92900-A that an FHA approved Loan Correspondent originated the loans. As a result, HUD/FHA was not provided the information needed to identify who actually performed the origination function. This information is needed for HUD/FHA to properly monitor the activities of the Single Family FHA Insurance Program.

Seller contributions were used to pay the mortgage broker fee for 19 loans

Seller contribution used to pay mortgage broker fees

Our review disclosed that for 19 loans, the sellers' contributions were used to pay all or a portion of the mortgage broker fees. We believe the use of a seller's contributions to pay the mortgage broker fee is unallowable. HUD Handbook 4155.1 REV-4 CHG-1 Paragraph 1-7A permits sellers to contribute up to six percent of the property's sales price toward the buyer's actual closing costs, prepaid expenses, discount points, and other financing concessions. Closing costs normally paid by the borrower are considered contributions if paid by the seller. In our opinion, mortgage broker fees are not considered a normal closing cost; therefore, we believe that they should not be paid with seller contributions.

However, the former Branch Manager of Colban provided us with a letter signed by an Acting Supervisor of Underwriting in the Philadelphia Homeownership Center dated November 30, 1998, confirming that the use of seller contributions to pay mortgage broker fees is allowable. The letter was a follow-up to a conversation that was obtained when the Branch Manager worked for another Direct Endorsement Mortgagee.

We raised two concerns during this audit pertaining to sellers' contributions being used to pay mortgage broker fees. First, there were a number of borrowers who may not have had the assets available to pay the mortgage broker fee and other out of pocket closing costs. Thus, they may not have qualified for the loan. In this regard, there were 10 loans in which the borrower did not have enough verified assets to cover the cost of paying the mortgage broker fee and other out of pocket closing costs. In all of these cases, the seller's contribution paid for a majority of the mortgage broker fee.

Secondly, we found that the sales price may have been increased on loans with seller contributions to cover the cost of the contribution. Because of the increases in the sales price, HUD/FHA could have assumed unnecessary insurance risk to help pay for mortgage broker fees.

Borrowers may have incurred excessive fees and financing charges**Borrowers may have incurred excessive loan origination fees and higher mortgage amounts**

It appears that Colban has chosen to utilize the non-FHA approved mortgage brokers to perform application intake and processing functions to increase its loan volume without increasing its overhead. Ultimately, this cost was past onto the borrowers. For the various loans, we believe that mortgage broker fees included payments for processing services that resulted in borrowers incurring excessive loan origination fees. Furthermore, we believe that the use of sellers' contributions to pay the mortgage broker fee has led to higher sales costs and higher mortgage amounts, as previously discussed. Thus, HUD/FHA may have assumed unnecessary insurance risk.

HUD Handbook 4000.2 REV-2 Paragraph 5-3D allows lenders to collect customary and reasonable fees from borrowers. Included in these fees is an origination fee of one percent of the original principal amount of the mortgage. In most cases, Colban did not charge any origination fee to the borrowers. However, we found that a number of the mortgage broker fees were three percent or more of the mortgage amount. Mortgage brokers told us that if they did not provide processing services then their fees would be less. Thus, we believe that borrowers paid excessive fees for services that the mortgagee should have provided.

In conclusion, we believe that fees charged and paid by borrowers for mortgage broker services must be reasonable for the services provided. Therefore, mortgagees should not allow the mortgage broker to improperly assist in the processing of HUD/FHA insured loans and include the cost of such assistance in the fees charged to borrowers. Furthermore, mortgage broker fees should be paid directly by the borrower and not with seller contributions.

Auditee Comments

Colban stated that they do not allow non approved entities to originate mortgage loans on our behalf and that the broker does not originate the loan. Colban's position is that origination can really only occur when the loan is processed, underwritten, and closed. The broker/consultant assists their client by helping with the completion of the

application, and explaining what documentation will be requested by Colban. The package of documents is sent to Colban, and from that point Colban sends out all verifications, orders the appraisal and credit reports and performs all of the underwriting. Colban indicated that they issue the commitment letter, provide all the instruction to the attorneys, and fund the loan. Colban's President stated that Colban Funding clearly is the originator of these loans.

Colban stated that in some cases documents passed through mortgage brokers and they have ceased that practice.

Colban indicated that the three loans received from approved Loan Correspondents (LC) and not reported as such; were because the LC didn't really act in that capacity and Colban felt that it should not be reported as such.

Concerning the seller contribution used to pay for Mortgage broker fee, Colban stated that until such time as the HOC clearly states in the form of a Mortgagee Letter that it is not permissible Colban can only assume that November 30, 1998 letter from HUD staff was speaking for the HOC, and that what is happening is allowable.

OIG Evaluation of
Auditee Comments

We disagree with Colban's interpretation of what constitutes loan origination. The use of non-FHA approved entities, to take applications and perform other origination functions is not allowed and increased the risk to the FHA insurance fund. Also, our review indicted that the Loan Correspondents performed origination functions in the three loans and as such should have been listed the HUD-9200A form. As stated in our recommendation HUD should make a determination on the use of seller contributions to pay mortgage broker fees.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner, Chairman, Mortgagee Review Board:

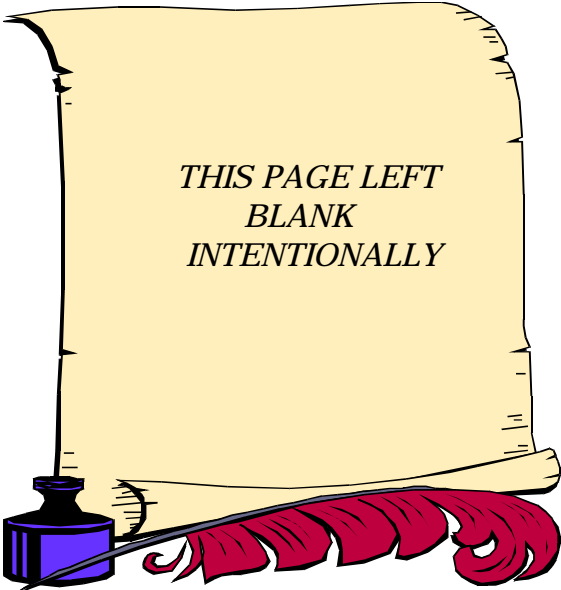
- 2A. Take the appropriate administrative sanction(s) against Colban based upon the deficiencies noted

in the finding.

- 2B. Determine whether mortgage broker fees can be paid with the use of seller contributions and advise Colban accordingly.

We further recommend that the Assistant Secretary for Housing-Federal Housing Commissioner, Chairman, Mortgagee Review Board require Colban to:

- 2C. Establish and implement procedures pertaining to the use of mortgage brokers to include:
- Assuring that mortgage brokers do not perform functions during the loan origination process that are to be performed by the mortgagee or an agent of the mortgagee.
 - Accepting only original documentation that supports information contained in the application.
 - Ensuring that application packages received by mail are received directly from the borrower.
 - Notifying HUD on the final Addendum to Uniform Residential Loan Application form HUD-92900-A whenever a FHA approved mortgage broker is used.
- 2D. Validate the reasonableness of the mortgage broker fee charged for allowable services provided.



Colban did not Resolve Deficiencies Found During Quality Control Reviews

Our review disclosed weaknesses in Colban's Quality Control Plan. Colban management has not documented actions taken to correct deficiencies found during quality control reviews. This occurred because Colban management has not implemented all of the reporting procedures of its Quality Control Plan. As a result, Colban is not fully utilizing its Quality Control Plan, which is designed to enhance and maintain accuracy, validity, and completeness in its loan origination process.

Actions to correct deficiencies not taken

We reviewed Colban's Quality Control Plan that was revised September 2002. The revision meets all the requirements of HUD Handbook 4060.1 REV-1 Paragraph 6-1D. But, senior management has not initiated actions to correct all deficiencies identified as required in the plan.

Criteria

Paragraph 6-1G of HUD Handbook 4060.1 REV-1, requires a mortgagee's senior management to promptly initiate actions to correct all deficiencies cited as a result of quality control reviews. The actions taken by management must be formally documented by citing each deficiency, identifying the cause of the deficiency, and providing management's response or actions taken. Also, it indicates that employees should be provided with corrective instructions where patterns of deficiencies are identified in processing, underwriting, or servicing.

Reviews performed monthly

Colban's quality control reviews are performed by an independent outsource firm. The firm performs monthly audits, other reviews, and issues reports, such as default reports, as requested by Colban. During the monthly reviews, all loans in the Quality Control Review sample are assigned a Risk Assessment Rating. The ratings are as follows:

Average - Acceptable risk to repurchase or default does not impair the quality of the loan or indicate control/procedure weaknesses.

High - Substandard risk to repurchase or default due to non-compliance with investor guidelines or control/procedure weaknesses.

Prohibitive - Unacceptable level of exposure or non-salable loans due to material variances of investor guidelines or misrepresentations.

Early Payment Default Reports

From the reviews, the outside firm issues Early Payment Default Reports. The reviews analyze all first payment defaults, all loans that are delinquent sixty days or more, and all FHA loans that became thirty days or more delinquent within the first six months of origination. The reviews focused on the cause of the delinquency and the quality of the approval decision.

We examined the quality control reviews completed between March 2000 and April 2002. Based on the reports, we determined that when a deficiency was noted, little or no explanation was given as to the corrective action taken to rectify the weaknesses. Also, no formal documentation addressing the deficiency could be found. The Assistant Vice President of Colban said that she discusses the issues disclosed in the Quality Control Reviews with the underwriter, but no formally documented actions are taken.

For example, Colban's August 2000 quality control review cited a prohibitive risk rating for one HUD/FHA loan in the sample. The prohibitive risk rating was given because the loan to value ratio exceeded the maximum 97.75% on the HUD-1 and the sellers' contribution exceeded the allowable 6%. We noted that during the review the underwriter was informed of the deficiency, but no other evidence of corrective actions or resolutions was documented.

Likewise, Colban's December 2001 Early Payment Default Report identified a high risk rating for two HUD/FHA loans in the sample. This rating was given due to overall poor credit history that was not properly addressed in the loan approval process, and an incorrect calculation of qualifying income in the loan approval decision. However, no evidence of corrective actions taken was documented.

No formal documentation of deficiencies

Contrary to Paragraph 6-1G of HUD Handbook 4060.1 REV-1, Colban senior management did not promptly initiate action to correct all deficiencies. The corrective actions taken by Colban management were not formally documented by citing each deficiency, identifying the cause of the deficiency, and providing management's response or actions taken. Additionally, Colban did not follow the procedures set forth in its plan. Colban's Quality Control Plan provides that the President will notify investors, agencies, and the Board of Directors if material discrepancies are noted. We found no evidence of any such notification. Furthermore, we did not find evidence that the operations staff responded to the President in writing about corrective actions taken.

Reporting to HUD of any violation of law or regulation

In accordance with Paragraph 6-1H of HUD Handbook 4060.1 REV-1, mortgagees are required to report any violation of law or regulation, false statements or program abuses by the mortgagee, its employees or any other party to the transaction to the HUD Regional Office, the HUD Area Office or to the HUD Regional Office of Inspector General. Colban stated that they have not implemented procedures to notify HUD of any violations of law or regulation, false statements or program abuses by its employees who perform the origination functions of FHA-insured loans. Thus, Colban is in violation of Paragraph 6-1H of HUD Handbook 4060.1 REV-1.

As discussed above, Colban representatives did not adhere to HUD/FHA requirements, nor comply with prudent lending practices when evaluating the results of its quality control reviews. In our opinion, the deficiencies may have resulted in a lack of controls that could expose HUD/FHA loans to unnecessary risk, as discussed in Finding 1.

Auditee Comments

Colban stated that they review the Quality Control findings with the appropriate party or parties. However they have not been formally documenting the discussion of, the responses to and the corrective action taken. They will begin that process immediately.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner, Chairman, Mortgagee Review Board require Colban to:

- 3A. Implement procedures in its Quality Control Plan to ensure that corrective action will be documented for all reported deficiencies.

Management Controls

In planning and performing our audit, we obtained an understanding of the management controls that were relevant to our audit. Management is responsible for establishing effective management controls. Management controls, in the broadest sense, include the plan of organization, methods, and procedures adopted by management to ensure its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting and monitoring program performance.

Relevant management controls

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

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

We assessed all the relevant controls identified above.

It is a significant weakness if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet an organization’s objectives.

Significant weaknesses

Based on our review, we believe that significant weaknesses exist in the following management controls. These weaknesses are described in the findings section of this report.

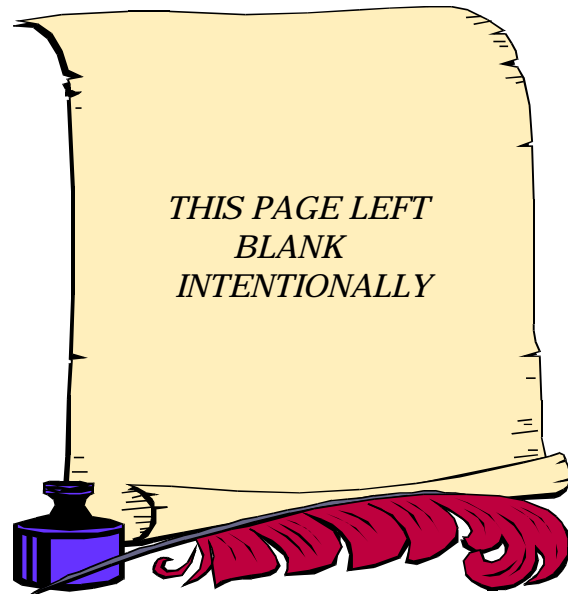
- Colban did not assure that the loans were processed in accordance with all applicable HUD/FHA requirements,

Finding 1 (Program Operations), (Compliance with Laws and Regulations).

- Colban violated HUD/FHA requirements in the origination of HUD/FHA insured mortgages involving mortgage brokers, Finding 2 (Validity and Reliability of Data), (Compliance with Laws and Regulations).
- Colban did not resolve deficiencies cited in the Quality Control Plan Reviews, Finding 3 (Program Operations).

Follow Up On Prior Audits

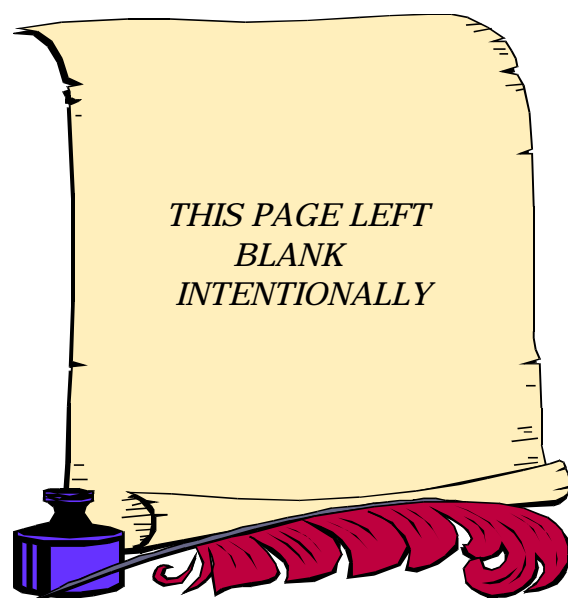
There were no prior OIG audit reports regarding Colban Funding, Inc.



Summary of Loan Origination Deficiencies

Colban Funding Inc.
Liverpool, NY
Summary of Loan Origination Deficiencies

HUD/FHA Case Number	Mortgage Amount	Settlement Date	Minimum Investment Not Provided	Not Enough Funds to Close	Understated Debt and Underwriting Ratio	Inaccurate Closing Documentation	Insufficient Gift Information	Earnest Money Not Verified	Inadequate Property Valuation	Appendix Reference
372-3037514	\$60,968	09/29/00	X							B-01
372-3025335	\$74,847	09/22/00		X						B-02
371-2856125	\$93,037	06/27/00		X	X					B-03
371-2919310	\$59,073	02/06/01			X				X	B-04
372-3007955	\$67,744	06/26/00	X							B-05
371-2979270	\$109,518	07/24/01	X							B-06
371-2898761	\$45,436	11/15/00	X					X		B-07
372-2995679	\$74,861	06/14/00				X				B-08
371-2900728	\$85,956	11/09/00	X				X			B-09
372-3050612	\$68,964	11/30/00				X				B-10
371-2998785	\$122,035	09/28/01	X		X					B-11
Totals	\$862,439		6	2	3	2	1	1	1	



Narrative Case Presentations

FHA Case Number: 372-3037514

Loan Amount: \$60,968

Settlement Date: 09/29/00

Status: Claim
(Total amount paid by HUD \$69,005, loss to HUD \$54,077)

**Payments before first
Default Reported:** 6

Summary

Colban approved the mortgage although the borrower did not meet the minimum required investment. Our review disclosed that the borrower invested \$813 less than the required minimum cash investment. Therefore, HUD/FHA's decision to insure the loan was based on Colban's inaccurate representation that the borrower met HUD/FHA requirements.

Pertinent Details

A. Borrower Did Not Provide the Minimum Required Investment

The borrower's earnest money deposit of \$100, the \$562 paid at closing, the \$300 appraisal fee, and the \$55 credit report fee total \$1,017 for the borrower's investment. The \$1,017 is \$813 less than the minimum required investment of \$1,830. The National Housing Act requires minimum cash investments to be 3 percent of the Secretary's estimate of the cost of acquisition. FHA has determined that the minimum cash investment be based on sales price without considering closing costs (Mortgagee Letter 98-29, October 22, 1998).

Earnest Money Deposit	\$100.00
Cash paid at Closing	\$562.00
Appraisal Fee	\$300.00
Credit Report Fee	\$55.00
Total	\$1,017.00
Statutory Requirement	\$1,830.00
Amount under statutory requirement	\$813.00

Narrative Case Presentation

FHA Case Number: 372-3025335

Loan Amount: \$74,847

Settlement Date: 09/22/00

Status: Claim (Total amount paid by HUD \$85,964)

Payments before first Default Reported: 11

Summary

Colban did not verify that the borrower had sufficient assets to close the loan.

Pertinent Details

A. Inadequate Verification of Funds to Close

Our review found that Colban had not verified the borrower's funds to close. According to Colban, the borrower's assets were not verified because it's not required if the borrower's actual out of pocket closing costs were less than 4% of the mortgage amount. This was Colban's interpretation of the Freddie Mac Loan Prospector guidelines. We discussed this with Philadelphia Homeownership Center Officials who told us that Colban has to verify the source of funds for no cash out refinance when closing costs are greater than 4% of the loan amount according to Freddie Mac's matrix requirements. In this case, 4% of the mortgage amount would be \$2,993.88. We determined that the total closing costs was \$4,105.67. Since total closing cost of \$4,105.67 is greater than 4% of the mortgage amount, Colban was required to verify the borrower's funds to close.

In addition, we question the ability of the borrower to pay the closing costs based on information in the case file. According to the loan application, the borrower had assets of only \$1,933 in a savings account. Closing costs that had to be paid outside of closing totaled \$2,600.41. The case file did not have any documentation to support the payment of the mortgage broker fee of \$2,245.41. However, we found in the loan settlement file indications of a \$207.28 check to borrower, which was disbursed at settlement. The check was endorsed and forwarded to the mortgage broker to be used to pay a portion of the mortgage broker fee. This is an indication that at the time of closing the borrower did not have sufficient assets to pay all the closing costs.

Colban's Comments

Colban stated that Freddie Mac's matrix requirements for no cash out refinances does state that if the closing costs total more than 4% of the loan amount then the source of those funds must be

Narrative Case Presentation

verified. The HOC said that Colban had to verify the source of funds, which Colban believes they accomplished by determining that the borrower had sufficient equity to add the amount necessary to the mortgage. Concerning the borrowers ability to cover the broker fee and other costs paid outside closing, Colban stated that the borrower's bank account balance of \$1,933 was after the borrower wrote a check for \$355 to Colban. The additional \$207 that the borrower received at closing added to the \$1,933 was just \$105.00 less than what was needed at closing. It is Colban's contention that the borrower could have easily saved the additional money during the 2.5 months between application and closing.

OIG's Evaluation of Colban's Comments

Determining that the borrower has sufficient equity is not the same as verifying that the borrower has adequate funds to close, we agree with the HOC statement that since the closing costs exceeded 4 percent of the mortgage Colban was required to verify the borrower's funds to close. The use of the borrower's proceed check at closing to pay a portion of the mortgage broker fee is an indication that at the time of closing the borrower did not have sufficient assets to pay all the closing costs.

Narrative Case Presentation

FHA Case Number: 371-2856125

Loan Amount: \$93,037

Settlement Date: 06/27/00

Status: Default

**Payments before first
Default Reported:** 17

Summary

Colban approved the mortgage without adequately verifying that the borrower had sufficient assets available. Also, we found that Colban understated the borrower's monthly debt. Therefore, HUD/FHA's decision to insure the loan was based on Colban's inaccurate representation that the borrower met HUD/FHA requirements.

Pertinent Details

A. Questionable Asset Verification of Funds to Close

We were unable to determine whether Colban adequately verified the assets needed to close as required by HUD Handbook 4155.1 REV-4 CHG1, Paragraph 2-10, which states, "all funds for the borrower's investment in the property must be verified." In addition to the \$1,871.14 needed at closing, the borrower needed funds for the earnest money deposit of \$1,000, the appraisal fee of \$340, and the credit report fee \$110, which total \$3,321.14. The file included the borrower's bank balance at May 9, 2000, which was \$80.80, a verification of deposit dated May 30, 2000 indicating a current balance of \$27.67, and a deposit slip indicating a \$2,000 gift that was deposited into the borrower's account on June 5, 2000. As a result, our review indicated that Colban had not verified that the borrower had the sufficient assets to make the earnest money deposit, pay the appraisal, the credit report fees, and have the funds necessary to close.

Also, we found a discrepancy in the stated amount of earnest money deposit. The Mortgage Credit Analysis Worksheet and the final application listed the earnest money deposit as \$500. However, the HUD-1 and the sales contract showed the total earnest money deposit as \$1,000.

B. Inadequate Debt Verification

According to the credit report, the borrower's monthly payment was \$496. Colban did not include a \$60 monthly payment in its calculation on the Mortgage Credit Analysis Worksheet citing the fewer than 10 payment rule of HUD Handbook 4155.1 REV-4 CHG1, Paragraph 2-11A as the reason. However, the borrower had 11 payments remaining on this debt. Colban

Narrative Case Presentation

assumed the borrower would make the next payment. We did not find any evidence that the 11th payment was made. With the \$60 payment included in the borrower's total monthly payment, the borrower's back-end ratio would have increased from 43.85% to 45.51%. During an interview, the underwriter said that it was reasonable to project the 10-payment rule into the future for the \$60 monthly payment. However, we believe that prudent business practices would have required the underwriter to ensure that the borrower actually made the payment.

Colban's Comments

Colban stated that the earnest money was not verified as it was in an amount less than 2% of the purchase price. Also, that the gift funds were sufficient to cover the amount of closing costs, and that the contract stipulated that the borrower would receive their security deposit back from the seller at the time of closing which was estimated at \$650. That combined with the gift more than covered estimated costs. Colban indicated that they believe on the debt verification that with the borrower's quality history it was safe to assume that the additional payment would be made on time.

OIG's Evaluation of Colban's Comments

The borrower needed \$3,321.14 in funds to close and Colban did not verify that the borrower had sufficient assets necessary to close. Concerning the debt verification, HUD has established a standard it expects mortgagees to adhere to and that standard is 10 or fewer payments. Colban should have ensure that the borrower actually made the additional payment.

Narrative Case Presentation

FHA Case Number: 371-2919310

Loan Amount: \$59,073

Settlement Date: 02/06/01

Status: Default

**Payments before first
Default Reported:** 1

Summary

Colban approved the application of a borrower who had marginal credit worthiness. Colban did not account for some known outstanding debt, which would have raised the borrower's total fixed payment to effective income ratio over 41%. Moreover, the property purchased was a previous HUD Real Estate Owned sale within a year. Colban satisfied themselves regarding the appraisal price of \$60,000 when there wasn't adequate qualification of the previous purchase price of \$2,000 only 6 months earlier. According to HUD records, the borrower made only one payment before it went into default.

Pertinent Details

- A. Debt Understated in Calculation of Ratios
- B. Numerous Borrower Credit Issues

Per the Mortgage Credit Analysis Worksheet, the total monthly payments were listed as \$181. The amount was the payment under a Chapter 13 bankruptcy that was filed in March 1998. However, the credit report indicated subsequent outstanding debts for utilities. The credit report provided that arrangements have been made with the creditor to make partial payments. According to the support provided, the amount paid each month was \$10. But, this amount was not included in the ratio calculation. If it had been included, the total fixed payment to effective income ratio would have been 41.22% instead of 40.69%. This would have required the underwriter to provide compensating factors if they were to approve the application.

Notwithstanding the understated ratios, we believe there were enough questionable credit worthiness issues that should have caused Colban to reject the application. The following are credit items and other factors that should have made Colban question the borrower's ability to repay the loan. The borrower filed for Chapter 13 bankruptcy in 1998 and was currently late on utilities. Also, the borrower needed \$4,000 in gift funds to make the transaction occur and was left with reserves of only \$481. The property was a previous HUD Real Estate Owned property that sold within a year of the current transaction for \$2,000.

Narrative Case Presentation

The case had been with two other mortgagees and formally rejected by one prior to Colban's review.

C. Inadequate Property Valuation

The seller of this property purchased it from HUD on September 5, 2000 for \$2,000. The REO property was appraised on August 22, 1999 and given an as is value of \$15,300 and a repaired value of \$16,200. Having knowledge that this was a previous REO property, Colban inquired with the previous Mortgagee, who had obtain the HUD case number if they had followed the procedures in Circular Letter PH 00-05 in regards to acquiring a case number on REO properties. Circular Letter PH 00-05 requires that if the sale of a REO property took place within the last 12 months that the Mortgagee needs to submit certain documents to HUD for evaluation of the transaction. Colban received conflicting information from the previous mortgagee. Thus, they contacted the HOC and explained the situation. According to Colban's note, the HOC contended that the only obligation that Colban had was to ensure that the value of the subject property was supported by the appraisal. Thus, none of the required documentation was sent to the Philadelphia Homeownership Center for review.

The appraisal was conducted on December 7, 2000 and assessed the appraised value of the property as \$60,000. The appraiser made mention of the HUD foreclosure sale for \$2,000. Documents in the files only had the following statement about improvements to the property: The subject property was recently purchased as a two family home and converted to a single family home. Recent renovation work includes new floor coverings throughout, new heating system, updated plumbing and electrical, and a new roof. There was no other information in the files explaining how the property became worth \$60,000 when it was appraised at \$15,300, and took over a year to sell at \$2,000.

Based on the above information, we believe that it would have been prudent for Colban to have followed the instructions of Circular PH 00-05 and sent the required information to the Philadelphia Homeownership Center for an evaluation of the value and condition of the property.

Colban,s Comments

Colban indicated that they believe that the understated debt payment of \$10 had no bearing on the loan becoming delinquent. Colban disagrees with our analysis of the credit issues and stated that the borrower had some problems, but none that were outside the boundaries established by HUD. Concerning the property evaluation, Colban stated that they had contacted HUD and had followed the HUD staff person's recommendation and satisfied themselves that the value of the property was properly supported by the appraisals.

Narrative Case Presentation

OIG's Evaluation of Colban's Comments

Concerning the understated debt and credit issues it is our position that a reasonable/prudent person should have factored in all the questionable credit issues, and not approved the application. We believe, with the conflicting information and a large increase in property value, it would have been prudent for Colban to follow the instruction in Circulars PH 00-05 and have the HOC make an evaluation on the value and condition of the property.

Narrative Case Presentation

FHA Case Number: 372-3007955

Loan Amount: \$67,744

Settlement Date: 06/26/00

Status: Claim (Total amount paid by HUD \$74,848)

Payments before first Default Reported: 8

Summary

Colban approved the mortgage although the borrower did not meet the minimum required investment. Our audit disclosed that the borrower invested \$401.63 less than the required minimum cash investment. Therefore, HUD/FHA's decision to insure the loan was based on Colban's inaccurate representation that the borrower met HUD/FHA requirements.

Pertinent Details

A. Borrower Did Not Provide the Minimum Required Investment

The borrower's earnest money deposit of \$1,000, the cost paid at closing of \$276.77, the \$300 appraisal fee, and the \$55 credit report fee totals \$1,631.77 for the borrower's investment. The \$1,631.77 is \$401.63 less than the minimum required investment of \$2,033.40. The National Housing Act requires minimum cash investments to be 3 percent of the Secretary's estimate of the cost of acquisition. FHA has determined that the minimum cash investment be based on sales price without considering closing costs (Mortgagee Letter 98-29, October 22, 1998).

Earnest Money Deposit	\$1,000.00
Cash paid at Closing	\$276.77
Appraisal Fee	\$300.00
Credit Report Fee	\$55.00
Total	\$1,631.77
Statutory Requirement	\$2,033.40
Amount under statutory requirement	\$401.63

Colban,s Comments

Colban stated that the issue at hand is the consideration of the homeowners insurance payments paid outside of closing not counting towards minimum investment requirement. Colban stated that the reports interpretation penalizes borrowers by forcing them to make more than the required 3% investment. The hazard insurance is a legitimate prepaid expense that can be paid

Narrative Case Presentation

from the seller credit. The seller credits on the settlement statements reviewed were applied to prepaid first, then closing costs. Therefore, the seller credit being applied to the hazard insurance premium is basically a reimbursement of the borrowers out of pocket expense. If the hazard insurance premium were shown as being paid at closing and the seller credit was applied to it you would not question it, nor would it change the dollar amount of the borrowers investment.

OIG's Evaluation of Colban's Comments

We agree with the HOC's position that HUD does not permit discount points, prepaid expenses, etc., or any portion of such charges to be included as part of the borrower's cash investment when determining whether the minimum required investment is met

Narrative Case Presentation

FHA Case Number: 371-2979270

Loan Amount: \$109,518

Settlement Date: 07/24/01

Status: Current

**Payments before first
Default Reported:** 6

Summary

Colban approved the mortgage although the borrower did not meet the minimum required investment. Our audit revealed that the borrower invested \$598.61 less than the required minimum cash investment. Therefore, HUD/FHA's decision to insure the loan was based on Colban's inaccurate representation that the borrower met HUD/FHA requirements.

Pertinent Details

A. Borrower Did Not Provide the Minimum Required Investment

The borrower's earnest money deposit of \$1,000, the \$300 appraisal fee, the \$55 credit report fee and the cost paid at closing of \$1,740.39 totals \$3,095.39 for the borrower's investment. The \$3,095.39 is \$243.61 less than the minimum required investment of \$3,339. The National Housing Act requires minimum cash investments to be 3 percent of the Secretary's estimate of the cost of acquisition. FHA has determined that the minimum cash investment be based on sales price without considering closing costs (Mortgagee Letter 98-29, October 22, 1998).

Earnest Money Deposit	\$1,000.00
Appraisal Fee	\$300.00
Credit Report Fee	\$55.00
Cash paid at Closing	\$1,740.39
Total	\$3,095.39
Statutory Requirement	\$3,339.00
Amount under statutory requirement	\$243.61

Colban's Comments

Colban provide support that the appraisal and credit report fee were paid and we revised our analysis to include those items.

Narrative Case Presentation

FHA Case Number: 371-2898761

Loan Amount: \$45,436

Settlement Date: 11/15/00

Status: Current

**Payments before first
Default Reported:** 13

Summary

Colban approved the mortgage when the borrower did not meet the minimum required investment. Our audit disclosed that the borrower invested \$726.82 less than the required minimum cash investment. Therefore, HUD/FHA's decision to insure the loan was based on Colban's inaccurate representation that the borrower met HUD/FHA requirements.

Pertinent Details

- A. Borrower Did Not Provide the Minimum Required Investment
- B. Earnest Money Not Verified

According to HUD Handbook 4155.1 REV-4 CHG1, Paragraph 2-10A, if the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify the earnest money deposit amount and the source of funds. Satisfactory documentation includes a copy of the borrower's cancelled check. Colban did not verify the earnest money deposit, which was 2.2% of the contract sales price. The check used as evidence for the earnest money deposit payment was stamped "NSF"(Non Sufficient Funds). Also, there was no documentation to support the source of the donor's earnest money deposit payment amount. The final Loan Application did not indicate an earnest money payment amount.

The National Housing Act requires minimum cash investments to be 3 percent of the Secretary's estimate of the cost of acquisition. FHA has determined that the minimum cash investment be based on the sales price without considering closing costs (Mortgagee Letter 98-29, October 22, 1998). In this case the minimum investment was \$1,350. The HUD-1 indicated that the borrower made an investment of \$1,623.18. This included an earnest money deposit of \$1,000, of which \$298.18 was paid at closing, the appraisal fee of \$275, and the \$55 credit report fee. However, the \$1,000 earnest money deposit listed on the HUD-1 was not verified. As a result, we did not use this amount in calculating the borrower's investment.

Thus, the borrower did not meet the \$1,350 minimum required investment by \$726.82.

Narrative Case Presentation

Earnest Money Deposit	\$0.00
Cash paid at Closing	\$298.18
Appraisal Fee	\$275.00
Credit Report Fee	\$50.00
Total	\$623.18
Statutory Requirement	\$1,350.00
Amount under statutory requirement	\$726.82

Colban's Comments

Colban stated the file contains a check marked NSF and a letter from the realtor involved which states that the check bounced, but that upon redeposit it cleared the borrowers account. They accepted the information as verification that the borrower had in fact made a \$1,000.00 earnest money payment. Colban stated that they believe the borrower in fact did meet the 3 percent rule

OIG's Evaluation of Colban's Comments.

The realtor's statement is not sufficient documentation to support that the earnest money deposit was made.

Narrative Case Presentation

FHA Case Number: 372-2995679
Loan Amount: \$74,861
Settlement Date: 06/14/00
Status: Current
Payments before first Default Reported: 4

Summary

Colban approved the loan although the borrower had inaccurate closing documentation and questionable assets to close.

Pertinent Details

A. Inaccurate Closing Documentation

Our review disclosed that the HUD-1 stated the mortgage broker fee was paid outside of closing. However, the loan disbursement statement provided that the fee was paid at closing. The attorney's check to the mortgage broker indicates the mortgage broker was paid at closing. During our January 31, 2003 interview with the borrower, the borrower stated that it was his understanding that the mortgage broker fee was paid at closing from the amount due at settlement. According to the HUD-1, the settlement agent certified that he carefully reviewed the HUD-1 and it is a true and accurate statement of all receipts and disbursements made in the transaction. The settlement agent further certified that the HUD-1 is a true and accurate account of the transaction.

Narrative Case Presentation

FHA Case Number: 371-2900728

Loan Amount: \$85,956

Settlement Date: 11/09/00

Status: Current

**Payments before first
Default Reported:** 10

Summary

Colban approved the mortgage when the borrower did not meet the minimum required investment. Our audit disclosed that the borrower invested \$324.83 less than the required minimum cash investment. Therefore, HUD/FHA's decision to insure the loan was based on Colban's inaccurate representation that the borrower met HUD/FHA requirements. Also, Colban did not adequately verify gift funds.

Pertinent Details

A. Borrower Did Not Provide the Minimum Required Investment

The borrower's earnest money deposit of \$500, the \$1,450.17 paid at closing, the \$250 appraisal fee, and the \$55 credit report fee totals \$2,255.17 for the borrower's investment. The \$2,255.17 is \$324.83 less than the minimum required investment of \$2,580. The National Housing Act requires minimum cash investments to be 3 percent of the Secretary's estimate of the cost of acquisition. FHA has determined that the minimum cash investment be based on sales price without considering closing costs (Mortgagee Letter 98-29, October 22, 1998).

Earnest Money Deposit	\$500.00
Cash paid at Closing	\$1,450.17
Appraisal Fee	\$250.00
Credit Report Fee	\$55.00
Total	\$2,255.17
Statutory Requirement	\$2,580.00
Amount under statutory requirement	\$324.83

B. Inadequate Gift Verification

Colban loan files did not contain adequate gift documentation to support the financial gifts received by the borrower. Mortgage Letter 00-28, dated August 7, 2000, provides the specific

Narrative Case Presentation

requirements for borrowers using a gift to financially qualify to purchase a property. The file must contain a gift letter specifying the dollar amount, signed by the donor, the donor's name, address, telephone number, and relationship to the borrower, and a statement that the funds were not made to anyone with an interest in the transaction. In this case the borrower had four gift letters totaling \$15,824.13, two of the gift letters were used to pay off existing debts of the borrower. These two gift letters did not identify the dollar amount or contain a statement that the funds were not made to anyone with an interest in the transaction.

Also, gift amounts were not listed on the Mortgage Credit Analysis Worksheet (MCAW). Colban did not fully complete the MCAW to include the funds received as a gift by the borrower in the amount of \$15,824.13.

Colban's Comments

Colban states that again the issue of homeowners insurance is the problem here in the minimum required investment.

OIG's Evaluation of Colban's Comments

Again we agree with the HOC's position that HUD does not permit discount points, prepaid expenses, etc., or any portion of such charges to be included as part of the borrower's cash investment when determining whether the minimum required investment is met.

Narrative Case Presentation

FHA Case Number: 372-3050612
Loan Amount: \$68,964
Settlement Date: 11/30/00
Status: Current
Payments before first Reported Default: 16

Summary

The HUD-1 indicated that the broker fee was paid outside of closing; however, the closing documents indicated that the payment was made from the loan proceeds.

Pertinent Details

A. Inaccurate Closing Documentation

Our review disclosed that the HUD-1 showed that the mortgage broker fee was paid outside of closing. However, the loan disbursement statement provided that the fee was paid at closing. The attorney's check to the mortgage broker indicates the mortgage broker was paid at closing. During our January 31, 2003 interview with the borrower, we were told that it was her understanding that the mortgage broker fee was paid at closing from the amount due at settlement. According to the HUD-1, the settlement agent certified that he carefully reviewed the HUD-1 and that it is a true and accurate statement of all receipts and disbursements made in the transaction. The settlement agent further certified that the HUD-1 is a true and accurate account of the transaction. Thus, this indicates that the mortgage broker fee was paid at the time the loan proceeds were disbursed and that the HUD-1 incorrectly stated that it was paid outside of closing.

Narrative Case Presentation

FHA Case Number: 371-2998785

Loan Amount: \$122,035

Settlement Date: 09/28/01

Status: Current

**Payments before first
Reported Default:** N/A

Summary

Colban approved the mortgage although the borrower did not meet the minimum required investment. Our audit disclosed that the borrower invested \$304 less than the required minimum cash investment. Therefore, HUD/FHA's decision to insure the loan was based on Colban's inaccurate representation that the borrower met HUD/FHA requirements. Furthermore, Colban approved the loan although the borrower had questionable debt.

Pertinent Details

A. Borrower Did Not Provide the Minimum Required Investment

The borrower's earnest money deposit of \$500, the \$2,556 paid at closing, the \$275 appraisal fee, and the \$55 credit report fee totals \$3,386 for the borrower's investment. The \$3,386 is \$304 less than the minimum required investment of \$3,690. The National Housing Act requires minimum cash investments to be 3 percent of the Secretary's estimate of the cost of acquisition. FHA has determined that the minimum cash investment is to be based on sales price without considering closing costs (Mortgagee Letter 98-29, October 22, 1998).

Earnest Money Deposit	\$500.00
Cash paid at Closing	\$2,556.00
Appraisal Fee	\$275.00
Credit Report Fee	\$55.00
Total	\$3,386.00
Statutory Requirement	\$3,690.00
Amount under statutory requirement	\$304.00

Narrative Case Presentation

B. Inadequate Debt Verification

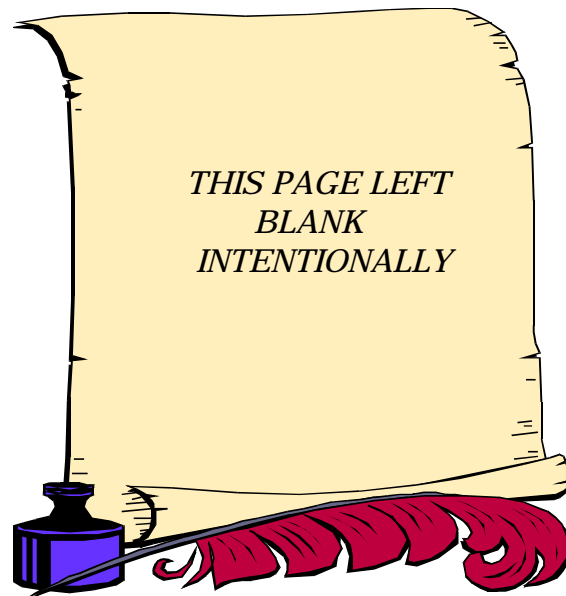
Our review determined that according to the credit report, the borrower's monthly payment totaled \$523. However, Colban did not include a \$261 monthly payment in its calculation, citing the fewer than 10 payment rule of HUD Handbook 4155.1 REV-4 CHG1, Paragraph 2-11A as the reason. At the time, the borrower had more than 10 payments remaining on this debt. Colban assumed the borrower would make the next payment on this debt, thereby, projecting this rule into the future. With this payment included in the borrower's total monthly payment, the borrower's back-end ratio would have increased from 50.57% to 59.04%. During an interview, the underwriter said that it was reasonable to project the 10-payment rule into the future for the \$261 monthly payment. However, we believe that prudent business practices would have required the underwriter to ensure that the borrower actually made the payment.

Colban's Comments

Colban states that again the issue of homeowners insurance is the problem here. Concerning the debt verification, Colban stated that with the borrowers quality history of paid all other monthly payments on time was safe to make that call that they would make the next payment due on time.

OIG's Evaluation of Colban's Comments

Again, we agree with the HOC's position that HUD does not permit discount points, prepaid expenses, etc., or any portion of such charges to be included as part of the borrower's cash investment when determining whether the minimum required investment is met. HUD has established a standard it expects mortgagees to adhere to and that standard is 10 or fewer payments. Colban should have ensured that the borrower actually made the additional payment.

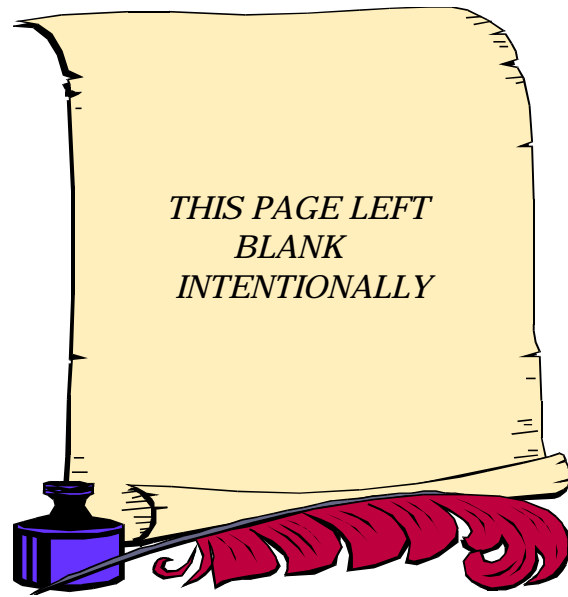


 Schedule of Questioned Costs and Funds Put to Better Use

<u>Finding Number</u>	Type of Questioned Costs <u>Ineligible 1/</u>	Funds Put to <u>Better Use 2/</u>
1	\$214,889.45	\$658,880
2	---0---	---0---
3	<u>---0---</u>	<u>---0---</u>
Total	<u>\$214,889.45</u>	<u>\$658,880</u>

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 put to better use are costs that will not be expended in the future if our recommendations are implemented, for example, costs not incurred, de-obligation of funds, Withdrawal of Interest, Reductions in Outlays Avoidance of Unnecessary Expenditures, Loans and Guarantees not made, and Other Savings.



Auditee Comments



July 7, 2003

Mr. Patrick C. Anthony, Auditor
U.S. Dept. of Housing and Urban Development
Office of Inspector General
465 Main Street
Lafayette Court
Buffalo, NY 14203

Re: Audit Responses

Dear Mr. Anthony,

I would like to begin this process by addressing each of the Narrative Case Presentations (NCP) that were made as part of your recent audit. After each response I will indicate what has already been done or what pending changes will be put into practice to keep the occurrence from being repeated. After completing the 12 responses I will address the issues of mortgage brokers involvement and Quality Control follow-up.

1. 372-30375 14 / Wimes

After a thorough review of this file it appears that we approved this borrower with the understanding that the funds they would be investing in the transaction were in excess of \$2,100.00. The actual closing cost figures required the borrower to bring approximately \$1,100.00 less. The borrower did in fact come up short of the minimum required investment, and unfortunately this variation was not brought to our attention by the closing attorney. I acknowledge that Colban is ultimately responsible for ensuring that all the rules are followed but this error in communication should not be seen as a contributing factor to the delinquency, and ultimate default of this loan.

When this type of problem was pointed out during our initial HUD audit we immediately required that the minimum cash investment amount be reported to the closing attorney on our closing instruction sheet, and that we be notified of any amounts falling below that level so all necessary adjustments can be made. This review and notification request seems to be working well, and we certainly are hopeful that it has eliminated this problem.

3401 EAST MAIN STREET, ENDWELL, NY 13760 • OFFICE: 607 754-5529 • FAX: 607 748-6339
Licensed Mortgage Banker - New York State Banking Department

2. 372-3025355 / Dietterich

Freddie Mac's matrix requirements for no cash out refinances does state that if the closing costs total more than 4% of the loan amount then the source of those funds must be verified. The matrix does not state what sources are acceptable, and in speaking with Tricia Tubbs from Loan Prospector's underwriting hotline it appears that as long as we can document that borrower has those funds available to them either in the form of cash in the bank or equity in their home then we have met that requirement. The NCP referred to the fact that the HOC said that Colban had to verify the source of funds, which I believe we accomplished by determining that the borrower had sufficient equity to add the amount necessary to the mortgage. In addition to that, the question raised over the borrowers ability to cover the broker fee and other costs paid outside closing (appraisal and credit) is responded to by stating that the balance in the Elmira Savings Bank savings account of \$1,933 was after \$355.00 was removed on July 7, 2000. The same day the borrower wrote us a check for the same amount. The additional \$207 that the borrower received at closing added to the \$1,933 gave her a total of \$2,140 to work with which is \$105.00 less than what was needed. It is our contention that the borrower could have easily saved the additional money during the 2.5 months between application and closing.

With a clearer understanding of this LP matrix item our staff will always verify the portion of the funds that the borrower has to bring in cash to close. The portion being added to the mortgage will be verified as being part of the proceeds of the loan transaction.

I believe this item should be removed from the findings

3. 371-2856125 / Pierce

Asset Verification: The earnest money was not verified as it was in an amount less than 2% of the purchase price, and it is our understanding that in those cases the funds are not required to be verified. The appraisal and credit report moneys that we received from the borrower was in the form of a check that cleared their account, and I would assume that it did prior to the deposit of the gift funds 2 weeks later. The gift funds were sufficient to cover the amount of closing costs, and in addition to that the contract stipulated that the borrower would receive their security deposit back from the seller at the time of closing which was estimated at \$650.00. In fact the HUD I indicated a refund of \$610.00. That combined with the gift more than covered estimated costs.

Debt Verification: The question here is whether or not it is reasonable to assume that the borrower, who had missed no payments of this loan, who had a spotless rental verification, and paid all other monthly payments on time would make the next payment due on time. Our argument is obvious; With the quality history it was safe to make that call.

I have requested that in the future, even though I believe that in certain cases (This being one of them) it is not warranted, that our staff ensure that the necessary payments have been made. As I stated above I feel that we acted prudently and that this case be removed from the findings.

4. 371-2919310/Price

Debt Understated: In reviewing the file it does appear that the \$10.00 payment to the utility company was not included in the underwriting, but I am comfortable in stating that the .005 difference in the total debt to income ratio is not a factor in whether or not this loan was going to be approved, and certainly had no bearing on why this loan went delinquent.

Borrower Credit Issues: The NCP references numerous credit issues that should have caused us to reject the application. The first item referenced is the Chapter 13 Bankruptcy. I believe that HUD guidelines provide for the approval of borrowers who have filed in such a manner. The key condition is that the payment schedule is and has been current. We verified that the borrower was in fact current and had been since the schedule started. This is not grounds for rejection. A review of the credit report indicates that the utility collection was opened in June of 1997 and that arrangements were made at that time. It could have been included in the bankruptcy but wasn't, and the borrower continued to make payments to utility. The utility continues to show her late because she continues to owe them money and the partial payment is not enough to bring her current. We rated her 10 year rental history with no late payments much higher. In addition to that the fact that her history on three auto loans were all paid as agreed. The next issue raised in the NCP was the fact that the borrower source of funds was a \$4,000.00 gift. I believe that HUD guidelines permit the use of gift funds for all of or a portion of the costs to close. I cannot figure out why we should deny a borrower based on the fact that there are gift funds being used. In addition to that the NCP states that the borrower had only \$481.00 in reserves. Again it is my understanding that HUD does not require reserves, and that many borrowers have no reserves at all. In this case a woman, whose husband had recently died, was trying to make a fresh start. She had some problems, but none that are outside the boundaries established by HUD.

Property Evaluation: The NCP indicates that the property previously took a year to sell and generated a price of \$2,000.00. It goes on to state that it was appraised for a value ranging from \$15,300 to \$16,200. And that we should have followed procedures outlined by HUD when we saw the purchase price of \$60,000.00. It is accurately stated that we received conflicting information from the previous mortgagee, and being unsure of how to proceed we elected to contact Gerry Glavey at the Philadelphia HOC. He stated that our obligation was to make sure we satisfied ourselves that the value of the property was properly supported by the appraisal. I can't think of any safer move than to contact the HOC to get a ruling when there are gray areas surrounding issues such as this. I will also make a brief commentary regarding the audit comment regarding support for the \$60,000.00 appraisal. It reviews various items that were done to increase value. The largest of these is the transition of this property from a two family to single family. FHA approved appraisers I spoke with all indicate that all things being equal the single family property would be worth more than the two family. All of the improvements made, although not appearing to the auditor to be significant, are the types of improvements that add more value than the cost of doing them. On top of it all the appraisal

supported the value. Solid comparables were used, with two of the 4 used being on the same street, and all sale dates were within six months. It is my contention that we followed Mr. Glavey's recommendation to the letter, and proceeded with reasonable care.

Based on my review of this NCP and subsequent review of the file I believe that these items should be removed from the findings.

5. 372-3007955 / Mihalovich

NCP states that the borrower did not meet minimum required investment. The issue at hand is the consideration of the homeowners insurance payment. I would like to include in my comments the interpretation of our underwriter" regarding hazard insurance payments paid outside of closing not counting towards minimum investment requirement; it appears that your (the auditors) interpretation penalizes borrowers by forcing them to make more than the required 3% investment. The hazard insurance is a legitimate prepaid expense that can be paid from the seller credit. Hazard insurance companies require payment before they will issue a binder, therefore the premium is by necessity paid outside of closing. The seller credits on the settlement statements reviewed were applied to prepaid first, then closing costs. Therefore, the seller credit being applied to the hazard insurance premium is basically a reimbursement of the borrowers out of pocket expense. If the hazard insurance premium were shown as being paid at closing and the seller credit was applied to it you would not question it, nor would it change the dollar amount of the borrowers investment. I believe that your (the auditor) interpretation of this issue is not in the best interest of borrowers and does not follow the intent of ML 98-29"

I would ask that the HOC review this thought process and determine its validity. If HOC agrees with us then I would ask that this item be removed from the findings. If they do not agree I would ask that we receive the reasons why in writing, and would cease using the homeowners insurance costs as part of the required investment. In either case, due to the confusion over this item, I would ask that the item be removed from the findings

6. 37 1-2979270 / Rippey

NCP states that borrower did not meet required investment. There are two issues to reference. The first one deals with the Appraisal and credit money (total of \$355.00) could not be documented. Had the auditor requested this information it could have been provided. The file contained a bank statement from First Choice that shown CK# 192 for \$355.00 clearing the account on 5-18. We made a copy of the check before deposit and the check number agrees. The check which was made payable to MORPAC, and endorsed to us was deposited into our account on 5-17. I have attached documentation to support those items. That brings the shortfall to \$243.63. The second issue is the homeowners insurance question reviewed in #5 above.

I would ask that the HOC review the thought process referenced in #5 above and determine its validity. If HOC agrees with us I would ask that this item be removed from the findings. If they do not agree I would ask that we receive the reasons why in writing, and would cease

using the homeowners insurance costs as part of the required investment. In either case, due to the confusion over this item, I would ask that the item be removed from the findings.

7. 371-2898761 /Borcilo

NCP states that the borrowers earnest money was not verified and therefore the borrower did not meet the minimum required cash investment. We do have in our file the check marked NSF and a letter from the realtor involved which states that the check bounced, but that upon redeposit it cleared the borrowers account. We accepted the information as verification that the borrower had in fact made a \$1,000.00 earnest money payment. That being the case I believe the borrower in fact did meet the 300 rule.

I believe that based on the above that this item should be removed from the findings.

8. 372-2995679 / Medlock

NCP states that assets needed to close were not accurately verified. Using the figure of \$7,837.34 as the funds necessary to close, I would state that we more than readily verified that the borrower had the necessary funds to close. I believe that when we verified the receipt of the funds withdrawn from the borrowers 401k account that the deposit receipt indicated a balance of \$8,855.20. This was as of April 26th. In addition we received another account listing from ESL FCU showing a balance in the same account was \$9,085.06 as of April 29th.

Based on the above information, of which copies are supplied, I request that this item be removed from the findings.

The NCP also states that there was inaccurate closing documentation. I have no explanation for this item, and I do not know the circumstances as to why the check was cut the way it was. I can only assume that it was for the convenience of the borrower. Although it is after the fact, this attorney is no longer closing loans for us. If in the future we elect to consider them we will ensure that they understand the shortcomings to this practice so it is not repeated.

9. 37 1-2900728 / Hull

NCP states that the borrower did not meet the minimum required investment. Again the issue of homeowners insurance is the problem here. Please see #5 above for explanation as to our position.

I would ask that the HOC review the thought process referenced in #5 above and determine its validity. If HOC agrees with us I would ask that the item be removed from the findings. If they do not agree I would ask that we receive the reasons why in writing, and would cease using the homeowners insurance cost as part of the required investment. In either case, due to the confusion over this item, I would ask that it be removed from the findings.

NCP also states that Colban did not adequately verify gifts. The two gift letters in question

were older forms that should have been replaced by the more current form prior to closing. Unfortunately they were not. Our staff is aware of the required wording and I have been informed that this area will be checked more closely in the future. The dollar amount did not appear on the gift letters, however the gift letters specifically stated what items the gift was going to pay off and right behind the gift letter in the file were the payoff amounts for those items Underwriter believes, as do I, that although it would have been cleaner to have had the dollar amount written on the gift letter, that the wording and additional back up data should be sufficient. I would also like to state that the use of the wrong forms is not the reason this loan went delinquent.

Based on that I would request that the item be removed from the findings.

10. 372-3050612 / McWhorter

NCP states that there was inaccurate closing documentation. I have no explanation for this item, and do not know the circumstances as to why the check was cut the way it was. I can only assume it was for the convenience of the borrower. Although it is after the fact, this attorney is no longer closing loans for us. If in the future we elect to consider them we will ensure that they understand the shortcomings to this practice so it is not repeated.

11. 371-2835676 / Reed

NCP states that assets needed for closing not adequately verified. The amount in question here is \$186.00 I feel that it is reasonable to assume that the borrower could easily save the additional funds needed to close. Please review attached e-mail between our underwriter and John Cullen from HUD. "if it involves a small sum of money needed to close then it is a judgment call made by the underwriter at the time of closing. I feel that \$186.00 qualifies as a small sum of money, and would therefore ask that this item be removed from the findings.

12. 371-2998785 / Girma

NCP states that the borrower did not meet the minimum required investment. Again the issue of homeowners insurance is the problem here. Please see #5 above for explanation as to our position.

I would ask that the HOC review the thought process referenced in #5 above and determine its validity. If HOC agrees with us I would ask that the item be removed from the findings. If they do not agree I would ask that we receive the reasons why in writing, and would cease using the homeowners insurance cost as part of the required investment. In either case, due to the confusion over this item, I would ask that it be removed from the findings

Debt Verification: The question here is whether or not it is reasonable to assume that the borrower, who had missed no payments of this loan, who had a spotless rental verification, and paid all other monthly payments on time would make the next payment due on time. Our argument is obvious; With the quality history it was safe to make that call.

I have requested that in the future, even though I believe that in certain cases (This being one of them) it is not warranted, that our staff ensure that the necessary payments have been made. As I stated above I feel that we acted prudently and that this case be removed from the findings.

This concludes my comments on the twelve Narrative Case Presentations. I look forward to hearing from you regarding my comments and requests.

I would at this time like to comment on a couple of other issues raised in the audit.

1. The audit comments that Colban used non-FHA approved entities to originate FHA/HUD insured mortgages. Let me begin by clearly stating that we do not allow non approved entities to originate mortgage loans on our behalf. We explained repeatedly that the broker, who is not working for us in any way, and who has in fact been hired by the borrower to consult with them over the mortgage process does not originate the loan. Origination can really only occur when the loan is processed, underwritten, and closed. The borrower seeks out the broker and agrees to hire them. The broker/consultant assists their client by helping with the completion of the application, and explaining what documentation will be requested by Colban. The package of documents is sent to Colban, and from that point we send out all verifications, order the appraisal and credit reports and perform all of the underwriting. We issue the commitment letter, provide all the instruction to the attorneys, and fund the loan. I would say that Colban Funding clearly is the originator of these loans. Colban does not pay the broker for their time, the borrower does. To sum up this part of my thinking let me clearly state again that helping someone complete an application is not the origination of a loan. We offer each applicant the opportunity to meet with on a face to face basis to discuss their application, and although many refuse to meet we believe we continue to meet the requirements of being the originating source. If there are changes to be made with the way we are handling these files, we will be willing to comply. More specific direction from the HOC would be helpful for both sides. I would like to finish this section by saying that since there are numerous lenders operating in the same or similar fashion that Colban is that a formal policy be disseminated to all lenders.

During our original HUD audit it was discovered that there were files that contained fax documents from the broker. I questioned the manager of the office and was told that that in fact was happening. I informed her that effective immediately that process had to cease. In those cases where documents needed to be received from the borrower that they needed to come directly from the borrower, and that we would return any original received. It is my understanding that that is what is being done at this point in time. The receipt of fax documents, and the stamping of them as copies of the original was inappropriate and has been discontinued.

Three loans were in fact received from approved Loan Correspondents (LC) and not reported as such in that we treated those applications the same as those we receive by mail. We do all the processing, underwriting and closing functions. Based on the fact that the LC didn't really act in that capacity we felt that it should not be reported as such. If it is the wish of the HOC that we report that way, regardless of what the LC does we will immediately begin doing so. Please advise us on this issue.

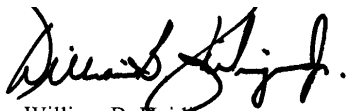
Seller contributions used to pay mortgage broker fees for the borrower. We will continue to follow the direction received from Richard Nodine from the HOC regarding the use of seller fees. Until such time as the HOC clearly states in the form of a Mortgagee Letter that it is not permissible we can only assume that Mr. Nodine was speaking for the HOC, and that what is happening is allowable. The audit references the concern that a number of borrowers who relied on the seller to cover the fee to their consultant/broker did not have the funds to do so themselves. My response would be why would they need those funds if the seller was paying them, and it was permissible to do so. I think the reference to this item should be removed from the findings because there is nothing definitive stating the seller can't pay.

The audit also made comment regarding the fact that seller paying the consultant/broker fee may contribute to higher sales prices and loan amounts. Let me suggest to you that almost every loan that has any type of seller concessions (6% or otherwise) has the purchase price raised to accommodate the seller payment. If for one minute you think that there are a lot of sellers out there who are desperate enough to give up 6% of their proceeds to facilitate their sale I think it would be important to rethink. It would be my impression that 95 to 99% of transactions of this type have the sales price higher than it needs to be so the seller gets what they want and the borrower gets what they need. I would like to see any reference to this situation be removed from the findings, as it appears to be common practice, with the HOC making no specific comment to the contrary. In addition HUD has come out supporting the use of Non Profits for the purpose of assisting the borrower towards their dream of home ownership. Again let me state that nearly every one of those dollars provided to buyers come from the seller through the Non Profit. I am certain that in almost all those cases as well that the price of the home was inflated to absorb the sellers contribution. I would think that until such time as the practice is outlawed in some fashion and the Non Profits being stopped then, as I said, I think this finding and subsequent commentary needs to be removed from the audit.

2. Quality Control Issues that were referenced in the Audit do exist. I review the findings with my assistant, who in turn discusses the issues with the appropriate party or parties. Unfortunately we have not been formally documenting the discussion of, the responses to and the corrective action taken. We will begin that process immediately.

I have tried to be as complete in my responses as possible, but should any questions arise after the review of this document, please feel free to contact me immediately. Again let me say thank you for being as helpful as possible, and for helping us to become better at what we do. Our goal is to provide access to the tools necessary for potential homebuyers and to do it within the established rules. As I stated during our exit conference one of the reasons we have new people managing our Syracuse branch is that I had become uncomfortable with some of the methods and practices of the former management team. I believe that overall things will be run more appropriately from this point forward. I look forward to hearing from you regarding the next steps.

Very Truly Yours,



William B. Haidinger
President