AUDIT REPORT

CAMBRIDGE HOME CAPITAL, LLC
NON-SUPERVISED MORTGAGEE
GREAT NECK, NEW YORK

2004-NY-1003

July 19, 2004

OFFICE OF AUDIT
NEW YORK/NEW JERSEY

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2004-NY-1003

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

Alexander C. Malloy

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

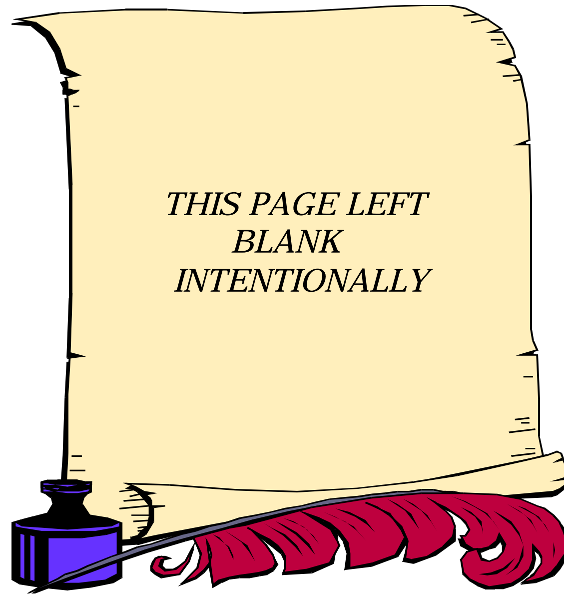
SUBJECT: Cambridge Home Capital, LLC
Non-Supervised Mortgagee
Great Neck, New York

We completed an audit of Cambridge Home Capital, LLC (Cambridge), a non-supervised mortgagee. The objectives of the audit were to determine whether Cambridge: (1) 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) developed and implemented a Quality Control Plan that meets HUD/FHA requirements. The review covered the period between September 1, 2001 and August 31, 2003.

Our review concluded that Cambridge did not always adhere to prudent lending practices during the approval process of 11 of the 18 loans that we examined during our audit. In addition, we found that Cambridge did not document variations in its mortgage charge rate and that its Quality Control Plan has not been fully implemented.

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 decision. 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.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Executive Summary

We completed an audit of Cambridge Home Capital, LLC (Cambridge) in Great Neck, New York, a non-supervised mortgagee. The objectives of the audit were to determine whether Cambridge: (1) 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) developed and implemented a Quality Control Plan that meets HUD/FHA requirements. The audit covered the period between September 1, 2001 and August 31, 2003 and involved a review of 18 HUD/FHA insured loans that totaled $4,190,050. A summary of the results of our review is provided below.

Eleven loans with underwriting deficiencies

We concluded that Cambridge did not always adhere to prudent lending practices in approving 11 of the 18 HUD/FHA insured loans we reviewed. In particular, we noted that 11 of the 18 loans had at least one significant underwriting deficiency. Some of the underwriting deficiencies identified are as follows:

Underwriting processing deficiencies

- Debt/Income Ratios Exceeded HUD/FHA Standards
- Inadequate Property Valuation
- Inadequate Asset Verification
- Inadequate Income Verification
- Insufficient Gift Information
- Inadequate Debt Verification
- Minimum Investment Not Provided
- Bankruptcy Discharge less than 2 Years

We believe that the underwriting deficiencies occurred because Cambridge did not ensure that the loans were approved in accordance with HUD/FHA requirements and did not ensure that its Quality Control Plan was being fully implemented. As a result, mortgages were approved for unqualified borrowers causing HUD/FHA to assume an unnecessary insurance risk.

Variations in mortgage charge rates were not documented

Also, our review disclosed that Cambridge did not document variations in its mortgage charge rate. HUD's Tiered Pricing Rule limits the variation in the mortgage charge rate to FHA single-family borrowers when the borrowers 'lock in' the interest rate on or around the same day, using the same mortgage type (e.g., 30 year fixed), and the properties financed are located in the same geographical area. The rule prohibits any variation of more than two-percentage points in mortgage charge rates (discount points, loan origination, interest rate and other fees,

combined). The rule also requires that, for variations in the mortgage charge rates up to two percentage points, the lender base the charges on actual costs incurred in the origination of each respective FHA loan, provide a justification for the variance in the loan file, and retain the record for two years.

Cambridge did not document, nor provide adequate justification for variations in its mortgage charge rates. As a consequence, we believe Cambridge's lending practices may unfairly impose greater borrowing costs on some FHA borrowers. Moreover, we could not determine whether the borrowers received anything of value for discount points that were charged. We attribute this to Cambridge's failure to properly monitor to ensure compliance with HUD requirements on mortgage charge rates, overages, and tiered pricing.

Weaknesses in Quality Control Plan Implementation

In addition, Cambridge has not implemented procedures or established controls to ensure that all loans defaulting within six months of closing undergo a quality control review. This occurred because Cambridge did not ensure that its Quality Control Plan was being fully implemented. Consequently, Cambridge is not fully utilizing its Quality Control Plan, which is designed to enhance and maintain accuracy, validity, and completeness in its loan origination process.

Recommendations

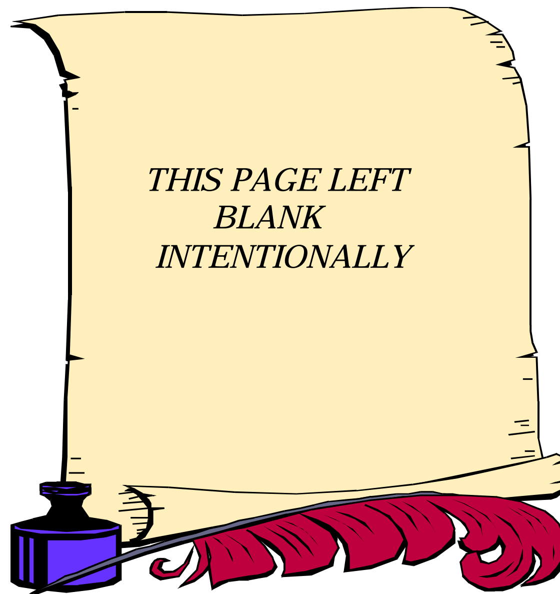
Regarding the first finding, we recommend that Cambridge reimburse HUD/FHA for losses on four of the loans that have gone to claim/partial claims and indemnify HUD/FHA against future losses on 10 of the 11 loans identified in Appendix A of this report. Also, Cambridge should provide your office with a corrective action plan containing assurances that all 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.

Although our audit disclosed significant deficiencies relating to loan underwriting, quality control, and mortgage charge rates, we noted Cambridge has restructured its operations to address some of these deficiencies. For instance, Cambridge has replaced some of its underwriters and no longer contracts with most of the appraisers utilized during the audit period. Cambridge acknowledged that the

operational changes were initiated because they became aware of certain weaknesses associated with past practices. Cambridge has been proactive in an effort to affect positive change within its operating and control environments. Notwithstanding, Cambridge needs to address the deficiencies sited in this report to prevent HUD from assuming an unnecessary insurance risk on HUD/FHA insured mortgages.

Exit conference

The results of our audit were discussed with Cambridge personnel throughout the course of the on-site audit work. We forwarded a copy of the draft report for review and comment to Cambridge on May 11, 2004 and held an exit conference on June 16, 2004 at Cambridge's Offices. We received Cambridge's narrative response and supporting documentation at the exit conference. Cambridge requested that the narrative response and supporting documentation be included in whole in the report. We included excerpts of the comments with the findings, and provided the complete text in Appendix D of this report; we did not attach the supporting documentation because it was too voluminous.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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

Introduction

Cambridge Home Capital, LLC (Cambridge) is a non-supervised mortgagee located at 80 Cuttermill Road, Great Neck, New York. Cambridge became an authorized Direct Endorsement mortgagee on November 12, 1999 and currently underwrites HUD/FHA insured loans and conventional loans. During our audit period from September 1, 2001 to August 31, 2003 Cambridge originated, under its Direct Endorsement Program, 436 HUD/FHA insured loans amounting to $108,721,834 in the New York Field Office area. At March 31, 2004, the mortgages for 41 of the 436 loans were in default status.

Audit Objectives

The objectives of the audit were to determine whether Cambridge: (1) adhered to prudent lending practices and approved insured loans in accordance with U.S. Department of Housing and Urban Development/Federal Housing Administration (HUD/FHA) rules and regulations; and, (2) developed and implemented a Quality Control Plan that meets HUD/FHA requirements.

Audit Scope and Methodology

The purpose of our review was to confirm the accuracy of the 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 selected a sample of 18 loans from HUD's Neighborhood Watch System with beginning amortization dates between September 1, 2001 and August 31, 2003. In selecting our sample we focused on identifying loans currently in default, which had very few or no payments made prior to a first reported default. As a result, the sample of 18 loans consisted of loans where borrowers made less than seven payments prior to the first reported default. The 18 loans in our sample were HUD/FHA insured loans that totaled $4,190,050. The results of our detailed testing only apply to the 18 loans selected and cannot be projected over the universe of the 436 loans.

In 14 of the 18 loans in our sample there was a prior sale within one year of the closing date. Many of these properties involved rehabilitation and had a significant increase in the sales price of the property. As a result, we selected eight of the properties to have the appraisals reviewed by the OIG appraiser. The purpose of the reviews was to determine if the estimated value ascribed in the appraisal report was adequately supported; and if not, should Cambridge have known that the appraisal was deficient and returned it to the appraiser for corrections and explanations.

In addition, we used Audit Command Language (ACL) software to analyze data provided by Cambridge on all 436 loans relating to discount points and mortgage charge rates.

Our file review and audit procedures included: (a) analyses of borrowers' income, assets, and liabilities; (b) verifications of selected data on the settlement statements; (c) desk reviews of selected appraisals; (d) analyses of discount points and mortgage charge rates; and, (e) inquiries with borrowers, HUD Officials, and Cambridge staff.

Audit Period

We performed the audit fieldwork between November 2003 and May 2004. Our audit pertained to loans originated between September 1, 2001 and August 31, 2003. As necessary, we reviewed loan activity prior and subsequent to our audit period. Our audit work was performed at Cambridge's office in Great Neck, New York. 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 Cambridge did not adhere to prudent lending practices when approving 11 of the 18 loans that we examined during our audit. We noted that underwriting deficiencies occurred because Cambridge personnel did not assure that the loans were processed in accordance with all applicable HUD/FHA requirements and did not ensure that its Quality Control Plan was being fully implemented. 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-l, 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, Cambridge did not always adhere to the above requirements, as discussed below, when it underwrote 11 of the 18 loans we reviewed.

Examined 18 loans

Our examination of 18 loans approved by Cambridge between September 1, 2001 and August 31, 2003, disclosed that Cambridge either did not follow all applicable HUD requirements or did not exercise the care expected of a prudent lender in approving 11 of those loans. Consequently, we found significant underwriting deficiencies in those 11 cases, as shown below:

Deficiencies	Number of Loans
Ratios Exceeded HUD/FHA Standards	8 of 11 loans
Inadequate Property Valuation	8 of 11 loans
Inadequate Asset Verification	2 of 11 loans
Inadequate Income Verification	1 of 11 loans
Insufficient Gift Information	1 of 11 loans
Inadequate Debt Verification	1 of 11 loans
Minimum Investment Not Provided	1 of 11 loans
Bankruptcy Discharge < 2 Years	1 of 11 loans

For example, our review of FHA case number 374-3830526 disclosed that debt-to-income ratios exceeded

HUD/FHA standards. The borrower's mortgage payment expense to effective income ratio was 38.85 percent and the total fixed payment to effective income ratio was 46.80 percent. HUD Handbook 4155.1 REV-4, Paragraph 2-12 states that these ratios cannot exceed 29 percent and 41 percent respectively without listing compensating factors. The compensating factors provided on the Mortgage Credit Analysis Worksheet did not provide adequate justification for approving the loan with ratios exceeding the HUD/FHA standards.

For FHA Case number 374-3999860, our review of the appraisal disclosed several items that should have alerted Cambridge to problems with the appraisal report. For example, the appraiser did not comment as to the dollar amount of the renovations included in the value estimate, nor did the appraiser comment on the quality of the renovation work. The appraiser did not disclose the source or verify any cost of the renovation work. The appraisal report indicates a price range of $145,000 to $290,000 with the predominant price being $225,000. The appraiser's value estimate of $262,000 is considerably higher than the predominant price and no explanation is provided. Also, the appraiser indicates that this property has a separate unit in the basement consisting of a kitchen, bath, bedroom, and a den/living room. This is not acceptable for FHA mortgage insurance. Basement living units do not meet FHA's acceptability criteria. As a result, the appraisal did not adequately support the ascribed value estimate. The above items are indicators of problems with the appraisal and, as such, should have caused Cambridge to question the reliability of the appraisal report before accepting it.

At March 31, 2004, the mortgages of nine of the eleven loans were in default, one of the loans was current, and one had gone to claim. At the completion of our audit fieldwork, HUD had paid $146,530, representing partial claims on three loans and a full claim on one loan. This amount represents a loss to the government and is considered a disallowed cost. Thus, the amount should be reimbursed to HUD. The ten HUD/FHA insured loans that have not gone to full claim had delinquent mortgages amounting to $2,258,900. We are requesting indemnification for those 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 Cambridge representatives did not adhere to HUD/FHA requirements, comply with prudent lending practices and did not ensure that its Quality Control Plan was being fully implemented. 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

Cambridge's comments are included with the individual narrative case presentations in Appendices B-01 to B-11.

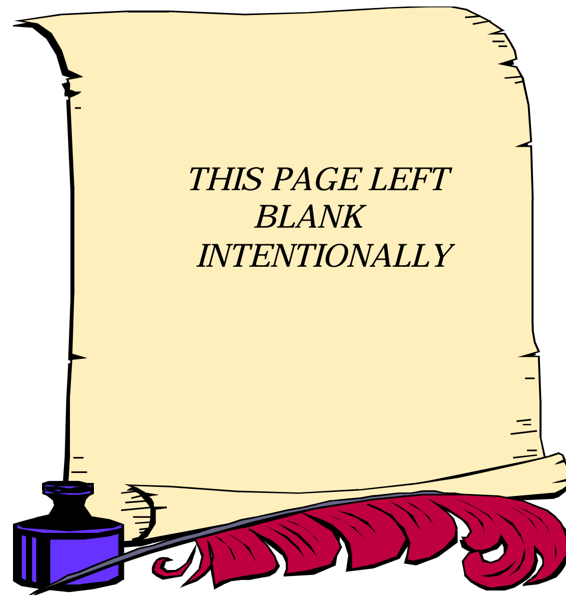
Recommendations

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

1A. Reimburse HUD for the actual loss of $96,265 on case number 374-3772590 and for the partial claim payments of $50,265 on case numbers 374-3956133, 374-3778152, and 374-3913246, which amount to a total of $146,530 (See Appendix C).

1B. Indemnify HUD/FHA against future losses on ten of the loans in question (374-3726304, 374-3776804, 374-3935308, 374-3833863, 374-3830526, 374-3999860, 374-4048106, 374-3956133, 374-3778152, and 374-3913246). The mortgage amounts associated with these loans total $2,258,900, which will be considered funds put to better use when indemnified (See Appendix C).

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.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Cambridge Did Not Document Variations in its Mortgage Charge Rate

HUD's Tiered Pricing Rule limits the variation in the mortgage charge rate to FHA single-family borrowers when the borrowers 'lock in' the interest rate on or around the same day, using the same mortgage type (e.g., 30 year fixed), and the properties financed are located in the same geographical area. The rule prohibits any variation of more than two-percentage points in mortgage charge rates (discount points, loan origination, interest rate and other fees, combined). The rule also requires that, for variations in the mortgage charge rates up to two percentage points, the lender base the charges on actual costs incurred in the origination of each respective FHA loan, provide a justification for the variance in the loan file, and retain the record for two years.

Cambridge did not document, nor provide adequate justification for variations in its mortgage charge rates. As a consequence, we believe Cambridge's lending practices may have unfairly imposed greater borrowing costs on some FHA borrowers. Moreover, we could not determine whether the borrowers received anything of value for discount points that were charged. We attribute this to Cambridge's failure to properly monitor to ensure compliance with HUD requirements on mortgage charge rates, overages, and tiered pricing.

Criteria

Tiered Pricing Rule 24 CFR 202.12 provides that the customary lending practices of a mortgagee for its single family insured mortgages shall not provide for a variation in mortgage charge rates that exceeds two percentage points for a designated day or other time period. Any variations in the mortgage charge rate up to two percentage points under the mortgagee's customary lending practices must be based on actual variations in fees or costs to the mortgagee to make the mortgage loan, which shall be determined after accounting for the value of servicing rights generated by making the loan and other income to the mortgagee related to the loan. Fees or costs must be fully documented for each specific loan.

Variation in mortgage charge rates for a mortgage type is determined by comparing all mortgage charge rates offered by the mortgagee within an area for the mortgage type for a designated day or other time period, including mortgage charge rates for all actual mortgage applications. Mortgagee Letter 94-16 provides that any variation within two percentage points must be based on actual variations in fees or costs to the lender to make a loan. Mortgagees are required to maintain records on pricing information that

would allow for reasonable inspection by HUD for a period of at least two years.

No justification for charge rate variations

Our review disclosed variations in Cambridge's mortgage charge rates on the 18 loans in our sample. For example, loan numbers: 374-3795401, 374-3795657, 374-3999860, 374-3935308, and 374-4099301 had a variation in the mortgage charge rate from other loans with the same interest lock-in date. While the variations were within two percentage points, Cambridge could not provide adequate documentation to support the variation as required by Mortgagee Letter 94-16.

Cambridge did not maintain rate sheets

Cambridge was unable to provide rate sheets for the loans in our sample. Cambridge officials told us that because their procedures did not allow the loan officers to price the loan, Cambridge did not maintain rate sheets. The prices were determined by the scenario desk based on the information Cambridge had from potential investors for the loan.

Borrowers may not have received anything of value

Without rate sheets, we could not determine whether borrowers received anything for the discount points charged. Cambridge's records indicated in many cases that there is no relationship between the interest rate charged and the discount points charged. For example, we examined loans that had the same lock date where borrowers were charged the same discount points but two different interest rates. Also, there were cases in which two borrowers were charged the same interest rate and one borrower was charged discount points while the other was not charged points. These examples are as follows:

Case Number	Lock Date	Closed Date	Origi-nation Fee	Discount Fee	Note Rate	Loan Amount	Loan Price	Service Release Premium	Loan Purpose	Loan Type
374-3970112	8/9/2002	8/13/2002	1	1	8	$236,250	104.5	2.2	Purchase	Fixed
374-4004560	8/9/2002	8/12/2002	1	1	7.5	$273,200	103.375	2.2	Purchase	Fixed
374-3731992	11/27/2001	11/27/2001	1	0	8	$310,550	103.375	2.2	Purchase	Fixed
374-3802026	11/27/2001	11/28/2001	1	2	8	$188,000	103.375	2.2	Purchase	Fixed

Scope

Because of the variations in Cambridge's charge rates on the 18 loans in our sample, we performed an analysis on a broader range of loans. We examined the 436 FHA insured loans originated by Cambridge in the New York Field Office area with beginning amortization dates in our audit period.

We performed a separate analysis on 386 fixed rate loans, and 50 adjustable rate mortgages.

Cambridge has not performed adequate monitoring of its variations in charge rates

Our analysis disclosed instances over the two-year period in which there was a variation in the origination fee, discount points, and interest rates for loans with a lock date on the same day or within a few days span. Based on these results, we believe that Cambridge did not perform adequate monitoring of the variations in origination fee, discount points, and interest rates. Examples of the variations in the origination fee, discount points, and interest rates are as follows:

Case Number	Lock Date	Closed Date	Origi-nation Fee	Discount Fee	Note Rate	Loan Amount	Loan Price	Service Release Premium	Loan Purpose	Loan Type
374-3734159	10/9/2001	10/10/2001	1	1	7	$310,550	100.75	1.5	Purchase	Fixed
374-3749521	10/9/2001	10/9/2001	1	2	8	$299,150	102.875	1.5	Purchase	Fixed
374-3777017	10/9/2001	10/9/2001	1	2	8.25	$201,800	103	1.5	Purchase	Fixed
374-3673139	11/30/2001	11/30/2001	1	1	8.25	$231,350	102.875	1.5	Purchase	Fixed
374-3749284	11/30/2001	12/6/2001	1	2	8	$302,700	103.625	2.2	Purchase	Fixed
374-3806381	11/30/2001	12/12/2001	1	2	7.5	$301,250	102.375	2.2	Purchase	Fixed
374-3820659	11/30/2001	11/30/2001	1	2.5	7	$223,700	102.375	2.2	Purchase	Fixed
374-3844213	11/30/2001	11/30/2001	1	0	7.875	$235,250	105	2	Purchase	Fixed
374-3850622	11/30/2001	12/5/2001	1	2	7.75	$314,050	106.5	2	Purchase	Fixed
374-3852810	11/30/2001	12/12/2001	1	2	8	$196,400	103.625	2.2	Purchase	Fixed
374-4121763	4/4/2003	4/8/2003	1	2	7	$215,500	102.75	2	Purchase	Fixed
374-4149437	4/8/2003	4/9/2003	0	0	7	$383,950	102.75	2	Purchase	Fixed
374-3805311	2/19/2002	2/20/2002	1	5	8	$152,250	104.625	2.2	Refinance	Fixed
374-3831278	2/21/2002	2/22/2002	1	2	7.5	$198,400	102.581	1.5	Refinance	Fixed
374-3827381	1/2/2002	1/2/2002	1	3	6	$217,850	102.588	1	Purchase	ARM
374-3875370	1/3/2002	1/4/2002	1	0.75	6	$219,050	102.494	1	Purchase	ARM
374-3862144	1/10/2002	1/11/2002	1	3	7	$241,200	102	1	Purchase	ARM

The variations in the origination fee, discount points, and interest rates may have resulted in overages to Cambridge. Mortgagee Letter 94-43 provides that overages occur when loan officers or someone at the lender are allowed to charge a higher interest rate, origination fee, or discount points for a loan than the lender's market rate for FHA-insured loans during the same period of time. Lenders should be careful that overages are not applied in a manner that would violate FHA's Tiered Pricing Rule. Paragraph 6-8A(2) of HUD Handbook 4060.1 REV-1 CHG-1, provides that a

mortgagee's Quality Control Plan verify that the mortgagee is in compliance with HUD's requirements concerning tiered pricing, overages, and premium pricing. Since Cambridge did not maintain adequate justification for its variations in the origination fee, discount points, and interest rates, it could not properly monitor to ensure compliance with HUD requirements on overages or tiered pricing.

Summary

In summary, Cambridge did not provide adequate justifications for variations in mortgage charge rate within the two percentage points. Also, Cambridge did not monitor compliance with HUD requirements on overages or tiered pricing. Furthermore, we question whether borrowers received something of value for the discount points that they were charged. Thus, we are questioning the eligibility of the $1,599,865 in total loan discount fees charged to the borrowers during our audit period based on a lack of pricing documentation justifying the fees. In this regard, we consider the $1,599,865 unsupported costs pending further review by HUD (See Appendix C).

Auditee Comments

Cambridge stated that it's mortgage interest rates and discount points structure is set by its president and no loan officers are or ever have been permitted to seek a rate or discount points in excess of that determined by the president and prohibited by HUD requirements. That being the case, Cambridge submits that there are no overages as HUD defines that term, much less those resulting from discriminatory practices.

Cambridge provided that only its principals know the basis for rate determination. They alone are aware of general overhead, commissions, pricing in the secondary market and other relevant factors. It is the company's president who makes this determination. In setting rates on FHA-insured mortgage loans for home purchasers, those rates presume the payment of two discount points. The reason for this presumption is inherent in the structure of these transactions and a direct result of HUD's willingness to permit homebuyers to obtain from sellers a concession of up to 6%. Most importantly, neither in the case of loans facilitating purchases nor in the case of refinancing does Cambridge consider the size of the loan nor does it consider race, color, religion, sex, national origin or any other

prohibited basis in determining either rate or discount points to be charged.

Cambridge submits that accommodations are made for instances when there is no concession, the concession is limited in dollar amount, or the buyer may have no other available funds from which to pay discount points. While causing variations in interest rates and discount points charged among borrowers, these business accommodations are fully compatible with HUD's objective to encourage home ownership, evidence Cambridge's sound business judgment and cannot reasonably be seen as a violation of the Tiered Pricing Rule or other HUD prohibition. While the foregoing accounts for most variations, other business considerations explain the balance. Business considerations, applied on an occasional basis, do not violate the Tiered Pricing Rule and are permissible as amplified by HUD's responses to public comments.

Cambridge submits that the auditor's concern that borrowers may have not received anything of value for discount points charged, is unwarranted. As previously indicated, in the case of home purchasers, those borrowers obtained favorable rates on the basis of the payment of discount points which rates would not have been available had those points not been agreed upon.

The record of all pertinent transactions appears in the individual loan files maintained by Cambridge at its offices. Cambridge respectfully submits that had the auditors more carefully reviewed those files, they would have noted ratio limitations causing loan rate reductions and further noted that Cambridge's variations in discount points charged was occasioned by individual borrower's insufficiency of funds to meet those charges.

HUD-1's for loans closed at Cambridge during the audit period properly classified discount points. In the event that any Cambridge employee stated otherwise, that employee was misinformed. At no time was risk assessment reflected in Cambridge's pricing. Since the president determined that pricing, only he could have explained fully the manner in which he set Cambridge's rates.

OIG Evaluation of Auditee Comments

The point in our finding is that Cambridge did not provide adequate justification for variations within two percentage points in mortgage charge rates. Because adequate justification was not provided for the variations, we could not determine if Cambridge complied with the HUD requirements on tiered pricing as stated in Mortgagee letter 94-16. To date, Cambridge has not been able to provide documentation that its variations in mortgage charge rates are based on actual variations in fees or costs to the lender to make the loan.

Also, Cambridge did not provide documentary evidence supporting the fact that borrowers received something of value for the discount points charged. In fact, Cambridge's comments support that its lending practices may unfairly impose greater borrowing costs on some FHA borrowers. Some borrowers are charged more simply because they have the ability to pay the presumed two percentage discount points set in Cambridge's price. Our concern is with those cases where two or more borrowers obtain the same interest rate and there was a variation in the discount points, or cases where a borrower obtains a higher interest and had to pay more discount points than the borrower with a lower interest rate.

We removed the statements made by the Cambridge official on the charging of discount points from the finding based on Cambridge's statement that the official must have been misinformed, and that the statements do not reflect Cambridge's policies and procedures.

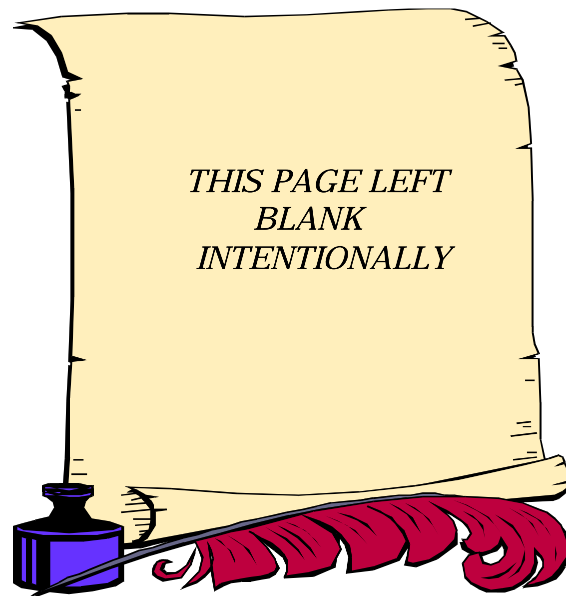
Recommendations

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

2A. Determine the eligibility of the $1,599,865 in loan discount fees charged to the borrowers that lacked adequate pricing documentation justifying the fees.

2B. Require Cambridge to adequately document that all variations in mortgage charge rates within two percentage points are based on actual variations in fees or costs to Cambridge to make the mortgage loan.

2C. Require Cambridge to implement Quality Control procedures to ensure compliance with HUD requirements on overages and tiered pricing.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Cambridge Has Not Fully Implemented Its Quality Control Plan

Our review disclosed that Cambridge did not always comply with its Quality Control Plan and HUD requirements pertaining reviews of defaulted loans. Specifically, Cambridge has not implemented procedures or established controls to ensure that all FHA/HUD insured loans that defaulted within six months of closing undergo a Loan Origination Quality Review as required by HUD requirements. This occurred because Cambridge did not ensure that its Quality Control Plan is being fully implemented. Consequently, Cambridge is not fully utilizing its Quality Control Plan, which is designed to enhance and maintain accuracy, validity, and completeness in its loan origination process.

Quality Control Plan established but not fully implemented

Cambridge developed and maintains a Quality Control Plan for the origination of insured mortgages. However, our review showed that Cambridge did not always comply with certain provisions of its Quality Control Plan. In particular, procedures have not been implemented, or controls established, to ensure that all insured loans that default within six months of closing are subjected to a loan origination Quality Control Review.

Criteria

Paragraph 6-1C of HUD Handbook 4060.1 REV-1, requires that a mortgagee's Quality Control Plan must provide for sampling of loans to be reviewed. Mortgagees that choose to use the random sample method must review all loans that went into default within six months of closing, in addition to the number selected for random sample.

Cambridge has established internal quality control procedures

In addition, Section 4.1.1 of Cambridge's Quality Control Plan mandates that for closed loans, 100% of the loans with defaults of 90 days within one year of origination are subject to a quality control review.

Also, Cambridge's operating policies and procedures manual contains the quality control policies and procedures of the third party provider that Cambridge uses for quality control services. The policy provides that early payment defaults are loans that have gone into default within the first six months of closing. It is important to have a complete review of these loans to identify problem areas in origination, through the analysis of loans and the loan

process. One hundred percent of early payment loans should be selected for quality control review.

Early default loans not reviewed for quality control

Despite clearly defined HUD regulations and internally established policies that require performing quality control reviews of loans defaulting within six months of closing, our audit showed that Cambridge has not implemented controls or procedures to ensure that early default loans have been adequately reviewed for quality control. In fact, none of the 18 loans selected for our audit testing were reviewed for quality control by Cambridge even though 17 of the 18 loans in our sample were in default within six months of closing.

Some of the deficiencies the quality control requirements are designed to prevent and correct were evident in the loan files we reviewed. In Finding 1, we discussed significant deficiencies in Cambridge's origination and underwriting processes, including: ratios exceeded HUD/FHA standards, inadequate property valuation, inadequate asset verification, and other deficiencies. Therefore, until Cambridge fully implements the quality control plan, there is inadequate assurance that Cambridge is originating and underwriting loans in accordance with HUD/FHA requirements, or that deficiencies are being corrected.

Quality control reviews of early default loans are particularly important since such reviews would provide valuable information to management regarding the causes of defaults, and may disclose underwriting deficiencies associated with the loan. Such reviews may also disclose indicators of fraudulent activities or other significant discrepancies that mortgagees are required to report to HUD.

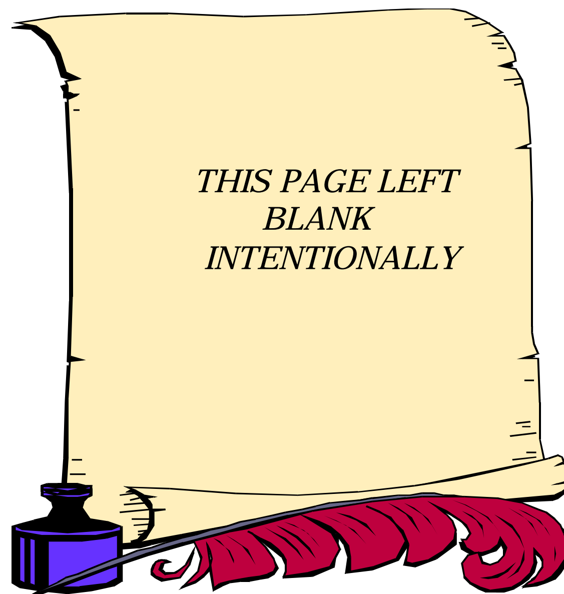
Auditee Comments

Cambridge acknowledged its failure to adhere to its Quality Control Plan to extent indicated by the audit team.

Recommendations

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

3A. Implement controls and procedures to ensure that all loans that default within six months of closing are properly reviewed in accordance with its Quality Control Plan.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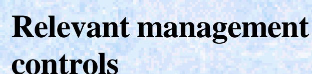
Management Controls

In planning and performing our audit, we considered the management controls of Cambridge to determine our auditing procedures, not to provide assurance on the controls. Management controls include the plan of organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. Management controls include the systems for measuring, reporting, and monitoring program performance.



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 and summarized below.

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

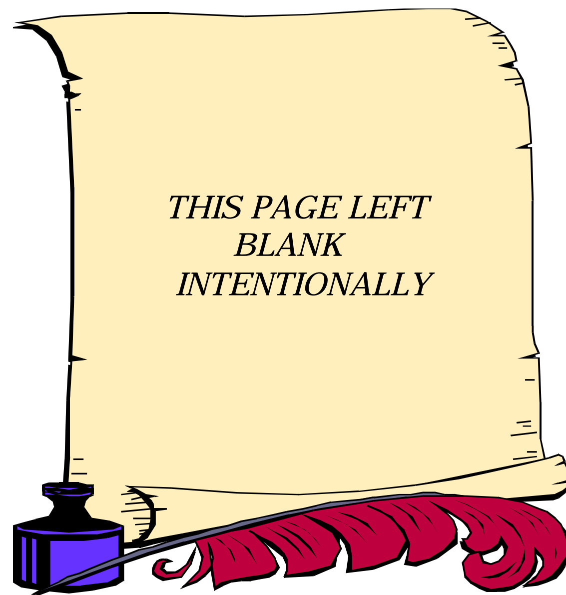
Finding 1 (Program Operations), (Compliance with Laws and Regulations).

- Cambridge did not document variations in its mortgage charge rates, Finding 2 (Compliance with Laws and Regulations).

- Cambridge did not fully implement its Quality Control Plan to ensure that all HUD/FHA insured loans that defaulted within six months of closing undergo a Loan Origination Quality Review, as required by HUD requirements, Finding 3 (Program Operations), (Compliance with Laws and Regulations).

Follow up on Prior Audits

There are no prior OIG audit reports regarding Cambridge Home Capital, LLC.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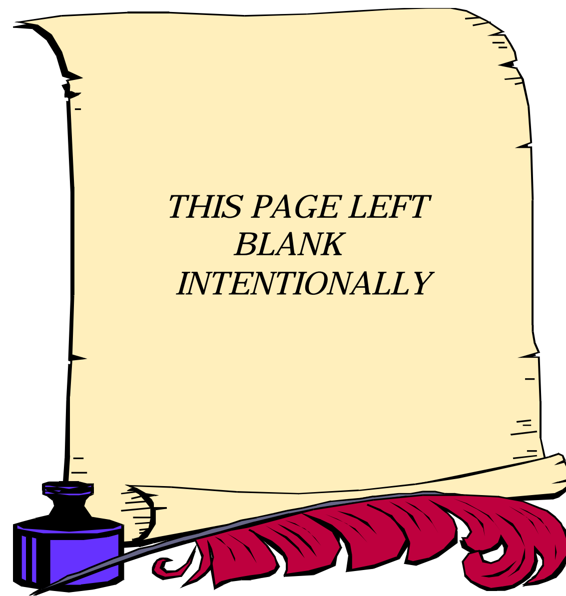
Summary of Loan Origination Deficiencies

Cambridge Home Capital, LLC
Great Neck, NY
Summary of Loan Origination Deficiencies

HUD/FHA Case Number	Mortgage Amount	Loan Settlement Date	Ratio(s) Exceeded HUD/FHA Standards	Inadequate Property Valuation	Inadequate Asset Verification	Insufficient Gift Information	Inadequate Income Verification	Inadequate Debt Verification	Minimum Investment Not Provided	Bankruptcy Discharged Less than Two Years	Appendix Reference
374-3830526	$172,250	11/9/01	**X**	**X**					**X**		**B-01**
374-3956133	$245,150	5/22/02	**X**		**X**					**X**	**B-02**
374-3999860	$257,050	5/23/02	**X**	**X**							**B-03**
374-3913246	$132,900	3/4/02	**X**	**X**		**X**					**B-04**
374-3935308	$231,350	6/27/02	**X**		**X**						**B-05**
374-3772590	$319,450	8/15/01	**X**	**X**			**X**				**B-06**
374-4048106	$293,350	8/20/02	**X**					**X**			**B-07**
374-3776804	$284,500	8/27/01	**X**	**X**							**B-08**
374-3778152	$221,500	9/6/01		**X**							**B-09**
374-3726304	$225,450	8/10/01		**X**							**B-10**
374-3833863	$195,400	4/16/02		**X**							**B-11**
Totals	**$2,578,350**		**8**	**8**	**2**	**1**	**1**	**1**	**1**	**1**	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Narrative Case Presentations

FHA Case Number: 374-3830526

Loan Amount: $172,250

Settlement Date: 11/9/01

Status: Default - Foreclosure Started

Payments Before First Default Reported: 5

Pertinent Details

A. Debt-to-Income Ratios Exceeded HUD/FHA Standards

The borrower's mortgage payment expense to effective income ratio was 38.85 percent, and the total fixed payment to effective income ratio was 46.80 percent. HUD Handbook 4155.1 REV-4, Paragraph 2-12 states that these ratios cannot exceed 29 percent and 41 percent respectively without listing compensating factors. The compensating factors provided on the Mortgage Credit Analysis Worksheet did not provide adequate justification for approving the loan with ratios exceeding the HUD/FHA standards.

B. Borrower Did Not Provide the Minimum Required Investment

The earnest money deposit of $3,000, the $700 paid at closing, the $400 appraisal fee, and the $100 credit report fee totals $4,200 for the borrower's investment. The $4,200 is $1,050 less than the minimum required investment of $5,250. The files did not contain evidence indicating that the borrower paid the loan origination fee outside of closing in the amount of $1,697.50. 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).

The minimum down payment requirement of 3 percent was not met by the borrower at closing according to the Post Endorsement Technical Review Underwriting Report prepared by Horizon Consulting Incorporated. The report claims that the borrower was short of the minimum down payment requirement by $1,550.00, and as such, the loan was overinsured.

C. Appraisal Report was Not Adequately Reviewed

Our review of the appraisal disclosed several items that should have alerted Cambridge to problems with the appraisal report. For example, the appraiser did not comment as to the dollar amount of the renovations included in the value estimate. Nor did the appraiser comment on the quality of the renovation work. As a result, the appraisal did not adequately support the ascribed value estimate.

Section 3-3G of HUD Handbook 4000.4, Single Family Direct Endorsement Program requires the mortgagee's underwriter to review the appraisal to determine whether or not the appraiser's conclusions are acceptable. The above items are indicators of problems with the appraisal and, as such, should have caused Cambridge to question the reliability of the appraisal report before accepting it.

Cambridge's Comments

Cambridge is willing to indemnify HUD with respect to this loan.

Narrative Case Presentation

FHA Case Number: 374-3956133

Loan Amount: $245,150

Settlement Date: 05/22/02

Status: Default - Foreclosure Started, Partial Claim paid $14,623.66

Payments Before First Default Reported: 1

Pertinent Details

A. Debt-to-Income Ratios Exceeded HUD/FHA Standards

The borrower's mortgage payment expense to effective income ratio was 38.02 percent, and the total fixed payment to effective income ratio was 46.28 percent. HUD Handbook 4155.1 REV-4, Paragraph 2-12 states that these ratios cannot exceed 29 percent and 41 percent respectively without listing significant compensating factors. The compensating factors provided on the Mortgage Credit Analysis Worksheet did not provide adequate justification for approving the loan with ratios exceeding the HUD/FHA standards.

B. Loan Closed 18 Months after Bankruptcy Discharged

HUD Handbook 4155.1 REV-4, Paragraph 2-3E, states that an elapsed period of less than two years from the date the bankruptcy was discharged may be acceptable if the borrower can show that the bankruptcy was caused by extenuating circumstances beyond his or her control and has since exhibited an ability to manage financial affairs. It also provides that the borrower's current situation should be such that the events leading to the bankruptcy are not likely to reoccur. The borrower's bankruptcy was discharged November 7, 2000 and the loan closed May 5, 2002. The files did not contain evidence that the bankruptcy was caused by extenuating circumstances or that the borrower has since exhibited an ability to manage financial affairs in a manner that would prevent another bankruptcy from occurring.

C. Inadequate Verification of Assets Available

Cambridge indicated on the Mortgage Credit Analysis Worksheet that assets available were $1,513.00. According to the borrower's bank statement, the borrower only had $682.18 available at the time the Mortgage Credit Analysis Worksheet was prepared. Our review of the borrower's bank statement indicated a large deposit of $1,005.01 was made on May 22, 2002. HUD Handbook 4155.1 REV-4, Paragraph 2-10B states that if there is a large increase in the borrower's bank account, an explanation and evidence of source of funds must be obtained by the lender. There was no indication in the file indicating that Cambridge determined the validity of this deposit. Also, the loan application and Cambridge's comments indicate that $500 of the

$1,513 assets available on the Mortgage Credit Analysis Worksheet is from cash saved at home. HUD Handbook 4155.1 REV-4, Paragraph 2-10M provides that borrowers who have saved cash at home and are able to adequately demonstrate the ability to do so are permitted to have this money included as an acceptable source of funds to close the mortgage. To include such funds in assessing the homeowner's cash assets for closing, the borrower must provide satisfactory evidence of the ability to accumulate such savings. Also, the asset verification process requires the borrower to explain how such funds were accumulated and the amount of time taken to do so. The lender must determine the reasonableness of the accumulation of the funds based on the borrower's income stream, the time period the funds were saved, spending habits, and a history of using financial institutions. Based on the documentation in the file, the borrowers did not provide satisfactory evidence of an ability to accumulate such savings.

Cambridge's Comments

There was a presence of at least five compensating factors, fully documented in Cambridge loan files, which collectively were considered in making this loan.

Cambridge stated that the borrower met the two-pronged requirement in the regulations regarding the extent that the bankruptcy was caused by extenuating circumstances and she exhibited a documented ability to manage her financial affairs after the bankruptcy filing.

The borrower regularly deposited into her checking account her bi-weekly paycheck and withdrew from that account such sums that were necessary for her to meet her day-to-day living expenses. The characterization by the auditors of the borrower's "large deposit" is unjustified. HUD guidelines provide that the lender must determine the reasonableness of an accumulation of funds based upon the borrower's income stream taking into account borrower's spending habits and history, which Cambridge properly considered in this case.

OIG's Evaluation of Cambridge's Comments

The compensating factors provided in the Mortgage Credit Analysis Worksheet were not adequate justification for the approval of the loan. Those additional factors provided by Cambridge do not depict the underwriters stated merits of the loan including which compensating factors apply.

We disagree that the stolen car was an extenuating circumstance. The police report indicated that the car was stolen on December 22, 1995 and the bankruptcy was not filed until July 27, 2000.

The underwriter did not provide evidence or an explanation of the large deposit or the cash saved at home at the time of loan approval.

Narrative Case Presentation

FHA Case Number: 374-3999860

Loan Amount: $257,050

Settlement Date: 05/23/02

Status: Default - Foreclosure Started

Payments Before First Default Reported: 6

Pertinent Details

A. Debt-to-Income Ratios Exceeded HUD/FHA Standards

The borrower's mortgage payment expense to effective income ratio was 34.58 percent, and the total fixed payment to effective income ratio was 43.41 percent. HUD Handbook 4155.1 REV-4, Paragraph 2-12 states that these ratios cannot exceed 29 percent and 41 percent respectively without listing compensating factors. The compensating factors provided on the Mortgage Credit Analysis Worksheet did not provide adequate justification for approving the loan with ratios exceeding the HUD/FHA standards.

B. Appraisal Report was Not Adequately Reviewed

Our review of the appraisal disclosed several items that should have alerted Cambridge to problems with the appraisal report. For example, the appraiser did not comment as to the dollar amount of the renovations included in the value estimate; nor did the appraiser comment on the quality of the renovation work. The appraiser did not disclose the source or verify any cost of the renovation work. The appraisal report indicates a price range of $145,000 to $290,000 with the predominant price being $225,000. The appraiser's value estimate of $262,000 is considerably higher than the predominant price and no explanation is provided. Also, the appraiser indicates that this property has a separate unit in the basement consisting of a kitchen, bath, bedroom, and a den/living room. This is not acceptable for FHA mortgage insurance. Basement living units do not meet FHA's acceptability criteria. As a result, the appraisal did not adequately support the ascribed value estimate. Section 3-3G of HUD Handbook 4000.4, Single Family Direct Endorsement Program, requires the mortgagee's underwriter to review the appraisal to determine whether the appraiser's conclusions are acceptable. The above items are indicators of problems with the appraisal and, as such, should have caused Cambridge to question the reliability of the appraisal report before accepting it.

Cambridge’s Comments

The existence of five compensating factors justifies Cambridge’s approval of the borrower and conforms fully to HUD/FHA guidelines.

The Audit Report notes that the appraiser did not disclose the source or verify any cost of renovation work. HUD/FHA requirements impose no obligation on the appraiser to include such information in his report and thus these comments are unwarranted. The auditors further contend that Cambridge should have been alerted to the discrepancy between the predominant prices of a single-family home in the neighborhood and the price of the subject premises. The subject premises was a fully renovated two-family residence and accordingly, any comparison to the price of a single-family residence, predominant or otherwise, is inappropriate. The auditors finally criticize the appraisal for including a finished basement as habitable space. A review of the file and in particular, the appraisal, indicates that it was not included.

<u>OIG's Evaluation of Cambridge's Comments</u>

The compensating factors provided in the Mortgage Credit Analysis Worksheet were not adequate justification for the approval of the loan. Those additional factors provided by Cambridge do not depict the underwriters stated merits of the loan including which compensating factors apply.

There is a lack of information relating to the source of the cost associated with the repairs. Also, it is unknown whether the value estimate included any portion of the repairs and improvements. Thus, the appraisal did not adequately support the ascribed value estimate. The predominant price relates to the neighborhood characteristics and not whether the subject property is one or more units. Moreover, our concern wasn't whether the basement unit was included in the price, but to point out that the basement unit does not meet FHA acceptability criteria and is not acceptable for FHA insurance. These items are indicators of problems with the appraisal and, as such, should have caused Cambridge to question the reliability of the appraisal report before accepting it.

Narrative Case Presentation

FHA Case Number: 374-3913246

Loan Amount: $132,900

Settlement Date: 03/4/02

Status: Default - Foreclosure Started, Partial Claim paid $15,387.93

Payments Before First Default Reported: 3

Pertinent Details

A. Debt-to-Income Ratios Exceeded HUD/FHA Standards

The borrower's mortgage payment expense to effective income ratio was 33.84 percent, and the total fixed payment to effective income ratio was 44.53 percent. HUD Handbook 4155.1 REV-4, Paragraph 2-12 states that these ratios cannot exceed 29 percent and 41 percent respectively without listing compensating factors. The compensating factors provided on the Mortgage Credit Analysis Worksheet did not provide adequate justification for approving the loan with ratios exceeding the HUD/FHA standards.

B. Gift Funds Not Verifiable

According to Mortgagee Letter 00-28, "When FHA reviews the performance of a lender on loans where gift funds were provided for the downpayment, it must be able to trace the gift funds from the donor to the homebuyer." The case file did not contain evidence showing that the donor account was verified, or a copy of the gift check, etc. for the $29,270 gift provided the borrower, which was used in part for the $4,050 down payment. The documentation in the case file only supported that $29,270 was deposited into newly opened bank accounts that were in the names of both the borrower and the donor. It is questionable whether the donor actually gifted any funds to the borrower since the donor retained access and control over the use of the funds, and since the funds remained in an account on which the donor was named.

C. Appraisal Report was Not Adequately Reviewed

Our review of the appraisal disclosed several items that should have alerted Cambridge to problems with the appraisal report. For example, the appraiser lists repairs and improvements that were made on the property and the cost associated with the repairs; however, the appraiser did not disclose the source of the information. Also, the appraiser did not indicate if the value estimate included any portion of the repair and improvement costs. As a result, the appraisal did not adequately support the ascribed value estimate. Section 3-3G of HUD Handbook 4000.4, Single Family Direct Endorsement Program, requires the mortgagee's underwriter to review the appraisal to determine whether the appraiser's conclusions are acceptable. The above items are

indicators of problems with the appraisal and, as such, should have caused Cambridge to question the reliability of the appraisal report before accepting it.

Cambridge's Comments

The existence of four compensating factors justifies Cambridge's approval of the borrower and conforms fully to HUD/FHA guidelines.

The contention that loan file did not contain evidence of a gift and that the gift was the source of the down payment is not supported by the documentation contained in the loan file. The source of the funds is documented in the loan file as having been derived by the donor as an award under Worker's Compensation Law. Initially, the funds were deposited into a joint account in the name of both the borrower and her sister, the donor. At all times the borrower had full use of the funds on deposit as verified in writing by the donor. Subsequently, the funds were transferred to an account solely in the borrower's name and from that account the contract deposit was made.

The Audit Report notes that the appraiser did not disclose the source or verify any cost of renovation work. HUD/FHA requirements impose no obligation on the appraiser to include such information in his report and thus these comments are unwarranted.

OIG's Evaluation of Cambridge's Comments

Review of the Mortgage Credit Analysis Worksheet does not indicate adequate compensating factors for the debt-to-income ratios exceeding HUD/FHA standards.

Cambridge has not provided any evidence that the gift funds were deposited into an account solely in the borrower name as stated in the comments.

HUD Handbook 4150.1 REV-1, Chapter 5-1 provides that an analysis of the physical improvements results in conclusions as to the desirability, utility and appropriateness of the physical improvements as factors in the determination of mortgage risk and the ultimate estimate of value. In the appraisal, there is a lack of information relating to the source of the cost associated with the repairs. Also, it is unknown whether the value estimate included any portion of the repairs and improvements. Thus, the appraisal did not adequately support the ascribed value estimate.

Narrative Case Presentation

FHA Case Number: 374-3935308

Loan Amount: $231,350

Settlement Date: 06/27/02

Status: Current - Foreclosure Started

Payments Before First Default Reported: 3

Pertinent Details

A. Debt-to-Income Ratios Exceeded HUD/FHA Standards

The borrower's mortgage payment expense to effective income ratio was 36.55 percent, and the total fixed payment to effective income ratio was 41.85 percent. HUD Handbook 4155.1 REV-4, Paragraph 2-12 states that these ratios cannot exceed 29 percent and 41 percent respectively without listing compensating factors. The compensating factors provided on the Mortgage Credit Analysis Worksheet did not provide adequate justification for approving the loan with ratios exceeding the HUD/FHA standards.

B. Inadequate Verification of Assets Available for Funds to Close

Cambridge indicated on the Mortgage Credit Analysis Worksheet, dated May 5, 2002, that the borrower had paid $12,187, and that the assets available were $11,247. We could only verify that $7,560 had been paid into the transaction at May 5, 2002. We found discrepancies in the supporting documents for the source of the funds deposited into the borrower's checking account. Our review showed that from May 3, 2002 to June 27, 2002 the borrower deposited $19,800 into a checking account with $15,900 of this amount coming from a private savings plan known as a Su Su (meaning to collect and then hand out). However, our review of the supporting documentation indicated that there were only two payments from the Su Su plans totaling $10,600 and that $6,800 was transferred into the checking account from an unidentified savings account.

Also, Cambridge did not question the reasonableness of whether the borrower had the ability to accumulate these amounts along with paying off debt based on the borrower's income and savings history. We reviewed bank statements from January 15, 2002 through June 27, 2002 and found that the borrower's income and savings would not have been sufficient to close the loan and to pay off the debts identified as being paid during this period.

Cambridge's Comments

Cambridge is willing to indemnify with respect to this loan.

Narrative Case Presentation

FHA Case Number: 374-3772590

Loan Amount: $319,450

Settlement Date: 08/15/01

Status: Claim, Preforeclosure Sale, Amount Claimed $96,265.42

Payments Before First Default Reported: 2

Pertinent Details

A. Debt-to-Income Ratios Exceeded HUD/FHA Standards

The borrower's mortgage payment expense to effective income ratio was 29.61 percent, and the total fixed payment to effective income ratio was 44.75 percent. HUD Handbook 4155.1 REV-4, Paragraph 2-12 states that these ratios cannot exceed 29 percent and 41 percent respectively without listing significant compensating factors. The underwriter identified four items on the Mortgage Credit Analysis Worksheet as compensating factors for approval of the loan. The compensating factors included job stability, conservative use of credit, previous homeowner with excellent payment history, and three months reserves,which based on the loan circumstances, were not adequate. Cambridge is required to document the stability of the borrowers' income. For properties with three or more units the borrower needs to have three months of reserves to qualify. In regards to the borrowers being a previous homeowner with excellent payment history, this would be an adequate compensating factor if the borrowers had shown the ability to pay housing expenses that were equal or greater than the proposed monthly expense. For this case, the borrowers' housing expense increased by 16 percent. Lastly, the compensating factor of conservative use of credit, in and of itself, is not adequate. Also, the credit reports on the borrower indicate less than a conservative use of credit. There are several newly opened accounts, accounts with high balances, and an instance of a delinquent account. The compensating factors provided on the Mortgage Credit Analysis Worksheet did not provide adequate justification for approving the loan with ratios exceeding the standards.

B. Inadequate Rental Income Documentation

Cambridge did not gather adequate documentation to determine the effects of rental income on the total fixed payment to income ratio. Specifically, Cambridge did not properly factor in a second rental property in calculating the total fixed payment to income ratio. Our analysis indicated that the second rental property would have resulted in an obligation of $842.87 that needed to be factored into the fixed payment to income ratio. Factoring this amount would increase the ratio from 44.75 percent to 54.18 percent. Basically, our concern was that Cambridge did not obtain the necessary documentation to accurately calculate the effects of rental income.

C. Appraisal Report was Not Adequately Reviewed

Our review of the appraisals disclosed several items that should have alerted Cambridge to problems with the appraisal report. For example, the appraiser did not offer any comments regarding the property meeting the FHA criteria for a three-unit structure. The appraiser listed repairs and improvements that were made to the property and the costs associated with the repairs, however the appraiser did not disclose any other source of information. Also, the appraiser did not indicate if the value estimate included any portion of the repair and improvement costs. The repair list shows that a new roof was installed. However, a roof certification by a roofing contractor was not in the file. In the section of the appraisal report on neighborhood data, it indicates the single-family house price range to be $165,000 to $225,000 with the predominant price being $180,000. The appraiser's value estimate of $325,000 is significantly higher than the predominant price and no explanation is provided. As a result, the appraisal did not adequately support the ascribed value estimate. Section 3-3G of HUD Handbook 4000.4, Single Family Direct Endorsement Program, requires the mortgagee's underwriter to review the appraisal to determine whether the appraiser's conclusions are acceptable. The above items are indicators of problems with the appraisal, and, as such, should have caused Cambridge to question the reliability of the appraisal report before accepting it.

Cambridge’s Comments

Cambridge acknowledges that it’s underwriting of this loan fell short of HUD/FHA requirements. Cambridge requests that it be provided with further information concerning HUD’s claimed loss expenses with respect to this loan.

Narrative Case Presentation

FHA Case Number: 374-4048106

Loan Amount: $293,350

Settlement Date: 08/20/02

Status: Default - Foreclosure Started

Payments Before First Default Reported: 6

Pertinent Details

A. Debt-to-Income Ratios Exceeded HUD/FHA Standards

The borrower's mortgage payment expense to effective income ratio was 35.96 percent, and the total fixed payment to effective income ratio was 41.77 percent. HUD Handbook 4155.1 REV-4, Paragraph 2-12 states that these ratios cannot exceed 29 percent and 41 percent respectively without listing compensating factors. The compensating factors provided on the Mortgage Credit Analysis Worksheet did not provide adequate justification for approving the loan with ratios exceeding the HUD/FHA standards.

B. Inadequate Debt Verification

An account named "Visa Secured - S51" indicated bi-weekly payroll deductions of $50.00 that were deposited in the account and then paid out of the account the day after the deposits were made. This liability wasn’t included on the Mortgage Credit Analysis Worksheet and was not addressed by the underwriter. Adding $108 per month to the borrower’s liabilities would have increased the total fixed payment to effective income ratio from 41.77 percent to 43.47 percent.

Cambridge’s Comments

In this case, there was minimal recurring debt and to criticize Cambridge with the benefit of hindsight is simply unfair. The auditors criticized Cambridge for not taking into account periodic payments made by the borrower in connection with a secured credit card, which they viewed as an additional debt which caused them to calculate that the borrower’s debt/income ratio slightly exceeded the 41% guideline, to wit: 43.47%. Cambridge submits that the auditor’s criticism in this regard is not supported.

OIG’s Evaluation of Cambridge’s Comments

The compensating factors provided in the Mortgage Credit Analysis Worksheet were questionable as valid justification for the approval of the loan. Those additional factors provided by Cambridge do not depict the underwriters stated merits of the loan including which compensating factors apply.

Narrative Case Presentation

FHA Case Number: 374-3776804

Loan Amount: $284,500

Settlement Date: 08/27/01

Status: Default - Foreclosure Started

Payments Before First Default Reported: 0

Pertinent Details

A. Debt-to-Income Ratios Exceeded HUD/FHA Standards

The borrower's mortgage payment expense to effective income ratio was 30.9 percent, and the total fixed payment to effective income ratio was 45.23 percent. HUD Handbook 4155.1 REV-4, Paragraph 2-12 states that these ratios cannot exceed 29 percent and 41 percent respectively without listing compensating factors. The compensating factors provided on the Mortgage Credit Analysis Worksheet did not provide adequate justification for approving the loan with ratios exceeding the HUD/FHA standards.

B. Appraisal Report was Not Adequately Reviewed

Our review of the appraisal disclosed several items that should have alerted Cambridge to problems with the appraisal report. For example, the appraisal report identifies the property as being a 2-unit structure. However, the appraiser does not offer any comments regarding the property meeting the FHA criteria for a two-unit structure. Also, there are discrepancies in the appraisal involving the repair list. The repair list shows that a new roof was installed, however, the roof condition certification states that the roof has a 4-5 year remaining life. This does not correspond with the life expectancy of a new roof. The appraisal report states that the heating system is a "new FHA" (forced hot air), but the repair list shows a "new boiler". The forced hot air system would not require a new boiler. In the section of the appraisal report on neighborhood data, it indicates the single-family house price range to be $150,000 to $275,000 with the predominant price being $190,000. The appraiser's value estimate of $290,000 is considerably higher than the predominant price and no explanation is provided. As a result, the appraisal did not adequately support the ascribed value estimate. Section 3-3G of HUD Handbook 4000.4, Single Family Direct Endorsement Program, requires the mortgagee's underwriter to review the appraisal to determine whether or not the appraiser's conclusions are acceptable. The above items are indicators of problems with the appraisal and, as such, should have caused Cambridge question the reliability of the appraisal report before accepting it.

Cambridge's Comments

Again, while acknowledging the existence of compensating factors, the auditors unjustifiably criticize Cambridge's underwriting in approving a loan with ratios exceeding HUD/FHA guidelines. Cambridge verified the borrower's employment. The verification revealed a steady increase in earnings (a compensating factor). The verification further indicated that the borrower had been employed for approximately seven years and that his probability of continued employment was good (a second compensating factor).

It is acknowledged that the appraisal report makes reference to a "boiler", whereas the proper reference should have been to a burner. This inconsistency, in Cambridge's opinion, did not in any way affect the value estimate of the premises, since the price of either piece of equipment is similar. Similarly, the fact that there appears to be a discrepancy between the appraisal report's notation of a new roof and the contents of the roof certification indicating a four to five year remaining life, does not impact significantly upon the value of the premises. Finally, the auditors again unfairly criticize the appraisal report citing the predominant price of a single-family residence in the neighborhood. The subject premise is a renovated two-family house, and accordingly, reference to the predominant price of a one-family house in the neighborhood is inappropriate.

OIG's Evaluation of Cambridge's Comments

The compensating factors provided in the Mortgage Credit Analysis Worksheet were not adequate justification for the approval of the loan. Those additional factors provided by Cambridge do not depict the underwriters stated merits of the loan including which compensating factors apply.

There is no evidence in the file that the underwriter questioned the inconsistencies acknowledged by Cambridge. Also, the predominant price relates to the neighborhood characteristics and not whether the subject property is one or more units. These items are indicators of problems with the appraisal and, as such, should have caused Cambridge to question the reliability of the appraisal report before accepting it.

Narrative Case Presentation

FHA Case Number: 374-3778152

Loan Amount: $221,500

Settlement Date: 09/6/01

Status: Default - Foreclosure Started, Partial Claim Paid $20,254.40

Payments Before First Default Reported: 3

Pertinent Details

A. Appraisal Report was Not Adequately Reviewed

Our review of the appraisal disclosed several items that should have alerted Cambridge to problems with the appraisal report. For example, one of the rear bedrooms should not be counted as a bedroom since one has to pass through the bedroom of the rear exit door to access other habitable space. The code for existing property states that the bedroom means of access shall not be through another bedroom or other habitable space. As a result, the appraisal did not adequately support the ascribed value estimate. Section 3-3G of HUD Handbook 4000.4, Single Family Direct Endorsement Program, requires the mortgagee's underwriter to review the appraisal to determine whether the appraiser's conclusions are acceptable. The above items are indicators of problems with the appraisal and, as such, should have caused Cambridge to question the reliability of the appraisal report before accepting it.

Cambridge's Comments

While the sketch in the appraiser's report erroneously makes it appear that one of the bedrooms did not have a separate entrance, a subsequent visit by the appraiser confirmed that it is the sketch and not the appraisal report that was in fact inaccurate. Each bedroom at the residence has a separate entrance notwithstanding that the appraiser's sketch did not properly depict this condition. Had the sketch been accurate, the appraisal report would have noted functional obsolescence; however, no such notation appears therein.

OIG's Evaluation of Cambridge's Comments

Our contention is that Cambridge should have questioned the reliability of the appraisal report before accepting it. The appraiser's records and interview with the homeowner on May 20, 2004, were not available to the underwriter at the time of approval.

Narrative Case Presentation

FHA Case Number: 374-3726304

Loan Amount: $225,450

Settlement Date: 08/10/01

Status: Default - Foreclosure Started

Payments Before First Default Reported: 0

Pertinent Details

A. Appraisal Report was Not Adequately Reviewed

Our review of the appraisal disclosed several items that should have alerted Cambridge to problems with the appraisal report. For example, the appraiser does not indicate when the renovations on the property took place or who the owner was at the time of the renovations. The appraiser did not comment as to the dollar amount of the renovations included in the value estimate, nor did the appraiser comment on the quality of the renovation work. Although the appraiser indicates that the appraisal is subject to completion of a list of repairs, inspections, and other conditions, the list was not attached to the appraisal. As a result, the appraisal did not adequately support the ascribed value estimate. Section 3-3G of HUD Handbook 4000.4, Single Family Direct Endorsement Program, requires the mortgagee's underwriter to review the appraisal to determine whether or not the appraiser's conclusions are acceptable. The above items are indicators of problems with the appraisal and, as such, should have caused Cambridge to question the reliability of the appraisal report before accepting it.

Cambridge's Comments

The appraiser first visited these premises on July 12, 2001. At that time the subject premises was "in the process of being completely renovated." Though not required, values of individual items are set forth, the total estimate of all work to be performed in the amount of $32,000. Subsequently, the appraiser revisited the premises on August 08, 2001 as indicated by the Compliance Inspection Report. The report indicates that all work had been completed and fully details the extent of the renovation.

OIG's Evaluation of Cambridge's Comments

The $32,000 in work identified had already been completed. There is a lack of information relating to the source of the cost associated with the additional repairs. Also, it is unknown whether the value estimate included any portion of the repairs and improvements. Thus, the appraisal did not adequately support the ascribed value estimate.

Narrative Case Presentation

FHA Case Number: 374-3833863

Loan Amount: $195,400

Settlement Date: 04/16/02

Status: Default - Foreclosure Started

Payments Before First Default Reported: 4

Pertinent Details

A. Appraisal Report was Not Adequately Reviewed

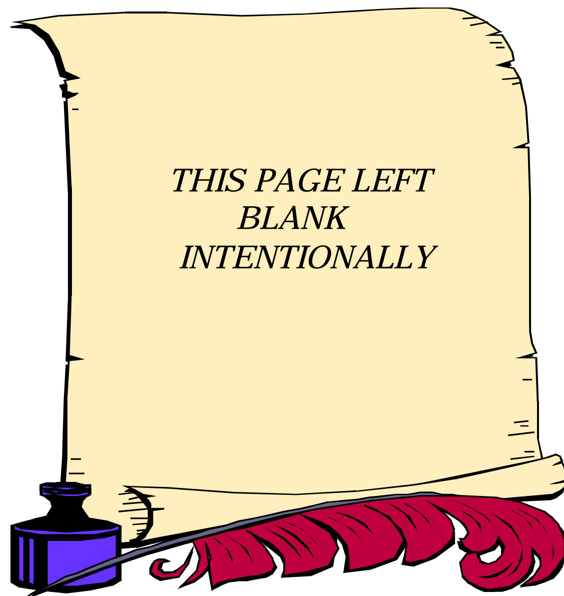
Our review of the appraisal disclosed several items that should have alerted Cambridge to problems with the appraisal report. For example, Cambridge should have obtained an explanation from the appraiser as to why the sales price per square foot exceeded the top end of the adjusted sales price. Also, the appraiser did not comment as to the dollar amount of the renovations included in the value estimate, nor did the appraiser comment on the quality of the renovation work. As a result, the appraisal did not adequately support the ascribed value estimate. Section 3-3G of HUD Handbook 4000.4, Single Family Direct Endorsement Program, requires the mortgagee's underwriter to review the appraisal to determine whether or not the appraiser's conclusions are acceptable. The above items are indicators of problems with the appraisal and, as such, should have caused Cambridge to question the reliability of the appraisal report before accepting it.

Cambridge's Comments

A careful review of the appraisal report contained in this loan file does not support the auditor's criticism that the sales price per square foot for the subject premises "exceeded the top end of the adjusted sales price." The auditor's report alleges that the dollar amount of renovations was not included in the value estimate. As previously stated, there is no HUD/FHA requirement for the inclusion of such information in the appraisal report.

OIG's Evaluation of Cambridge's Comments

Cambridge should have obtained an explanation why the sale price per square foot exceeded the top end of the adjusted sales price. Furthermore, there is a lack of information relating to the source of the cost associated with the repairs. Also, it is unknown whether the value estimate included any portion of the repairs and improvements. Thus, the appraisal did not adequately support the ascribed value estimate.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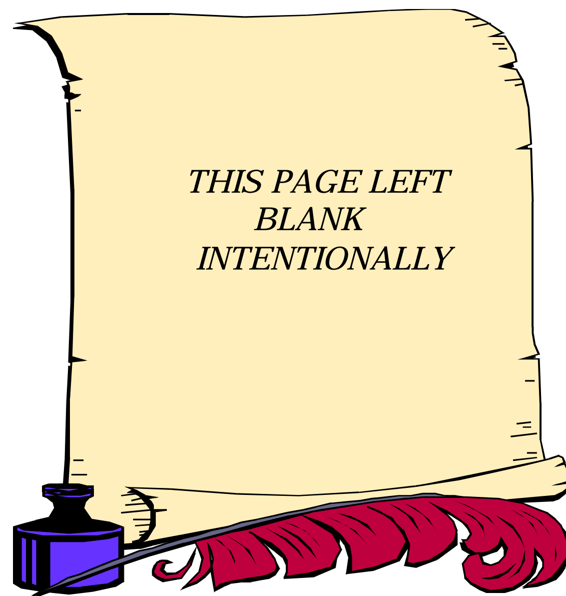
Schedule of Questioned Costs and Funds Put to Better Use

Finding Number	Type of Questioned Costs: Ineligible Costs 1/	Type of Questioned Costs: Unsupported Costs 2/	Funds Put to Better Use 3/
1	$146,530	---0---	$2,258,900
2	---0---	$1,599,865	---0---
3	---0---	---0---	---0---
Total	$146,530	$1,599,865	$2,258,900

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/ Unsupported costs are costs whose eligibility cannot be clearly determined during the audit since such costs were not supported by adequate documentation. A legal opinion or administrative determination may be needed on these costs.

3/ 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.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Auditee Comments

Cambridge Home Capital, LLC
80 Cuttermill Road, Suite 408, Great Neck, NY 11021 • 516-829-5700 • fax 516-829-5777

June 15, 2004

Mr. Alexander C. Malloy
Regional Inspector General
For Audit, 2AGA
Office of Audit
New York/New Jersey

RE: Response to Audit Report of Cambridge Home Capital, LLC issued by the Regional Inspector General, dated June, 2004.

Dear Mr. Malloy:

Enclosed, please find Cambridge Home Capital LLC's response to the Audit Report issued by the Office of Inspector General, Department of Housing and Urban Development, referenced above. Cambridge Home Capital, LLC, takes issue with the findings and recommendations contained in the Audit Report and has responded to each finding contained therein.

Should you have any questions concerning anything contained in Cambridge's response, please do not hesitate to contact us or our counsel at your convenience.

Very truly yours,

CAMBRIDGE HOME CAPITAL, LLC

Seth Kramer
President

LICENSED MORTGAGE BANKER NYS BANKING DEPARTMENT

FINDING 1
LOAN ORIGINATION DEFICIENCIES

As set forth in the Audit Report, the auditors concluded that Cambridge did not always adhere to prudent lending practices in approving eleven of the eighteen HUD/FHA insured loans reviewed. While various alleged underwriting deficiencies are identified, the two most often cited criticisms were (1) ratios exceeded HUD/FHA Standards (8 of 11 loans) and (2) Inadequate Property Valuation (8 of 11 loans).

On the basis of the foregoing, the auditors recommend that Cambridge be required to (1) reimburse HUD for actual losses; (2) indemnify HUD/FHA against future losses on ten of the loans in question; and (3) provide a corrective action plan.

CAMBRIDGE'S RESPONSE

Prior to offering a case-by-case response to the Auditors' findings, a brief overview is warranted. In each of the 18 cases reviewed, the loans were in default. It is respectfully submitted that this created a skewed audit sample and HUD's alleged findings are not indicative of Cambridge's overall performance. Cambridge respectfully submits further that the auditors appear to have (1) failed to consider and/or give weight to relevant information contained in the loan files; (2) overlooked or misstated and misapplied applicable HUD guidelines; and (3) otherwise focused on shortcomings insufficient to warrant the audit report recommendations. Cambridge's foregoing contention can be best demonstrated by analyzing the often stated criticisms regarding ratios allegedly exceeding FHA/HUD standards and claims of inadequate property valuations.

HUD/FHA RATIOS

HUD Handbook 4155.1 Rev-4, Chg 1, Mortgage Credit Analysis for Mortgage Insurance on One-to-four Family Properties (which contains the HUD guidelines applicable during the timeframe that Cambridge originated the loans subject to the audit) discusses debt-to-income ratios and the compensating factors that may be used to exceed those ratios. As stated therein, ratios can be exceeded when significant compensating factors exist. Rather than establishing arbitrary percentages that may not be exceeded, the underwriter is authorized and encouraged by HUD to judge the overall merits of the loan and permitted to determine what compensating factors apply and, most importantly, the extent to which ratios may be exceeded.

Handbook 4155.1 Rev-4, Chg 1 sets forth a variety of compensating factors which may be used in justifying approval of mortgage loans with ratios exceeding HUD benchmark guidelines, the lender is advised that it is HUD's intention to allow ratios to be exceeded where significant compensating factors exist. HUD further advises the lender that it relies on the underwriter to judge the overall merits of the loan application and to determine what compensating factors apply and to the extent to which ratios may be exceeded. Among the enumerated compensating factors set forth in Handbook 4155.1, Rev-4, Chg 1, Chapter 2, Section 5 paragraph 2-13 are:

- The borrower has demonstrated an ability to accumulate savings and a conservative attitude toward the use of credit;
- Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses;
- There is only a minimal increase in the borrower's housing expense;
- The borrower has substantial cash reserves after closing; The borrower has potential for increased earnings, as indicated by job training or education in the borrower's profession.

While Handbook 4155.1 Rev-4 Chg 1 establishes a guideline ratio of 29% of the total mortgage payment to gross income and a 41% ratio of total mortgage payment together with all recurring charges to gross income, that section does not quantify the extent to which those ratios may be exceeded given the presence of one or more of the compensating factors. The lender is left broad discretion to determine the extent to which ratios may be exceeded. This policy is fully consistent with HUD's Direct Endorsement Underwriting Procedures and objective of promoting home ownership opportunities to qualified low and moderate income borrowers.

Generally, each of the loans for which ratio deficiencies were cited had significant compensating factors fully documented in the loan files which supported Cambridge's favorable underwriting decision. In some instances, the auditors overlooked relevant existing compensating factors, fully documented in the files, and at other times failed to give such factors appropriate weight. Cambridge respectfully submits that it made appropriate underwriting decisions consistent with HUD guidelines regarding each of these loans.

INADEQUATE PROPERTY VALUATIONS

It is critical to the underwriting process that the lender obtain an accurate and complete appraisal to ensure that it properly meets the minimum requirement and eligibility standards for an FHA-insured mortgage. Cambridge has at all times complied fully with this requirement. Cambridge utilizes only appraisers who are approved by FHA and carefully reviews all appraisals in accordance with HUD-FHA guidelines.

The auditors' criticism of appraisal reports contained in the loan files reviewed falls into two categories: (1) the valuation of the subject premises was higher than the predominant price of single-family homes in the neighborhood; and (2) the appraiser either failed to note the cost of enumerated renovations or where cost estimates appear, the source of those estimates. Cambridge respectfully submits that the alleged findings are not supported or represent a misunderstanding of the facts.

The Uniform Residential Appraisal Report (URAP) form used by FHA approved appraisers contains various information concerning the subject premises. Included in that report is various data, including but not limited to the price range and predominant price of singlefamily housing in the neighborhood.

An analysis of the eight loans criticized for alleged appraisal deficiencies reveals that the auditors frequently misinterpreted the significance of the neighborhood information contained at the top of the report. The auditors repeatedly state that Cambridge should have been "alerted" to the discrepancy between the predominant price noted for a *single family home* in the neighborhood and the estimate value set forth by the appraiser after appropriate consideration of comparable sales. In this regard, Cambridge respectfully submits that the auditors were clearly wrong.

In the first instance, there is no provision in the appraisal report for noting the predominant price in the neighborhood of *multifamily housing*. That a multi-family house has a substantially higher value than the predominant price of single-family housing in the neighborhood is plainly not appropriate for purposes of comparison. Many of the loans criticized by the audit team were for multi-family housing and accordingly, the "discrepancy" noted by the auditors is not supported.

Further, and importantly, in the case of the valuation of one-family homes, the predominant price of single-family housing in the neighborhood does not impose a limit on the valuation of the subject premises where appropriate comparable sales are noted, justifying the appraiser's conclusion. HUD imposes no restriction on the lender limiting its lending to the price of the predominant home in the neighborhood. For the most part, the "discrepancy" between the predominant price stated and the estimate value of the subject premises reflects the fact that the subject premises had been fully

renovated. A full and fair reading of the relevant appraisal reports notes the improvements made to each premises and fully explains why Cambridge neither should have been nor was "alerted".

With respect to the auditors' allegations that property valuations were inadequate on the basis that appraisers either failed to note the cost of renovations or the source of such estimates where cost estimates were included, those allegations are not supported.

Cambridge is not aware of any *HUD/FHA requirement* that the appraisal reports must contain an estimate of the cost of renovations, much less the source of such cost estimates. Absent such a mandate, it is simply unfair for the auditors to criticize otherwise comprehensive appraisals that have been performed in accordance with HUD/FHA guidelines. To the extent that the appraiser considered the renovated condition of the premises in forming an opinion as to value, each of the relevant appraisals appropriately itemize those renovations. In so doing, the appraisers fully complied with all applicable HUD/FHA requirements.

While other criticisms of minor alleged shortcomings are cited by the auditors and addressed by Cambridge in the individual case responses stated below, in not one instance do the auditors (1) state an opinion as to valuation different than that set forth in the appraisal report; (2) indicate that any of the comparable sales are inaccurately reported or that such sales are not a fair measure of the subject properties' valuation; or (3) offer an appraisal at variance with the appraisals contained in Cambridge's files.

For the reasons set forth above, to the extent indicated below, Cambridge respectfully submits that the audit findings regarding appraisals be dismissed.

(1) FHA CASE NO.: 374-3830526
LOANAMOUNT. $172,250.00
SETTLEMENT DATE: 11/9/01

Cambridge is willing to indemnify HUD with respect to this loan.

(2) FHA CASE NO.: 374-3956133
LOANAMOUNT. $245,150.00
SETTLEMENT DATE: 05/22/02

OIG Finding

The auditors in their Narrative Case Presentation set forth the following three alleged violations by Cambridge in originating this loan; (a) Debt-to-Income Ratios Exceeded HUD/FHA standards and the compensating factors did not provide adequate justification for exceeding the standards; (b) Loan Closed 18 Months after Bankruptcy Discharge; (c) Inadequate Verification of Assets Available in that a large deposit of $1,005.01 was made on May 22, 2002 and the borrower accumulated $500 cash, saved at home without demonstrating the ability to have accumulated such funds.

Cambridge's Response

As referenced above, one of the enumerated compensating factors listed in Handbook 4155.1 Rev-4, Chg 1 is that the borrower has documented substantial cash reserves (equal to at least three months) after closing. In this case, the borrower had accumulated $14,000 in her pension plan which funds were not required for closing. While the assets accumulated by the borrower were not liquid, pension funds are readily convertible to cash, provided the requisite taxes are deducted. Such funds, therefore, met fully the requirements of one of the compensating factors as defined in Handbook 4155.1 Rev-4, Chg 1. Assuming a reduction of 25% of this non-liquid asset, to account for requisite taxes if

withdrawn, the borrower demonstrated cash reserves of approximately $10,500 which exceeded the three-month requirement.

The borrower, at the time of application, was a tenured employee of the New York City Department of Corrections having been on the job for a period in excess of eight years (such job stability was considered a second compensating factor though not specifically enumerated). Cambridge took into account prior union pay raises (a third compensating factor although not specifically enumerated), the borrower's proven ability to accumulate savings (a fourth compensating factor specifically enumerated) in exceeding the back ratio. The front ratio's variation was permitted after determining that there was only minimal recurring debt. An additional compensating factor considered by Cambridge's underwriter was the borrower's favorable long-term rental history (a fifth compensating factor specifically enumerated)

The foregoing clearly demonstrates the presence of at least five compensating factors, fully documented in Cambridge loan files, which collectively were considered in making this loan. While the auditors acknowledge the existence of these factors, they nonetheless criticize Cambridge's underwriting stating that such compensating factors did not provide adequate justification for approving the loan with ratios exceeding guidelines. Cambridge respectfully submits that this criticism is without basis when the fully documented compensating factors are given due consideration and appropriate weight as contemplated by HUD/FHA guidelines.

Handbook 4155.1 Rev-4, Chg 1, Chapter 2, Section 1, paragraph 2-3E states in pertinent part that a Chapter 7 bankruptcy does not disqualify a borrower from obtaining an FHA insured mortgage if at least two years have elapsed since the date of the discharge of the bankruptcy. That paragraph further provides that an elapsed period of less than two years, but not less than twelve months, may be acceptable if the borrower can show that the bankruptcy was caused by extenuating circumstances beyond her control and has since exhibited a documented ability to manage her financial affairs in a responsible manner.

In this case, the borrower met the two-pronged requirement to the extent that the bankruptcy was caused by extenuating circumstances and she exhibited a documented ability to manage her financial affairs after the bankruptcy filing.

The borrower had purchased a 1994 Ford 4-door sedan in order to travel to and from her job with the Department of Corrections of the City of New York. That vehicle was purchased in March 1997. Prior to the borrower having an opportunity to place the registration sticker on her vehicle, it was stolen. While the borrower had obtained liability insurance, she did not obtain sufficient insurance to cover the loss incurred as a result of the theft of her vehicle. The borrower at the time of the application was a single parent with three children and required the automobile to facilitate her travel to and from her job. As a result, she was left with insufficient funds to satisfy the loan which was incurred to acquire the vehicle and had to use her available disposable income to pay for alternate transportation to and from her job. This was the sole motivating factor in her decision to file for bankruptcy. The borrower reestablished new credit after the bankruptcy and all obligations thereafter were paid as and when due.

As demonstrated above, the bankruptcy was clearly caused by extenuating circumstances beyond the borrower's control. This event was a criminal act perpetrated by a third party unrelated to the borrower's actions and not in any way attributable to reckless acts of spending or otherwise, and accordingly, the event was not likely to recur. The credit report indicates eight accounts, post bankruptcy, with not a single late payment, which demonstrated to Cambridge that the borrower managed her financial affairs in a responsible manner. Cambridge properly found the borrower acceptable and the auditors' criticism is thus not supported.

The auditors' final criticism of this loan was that the borrower had made a "large unexplained deposit" shortly before the closing. Again, Cambridge respectfully submits that the auditors' comments

are not supported. As of May 22, 2002, the borrower had accumulated the sum of $1,012.69 in her bank. The auditors noted that a deposit of $1,005.01 was made on May 22, 2002. The borrower regularly deposited into her checking account her bi-weekly paycheck and withdrew from that account such sums that were necessary for her to meet her day-to-day living expenses. The characterization by the auditors of the borrower's "large deposit" is unjustified. HUD guidelines provide that the lender must determine the reasonableness of an accumulation of funds based upon the borrower's income stream taking into account borrower's spending habits and history, which Cambridge properly considered in this case.

With respect to the auditor's comment related to the failure to document the borrower's accumulation of $500, it is clear that the auditors did not review the bank statements contained in the loan file and failed to properly note the contents of those statements. The borrower's bank statements indicate a regular pattern of cash withdrawals. Taken together with the zero balances on her charge cards, it should have been evident to the auditors as it was to Cambridge that this borrower regularly accumulated cash at home to pay her bills and to meet expenses.

For the reasons set forth above, Cambridge believes that it properly underwrote and approved this borrower since Cambridge complied with applicable guidelines established by HUD. Annexed hereto and made a part hereof and marked as Schedule "J-2" are copies of the borrowers credit report; automobile registration and report of lost or stolen vehicle; retail certificate of sale and bank statements.

(3) FHA CASE NO. 374-3999860
LOANAMOUNT. $257,050
SETTLEMENT DATE: 05/23/02

OIG Finding

The auditors in their Narrative Case Presentation set forth the following three (3) alleged violations by Cambridge in originating this loan; (a) Debt-to-Income Ratios Exceeded HUD/FHA standards and the compensating factors did not provide adequate justification for exceeding the standards; (b) Appraisal Report was Not Adequately Reviewed in that the appraiser failed to comment as to the dollar amount of the renovations, included value estimate; the appraiser's value estimate of $262,000 is considerably higher than the predominant price of single-family homes; and the basement living units did not meet FHA acceptability criteria.

Cambridge's Response

In this case, the borrower had very little recurring debt based upon the credit report (a specifically enumerated compensating factor) which permits greater latitude in qualifying the borrower as provided in Handbook 4155.1 Rev-4, Chg 1. The only open account was Sears in the amount of $308 which accounted for a minimal monthly payment of $12. The borrower was employed as a field technician employed by Verizon and the borrower received a substantial pay raise in 2001. In accordance with Handbook 4155.1 Rev-4, Chg 1, the borrower had the potential for increased earnings by job training in the borrower's occupation (a second specifically enumerated compensating factor). The union contract historically provided for periodic raises and it was anticipated that the employment and increased compensation would continue (a third compensating factor). Additionally, overtime income was anticipated (a fourth compensating factor). The borrower's credit history demonstrated a history of timely repayment of loans and consistent timely payment of rent (a fifth compensating factor). The existence of the above-referenced compensating factors, justify Cambridge's approval of the borrower and conform fully to HUD/FHA guidelines.

The auditors were critical of the appraisal contained in Cambridge's files and cited four claimed deficiencies. The Audit Report notes that the appraiser did not disclose the source or verify any cost of renovation work. Again, HUD/FHA requirements impose no obligation on the appraiser to include such information in his report and thus these comments are unwarranted. Looked at fairly, the appraisal is comprehensive, including the itemization of the remodeling of the subject property with specific reference to new windows, flooring, drywall, paint, kitchen fixtures, cabinets and appliances, ceramic bathroom fixtures and updated electric and plumbing service.

The auditors further contend that Cambridge should have been alerted to the discrepancy between the predominant price of a single-family home in the neighborhood and the price of the subject premises. In the first instance, the subject premises was a fully-renovated *two-family residence* and accordingly, any comparison to the price of a *single family residence,* predominant or otherwise, is inappropriate. Additionally, as previously noted, the fact that a fully-renovated home may be substantially more valuable than the predominant price of such homes in a neighborhood in which many homes have yet to be fully renovated is unremarkable. Accordingly, the best measure of value is the comparable sales noted in the report which cannot and should not be discredited by reference to the predominant price of *single family homes.*

The auditors finally criticize the appraisal for including a finished basement as habitable space. A review of the file and in particular, the appraisal, indicates that it was not included. In support of this contention, as shown by the first page of the appraisal which identifies a square footage of gross living area of 1412. The aggregate of levels 1, 2 and 3 does not include the sum of 527 square feet, which is the basement area. Looking at the relevant information of the subject premises in the sales comparison analysis located on page two, the sales price is indicated as $261,100. A price per square foot of gross living area of $184.92 is stated, which is calculated by dividing the sales price by 1412 which, as previously noted, does not include the basement area. Annexed hereto and made part hereof and marked Schedule "J-3" are copies of the borrower's credit report, appraisal report and rental verification form.

(4) FHA CASE. NO. 374-3913246
LOAN AMOUNT. $132,900
SETTLEMENT DATE: 3/04/02

OIG Finding

The auditors in their Narrative Case Presentation set forth the following three alleged violations by Cambridge in originating this loan; (a) Debt-to-Income Ratios Exceeded HUD/FHA standards and the compensating factors did not provide adequate justification for exceeding the standards; (b) Gift Funds Not Verifiable in that it is indicated that the case file did not contain evidence that a gift existed and that the gift was the source of the down payment; (c) Appraisal Report Was Not Adequately Reviewed in that the appraiser failed to disclose the source of the information associated with the renovations and the cost and failed to support the value estimate.

Cambridge's Response

Again, reference is made to Handbook 4155.1 Rev-4, Chg 1 which describes the compensating factors that may be used to exceed the qualifying ratios. A review of Cambridge's file indicates that the borrower showed liquid cash reserves of $4,739.28 after closing which exceeded the three-month requirement (a specifically enumerated compensating factor). Additionally, the borrower anticipated experiencing only a minimal housing expense increase from $1,200 to $1,328 (a second compensating factor).

Further, the file demonstrates very little recurring debt (a third compensating factor) and the borrower demonstrated employment stability by retaining the same job for 27 years (a fourth compensating factor). Accordingly, Cambridge's decision to make this loan in spite of small variations in both the back and front ratios fully complied with HUD's guidelines and was in all respects proper.

The auditors' second criticism was that the loan file did not contain evidence of a gift and that the gift was the source of the down payment. This contention is not supported by the documentation contained in the loan file. The source of the funds is documented in the loan file as having been derived by the donor as an award under Worker's Compensation Law. Initially, the funds were deposited into a joint account in the name of both the borrower and her sister, the donor. At all times the borrower had full use of the funds on deposit as verified in writing by the donor. Subsequently, the funds were transferred to an account solely in the borrower's name and from that account the contract deposit was made. Finally, documenting this gift is a pre-funding Gift Letter confirmation form and Gift Affidavit appearing in Cambridge's files.

The auditors' final criticism of this loan is based on the appraiser's alleged failure to disclose the source of information associated with the renovations and the cost of such renovations. The appraisal contained all necessary information including comparable sales. Once again, the appraisal was performed by an FHA-approved appraiser and the contract price fell squarely within the range of recent comparable sales. The auditors' criticism regarding the appraisers' failure to disclose the source of information associated with renovations and the cost of such renovations, has been fully dealt with in prior sections of this response and, accordingly, need not be reiterated here.

Annexed hereto and made a part hereof and marked as Schedule "J-4" are copies of the borrower's credit report, Mortgage Credit Analysis Worksheet (MCAW), Gift Affidavit signed by borrower's sister, pre-funding gift letter confirmation, copy of Workers' Compensation Board Notice of Approval, copy of letter from donor indicating borrower has full use of funds in account and copies of probative bank statements.

(5) FHA CASE NO. 374-3935308
LOANAMOUNT. $231,350
SETTLEMENT DATE: 06/27/02

Cambridge is willing to indemnify with respect to this loan.

(6) FHA CASE NO. 374-3772590
LOANAMOUNT. $319,450
SETTLEMENT DATE: 08/15/01

While not in agreement with all of the auditors' criticisms, Cambridge acknowledges that its underwriting of this loan fell short of HUD/FHA requirements. The underwriter who reviewed this file is no longer employed by Cambridge. Cambridge respectfully requests that it be provided with further information concerning HUD's claimed loss expenses with respect to this loan.

(7) FHA CASE NO. 374-4048106
LOANAMOUNT. $293,350
SETTLEMENT DATE: 08/20/02

OIG Finding

The auditors in their Narrative Case Presentation set forth the following three alleged violations by Cambridge in originating this loan; (a) Debt-to-Income Ratios Exceeded HUD/FHA standards and the compensating factors purportedly did not provide adequate justification for approving the loan; and (b) Inadequate Debt Verification concerning an account entitled "Visa Secured-S51."

Cambridge's Response

Reference is once again made to Handbook 4155.1 Rev-4, Chg 1 which permits the lender to consider compensating factors in approving mortgage loans with ratios exceeding FHA's benchmark guidelines.

In this case, the borrower's only debt was $1,300 which required modest monthly payments in the amount of $35. The auditors criticized Cambridge for not taking into account periodic payments made by the borrower in connection with a secured credit card, which they viewed as an additional debt which caused them to calculate that the borrower's debt/income ratio slightly exceeded the 41% guideline, to wit: 43.47%. Cambridge respectfully submits that the auditor's criticism in this regard is not supported.

Even if the secured credit card is to be considered a recurring debt, the inclusion of the $50 deduction caused the ratio to be exceeded by less than 2-1/2%. As stated in Handbook 4155.1 Rev-4, Chg 1, the underwriter has broad discretion in approving borrowers who exceed the guidelines. In this case, there was minimal recurring debt and to criticize Cambridge with the benefit of hindsight is simply unfair. The adjustment to the ratios is clearly permitted.

Unlike an unsecured credit card debt, the cardholder in this case could not exceed charges on the IR card in excess of the security previously deposited. Accordingly, in the event that the borrower was unable to make the periodic payments as required, the credit card company would have merely offset any balance due and owing against the security. For that reason, Cambridge believes that a secured transaction of this type is clearly distinguishable from that where no security has been placed with the credit card company and, accordingly, should not be treated as a conventional debt.

Annexed hereto and made part hereof and marked as Schedule "J-7" is a copy of the borrower's credit report.

(8) FHA CASE NO. 374-3776804
LOANAMOUNT. $284,500
SETTLEMENT DATE: 08/27/01

OIG Finding

The auditors in their Narrative Case Presentation set forth the following three alleged violations by Cambridge in originating this loan; (a) Debt-to-Income Ratios Exceeded HUD/FHA standards without listing compensating factors and further state that the MCAW did not provide adequate justification for approving the loan with ratios exceeding the HUD/FHA standards; (b) Appraisal Report was Not Adequately Reviewed in that the report does not offer comment regarding the property meeting the FHA criteria for a two-unit structure; the repair list shows a new roof was installed, however, the roof certification states that the roof has only a four to five year remaining life; that the appraiser's value estimate is considerably higher than the predominant price of a single-family house; the repair list shows a "new boiler" when the heating system (forced hot air) does not require one and that the value appraisal is considerably higher than the single-family house price range contained in the report.

Cambridge's Response

Again, while acknowledging the existence of compensating factors, the auditors unjustifiably criticize Cambridge's underwriting in approving a loan with ratios exceeding HUD/FHA guidelines.

Prior to making this loan, Cambridge verified the borrower's employment as a field service technician with Keyspan, one of the area's largest utility companies. The verification revealed a steady increase in earnings (a compensating factor), from the year 1999, 2000 through 2001. The verification further indicated that the borrower had been employed for approximately seven years and that his probability of continued employment was good (a second compensating factor). When taking into account potential overtime and ordinary pay increases, Cambridge determined that the borrower met the criteria contained in Handbook 4155.1 Rev-4, Chg 1 in approving this loan. Further, based upon the contents of the verification of employment, the borrower enjoyed an approximate eight percent increase in income over the most recent three-year period. These compensating factors clearly provided adequate justification for the modest ratio variations noted in the audit report.

With respect to the appraisal report, prior to making this loan, Cambridge obtained a Certificate of Occupancy report which indicated that the premises was a two-family dwelling. The Certificate of Occupancy further indicated that the premises contained a gas heating system. It is acknowledged that the appraisal report makes reference to a "boiler", whereas the proper reference should have been to a burner. This inconsistency, in Cambridge's opinion, did not in any way affect the value estimate of the premises, since the price of either piece of equipment is similar. Similarly, the fact that there appears to be a discrepancy between the appraisal report's notation of a new roof and the contents of the roof certification indicating a four to five year remaining life, does not impact significantly upon the value of the premises.

Finally, the auditors again unfairly criticize the appraisal report citing the predominant price of a *single family residence* in the neighborhood. The subject premises are a renovated *two-family house,* and accordingly, reference to the predominant price of a one-family house in the neighborhood is inappropriate.

As contained on the comment addendum, the improvements were specifically enumerated. These improvements were completed and, accordingly, the appraiser determined the value of the premises by giving due consideration to the premises' renovated condition.

Based upon all of the foregoing, Cambridge respectfully submits that it made an appropriate underwriting judgment approval based upon all supportive documentation in its possession, which justified the approval of this loan. Annexed hereto and made part hereof and marked as Schedule "J-8" are copies of the following documents: appraisal report, Certificate of Occupancy report, and Employment Verification.

(9) FHA CASE NO. 374-3778152
LOANAMOUNT. $221,500
SETTLEMENT DATE: 09/06/01

OIG Finding

The auditors in their Narrative Case Presentation allege that Cambridge should have been "alerted" to problems with the appraisal report. However, only one such item is specifically noted in connection with this comment. That item relates to the fact that one of the rear bedrooms of the premises should not have been counted as a bedroom since allegedly one had to pass through an adjacent bedroom

in order to gain access to it. The basis for the auditor's comment is a sketch which was attached to the appraiser's report.

Cambridge's Response

While that sketch in the appraiser's report erroneously makes it appear that one of the bedrooms did not have a separate entrance, a subsequent visit by the appraiser confirmed that it is the sketch and not the appraisal report which was in fact inaccurate. Each bedroom at the residence has a separate entrance notwithstanding that the appraiser's sketch did not properly depict this condition. Had the sketch been accurate, the appraisal report would have noted functional obsolescence; however, no such notation appears therein.

The fact that the sketch was made in error, does not diminish the estimated value of the subject premises nor properly cause the quality of the overall report to be in question.

Annexed hereto and made part hereof and marked as Schedule "J-9" is a copy of the Appraisal Report with addendum.

(10) FHA CASE NO. 374-3726304
LOANAMOUNT. $225,450
SETTLEMENT DATE: 08/10/01

OIG Finding

The auditors in their Narrative Case Presentation allege that Cambridge should have been "alerted" to problems with the appraisal report noting that the appraiser did not indicate that renovations on the property had been made nor the identity of the owner who renovated the premises. The auditors further criticized the appraiser for not commenting on the dollar amount of the renovations or the quality of the work performed.

Cambridge's Response

Given the circumstances of this case, Cambridge respectfully submits that the auditor's comments are not supported. The appraiser first visited these premises on July 12, 2001. The appraisal report of even date indicates that at that time the subject premises was "in the process of being completely renovated." The addendum to the appraisal report indicates the nature of work that was ongoing, including new kitchen, walls, flooring, painting and some windows. Though not required, values of individual items are set forth, the total estimate of all work to be performed in the amount of $32,000. The auditor's comment that the owner of the premises at the time of renovation was not noted is indicative of the fact that the auditors failed to adequately read the report and to consider its contents. The report on its face indicates the identity of the owner at the time of renovation as The Chicago Corp.

Subsequently, the appraiser revisited the premises on August 08, 2001 as indicated by the Compliance Inspection Report. That report indicates that all work had been completed and fully details the extent of the renovation, including all new bathrooms and kitchens, all new drywall throughout the dwelling, including basement, new boiler and water heater, new stairs, exterior foundation repair and painting, siding repairs, new interior and exterior doors and garage painted. Appended to the Compliance Inspection Report are photographs of the renovated premises further confirming their condition subsequent to the renovation. Clearly, the renovation had been performed in an appropriate manner and the initial appraisal of the premises indicated, even prior to the completion of the renovations, that the condition of the premises was "good."

By reason of the foregoing, nothing in the appraisal report should have "alerted" Cambridge to any problems. It is clear that the appraisals were conducted in a most careful manner, including but not limited to, a compliance inspection. Further, the auditors, while commenting on this appraisal, do not state that the valuation set forth did not fairly and accurately reflect the condition of the premises at or about the time of sale. Annexed hereto and made part hereof and marked as Schedule "J-10" are copies of the Appraisal Report and Compliance Inspection Report.

(11) FHA CASE NO. 374-3833863
LOANAMOUNT. $195,400
SETTLEMENT DATE: 04/16/02

OIG Finding

The auditors in their Narrative Case Presentation allege that the appraisal report disclosed several items that should have "alerted" Cambridge to problems with the appraisal report. In particular, they note that the sales price per square foot for the subject premises "exceeded the top end of the adjusted sales price." Also, the auditor noted that the appraiser did not comment as to the dollar amount of renovations included in the value estimated, nor allegedly comment on the quality of the renovation work.

Cambridge's Response

A careful review of the appraisal report contained in this loan file does not support the auditor's criticism. While it is true that the subject premises' price per square foot is somewhat higher than three of the Comparable sales noted, it is almost identical to the per square foot calculation in Comparable #3 set forth in the appraisal report. It is noteworthy that with respect to Comparable #3, that it is the only Comparable which like the subject premises, includes a full finished basement. Further, the condition of both the subject premises and Comparable #3 are each noted as "average/good" whereas the other comparables note as their conditions merely "average". Based on the presence of a finished basement and the condition of the subject premises as noted in the appraisal report, it was both fair and appropriate to consider the subject premises more closely in line with the per square foot cost asserted with Comparable #3 than with the other Comparables noted.

While the auditor's report alleges that the dollar amount of renovations was not included in the value estimate. As previously stated, there is no HUD/FHA requirement for the inclusion of such information in the appraisal report. The addendum to the appraisal specifically notes that the property had been completely renovated. In particular, the presence of an all-new kitchen and bathroom were noted as were new walls and ceilings and the fact that all rooms had been painted. New carpeting was installed in all rooms except the kitchen and bathroom and the basement had been newly finished.

Accordingly, while the appraiser did not comment on the dollar amount of the renovations, clearly he considered the renovated condition of the premises in reaching a valuation determination and referred to the subject as renovated and in "good condition" in that section of the addendum entitled "Condition of Improvements."

Taking into account the foregoing, Cambridge respectfully submits that there is no justification for the auditor's comment that Cambridge should have been "alerted" to problems with the appraisal report. Annexed hereto and made part hereof and marked as Schedule "J-11" is a copy of the Appraisal Report.

Summary

Cambridge respectfully submits that the Audit Report should be amended to delete the findings except to the extent indicated above.

In each instance where Cambridge has disputed the auditor's findings, there is more than ample justification in each of the relevant files to support Cambridge's underwriting and approval of those loans.

Criticisms based on (1) alleged failures to obtain sufficient documentation warranting approval of loans where benchmark ratios were exceeded or (2) alleged undue weight ascribed to existing compensating factors are not supported. Cambridge respectfully submits that these criticisms indicate the auditors' failure to carefully scrutinize the contents of loan files and reluctance to give appropriate weight to fully documented existing compensating factors in accordance with HUD-FHA guidelines.

Similar criticisms regarding alleged inadequacy of appraisals are not supported. Those comments reflect the auditors' (1) improper efforts to impose requirements, i.e. costs and sources of renovations, not required by HUD/FHA and (2) inappropriate use of predominant neighborhood pricing of one family housing as contradicting recent comparable sales noted in otherwise comprehensive appraisals performed in accordance with HUD-FHA requirements.

Conclusion

Cambridge appreciates the opportunity to respond to the draft audit findings. Cambridge further respectfully submits that on the basis of this response, the Audit Report and its recommendations should be revised and, except to the extent noted, be amended.

FINDING 2 ORIGINALLY ENTITLED "CAMBRIDGE VIOLATED HUD's TIERED PRICING RULE" AND SUBSEQUENTLY AMENDED TO "CAMBRIDGE DID NOT DOCUMENT VARIATIONS IN ITS MORTGAGE CHARGE RATES"

Cambridge respectfully submits that it has always been committed to strict compliance with HUD requirements, including HUD's Tiered Pricing Rule and requirements regarding overages. Cambridge at all times adheres to all fair lending requirements and mandates the equal treatment of all prospective borrowers without regard to race, sex, sexual orientation, color, national origin, religion, age, marital status, disability or any other prohibited basis. Cambridge makes no exception to the principle that every prospective applicant for mortgage credit receives fair and equal treatment.

A. Background

HUD's Tiered Pricing Rule provides in pertinent part that "a lender's customary lending practices may not provide for a variation in `mortgage charge rates' (discount points, origination fees and other such fees) exceeding two percentage points on its FHA-insured single-family mortgages within a geographic area. "The rule further provides that "any variation within two points must be based on actual variations in fees or costs to the lender to make a loan" and that "variations may take into account the value of servicing rights generated by making the loan and other related income to the lender." (Mortgagee Letter 94-16)

The prohibition against tiered pricing implements section 203(t) of the National Housing Act. The purpose of the rule is to eliminate a mortgagee's discriminating pricing of FHA-insured mortgages. The section is concerned with lending practices that unfairly impose costs and charges that are higher for smaller loans than for larger loans. (Mortgagee Letter 94-16, Section I "Introduction")

As amplified by HUD's responses to public comments made a portion of Mortgagee Letter 94-16:

(i) The rule sought to minimize a mortgagee's recordkeeping burden and does not require a separate and distinct recordkeeping system;

(ii) The rule permits a mortgagee to have a lending policy that permits occasional deviations from the standard terms that it is generally offering to customers in its lending area, even if beyond a two percentage point variation, provided thosedeviations are not applied in a discriminating fashion and are available to purchasers on lower as well as higher-priced homes on an individual basis.

Overages are the subject of Mortgagee Letter 94-43. As defined therein "overages occur when loan officers are allowed to charge a higher interest rate, origination fee, or discount points for a loan than the lender's market rate for FHA-insured loans during the same period of time. As further set forth "although not inherently discriminatory, in some instances the practice of charging overages may result in discrimination on a prohibited basis in violation of the Fair Housing Act (FHAct) or the Equal Credit Opportunity Act (ECOA). Under both FHA and ECOA, prohibited bases include race, color, religion, sex and national origin.

B. Initial Audit Report Finding

The Audit Report initially stated that "Cambridge did not always comply with HUD's Tiered Pricing Rule in determining the mortgage charge rates for its FHA borrowers." The report indicated that "Cambridge originated FHA insured mortgages with the same interest lock date that have variations in mortgage charge rates exceeding two percentage points." Further, the auditors stated that "Cambridge did

not document nor provide adequate justification for variations in its mortgage charge rates for loans originated within two percentage points."

In support of these findings, the report identified ten instances over a two-year period out of 436 FHA loans in which it was claimed that variations in Cambridge's mortgage charge rates exceeded two percentage points. Those instances were set forth in charts appearing at pages 8, 9 and 10 of the report.

C. Redrafted Audit Report Findings

On May 26, 2004, Cambridge received an amendment to the initial audit report consisting of a new Finding 2. No longer entitled "Cambridge Violated HUD's Tiered Pricing Rule," the new Finding 2 is entitled: "Cambridge did not Document Variations in its Mortgage Charge Rate." This redraft is of considerable import. Apparently, the auditors upon due consideration have themselves determined that their audit did not disclose adequate support for their original claim that Cambridge had violated the Tiered Pricing Rule. Instead, the auditors most recently have decided that the most they can conclude from their audit is that Cambridge failed to properly document variations and that the auditors are therefore left to speculate as to the reason for variations in mortgage charge rates. As set forth in the redrafted Finding 2, the auditors now speculate that the variations *may have been* the result of lending practices that did not comply with HUD requirements on overages or tiered pricing.

As shall be demonstrated in this response, justification for variations in the mortgage charge rates appear in each of the relevant loan files and such variations are not the result of discriminatory lending practices either those prohibited by the Tiered Pricing Rule or barred as discriminatory overages as stated in Mortgagee Letter 94-43.

D. Preliminary Statement

As shall be demonstrated in latter portions of this response, variations in mortgage rates and discount points charged to Cambridge customers are unrelated to either the size of the loan sought or reflective of any overages discriminatory or otherwise.

Cambridge's mortgage interest rates and discount points structure is set by its president, Seth Kramer, and no loan officers are or ever have been permitted to seek a rate or discount points in excess of that determined by Mr. Kramer and prohibited by HUD requirements. That being the case, Cambridge respectfully submits that there are no overages as that term is defined by HUD, much less those resulting from discriminatory practices.

E. The Method of Determining Mortgage Charge Rates Employed by the Auditors is Flawed

In support of the auditor's original conclusion, that Cambridge had violated HUD's Tiered Pricing Rule, they calculated mortgage charge rates by merely adding the original fee to the discount fee and note rate. This methodology is best visualized by reference to the charges originally appearing at page 8, 9 and 10 of the initial report. In each of those instances, a calculation appears entitled "Mortgage Charge Rate" and the numeral below that heading is the sum of those numerals appearing under the headings "Origination Fee", "Discount Fee", and "Note Rate".

Apparently, after review of the initial report, the auditors themselves concluded that they were not comfortable with this method of calculation. Accordingly, while the revised report continues to refer to "variations in mortgage charge rates", the charts now contained within that section no longer reflect a mortgage chart rate or how such rate was determined on a case-by-case basis.

In the auditor's initial report, the discount fee and note rate were given equal weight thereby causing apparent variations where none existed or otherwise overstating such variations. If, and only if, a 1 % discount fee would entitle a borrower to a corresponding 1 % reduction in the note rate, would the auditor's analysis be appropriate and accurate. As shall be more fully described below, Cambridge respectfully submits that such an assumption was completely unwarranted; contrary to industry-wide standards; incompatible with Cambridge's practices and accordingly, wholly unsustainable.

By way of example, one need only consider case numbers 374-3673139 and 3743749284 appearing in the initial report. Both of these loans were locked on the same date. Each borrower paid a 1% origination fee. The difference in these loans is that one borrower paid a 1% discount fee obtaining a note rate of 8.25 while the other paid an additional 1 % discount fee (a total of 2%) thereby obtaining an 8% note rate. Clearly, these borrowers were treated fairly and equally in that the additional discount fee paid by the borrower in case number 374-3749284 was reflected in a corresponding reduction in note rate. By merely adding the note rate paid by these borrowers to the discount and origination fees charged, the auditors arrived at different mortgage charge rates of 10.25 and 11. This difference was illusory.

For purposes of further illustration of the flawed methodology initially utilized by the auditors in calculating the mortgage charge rate, consider the following hypothetical. Assume a mortgagee prevailing rate of 8%. Further assume that borrower A chooses to accept that rate and does not take advantage of the opportunity to buy down the rate by the payment of discount points. On the other hand, borrower B prefers a lower rate and thus pays four points to buy the rate down a full 1% to 7%. The auditor's method of calculation, assuming each borrower pays a 1 % origination fee would lead to the following calculation in the mortgage charge rate paid by the two hypothetical borrowers:

Borrower A: Origination fee 1 + discount fee 0 + note rate 8 =
Mortgage charge rate of 9

Borrower B: Origination fee 1 + discount fee 4 + note rate 7 =
Mortgage charge rate of 12

The apparent difference in the mortgage charge rates of the two hypothetical borrowers would thus be calculated at 3, well in excess of the limitations imposed to the Tiered Pricing Rule. Utilizing the auditor's flawed methodology, to equalize the mortgage charge rates of borrower A and borrower B, borrower B's note rate would have had to have been reduced to 4%!

This result again merely reflects the auditor's inappropriate calculation of the mortgage charge rate rather than indicating a real difference in the treatment of our two hypothetical borrowers. This example further illustrates that in accepting discount points without reducing the note rate on a one-for-one basis (which, of course, no lender can prudently do), a lender may be viewed as having violated the Tiered Pricing Rule where no such violation has occurred.

Cambridge respectfully submits that an appropriate analysis would require the auditors to consider the impact of each discount point on the note rate rather than merely adding the two. Assuming that each discount point paid entitles a borrower to a .25% reduction in the note rate, the mortgage charge rate for case numbers 374-3673139 and 374-3749284 would be identical.

Further, Cambridge respectfully submits that nowhere within the rule is there authority for the methodology employed by the auditors in this case. While the rule requires the auditors to consider origination fees, discount fees and loan rates, it neither requires nor authorizes auditors to merely derive the arithmetic sum of the three, giving equal weight to discount points and note rate as if they bore a 1 to 1 relationship.

Importantly, an analysis of the loans set forth at pages 8, 9 and 10 of the initial audit report considering the discount fees paid as impacting of the note rate as previously described, rather than merely calculating the arithmetic sum, yields mortgage charge rates *none of which vary in excess of 2%.*

F. Cambridge's Standard Practice and Procedure in <u>Setting Interest Rates on FHA Insured Mortgage Loans</u>

HUD permits a lender to set interest rates on a periodic basis without limitation. Such rates reflect a lender's business judgment as to the rate which it requires at any point in time to originate a mortgage loan. Various factors typically influence a lender in considering and setting rates. At Cambridge, such factors include, but are not limited to, the average basic cost of origination by allocation of general overhead among the mortgages originated; commissions; prices available in the secondary market; servicing release premiums and rates set by competitors in the marketplace.

Establishing an appropriate "par" rate is critical to the success or failure of a mortgage lender. If the rate is too low on a worst-case basis, the enterprise will fail. It is equally critical to avoid setting the rate so high as to adversely affect market share.

The information which forms the basis for rate determination at Cambridge is known only to its principals. They and they alone are aware of general overhead, commissions, pricing in the secondary market and other relevant factors. It is the company's president who makes this determination.

In setting rates on FHA-insured mortgage loans for home purchasers, those rates presume the payment of two discount points. The reason for this presumption is inherent in the structure of these transactions and a direct result of HUD's willingness to permit home buyers to obtain from sellers a concession of up to 6%.

Cambridge's typical borrowers have negotiated a full seller's concession of up to 6% reflected in the contract between the parties. In so doing, the borrower has, *in advance,* determined it advantageous to obtain the best rate obtainable by the payment of discount points. Were it otherwise, the seller's concession would be of limited value, if not wholly valueless to the borrower. This is true because any portion of a seller's concession not utilized for allowable closing costs is retained by the seller and results in a windfall to him or her.

By way of further clarification allowable costs without inclusion of discount points would rarely, if ever, exceed 3% to 4% of the purchase price. To the extent that the borrower negotiates a concession of up to 6%, it is clear from the outset that they expect to pay discount points, the purpose of which is to obtain a favorable rate, resulting in a lower monthly payment.

To fully utilize the maximum available seller's concession, thereby giving full benefit to the borrower, customarily permits the inclusion of two discount points within allowable costs. Cambridge accordingly sets its prevailing rate assuming the payment of two discount points, such rate being lower than it would have been had the points not been charged, thus benefiting the borrower.

Interest rates and discount fees are treated somewhat differently for refinance transactions since there are no seller's concessions and, accordingly, the borrower's intention to pay points cannot be inferred. Additionally, this market is especially competitive and rate sensitive.

The rate and discount point structure in these transactions is thus negotiated on a case-by-case basis. In some instances, borrowers prefer a higher rate without requiring the payment of discount fees. In other cases, the prime objective is the lowest rate, in which event discount fees are warranted and

acceptable. It is thus difficult and unavailing to compare rates and points in these cases, particularly since rates often vary merely on the basis of whether or not the borrower seeks a "cash out" from the refinance.

Most importantly, neither in the case of loans facilitating purchases nor in the case of refinancing does Cambridge consider the size of the loan nor does it consider race, color, religion, sex, national origin or any other prohibited basis in determining either rate or discount points to be charged. While the auditors, noting variations in rates and discount points charged, stated a concern that Cambridge's lending practices may violate the Tiered Pricing Rule or evidence prohibited overages, there is no justification for these concerns that is supported by any information contained in the loan files which were carefully reviewed by the auditors for a period of seven months.

G. Variations

Cambridge's ability to obtain its prevailing rate is impacted by (1) availability of funds from which to pay discount points; and (2) ratio requirements limiting loan rates to be charged, to qualified borrowers.

As previously stated, a 6% seller's concession typically permit the payment of two discount points. However, in some instances there is no concession negotiated by the buyer or the concession is limited in dollar amount. In such cases, the buyer may have no other available funds from which to pay discount points. Cambridge then seeks to increase the loan rate; however, in most cases the ratio requirements imposed by HUD prevent Cambridge from doing so. Accordingly, Cambridge then has two choices: (1) not make the loan; or (2) reduce the loan rate without the payment of discount points. Cambridge's policy is and has always been, whenever feasible and when circumstances dictate, to select option (2). That is, when debt/income ratios require a reduction in note rate below its prevailing rate, Cambridge first seeks additional discount points to compensate for such reduction and, if the borrower does not have sufficient funds with which to purchase such discount points, Cambridge closes the loan nonetheless rather than refusing to do so. In no event is Cambridge's policy impacted by the size of the loan or any other discriminatory consideration.

Conversely, there are numerous instances where, often at the closing, it appears that the total of all allowable costs (which cannot be readily calculated until shortly before or at the closing) including the two discount points to be charged exceed the 6% allowable seller's concession. It is not the exception but the rule that in most instances the borrower has insufficient funds to pay the closing costs in excess of the concession. Cambridge again facilitates closings and accommodates its borrowers by waiving that portion of the discount fees to which it is entitled required to permit the transaction to close.

Cambridge respectfully submits that these accommodations, while causing variations in interest rates and discount points charged among borrowers are fully *compatible with HUD's objective to encourage home ownership,* evidence Cambridge's sound business judgment and cannot reasonably be seen as a violation of the Tiered Pricing Rule or other HUD prohibition.

While the foregoing accounts for most variations, other business considerations explain the balance. In one instance, case number 374-4245311, the low note rate (4.5%) and absence of a discount fee was due to the fact that the borrower was a close personal friend of the company's president.

In some instances, borrowers obtained favorable rates and discount point structures to enable Cambridge to compete with other lenders actively soliciting the borrower (i.e., 374-3806092).Similarly, a discount point was waived to accommodate a borrower who was a client of a

business acquaintance (374-3822332). These types of considerations, applied on an occasional basis, do not violate the Tiered Pricing Rule and are permissible as amplified by HUD's responses to public comments.

The foregoing further constitutes a response to the auditors' concern that their audit identified loans having the same lock date where borrowers were charged the same discount points but two different interest rates. From this, it appears that the auditors incorrectly deduced that there was no relationship between interest rate and discount points charged and caused them to observe that they could not determine whether borrowers received anything for discount points charged.

Due to ratio limitations and cash availability, rates and discount points were adjusted (reduced) to accommodate the needs of individual borrowers so that loans which would otherwise have been rejected were closed. Cambridge at all times sought to obtain its prevailing rate including two discount points in the case of home purchases; however, when prevented from doing so, sound business judgment prevailed. This policy fully explains why on a given day two borrowers may have paid equal discount points and obtained different loan rates. In all probability, the lower loan rate was dictated by ratio limitations which ordinarily would have warranted an additional discount fee which was not available and therefore waived by Cambridge for the benefit of the borrower.

Cambridge respectfully submits that the auditor's concern that borrowers may have not received anything of value for discount points charged, is unwarranted. As previously indicated, in the case of home purchasers, those borrowers obtained favorable rates on the basis of the payment of discount points which rates would not have been available had those points not been agreed upon.

Cambridge is engaged in a highly competitive business. If it had indeed charged discount points, not reflected in its note rates, it would not have been able to effectively compete with other FHA lenders. At all times Cambridge has sought to enhance its market share and effectively compete with other FHA lenders by establishing and implementing competitive pricing policies. As part and parcel of this policy, discount points are charged to permit reduced note rates and any suggestion to the contrary is simply erroneous.

H. Cambridge's Recordkeeping Responsibility

As articulated in both the original draft audit report and as appears in the more recent revision, including in its heading, the auditors were troubled by Cambridge's alleged failure to document variations in mortgage charge rates. On this point, Cambridge respectfully submits that the auditors are clearly in error. HUD imposes no requirement on lenders to maintain or publish rate sheets. While rate sheets may be useful to lenders who regularly engage in a wholesale operation, they are of no practical value to Cambridge. Moreover, as appears in the comments to the Tiered Pricing Rule, HUD seeks to minimize a mortgagor's recordkeeping practices and does not require a separate and distinct recordkeeping system.

The record of all pertinent transactions appears in the individual loan files maintained by Cambridge at its offices. Cambridge respectfully submits that had the auditors more carefully reviewed those files, they would have noted ratio limitations causing loan rate reductions and further noted that Cambridge's variations in discount points charged was occasioned by individual borrower's insufficiency of funds to meet those charges. The fact that the auditors did not recognize these practical constraints on Cambridge's charges does not support their claim that they were not documented, but rather merely supports the conclusion that the auditors did not fully appreciate the importance of the documents which were maintained and appear in each relevant loan file.

I. Statement Attributable to Cambridge Employees

Both of the audit reports allege that "a Cambridge official acknowledged that they most likely misclassified it (discount points) on HUD-1 for loans during the examination period." The report further states that "according to a Cambridge official" in most cases a borrower did not receive a lower interest rate for discount points and that the unnamed official considered the loan discount on the HUD-1 to be "risk based pricing." It is inconceivable that any Cambridge senior management employee familiar with Cambridge's policies and practices would have made such remarks. These comments, if accurately reported, do not accurately reflect Cambridge's lending policies, and must have been taken out of context. Unfortunately, the auditors failed to speak to Cambridge's president, Seth Kramer, notwithstanding that they were present in Cambridge's offices for several months. Had they done so, they would have been informed that (1) Mr. Kramer sets daily rates and policy on discount points; and (2) that such policy is as described above, benefiting borrowers for the discount points paid.

HUD-1's for loans closed at Cambridge during the audit period properly classified discount points. In the event that any Cambridge employee stated otherwise, that employee was misinformed.

At no time was risk assessment reflected in Cambridge's pricing. Since that pricing was determined by Mr. Kramer, only he could have explained fully the manner in which he set Cambridge's rates and had anyone inquired, would have readily dispelled the auditors of any notion that Cambridge engaged in risk-based pricing.

As a final observation, perhaps the audit team misinterpreted remarks made by the unnamed Cambridge official who in good faith believed he or she was accurately characterizing the manner in which rates were set. Mr. Kramer has often stated that in setting mortgage rates for FHA borrowers, one of the many considerations he as Cambridge's president evaluates is the mortgagee risk inherent generally in such transactions, for example, the potential obligation to repurchase certain loans in the event of an early payment default or fraud perpetrated by the borrower. This is merely a reflection of the cost of doing business as are other costs in maintaining and staffing of loan officers. Seen in this light, risk assessment is but one factor reflected in par rates set but has no relevance in determining rates among borrowers. This is not risk-based pricing as prohibited by HUD.

Summary

In the opinion of Cambridge, the entire contents of Findings 2 of the Audit Report should be deleted for the following reasons:

- The auditors found no evidence of discriminatory lending targeting borrowers of lesser amounts for excessive charges in violation of the Tiered Pricing Rule;
- The auditors found no evidence of either overages or discriminatory overages in violation of the prohibitions set forth in Mortgagee Letter 94-43;
- The auditor's method in determining mortgage charge rates was fatally flawed and thus they could not conclude that any instances variations exceeded 2%;
- The auditors failed to note information in loan files justifying variations mistakenly believing that such justification required separate documentation;
- The auditors failed to interview Cambridge's president to obtain information on policies and procedures in place respecting the manner in which daily par rates were established and how rates were impacted by discount fees charged.

Conclusion

On the basis of the foregoing, Cambridge respectfully submits that Finding 2 of the Audit Report should be deleted in its entirety.

FINDING 3
CAMBRIDGE HAS NOT FULLY IMPLEMENTED ITS QUALITY CONTROL PLAN

As set forth in the Audit Report the auditors found that Cambridge did not always comply with its Quality Control Plan (QCP) and HUD requirements pertaining to reviews of defaulted loans. Specifically, the auditors cited Cambridge's failure to ensure that all FHA/HUD insured loans that defaulted within six (6) months of closing undergo a Loan Origination Quality Review.

The auditor's claim this deficiency was "evident" in the loan files reviewed and imply that deficiencies cited in Findings 1 & 2 of the audit report might have been avoided had Cambridge fully implemented its QCP.

CAMBRIDGE'S RESPONSE

Cambridge acknowledges its failure to adhere to its QCP to the extent indicated by the audit team. Cambridge did not, as required by its QCP, review 100% of all loans defaulted within six (6) months of closing. The principals of the company accept full responsibility for this omission.

Having been advised of this oversight, Cambridge has reacted immediately and appropriately to ensure full compliance with its QCP. The Company's Executive Vice President and its Quality Control Manager have been directed to regularly monitor HUD's Neighborhood Watch Early Warning System (at least on a monthly basis), so that early defaults may be identified.

The files for each such loan shall be promptly and carefully reviewed by management to determine, where possible, the cause of such defaults and to enable identification of any underwriting deficiencies. Any fraudulent borrower activity will be duly noted and reported to HUD.

On the basis of the foregoing, HUD should be assured that going forward Cambridge will fully implement and adhere to its QCP.

Notwithstanding the foregoing, the auditor's implication that alleged deficiencies cited in Findings 1 & 2 were related to Cambridge's acknowledged failure to subject all early defaulted loans to Quality Control Review is rejected. As to Finding 1, in all but three (3) instances, Cambridge has refuted the claim of loan origination deficiencies. Similarly, Cambridge has demonstrated that Finding 2 is unsustainable and, with all due respect, the auditor's contentions inconsistent with pertinent documents contained in the loan files reviewed.

To the extent that Cambridge's underwriting of the reviewed loans was appropriate and in full compliance of HUD/FHA requirements, strict adherence to its QCP would not have affected its determination to make these loans nor have caused alteration of its underwriting procedures.