audit report

Issue Date May 3, 2004	
Audit Case Number 2004-AT-1008	

TO: John C. Weicher, Assistant Secretary for Housing – Federal Housing Commissioner, H

James D. McKay

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

SUBJECT: American Mortgage Services, Inc.
Non-supervised Loan Correspondent
Millington, Tennessee

INTRODUCTION

We have completed an audit of the loan origination activities of American Mortgage Services, Inc. We selected American Mortgage for review mainly due to its high default rate. Our objective was to determine whether: (1) American Mortgage acted in a prudent manner and complied with the Department of Housing and Urban Development (HUD) regulations, procedures, and instructions in the origination of Federal Housing Administration (FHA) insured single-family mortgages; and, (2) American Mortgage's quality control plan, as implemented, met HUD requirements.

To accomplish our objectives we tested compliance with HUD's requirements for the origination of FHA-insured loans. We reviewed a sample of 15 FHA-insured loans that were in default (14 of 15) or had been at some time during our audit period (1 of 15). American Mortgage originated the loans between May 1, 2001, and April 30, 2003. We interviewed officials and staff at HUD's Atlanta Single Family Homeownership Center, American Mortgage officials and staff, 11 of the 15 borrowers, closing attorneys, and other interested parties. In addition, we reviewed HUD, FHA, American Mortgage, and the closing attorneys' files and documents.

Our review generally covered the period May 1, 2001, through April 30, 2003. We extended the audit period as necessary to achieve the audit objectives. We conducted our fieldwork from July 7, 2003, through December 12, 2003. We conducted our audit in accordance with generally accepted government auditing standards.

We discussed our review results with American Mortgage officials during the audit and at an exit conference on March 19, 2004. We provided a copy of the draft report to American Mortgage officials on March 9, 2004, for their comments. American Mortgage provided written comments on March 29, 2004, which are summarized in the finding and included in their entirety as Appendix A. As discussed in the Finding, we removed some issues from the draft report and revised some recommendations based on American Mortgage's comments.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide us, for each recommendation without a management decision, 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 recommendation 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 me at (404) 331-3369 or Gerald Kirkland, Assistant Regional Inspector General for Audit at (865) 545-4368.

SUMMARY

Our review showed American Mortgage did not always follow prudent lending practices or always demonstrate responsibility when it originated FHA-insured loans. For 5 of the 15 cases we reviewed, American Mortgage did not exercise due diligence or fully consider all factors in its review of borrowers' liabilities, credit, assets, and income. While the borrowers may have met minimum requirements to qualify for loan approval, we question whether American Mortgage originated the loans with the same care that it would have exercised if the loans were entirely dependent on the properties as security. This occurred because American Mortgage's quality control plan did not meet HUD requirements and its quality control review process was ineffective. Further, by American Mortgage's own admission, it was concerned that applicants would file suits if their applications were denied and subsequently approved by another mortgagee. As a result, American Mortgage originated loans for borrowers who were, at best, marginally qualified for FHA-insured loans. American Mortgage's questionable loan origination practices resulted in its high loan default rate of 12.88 percent, well above the national average of 2.99 percent for the 2-year period ending December 31, 2002. Further, HUD paid claims totaling $170,636 for three of the five loans. We recommend you uphold American Mortgage's suspension under Credit Watch until such time as your office performs a quality assurance review to assess American Mortgage's ability to properly originate loans in accordance with all HUD requirements.

BACKGROUND

HUD grants FHA insurance on mortgages made by private lending institutions under Title II, Section 203(b) of the National Housing Act as governed by regulations in Title 24 Code of Federal Regulations (CFR) Part 203. HUD designates these institutions as supervised, non-supervised, loan correspondent or investing lenders and mortgagees. Depending upon their respective designation, the institutions have the authority to originate, purchase, sell, or service

HUD FHA-insured mortgages. Specifically, a loan correspondent can only originate loans for approved non-supervised mortgagees/sponsor.

American Mortgage was incorporated on June 26, 1992, in the state of Tennessee, and received approval from HUD as a Title II non-supervised loan correspondent on November 19, 1992. American Mortgage was formed for the purpose of originating residential mortgage loans with FHA, the Department of Veterans Affairs, and conventional financing resources for borrowers in the Memphis and Millington, Tennessee, area. As a non-supervised loan correspondent mortgagee, American Mortgage only originated loans and did not underwrite them. We reviewed the documentation in both American Mortgage's and FHA's case files as they related to the origination function. American Mortgage had 25 sponsoring mortgagees that performed the underwriting of its loans. The sponsoring mortgagees approved or rejected the loans based on information in the loan package received from American Mortgage. Therefore, it was critical American Mortgage exercise prudent lending practices during the loan origination process.

On June 23, 2003, HUD terminated American Mortgage from originating FHA-insured loans due to its high default rate. HUD permitted American Mortgage to re-apply for a new loan origination approval agreement at the completion of a 6-month exclusion period. On December 23, 2003, American Mortgage requested reinstatement.

American Mortgage originated 391 FHA-insured loans totaling $35,103,749 between May 1, 2001, and April 30, 2003. As of April 30, 2003, 42 of the 391 loans were in default and 2 had claims paid on them. American Mortgage's central office is located at 8086 Highway 51 North, Millington, Tennessee. American Mortgage has one branch office located at 5719 Raleigh-LaGrange #7, Bartlett, Tennessee.

Finding 1 – American Mortgage Did Not Always Follow Prudent Lending Practices

American Mortgage did not always follow prudent lending practices or always demonstrate responsibility when it originated FHA-insured loans. For 5 of the 15 cases we reviewed, American Mortgage did not exercise due diligence or fully consider all factors in its review of borrowers' liabilities, credit, assets, and income. While the borrowers may have met minimum requirements to qualify for loan approval, we question whether American Mortgage originated the loans with the same care that it would have exercised if the loans were entirely dependent on the properties as security. This occurred because American Mortgage's quality control plan did not meet HUD requirements and its quality control review process was ineffective. Further, by American Mortgage's own admission, it was concerned that applicants would file suits if their applications were denied and subsequently approved by another mortgagee. As a result, American Mortgage originated loans for borrowers who were, at best, marginally qualified for FHA-insured loans. American Mortgage's questionable loan origination practices resulted in its high loan default rate of 12.88 percent, well above the national average of 2.99 percent for the 2-year period ending December 31, 2002. Further, HUD paid claims totaling $170,636 for 3 of the 5 loans. We recommend you uphold American Mortgage's suspension under Credit Watch until such time as your office performs a quality assurance review to assess American Mortgage's ability to properly originate loans in accordance with all HUD requirements.

Criteria

HUD Handbook 4000.4, REV-1, Single Family Direct Endorsement Program, Paragraph 2-1, requires mortgagees to develop FHA-insured loans in accordance with accepted sound lending practices, ethics, and standards. Paragraph 2-5 provides that mortgagees must obtain and verify information with at least the same care that would be exercised if originating a mortgage entirely dependent on the property as security to protect its investment.

Paragraph 2-13 states that a loan correspondent may participate in Direct Endorsement in a limited manner within the HUD Field Office jurisdiction where it is approved to originate loans, provided its sponsor is approved for Direct Endorsement. Under this arrangement, the loan correspondent will take the initial application, handle the appraisal assignment with HUD, procure verifications of deposit and employment and the credit report, close the loan after it has been underwritten and submit the loan package to HUD for insurance endorsement.

HUD Handbook 4060.1, Mortgagee Approval Handbook, Paragraph 2-23D, and 24 CFR 202.5(j)(4), state that to be approved and to maintain mortgagee approval, neither the mortgagee nor any officer, partner, director, principal, or employee shall be engaged in business practices that do not conform to generally accepted practices of prudent mortgagees or that demonstrate irresponsibility.

HUD Handbook 4155.1, REV-1, CHG-1, Section 2, paragraph 2-6, provides guidance for determining borrowers' employment stability. While HUD does not impose an arbitrary minimum length of time a borrower must have held a position to be eligible, the lender must verify the borrower's employment for the most recent 2 full years.

To analyze the probability of continued employment, lenders must examine the borrower's past employment record, qualifications for the position, previous training and education, and the employer's confirmation of continued employment. A borrower who changes jobs frequently within the same line of work, but continues to advance in income or benefits should be considered favorably. In some cases, a borrower may have recently returned to the work force after an extended absence. In these circumstances, the borrower's income may be considered effective and stable provided: (1) the borrower has been employed in the current job for 6 months or more, and the borrower can document a 2-year work history prior to the absence from the work force. This can be accomplished by providing traditional employment verifications.

Chapter 2, Section 1, Paragraph 2-3, provides guidance for originating loans for prospective borrowers that have not established a credit history. For those borrowers, and those who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider, or may elect to use a non-traditional mortgage credit report developed by a credit reporting agency. Neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejection.

Paragraph 2-3A states the payment history of the borrower's housing obligations is of significant importance in evaluating credit. The lender must determine the borrower's payment history of the housing obligations through either the credit report, directly from the landlord or mortgage servicer, or through canceled checks covering the most recent 12-month period.

Chapter 2, Section 5, Paragraph 2-12, provides requirements for assessing whether borrowers can reasonably be expected to meet the expenses involved in homeownership, and otherwise provide for the family. If the total mortgage payment (principal and interest, escrow deposits, homeowners' association dues, ground rent, and any special assessments, and payments for any acceptable secondary financing) does not exceed 29 percent of gross effective income, the relationship of the mortgage payment to income is considered acceptable. A ratio exceeding 29 percent may be acceptable if significant compensating factors are presented.

<u>Loan Origination Deficiencies</u>

We performed a detailed review of 15 FHA-insured loans originated by American Mortgage. For 5 of the 15 cases we reviewed, American Mortgage did not exercise due diligence or fully consider all factors in its review of borrowers' liabilities, credit, assets, and income. HUD paid claims totaling $170,636 on 3 of the loans.

FHA Case Number	**Inadequate Credit Analysis**	**Inadequate Rental History**	**Unstable Income or Employment**	**Inadequate Consideration of All Factors**
482-3484186	X	X	X	X
482-3398943	X	X		X
482-3406626	X			X
482-3428473	X			
482-3446816	X	X		X

FHA Case Number: 482-3484186

At the time of the initial application, December 2, 2001, the borrower had not demonstrated a stable employment or income history. The borrower had been employed by the current employer, a tire and alignment company, since September 6, 2001, or about 4 months. The only other reported period of employment was with a tree trimming company from December 28, 1999, until the end of August 2001.

According to employment verifications, the borrower currently earned about $290 weekly. The borrower had previously earned $323 weekly at the prior place of employment. Thus, the borrower's income had declined by $33 a week, or about 10 percent. Also, the jobs were not in the same line of work (tire and alignment versus tree trimming). A borrower who changes jobs frequently within the same line of work, but continues to advance in income or benefits should be considered favorably. However, this borrower not only changed lines of work, but the income declined. Further, because of the lower income, the borrower's ratio of mortgage payment to income was 30.7 percent, slightly above HUD's threshold of 29 percent. Exceeding the ratio was technically justified because the borrower's monthly housing payment was reportedly declining about $100 per month.

At the time of the initial application, the borrower had minimal traditional credit history. The credit report only showed one small installment loan of $44 per month. The only other reported monthly payment was for rent (one other person was included on the lease).

The borrower was renting the property he wished to purchase. The property owner signed a rental verification form reporting the borrower began renting the property on April 1, 2001. However, a rental agreement obtained at the closing agent's office shows that the borrower began renting the property on June 1, 2001. Thus, the rental history only covered a period of 6 to 8-months. American Mortgage did not verify the borrower's housing obligations for the most recent 12-month period as required.

A limited credit and rental history does not necessarily disqualify the borrower from obtaining a loan. However, because of the limited credit history, American Mortgage was required to develop a credit history based on other information. American Mortgage did not develop the credit history.

The borrower may have technically met FHA requirements for loan approval; however, the Mortgage should have considered all factors relevant to the loan. In addition to the borrower's unstable employment and income, high mortgage payment to income ratio, limited credit, and lack of rental history, the borrower had to obtain a gift of $2,650 to pay closing costs. Further, following closing, the borrower only had $58 in reserves. We question whether it was prudent for American Mortgage to approve the loan and place the FHA insurance fund at increased risk. The borrower defaulted on the loan after making one payment. The mortgage was foreclosed and the property was conveyed to HUD on October 1, 2003. HUD paid claims of $60,667.

FHA Case Number: 482-3398943

The borrower had a history of bad credit, including collection accounts, charged off accounts, and bad checks. A May 2, 2001, credit report showed the borrower had four collection accounts. Three of the accounts were in collection as of September 2000. No payments had been made on the three accounts from September 2000 through May 2, 2001. American Mortgage was aware of the derogatory credit. In fact, American Mortgage obtained numerous credit reports between January 30, 2001, and July 13, 2001, all of which showed derogatory credit. Yet, American Mortgage approved the loan.

American Mortgage was required to verify 12-months payment history for the borrower's housing obligations. American Mortgage obtained evidence supporting the borrower paid rent at the current residence, the property being purchased, for 1-month. The only other evidence of a rental history was a statement from an American Mortgage loan officer that the borrower previously rented somewhere else. American Mortgage did not obtain sufficient evidence to support the borrower's ability to meet housing obligations.

Given the borrower's poor credit and insufficient rental history, American Mortgage should have denied the loan.

We question whether it was prudent for American Mortgage to approve the loan and place the FHA insurance fund at increased risk. The borrower defaulted on the loan after making one payment. The mortgage was foreclosed and the property was conveyed to HUD on May 1, 2003. HUD paid claims of $65,644.

FHA Case Number: 482-3406626

The borrower had a minimal credit history. Thus, American Mortgage was required to develop an alternative credit history based on the borrower's ability to make monthly payments, including utility payments. We did not find any evidence that American Mortgage developed the required alternative credit history. In fact, according to a February 10, 2001, credit report, the borrower had a past due debt to a phone company at the time of the initial application.

The borrower's monthly housing expense was increasing significantly. The borrower was paying $275 per month rent. The proposed mortgage payment was $531 per month, an increase of 93 per cent.

Further, American Mortgage claimed to have verified the borrower's ability to save funds based on the borrower's bank statements. However, our review of the bank statements showed a significant, unexplained discrepancy between the ending balance of one bank statement and the beginning balance of the next bank statement. American Mortgage was required to verify assets needed to meet the borrower's minimum required investment. Given the unexplained discrepancy, we question whether American Mortgage adequately reviewed the bank statements.

Given the borrower's minimal credit history, recent delinquent phone bill, significant increase in housing expense, and questionable bank statements, we question whether it was prudent for American Mortgage to approve the loan and place the FHA insurance fund at increased risk.

The borrower defaulted on the loan after 13 payments. Foreclosure began on November 1, 2002. As of January 30, 2004, HUD had not paid a claim.

FHA Case Number: 482-3428473

The borrower had a minimal credit history. Thus, American Mortgage was required to develop an alternative credit history based on other monthly payments being made by the borrower (rent, utilities, cable bill, phone bill, etc.). We did not find any evidence that American Mortgage developed the required alternative credit history. Even if American Mortgage had developed a history, it would have been inadequate to support loan approval. According to American Mortgage's records, the borrower only had two monthly bills, utilities and cable, both of which were delinquent.

We question whether it was prudent for American Mortgage to approve the loan and place the FHA insurance fund at increased risk. The borrower defaulted on the loan after making three payments. The mortgage was foreclosed and the property was conveyed to HUD on August 1, 2003. HUD paid claims of $44,325.

FHA Case Number: 482-3446816

The borrower had a minimal credit history. Thus, American Mortgage was required to develop an alternative credit history based on other monthly payments. We did not find any evidence that American Mortgage developed the required alternative credit history. Even if American Mortgage had developed a history, it would have been inadequate to support loan approval. The borrower had three unpaid collection accounts at the time of initial application.

The borrower reported that there was no monthly rent expense. Thus, American Mortgage had no rental history to assess the borrower's ability to pay housing obligations. The payment history of the borrower's housing obligations is of significant importance in evaluating credit.

The borrower's monthly mortgage payment on the loan was $420. The underwriter wrote on the Mortgage Credit Analysis Worksheet, "Payment shock, however housing is minimal." Although $420 per month may seem minimal, the borrower reportedly had not been paying a monthly housing expense. Thus, the increase was significant. In fact, the monthly housing expense to income ratio jumped from zero percent to 33 percent, which exceeds HUD's threshold of 29 per cent. Based on HUD guidance, American Mortgage should have concluded that the borrower could not reasonably be expected to meet the expenses involved in homeownership, and otherwise provide for the family.

Even though the borrower had a poor credit history, insufficient rental history, and the monthly housing expense to income ratio exceeded HUD's threshold, American Mortgage approved the loan for underwriting.

We question whether it was prudent for American Mortgage to approve the loan and place the FHA insurance fund at increased risk. The borrower defaulted on the mortgage after making 14 payments. As of January 30, 2004, the mortgage was current.

American Mortgage's Quality Control Plan Did not Include all Required HUD Elements

The HUD Handbook 4060.1, REV-1, outlines specific items required to be included in the mortgagee's quality control plan. American Mortgage's quality control plan did not include all HUD required elements. Specifically, it did not include requirements to: (1) document actions taken by management to identify causes of deficiencies and initiate prompt action to notify employees and correct the deficiencies, (2) assure that procedures existed for expanding the scope of quality control reviews where fraudulent activity or patterns of deficiencies were identified, (3) determine whether verifications of employment, verifications of deposit, and credit reports were handled by any interested third party or the mortgagor, or (4) assure that escrow funds received from mortgagors were not excessive or used for any purpose other than that for which they were received**.** Because its quality control plan was inadequate, American Mortgage originated ineligible or questionable loans that were subsequently insured by FHA. As a result, the FHA insurance fund incurred losses of $170,636 for three loans, and faces potential losses of $98,293 for two loans.

Although American Mortgage used an outside contractor to develop its quality control plan, and perform its quality control reviews, American Mortgage remained responsible for ensuring HUD requirements were met. It failed to ensure the quality control plan met requirements. Further, the reviews proved to be inadequate to identify and correct deficiencies.

To reduce its default rate, American Mortgage took steps to correct its weaknesses. American Mortgage implemented risk-layering procedures for analyzing borrower applications. Also, during our audit, American Mortgage replaced its quality control contractor and implemented a new quality control plan. We did not assess whether the new plan met HUD requirements or whether the new contractor performed adequate reviews.

AUDITEE COMMENTS

American Mortgage explained that in 2 ½ years its prior contractor never identified any changes that were needed from the original documentation submitted to underwriting. American Mortgage changed contractors based on a suggestion from its Certified Public Accountant. Subsequently, it identified the reasons for an increase in its defaults.

American Mortgage believed a very large portion of the findings were underwriter issues and their responsibility, thus American Mortgage questioned why we did not interview the underwriters during our audit.

American Mortgage provided a brief discussion to dispute each of the five loans we questioned. Generally, American Mortgage claimed that it obtained the necessary documentation and properly analyzed the borrowers' credit history, income, assets, payment of housing obligations, and other factors. As such, American Mortgage claimed it met requirements.

Further, American Mortgage stated that recommending it indemnify the loans would be an injustice.

OIG EVALUATION OF AUDITEE COMMENTS

As stated in the Finding, we recognized American Mortgage took steps to correct its weaknesses, including replacing its contractor. We did not interview the underwriters because our objective was to determine whether American Mortgage followed HUD policies and procedures and prudent lending practices, not the underwriting/sponsoring mortgagees. The concerns we raise are attributable to American Mortgage. It was American Mortgage's responsibility during loan origination, and prior to submitting for underwriting, to assess the borrowers' credit, income, payment of housing obligations, and other issues identified in the Finding.

We considered American Mortgage's discussions on the five cases as well as comments we received from HUD's Quality Assurance Division. Based on the comments, we removed the recommendations to require American Mortgage to indemnify the loans. However, we recommended that HUD uphold American Mortgage's suspension under Credit Watch until such time as HUD performs a quality assurance review to determine whether American Mortgage can originate loans in accordance with all HUD requirements. We also removed a discussion on loan 482-3406626 pertaining to the borrower's lack of rental history and a discussion on loan 482-3446816 pertaining to the borrower's ability to save funds. Further, we removed a discussion on loan 482-3428473 pertaining to the borrower's income.

We revised the Finding to emphasize that while the borrowers may have met minimum requirements to qualify for loan approval, we question whether American Mortgage exercised due diligence or fully considered all factors in its review of borrowers' liabilities, credit, assets, and income. We questioned whether American Mortgage originated the loans with the same care that it would have exercised if the loans were entirely dependent on the properties as security.

RECOMMENDATIONS

We recommend the Assistant Secretary for Housing – Federal Housing Commissioner:

1A. Perform a quality assurance review of American Mortgage.

1B. Uphold American Mortgage's suspension under Credit Watch until such time as a quality assurance review determines American Mortgage can originate loans in accordance with all HUD requirements.

1C. Review American Mortgage's implementation of its new quality control plan, and ensure its loan origination procedures and management controls process are fully implemented in conformity with HUD requirements.

MANAGEMENT CONTROLS

In planning and performing our audit, we considered American Mortgage's management controls relevant to the Section 203 Program to determine our auditing procedures and not to provide assurance on the controls. Management is responsible for establishing effective management controls to ensure that its goals are met. Management controls include the plan of the 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. They include systems for measuring, reporting, and monitoring program performance.

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

1. Loan origination process.

2. Quality Control process.

We assessed the relevant controls identified above by:

Reviewing the regulations governing the program and procedures established by American Mortgage in originating FHA-insured loans;

Interviewing HUD officials and staff, American Mortgage officials and staff, 11 of the 15 borrowers, closing attorneys, and other interested parties; and,

Reviewing American Mortgage's and HUD's records and related documents and controls for FHA-insured loans originated between May 1, 2001, and April 30, 2003.

A significant weakness exists if management controls do not provide reasonable assurance that resource use is consistent with laws, regulations and policies; that resources are safeguarded against waste, loss and misuse; and that reliable data are obtained, maintained and fairly disclosed.

Based on our audit, we identified weakness in all relevant control areas. See Finding 1.

FOLLOW-UP ON PRIOR AUDITS

This is the first Office of Inspector General Audit of American Mortgage's origination of FHA-insured loans. Cook, Greer, Huddleston, McLean, P.C. completed the most recent Independent Auditor audit report for the 12-month period ended May 31, 2002. The report disclosed one reportable condition, a lack of segregation of duties as they relate to cash, revenue/receipts and disbursements. The finding did not impact our audit objectives.

AUDITEE COMMENTS

American Mortgage Services

"Complete Mortgage Loan Specialist"

March 26, 2004

U.S. Department of Housing and Urban Development
Office of the Inspector General
John Duncan Federal Building
Room 116
Knoxville, Tennessee 37902
Att; Mr. Charles S. Pagano, Senior Auditor

Dear Mr. Pagano,

Please find enclosed my response and rebuttal to issues in your draft, on the 5 loans in question that was audited by Mr. Jeffrey Van Lieshout and yourself during the period of July 2003 through December 2003. This attachment was discussed during your exit conference with me on March 19, 2004.

First I would like to express our gratitude to both of you in your courteous and business manner during your time here. It was unfortunate for the both of you to have us as your 1st "guinea pig" in conducting a HUD audit. I hope we answered any questions and assisted you as needed during your stay here.

Before I address each loan in question I would like to cover our past and present quality control plans along with the Neighborhood Credit Watch, and how we have used it to reduce the delinquencies. I will also address the **underwriting of the loans performed by the investors** along with the closing and insuring of each loan.

Our previous quality control was performed by Culp QC for the past 2 1/2 years. During this time we *never* had a file to be audited that reflected any changes from the original documentation submitted to underwriting. We have always had the required 10% of loans audited. So has each investor we have dealt with which increases the quality control to 20%. This quality control plan was approved by Mr. Patrick C. Liao, Director Quality Assurance Division in the Atlanta Homeownership Center on September 26, 2000 from a previous HUD audit and reflected no weaknesses.
Our change from Culp QC to Quality Mortgage Services, LLC was due to the suggestion of our CPA. This was done in part because the owner of Quality is a retired HUD auditor from the Memphis field office, and personally signs off on each audit. In the future we want ***all FHA loans audited*** *through quality control as if they were being audited by HUD. This* along with Quality's expertise in FHA guidelines and audits, will only strengthen our quality control.

Of the five (5) loans in question, **4 of the 5 had quality control done** on them, and one of them twice with a prior to closing quality control done.

Through our quality control plan along with the Neighborhood Credit Watch *we were able to identify the reasons for an increase in defaults*, which was reflected from credit layering, along with a down payment assistance. Currently **our default rate has dropped below the Credit Watch Threshold** of 200% which is from the direct results of our policy initiated in April of 2002, which you have a copy. I also discussed this with Joann Kuczma in the Atlanta Homeownership Center in February 2003, regarding the Memphis Down Payment assistance program and the problems what I thought were causing high defaults.

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Since **we do not service or underwrite any loans,** the only way we are notified of any defaults (except in fraud which *has never happened in 12 years* of business) is through the Neighborhood Watch delinquencies. Unfortunately they may not show up for several months before you can realize the pattern for defaults and address the problem.

In regards to the underwriting issue, we find it hard to understand why no underwriters were interviewed in this audit as has been done so in the past audits. **A very large portion of these findings are underwriter issues and their responsibility.** Their input may have shed a more different light on each loan since this also reflects on them in their reports from HUD in their grading.

Whenever there are complexities in making a loan and following HUD guidelines, we always confer with that underwriter for their input and suggestions on each loan. Based upon their guidance, suggestions, and documentation requirements for us to submit, **these sponsors then approve, close the loan in their name,** and insure each loan. As you noted on each HUD-1, our name was not in the lender section, but the sponsors.

With the numerous lenders and loan products today in sub prime lending, **we would not submit a borrower** to FHA underwriters if we did not feel they would meet their obligation. I feel the underwriters would not approve each loan if they felt the borrowers did not meet *HUD guidelines.*

1. FHA Case Number: 482-3484186 *
(A) This loan was QC'd twice. **(B)** Mr. Parrett's **employment was verified with NO GAPS for 2 years.** His previous pay stubs reflected a seasonal income compared to his current 40 hour a week steady employment. This resulted in a long term **increase in pay. (C)** Although he had minimal credit his credit score was 622.**(D)** To further strengthen his credit the underwriter asked for ***additional alternative credit*** which was produced. Based on the HUD Handbook 4155.1, REV-1, CHG-1, Chapter 2, Paragraph 4, *Neither the lack of credit history nor the borrowers decision not to use credit may be used as a basis for rejection.*
(F) The borrower also completed a source of funds letter verifying he had **saved the required down payment** of $425.00 which was re verified on the underwriters worksheet and attached to the MACAW. **(G)** The borrower also had a **reduction in his monthly housing** which was verified. **(H)** The borrower also **attended and completed the HUD approved homeownership course.**

2. FHA Case Number 482-3398943 *
(A) This loan was QC'd. **(B)** There were **24 months rent verified** on Ms. Conner. There was 4 months canceled checks on her current, and 20 months verified through the credit bureau . **(C)** The *initial credit* report was incorrect due to the fact that Ms. Conner's last 4 digits of her social security were not correct. This was the report that was audited in the file. ***Her correct credit report not audited*** *reflected* a **high credit score of 717. (D)** Ms. Conner's **housing expense was reduced** from $600 per month to $517 per month. **(E)** There was **24 months employment** verified. **(F)** Ms. Conner **attended the HUD approved Homeownership course.**

3. FHA Case Number 482-3406626 *
(A) This loan was QC'd. **(B)** Once again, *neither the lack of credit history nor the borrowers decision not to use credit may be used as a basis for rejection.* **(B)** Very low **ratios of 23 / 23% (C)** Had verified a minimum of **32 months of rental history. (D)** Had been employed at same place and same line of work for **3 years with MCI.** (Could this be the reason for default ?) **(E)** Verified **ability to save** with verifications from Southern Security with a high of $2300 to $885 in bank 4 days prior to closing. **(F)** Ms. Norman **attended and completed the HUD approved Homeownership course.**

* Borrower's name has been deleted.

4. FHA case Number 482-3428473 *

(A) This file was QC'd. (B) There is **2 years rental verified.** (C) Current rental was $400 per month and new **housing expense was reduced.** (D) A note in the file stated that the underwriter averaged his income and did not use the full amount to qualify borrower, although he was scheduled for 40 hours per week. She used **this as a compensating factor,** making his ratios 30 / 30%. (E) Mr. Taylor had been **employed at the same place for 5 years.** The delinquencies on his credit report were filed without his knowledge in which he paid. (F) Borrower had to save money for the required investment on the property. (G) Borrower **attended and completed the HUD approved Homeownership course.**

5. FHA Case Number 482-3446816 *

(A) Mr. Williams explained in his credit letter about the past due hospital bills on his credit report due to a lack of insurance. The other credit he had was satisfactory. There was also additional alternative credit produced. (B) Mr. Williams was in the same **line of work for 6 years.** (C) Mr. Williams showed the **ability to save** for the investment required on the subject property. (D) Mr. Williams **produced a budget** to show his expenses and housing. (E) Mr. Williams **attended and completed the HUD approved Homeownership course.**

As we discussed during the audit period most FHA loans are made to lower income families, which is what FHA was designed for in 1932. The five loans in question range from $37,500 to $65,000 loan amounts. Unfortunately these are the people who first feel any monetary or economic difficulties either through auto repairs, health issues, or cuts in income. For instances the local Habitat for Humanity has a 40% default rate on principal payments only. Mr. Williams **made 14 payments** before he defaulted **only to become current again.** This suggests to me that something out of the ordinary resulted for Mr. Williams, and proof that poor origination or underwriting does not always reflect on defaulted loans.

I only hope that you reconsider your recommendations as outlined in your draft, as I have tried to respond to your audit as clearly as possible. For us to idemnify these loans I feel *is an injustice to us*. This normally would happen in cases of fraud, originator manipulation practices, or poor overall underwriting. As far as administrative actions are concerned, you already know our situation of termination for 6 months from doing FHA loans. I think this should be sufficient. This action has also caused some of our investors to cease relationships with us, along with a reduction in our production the past year of 35%.

I will be glad to send you our most recent quality control audit along with the responses, upon your request. Thank you so much for your time, and feel free to contact me immediately should you need anything else.

Sincerely,

Monte Connell, President
American Mortgage Services, Inc.

* Borrower's name has been deleted.