AUDIT REPORT

GERSHMAN INVESTMENT CORPORATION
NON-SUPERVISED DIRECT ENDORSEMENT LENDER
CLAYTON, MO

2004-KC-1004

July 28, 2004

REGION 7 OFFICE OF AUDIT
KANSAS CITY, KS

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audit report

Issue Date July 28, 2004	
Audit Case Number 2004-KC-1004	

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

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

SUBJECT: Gershman Investment Corporation, Clayton, MO

We have completed an audit of Gershman Investment Corporation, a non-supervised direct endorsement lender approved to originate Federal Housing Administration insured loans. We selected Gershman for audit because they are one of the larger mortgagees in the St. Louis area and had a slightly above average default rate. Our audit objectives were to determine if Gershman complied with HUD regulations, procedures, and instructions in the origination of the FHA-insured single-family mortgages and to determine whether Gershman's late requests for endorsement complied with HUD's requirements.

We found that Gershman improperly originated 27 loans, with original mortgage amounts totaling $2,476,749. While Gershman's procedures for submitting late requests for endorsement were effective overall, Gershman did improperly submit five loans for late endorsement, with mortgage amounts totaling $525,402. In addition, Gershman was deficient in its quality control review activities. This report contains three findings with recommendations requiring action by your office.

In accordance with HUD Handbook 2000.06 Revision-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 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 (913) 551-5870.

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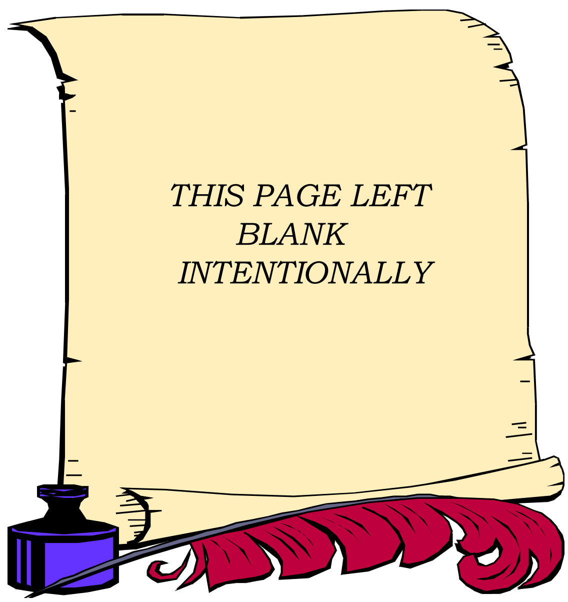

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Executive Summary

We have completed an audit of Gershman Investment Corporation (Gershman), a non-supervised direct endorsement lender approved to originate Federal Housing Administration insured loans. We selected Gershman for audit because they are one of the larger mortgagees in the St. Louis area and have a slightly above average default rate on Federal Housing Administration loans. Our audit objectives were to determine if Gershman complied with HUD regulations, procedures, and instructions in the origination of the FHA-insured single-family mortgages and to determine whether Gershman's late requests for endorsement complied with HUD's requirements.

Gershman Did Not Follow HUD Requirements When Originating Loans

Gershman did not adhere to HUD requirements and prudent lending practices when originating 27 of the 43 loans we examined for compliance. The 27 loan files contained unsupported income, unsupported assets, underreported liabilities, questionable and/or derogatory credit histories, inadequate qualifying ratios, and other inconsistent and/or questionable documentation. The deficiencies occurred because Gershman did not have an adequate control environment to ensure that its employees followed HUD requirements when processing and underwriting loans. These 27 loans totaling $2,476,749, represent an increased risk to the Federal Housing Administration insurance fund.

Gershman's Late Endorsement Request Procedures Were Generally Effective

Overall, Gershman's procedures for submitting late requests for endorsement were effective. However, Gershman did improperly submit five loans for insurance endorsement when the borrowers had delinquent payments prior to loan submission. These five improperly submitted loans, with mortgages totaling $525,402, represent an increased risk to the Federal Housing Administration insurance fund.

Gershman Was Deficient In Its Quality Control Review Activities

Gershman was deficient in its quality control review activities. Gershman did not conduct reviews within 90 days of loan closing and did not review the required number of loans closed. Without fully implementing adequate quality control policies and procedures, Gershman is unable to ensure the accuracy, validity, and completeness of its loan origination operations.

Coordination Regarding Audit Results

We provided results of our loan file reviews and late endorsement testing to Gershman during the audit, and received and evaluated its verbal responses. We also held an exit conference with Gershman on June 3, 2004. Gershman provided written comments to our findings on July 8, 2004. We incorporated excerpts of the comments into our report as

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appropriate. Appendices C and E contain Gershman's response to our draft report. While the 35 attachments referenced in Gershman's response are not included in this report, they are available upon request. We provided a complete copy of Gershman's response to the Action Official addressed in this report.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner, and Chairman, Mortgagee Review Board, take appropriate administrative action against Gershman Investment Corporation based on the information contained in the findings. This action should, at a minimum, include requiring indemnification for the 28 actively insured loans and reimbursement for claims and related losses already incurred on the three loans that have gone into claim status. Additionally, HUD should ensure that Gershman's quality control policies and procedures are fully implemented in accordance with current HUD requirements.

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Abbreviations:

FHA	Federal Housing Administration
HUD	Department of Housing and Urban Development
OIG	Office of Inspector General

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Introduction

HUD's Single Family Direct Endorsement Program insures mortgage loans under Section 203 of the National Housing Act (12 U.S.C. 1709). This program allows mortgagees to originate loans without prior HUD review or approval. Gershman Investment Corporation, located at 7 North Bemiston, Clayton, Missouri, received HUD approval to participate in the Direct Endorsement Program on August 5, 1983. Between August 1, 2001 and July 31, 2003, Gershman originated 1,210 loans totaling $130,962,140 under FHA programs.

Audit Objectives and Scope

Our audit objectives were to determine if Gershman complied with HUD regulations, procedures, and instructions in the origination of the FHA-insured single-family mortgages and to determine whether Gershman's late requests for endorsement complied with HUD's requirements.

Our audit generally covered the period of August 1, 2001 through July 31, 2003. We conducted field work from December 2003 through April 2004.

Audit Methodology

Our audit approach was to evaluate Gershman's loan origination and submission processes.

To accomplish the audit objectives, we reviewed HUD's rules, regulations, and guidance for proper origination and submission of FHA loans. We interviewed HUD management and staff to obtain background information on FHA requirements and Gershman. We also reviewed previous HUD reviews and OIG audits of Gershman to understand deficiencies previously reported by HUD.

We interviewed Gershman's management and staff to determine its process for originating FHA-insured loans and submitting them for endorsement. Additionally, we reviewed Gershman's policies and procedures to gain an understanding of how its processes are designed to function. We also reviewed Gershman's quality control plan and quality control review reports covering twenty-three months.

During our audit, we examined documents in the HUD and Gershman loan files for 43 loans originated under HUD's 203(b) or 234(c) programs to determine whether the files contained adequate documentation to support approval of the loans. With the exception of those loans included in

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Finding 2 and those whose insurance had been terminated without a claim by the time of selection, we reviewed all loans that had gone into default within the first two years. Additionally, we reviewed payment histories for all 336 loans submitted for endorsement more than 61 days after closing to determine whether the late requests met HUD's requirements for timely borrower payments before submission for FHA-insurance endorsement.

To conduct our audit, we relied upon computer-processed data contained in HUD's Single Family Data Warehouse. We assessed the reliability of this data including relevant general and application controls and found them to be adequate. We also conducted sufficient tests of the data. Based on these tests and assessments, we conclude the data are sufficiently reliable to be used in meeting our objectives.

Specifically, we relied upon default status information in HUD's systems when selecting loans for detailed review. Additionally, we relied upon closing and endorsement dates when conducting our review of late endorsements. We used the mortgage amount and claims status from HUD's system for information purposes.

We conducted the audit in accordance with generally accepted government auditing standards.

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Gershman Did Not Follow HUD Requirements When Originating Loans

Gershman Investment Corporation did not adhere to HUD requirements and prudent lending practices when originating 27 of the 43 loans we examined for compliance. The 27 loan files contained unsupported income, unsupported assets, underreported liabilities, questionable and/or derogatory credit histories, inadequate qualifying ratios, and other inconsistent and/or questionable documentation. The deficiencies occurred because Gershman did not have an adequate control environment to ensure that its employees followed HUD requirements when processing and underwriting loans. These 27 loans totaling $2,476,749, represent an increased risk to the Federal Housing Administration insurance fund.

HUD Requirements

HUD Handbook 4155.1, Revision 4, Change 1, requires mortgagees to determine the borrowers' ability and willingness to repay the mortgage debt, and thus, limit the probability of default or collection difficulties. Mortgagees should evaluate the stability and adequacy of income, funds to close, credit history, qualifying ratios, and compensating factors. Lenders must ensure that application package contains sufficient documentation to support their decision to approve the mortgage loan.

HUD Handbook 4000.4, Revision-1, Change-2, requires mortgagees to employ underwriters who will make underwriting decisions with due diligence in a prudent manner. Underwriters are to coordinate all phases of the underwriting process, personally reviewing the application documents of each loan. They should have an ability to detect fraud and be aware of warning signs that may indicate irregularities.

HUD also permits mortgagees to use approved automated underwriting systems, including Fannie Mae's Desktop Underwriter. Desktop Underwriter requires all data entered, downloaded, or imported to be true, accurate, and complete. Additionally, when Desktop Underwriter approves a loan, it requires lenders to comply with all messages and conditions listed on the Findings Report and to review the credit report, confirming that the data evaluated was accurate.

Loans Did Not Comply with HUD Requirements

Our examination of 43 loans originated by Gershman from August 1, 2001 through July 31, 2003 disclosed significant

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origination deficiencies in 27 of the 43 cases. The following table summarizes the individual categories of loan deficiencies.

TYPE OF NON-COMPLIANCE	# OF LOANS	% OF LOANS
Inconsistent/Unsupported Income	16	37%
Inconsistent/Unsupported Assets	14	33%
Inconsistent/Underreported Liabilities	6	14%
Questionable/Derogatory Credit History	7	16%
Inadequate Qualifying Ratios	4	9%
Inconsistent/Questionable Information	3	7%

The deficiencies noted in this table are not independent of one another as many of the loan files contained more than one deficiency. Appendix B provides a chart summarizing the files with loan processing deficiencies. Additionally, Appendix C details the deficiencies identified on each loan reviewed, including the specific HUD requirements not met when processing the loans.

According to Neighborhood Watch, as of March 31, 2004, one of the 27 loans has terminated FHA insurance without a claim. Because this loan no longer represents a risk to the insurance fund, we have removed the loan from our recommendations. The original mortgage amount of the remaining 26 loans is $2,427,141.

HUD has paid claims on three of the 26 loans, with original mortgage amounts totaling $187,043. HUD has sold two of the three properties, incurring losses of $40,217. While claims of $71,010 have been paid on the third loan, the amount of the loss will not be known until the property is sold. 10 of the 23 loans actively insured are currently in default; four are in some stage of the foreclosure process, and the borrowers on five of the loans have filed for bankruptcy. The remaining 13 loans are no longer in default.

Inadequate Control Environment

Gershman did not have an adequate control environment to ensure that its employees followed requirements when underwriting loans.

A direct endorsement underwriter manually underwrote 11 of the deficient loans. When processing these loans, Gershman did not sufficiently adhere to HUD requirements

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and prudent lending practices. For example, in FHA Case #292-4058693, Gershman failed to document adequate compensating factors when the 54.96% debt ratio exceeded the regulatory maximum of 41%.

Gershman used Desktop Underwriter to underwrite 16 of the deficient loans. In many of these cases, Gershman did not comply with all messages and conditions listed on the Findings Report. In some cases, Gershman failed to ensure that all data entered into the system was true, accurate, and complete. For example, in FHA Case 133-0103574, Gershman did not include a real estate loan with $978 monthly payments when entering liabilities into Desktop Underwriter.

Gershman's loan processors are responsible for submitting information to Desktop Underwriter and clearing all messages and conditions listed on the Findings Report. During the audit period, loans were reviewed by underwriters only when Desktop Underwriter rejected a loan. Gershman reports that it now requires underwriters to review all loans underwritten by Desktop Underwriter.

Gershman's deficient quality control activities may have also contributed to the loan origination deficiencies. As discussed in Finding 3 of this report, this failure has led to Gershman's inability to ensure the accuracy, validity, and completeness of its loan origination operations.

Impact of Inadequate Underwriting

Because HUD's Single Family Direct Endorsement Program allows mortgagees to underwrite and close loans without prior HUD review or approval, it is imperative that approved lenders follow HUD requirements and prudent lending practices when originating loans to be insured by HUD. Inadequate underwriting results in HUD insuring mortgages that do not meet the minimum requirements. Improperly originated loans increase the risk of loss to the HUD mortgage insurance fund. For example, all 27 loans cited with origination deficiencies had been in default within two years of closing.

The deficiencies cited relate to loans closed between August 1, 2001 and July 31, 2003. Prior to this two-year period, Gershman's percentage of total defaults within two years of loan origination was average for the area. However, during the two-year audit period, this percentage was consistently

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above average, at times more than fifty percent higher than the St. Louis HUD Office average. However, since the audit period, Gershman's percentage has declined and is now below the area average.

Auditee Comments

While Gershman did not provide an overall response to our draft finding, the cover letter to their response package indicates that they have always been committed fully to strict compliance with HUD-FHA requirements and are committed to demonstrating this through their loan origination activities. Additionally, Gershman notes that many of the alleged findings are not supported or represent a misrepresentation of the facts. Appendix E contains the complete text of Gershman's response package cover letter

Gershman's comments to our draft report included responses to each of the 64 deficiencies cited for the 31 loans included in the draft finding. These responses were transcribed and inserted into Appendix C. While the 35 attachments referenced in Gershman's response are not included in this report, they are available upon request.

OIG Evaluation of Auditee Comments

Gershman provided additional documentation sufficient to clear 14 of the 64 individual deficiencies included in the draft finding. This removed 4 loans from the finding as many loans had multiple deficiences. We adjusted the body of this finding as well as Appendices B and C to reflect the updated deficiency counts. Additionally, Appendix C contains OIG's evaluation of Gershman's comments regarding each of the 64 deficiencies cited in the draft finding.

Recommendations

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

1A. Require Gershman to indemnify HUD/FHA for the 23 actively insured loans, totaling $2,240,098, in which Gershman did not follow HUD/FHA loan origination requirements. Appendix B lists FHA case numbers for the loans included in this recommendation.

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1B. Require Gershman to reimburse HUD/FHA $4,675 for losses already incurred on loans in which Gershman did not follow HUD/FHA loan origination requirements. Appendix B lists FHA case numbers for the loans included in this recommendation.

1C. Require Gershman to reimburse HUD/FHA for the $40,217 in related losses incurred on properties sold for two loans in which Gershman did not follow HUD/FHA loan origination requirements. Appendix B lists FHA case numbers for the loans included in this recommendation.

1D. Require Gershman to reimburse HUD/FHA for the $71,010 in claims paid for the property not yet sold on a loan in which Gershman did not follow HUD/FHA loan origination requirements. Appendix B lists FHA case number for the loan included in this recommendation.

1E. Ensure that Gershman has implemented an effective control environment that prevents Gershman from submitting loans for FHA insurance endorsement that do not meet HUD/FHA requirements.

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Gershman's Late Endorsement Request Procedures Were Generally Effective

Overall, Gershman's procedures for submitting late requests for endorsement were effective. However, Gershman did improperly submit five loans for insurance endorsement when the borrowers had delinquent payments prior to loan submission. These five improperly submitted loans, with mortgages totaling $525,402, represent an increased risk to the Federal Housing Administration insurance fund.

HUD Requirements

HUD Handbook 4165.1, Revision-1, requires that loans submitted for insurance endorsement more than 60 days after closing meet certain late request standards. These standards are designed to ensure the degree of risk to HUD at the time of endorsement is no greater than the degree of risk existing at the time of closing.

Specifically, HUD requires late requests to include a payment ledger reflecting all payments received, including the payment due for the current month, if the case is submitted after the 15th of the month. The mortgage payments must not be delinquent when the loan is submitted for endorsement, and each payment must be made in the calendar month due. If a payment is made outside the calendar month due, the lender cannot submit the case for endorsement until six consecutive payments have been made within the proper calendar month due.

Loan Universe to Test

Using HUD's Neighborhood Watch and Single Family Data Warehouse systems, we identified 1,210 loans originated by Gershman between August 1, 2001 and July 31, 2003.

We limited our universe to only those loans received by HUD more than 61 days after the loan closed or with blank endorsement dates in HUD systems. We eliminated loans received or submitted to HUD within 60 days of closing and those submitted before the first due date. We also eliminated new construction loans, which are not subject to late endorsement procedures, and loans subsequently paid-in-full, as they no longer represent a risk to the FHA insurance fund. We tested the remaining 336 loans for improper late requests for endorsement. Appendix D

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includes a diagram illustrating both the scope and findings of our testing.

Testing Methodology

In performing our tests to determine whether Gershman complied with HUD's endorsement requirements, we compared HUD and Gershman loan data. We also examined payment histories to identify the presence of payments made outside of the month due and delinquent payments prior to submission.

Improperly Submitted Loans

Overall, Gershman did not have a significant problem with late requests for endorsement as their procedures for submitting late requests for endorsement were generally effective. Our analysis of the payment histories and endorsement data for the 336 loans tested revealed only five improper late requests. These five loans, totaling $525,402 in original mortgage amounts, were submitted for endorsement even though the borrowers had delinquent payments prior to submission. The following table lists the original mortgage amounts and the late payment dates for each of the five loans improperly submitted.

FHA Loan Number	Original Mortgage Amount	Late Payment Date
292-4083810	$150,220	2/1/02
292-4200558	$91,563	9/1/02
292-4263088	$82,113	4/1/03
292-4294692	$83,653	5/1/03
292-4329421	$117,853	6/1/03
	$525,402	

According to Neighborhood Watch, as of March 31, 2004, two of the five loans, with original mortgage amounts of $241,783, are in some stage of the foreclosure process. HUD cannot identify the loss on these loans until the claims are completed and the properties are sold. In addition, HUD has paid $500 loss mitigation costs on one of the loans that is in foreclosure. Because each of the five actively insured loans had delinquent payments prior to submission to HUD, the degree of risk to the FHA insurance fund at the time of endorsement was greater than the degree of risk existing at the time of closing.

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Auditee Comments

A summary of Gershman's comments on our draft finding follows. Appendix E contains the complete text of the comments.

In its response, Gershman noted that they have implemented a new procedure to assure that loans are submitted to HUD for endorsement with the correct documentation. Specifically, all loans submitted for endorsement after 60 days of closing, or that are re-submitted for endorsement and require copies of pay histories, are now required to be reviewed by the insuring department supervisor. The supervisor initials the loan file after confirming that the pay history is correct and the submission is in compliance with HUD guidelines. As a result of this change, Gershman believes that its late requests for endorsement will be fully consistent with HUD guidelines.

Gershman's review of the five loan files disclosed that in three cases, the monthly payments were made timely but one of the payments was subsequently returned for insufficient funds. They note that, in each of the three cases, the borrowers replaced the insufficient funds check the month following the payment due date.

Gershman's review also disclosed that HUD had returned four of the five loan files prior to the payment date cited. According to Gershman, two files were returned for additional documentation while one file was returned for mortgage insurance payment. Gershman claims that one file (FHA Case #292-4329421) was incorrectly returned because of a zip code discrepancy on the insured property.

OIG Evaluation of Auditee Comments

We commend Gershman for taking steps to improve its submission process. If fully implemented, the new procedure should help prevent future occurrences of improper late submissions.

Gershman noted that four of the five loan files had been returned by HUD. Specifically, Gershman explains that one file (FHA Case #292-4329421) was incorrectly returned by HUD because of a zip code discrepancy. However, because Gershman did not provide a copy of the Notice of Return sent by HUD, we were unable to verify the reason for late submission and included this loan in our

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finding. We did not review the Notices of Return for the remaining three loans; however, the reasons cited by Gershman would subject the loan to late endorsement procedures.

While Gershman's comments may put the individual cases in context, we believe that all five loans were improper submissions and should be indemnified. Regardless of the individual circumstances, each of the five loans cited had payments made outside the calendar month due prior to the late submission. This is a clear violation of HUD guidelines. Gershman should not have submitted the five cases for endorsement until six consecutive payments had been made within the proper calendar month due.

Recommendations

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

2A. Require Gershman to indemnify HUD/FHA for the five loans improperly submitted for endorsement with mortgage amounts totaling $525,402.

2B. Require Gershman to reimburse HUD/FHA $500 for losses already incurred on the loans improperly submitted for endorsement.

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Gershman Was Deficient In Its Quality Control Review Activities

Gershman was deficient in its quality control review activities. Gershman did not conduct reviews within 90 days of loan closing and did not review the required number of loans closed. Without fully implementing adequate quality control policies and procedures, Gershman is unable to ensure the accuracy, validity, and completeness of its loan origination operations.

HUD Requirements

HUD Handbook 4060.1, Revision-1, Chapter 6 requires mortgagees to have and maintain a written Quality Control Plan which provides for internal or external audits, or other independent reviews, of the mortgagee's origination of insured mortgages.

Scope and Methodology

We queried HUD's Single Family Data Warehouse for all loan origination activity between August 1, 2001 and July 31, 2003 and for default activity on those originated. We reviewed Gershman's external quality control review reports as well as internal management review and early payment default reports. However, because the quality control review reports and subsequent management review reports were only available through June 2003, we were unable to conduct full testing of July 2003.

In performing our tests to determine whether Gershman complied with HUD's quality control requirements, we compared HUD requirements and data with Gershman's quality control plan and related review reports. When examining the number of loans originated each month, we rounded the number of loan reviews required before comparing with Gershman data.

Deficient Quality Control Activities

Gershman was deficient in its quality control review activities. Gershman did not conduct the required reviews within 90 days of loan closing and did not review the required number of loans closed.

Closed Loan Review Timeliness Requirement

HUD requires quality control reviews be performed within 90 days of loan closing. Gershman's quality control policy does not contain a similar statement.

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On average, the contracted quality control firms received loans selected for review 161 days after closing and issued reports 228 days after closing. The following table details the timeliness of reviews performed both before and after the contractor changes made by Gershman.

Quality Control Contractor	Months Reviewed	Average # Days Between Loan Closing and Receipt	Average # Days Between Loan Closing and Report
Firm A	8/01 - 10/01	134	176
Firm B	11/01 - 4/03	168	247
Firm A	5/03 - 6/03	171	193

While Gershman did not meet HUD's timeliness requirements for any of the 23 months reviewed, they report that reviews are now consistently performed within 90 days of closing.

Closed Loan Review Sampling Requirement

HUD requires mortgagees to review the lesser of ten percent of all loans closed on a monthly basis, or a random sample that provides a 95 percent confidence level with two percent precision. Gershman's quality control policy requires review of at least ten percent of loans closed.

While Gershman reviewed ten percent of the loans closed between August 2001 and June 2003, they did not meet the ten percent sample requirement for five of the 23 months reviewed.

Month Reviewed	Number of Loans Closed	Number of Reviews Required (rounded)	Number of Reviews Performed
9/01	56	6	5
3/02	42	4	3
4/02	45	5	1
5/02	36	4	3
7/02	39	4	3

Gershman did consistently meet HUD's sampling requirements for the last 11 months of the review period. They report that the deficiency has been corrected.

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Early Default Reviews

HUD requires mortgagees to analyze all loans that go into default within the first six months. Accordingly, Gershman's quality control policy requires review of all loans which go into default within the first six payments.

Gershman analyzed all 19 loans that defaulted during the first six payments. Gershman reports that both internal quality control personnel and an independent underwriter analyze early default loans for trends and deficiencies. Although Gershman's early default analysis met HUD's requirement, it did not result in identifying specific deficiencies with individual loans. Our examination of 14 of the 19 loans reviewed by Gershman staff disclosed significant origination deficiencies in eight cases. These eight loans are included in Finding 1.

Since the audit period, in November 2003, HUD updated its quality control handbook. It now requires a more comprehensive documentation review and verification process be performed on early payment defaults. Gershman should update their quality control policies and procedures to comply with the updated handbook.

Inability to Adhere to Requirements

The deficiencies associated with Gershman's quality control activities stem from Gershman's inability to adhere to HUD requirements and their own established requirements while outsourcing quality control activities.

In 1999, Gershman began utilizing an outside quality control firm to perform reviews of loans originated. Gershman reports that once they identified that reviews were not being performed in a timely manner and that the contractor was often selecting loans on a quarterly basis, they took several actions to remedy the situation, including switching contractors twice. Additionally, Gershman reports that in June 2004, they will begin performing all quality control procedures internally in an attempt to further strengthen controls.

Gershman's written quality control policy may have also contributed to the deficient quality control activities. While the policy requires ten percent of all loans closed be selected for review, it does not specify that loans are to be selected on a monthly basis as required by HUD. Additionally, Gershman's quality control policy does not

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include a statement requiring reviews be performed within 90 days of the closing of the loan as required by HUD.

Under HUD's Single Family Direct Endorsement Program, the mortgage loan is underwritten and closed without prior HUD review or approval. Therefore, it is imperative that approved lenders implement quality control policies and procedures in accordance with HUD's and its own requirements. Without fully implementing adequate quality control policies and procedures, Gershman is unable to ensure the accuracy, validity, and completeness of its loan origination operations.

Auditee Comments

A summary of Gershman's comments on our draft finding follows. Appendix E contains the complete text of the comments.

While Gershman recognizes that there were some shortcomings regarding the timeliness and sample size of its closed loan reviews during the audit period, they believe the concerns primarily resulted from the failure of their former quality control firm to conform fully with HUD requirements. Further, Gershman believes that the shortcomings cited in our draft finding are not representative of their overall quality control review activities and notes that their quality control activities have not been an issue in prior OIG audits or HUD reviews

Specifically, Gershman noted the following regarding the timeliness and sample size of its closed loan reviews covering our audit period.

- 11 of the 21 closed loan reviews performed by Firm A in 2001 were completed timely.
- During the time Gershman contracted Firm B, they were instructed not to send the monthly listing of closed loans until the prior month review was complete. Additionally, Firm B selected loans on a quarterly basis for the first half of 2002 and did not select an adequate number of loans for the July 2002 review.

Gershman notes that it has been able to substantially reduce its early default ratio as a result of its internal early default reviews. Gershman explains that its previously above average early default ratio was due to the selling of its servicing portfolio and increased refinance activity.

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According to Gershman, its constant review of early default loans led to changes in its underwriting procedures and has contributed to its early default ratio decreasing to 63% of the HUD St. Louis Office average.

Gershman declares that it has an effective Quality Control program in place and is in compliance with the HUD requirements. Gershman notes that it has taken the necessary steps to assure that reviews are completed timely and indicates that sampling for closed loan reviews is in full compliance.

In their written comments, Gershman also states that the July 2003 closed loan review was completed by Firm A December 11, 2003 and was available for OIG review.

OIG Evaluation of Auditee Comments

We commend Gershman for its current early default ratio, which is below the HUD St. Louis Office average. By updating and fully implementing its quality control plan, Gershman can better ensure the accuracy, validity, and completeness of its loan origination operations.

As noted both in this finding and in the introduction of this report, our audit covered the period of August 1, 2001 through July 31, 2003. This finding is a snapshot of Gershman's quality control activities and is not intended to report on Gershman's activities prior to or subsequent to the audit period. Further, we disagree with Gershman's assertion that its quality control activities have not been an issue in prior audits or reviews. While we did not examine all prior HUD reviews, the 1987 OIG audit found that Gershman's quality control plan needed to be improved and followed.

Gershman notes that it was properly relying upon the contracted quality control firms. However, HUD Handbook 4060.1, Revision-1, Chapter 6 states that mortgagees are responsible for ensuring that the quality control requirements are met when utilizing outside firms. It is ultimately Gershman's responsibility to comply.

Our analysis indicates that only one of the 21 loans selected for review in 2001 by Firm A was received within 90 days of loan closing. Based on report dates, none were completed within 90 days of closing.

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Last, we question Gershman's comment that the July 2003 report was available for our examination. The audit notification letter requested all documents for the audit period, including quality control reports. Gershman initially provided reviews covering 21 months of the audit period and subsequently provided two monthly reviews completed by Firm A on December 11, 2003. However, they did not supply the July 2003 review. Regardless, the July 2003 review was not completed within 90 days of closing.

Recommendations

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

3A. Require Gershman to update its quality control policies and procedures in accordance with HUD requirements.

3B. Ensure Gershman's quality control process is fully implemented in accordance with HUD requirements.

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Management 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. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Management Controls

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

- Controls over the loan origination process.
- Controls over the loan submission process.
- Controls over the quality control process.

Assessment Procedures

The following procedures were used to examine the management controls:

- Review of established loan origination and quality control procedures formulated by Gershman.
- Examination of records and documents for FHA-insured loans originated during a two-year period.
- Interviews with applicable officials and employees of HUD's Quality Assurance Division.
- Interviews with Gershman officials and employees.

Significant Weaknesses

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.

Based on our review, we believe significant weaknesses exist in the following areas:

- Loan origination process (see Finding 1).
- Quality control process (see Finding 3).

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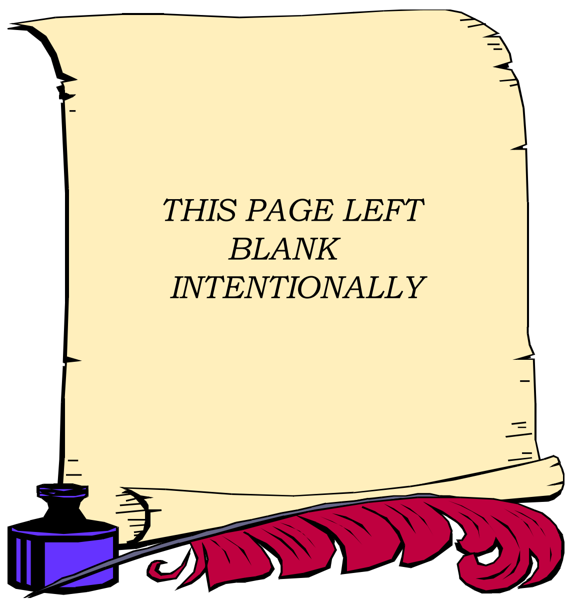

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Follow Up On Prior Audits

This is the third HUD Office of Inspector General Audit of Gershman Investment Corporation.

The first OIG audit report pertaining to the origination, settlement, administration, and servicing of mortgage loans insured with HUD was issued June 15, 1984. All findings have been cleared.

The second OIG audit report pertaining to loan origination and quality control was issued March 25, 1987. All findings have been cleared.

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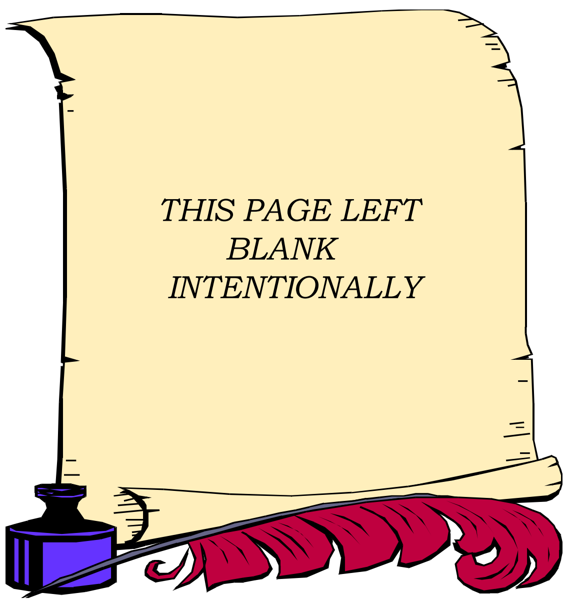

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Schedule of Questioned Costs and Funds Put to Better Use

Recommendation Number	Type of Questioned Cost: Ineligible (1/)	Unsupported (2/)	Funds Put to Better Use (3/)
1A			$2,240,098
1B	$4,675		
1C	$40,217		
1D		$71,010	
2A			$525,402
2B	$500		

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 charged to a HUD-financed or HUD-insured program or activity and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the costs. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

3/ Funds Put to Better Use are costs that will not be expended in the future if our recommendations are implemented. For this review, the funds put to better use consist of loans and guarantees not made because of indemnification.

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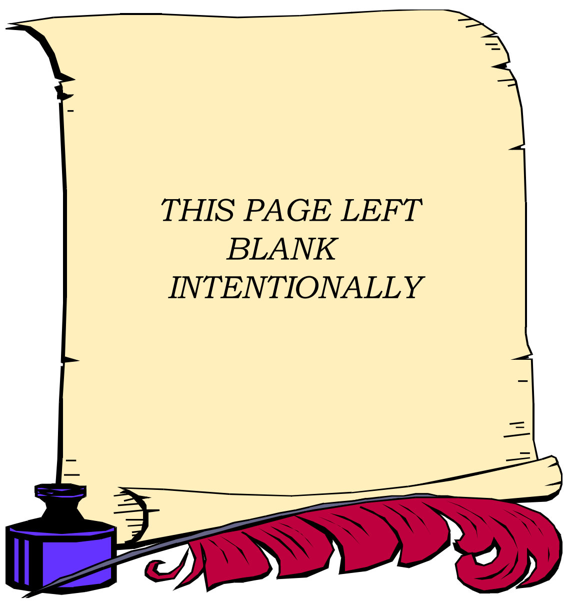

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Loan Processing Deficiencies Chart

FHA Case Number	Inconsistent and/or Unsupported Income	Inconsistent and/or Unsupported Assets	Inconsistent and/or Underreported Liabilities	Questionable and/or Derogatory Credit History	Inadequate Qualifying Ratios	Other Inconsistent and/or Questionable Documentation	Finding 1 Recommendation
292-4051541		X		X			1C
292-4054430		X		X	X		1A
292-3998744	X		X				N/A
292-4064761		X	X				1A
292-4058693				X	X	X	1A
292-4057783				X			1A
292-4067535	X						1A
292-4076810	X			X			1A, 1B
292-4076992	X	X					1C
292-4082499	X	X	X				1A
292-4079136	X						1A, 1B
292-4105387	X	X					1A, 1B
292-4095609	X						1A, 1B
292-4108675		X					1A
292-4119353	X	X					1A, 1B
292-4126430	X	X					1A
292-4123196				X		X	1A, 1B
292-4153878		X	X	X			1A, 1B
292-4159228	X						1A
292-4129226	X					X	1A
292-4169219	X	X					1A, 1B
292-4171792		X					1A
133-0103574			X				1A
292-4194032					X		1A, 1B
133-0104240	X	X					1D
292-4218860	X		X				1A
133-0104569	X	X			X		1A
Total	16	14	6	7	4	3	

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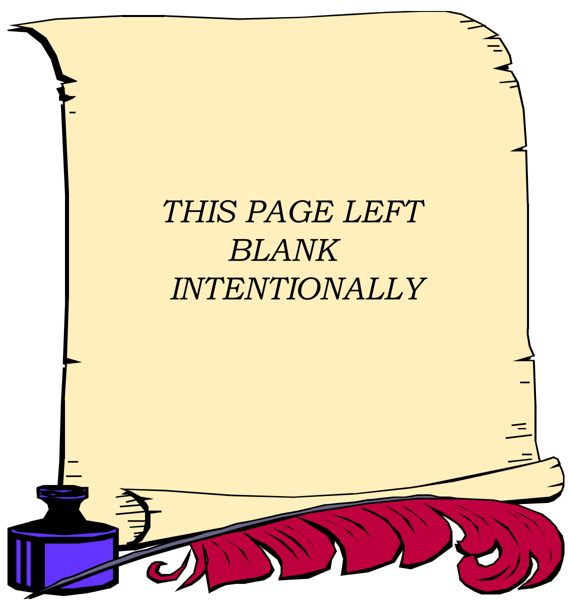

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Narrative Case Presentations

Gershman's response to the deficiencies cited in Finding 1 of the draft report was transcribed and inserted into this appendix. Appendix E contains the cover letter of Gershman's response to our draft report and its comments on Findings 2 and 3. While the 35 attachments referenced in Gershman's response are not included in this report, they are available upon request.

FHA CASE NUMBER: 292-4051541 DATE OF LOAN CLOSING: 8/3/2001
LOAN PURPOSE: Purchase INSURED AMOUNT: $29,968
UNDERWRITER TYPE: Manual HOUSING/DEBT RATIOS: 21.80/21.80
STATUS AS OF 3/31/2004: Property conveyed to Insurer. HUD incurred a loss of $17,722 on the sale of the subject property. First default reported after three payments.

Inconsistent/Unsupported Assets
CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-10 requires lenders to ensure that the borrower has sufficient funds available to close the loan. Paragraph 2-10B requires the lender to obtain an explanation and source of funds when savings and checking account verification reveals a large increase in the account balance.
OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $897 and the borrower needed $2,166 to close. According to the settlement statement, the borrower only needed $143 to close after taking out gift funds, earnest money, seller paid expenses, and borrower prepaid expenses. According to the underwriting worksheet and application, the borrower's assets include a checking account with a $559 balance. Bank statements covering 4/13/01-6/8/01 indicate two unidentified deposits on 5/16/01 ($200) and 6/7/01 ($250). These deposits warrant an explanation and evidence of source of funds as they caused a large increase in the account balance, given the otherwise small balance. Without the deposits, the borrower would not have had sufficient funds available to close the loan.
AUDITEE COMMENTS: According to the [settlement statement], the borrower needed $142.73 to close this loan. We did not deem it necessary to question the 2 deposits on the borrower's bank statement as there was not a large increase in the account balance and did not exceed 2% of the sales price. To the contrary, the 6/8/01 bank statement had confirmed a balance as of 5/11/01 of $674.91 and an ending balance of $559.58. This balance was sufficient for the cash needed to close. We respectfully submit that we complied fully with HUD guidelines and there is no basis for this finding.
OIG EVALUATION OF AUDITEE COMMENTS: HUD regulation does not specify that only deposits in excess of 2% of the sales price be considered large deposits. As documented above, the unexplained deposits represent a large increase in respect to the account balance. The loan was approved using a bank statement balance of $559.58. Without the two deposits, the borrower's account balance would have been $109.58 and there would not have been sufficient funds available to close the loan.

Questionable/Derogatory Credit History
CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-3 requires lenders to develop a credit history from utility payment records, rental payments, automobile insurance

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payments, or other means of direct access from the credit provider for borrowers who do not use traditional credit. Also, neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejection. According to Paragraph 2-3A, the payment history of the borrower's housing obligations is of significant importance in evaluating credit. Lenders must determine the borrower's payment history of the housing obligations for the most recent 12-month period.

OIG FINDING: The credit report did not list a credit score; the only item listed on the credit report is a paid collection ($55) from 1997/1998. Gershman did verify seven months worth of payment records for one utility and the borrower's rent. The verification of rent does verify $200 monthly payments. However, it was completed by the landlord the same day as the processor and does not list a phone number, fax number, or address for the landlord, possibly indicating that Gershman did not directly verify the rent. The file also contained a gas service bill for one month, which shows a balance brought forward. It is unclear if the borrower made late payments for gas service or for any of the unverified utilities (i.e. telephone/water/sewer/trash/ insurance). Gershman did not adequately develop the borrower's credit history.

AUDITEE COMMENTS: We respectfully submit that this borrower did not have a credit score. We properly developed the borrower's credit history using his landlord verification and one utility account. The most weight was put on the rent of $200 per month given that his new monthly mortgage payment was $274. With regards to the landlord verification being completed the same day, Gershman permits its employees to hand carry verification in order to expedite the processing.

OIG EVALUATION OF AUDITEE COMMENTS: While Gershman did verify seven months of rental history and electricity payments, they failed to satisfy HUD requirements. Gershman did not verify twelve months of housing payments and failed to explain the balance brought forward on the gas service bill.

FHA CASE NUMBER: 292-4054430	DATE OF LOAN CLOSING: 8/3/2001
LOAN PURPOSE: Purchase	INSURED AMOUNT: $120,582
UNDERWRITER TYPE: Manual	HOUSING/DEBT RATIOS: 25.12/43.73

STATUS AS OF 3/31/2004: Reinstated by mortgagor. First default after nine payments.

<u>Inconsistent/Unsupported Assets</u>

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-10 requires lender to ensure that the borrower has sufficient funds available to close the loan. Paragraph 2-10K states that if the borrower claims assets through the sale of stocks and bonds, actual receipt of funds must be verified. Paragraph 2-10A allows for savings and checking account verification by obtaining a verification of deposit and the most recent bank statement. Paragraph 3-1F permits alternative verification consisting of the two most recent consecutive bank statements showing the previous month's balance. Provided documents are not more than 120 old when the loan closes, there is no need to update.

OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $3,960 and the borrower needed $15,172 to close. According to the settlement statement, the borrower only needed $13,553 to close after taking out earnest money, seller paid

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expenses, and borrower prepaid expenses. The HUD case binder included documentation of a savings account, checking account, savings bonds, gift, and equities account. A 7/28/01 document reveals that the savings account balance was $4,369 after depositing all savings bonds. An 8/2/01 document reveals that the checking account balance was $9,000 after depositing the fully documented gift. While a bank statement shows a $2,172 equities account balance, the statement is outdated and there is no proof that the borrower ever received the funds. Based on the $4,369 savings account balance and $9,000 checking account balance listed on the most recent documents located in the file, the borrower had only $13,369 available. Had the correct amount been entered on the underwriting worksheet, the borrower's reserves would have been negative and there would not have been sufficient funds to close the loan.

AUDITEE COMMENTS: The borrower had assets of $13,369 that we verified and he needed $13,553 to close. This was a difference of $184. The borrower received a paycheck on the day of closing that would have more than covered this difference. Further, the cash investment for this loan was substantially more than the statutory investment requirement of $3,960. The underwriter made a judgment call to accept the documentation received for the assets for these reasons. We respectfully submit that we properly underwrote and approved this borrower.

OIG EVALUATION OF AUDITEE COMMENTS: While closing occurred on a Friday, a day on which the borrower would normally receive a paycheck, Gershman still failed to properly verify and document that the borrower had sufficient funds to close.

<u>Questionable/Derogatory Credit History</u>

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-3 describes the criteria for analyzing the borrowers credit, stating that HUD does not arbitrarily require that collection accounts be paid off as a condition for loan approval, but does require that court-ordered judgments be paid-off before the mortgage loan is eligible for insurance endorsement (An exception may be made if the borrower has been making regular and timely payments on the judgment and the creditor is willing to subordinate that judgment to the insured mortgage).

OIG FINDING: A court order indicates that the borrower owed $2984 in retroactive child support due 3/30/99; additionally, a 7/30/01 credit report indicates a collection from the Division of Child Services with a $442 balance and 4/99 opening date. While it appears that the borrower might be paying the collection off slowly in conjunction with his $373 monthly child support payments (the amount deducted is approximately $466 monthly), there is no documentation showing that the $442 has been paid off or that the Division of Child Services agreed to subordinate the judgment.

AUDITEE COMMENTS: It was noted that a 7/30/01 credit report indicated a collection from the Division of Child Services with a $442 balance, and an April 1999 opening date. Although it is true that court-ordered judgments be paid off before the mortgage loan is eligible for insurance endorsement, it was noted that an exception may be made if the borrower has been making regular and timely payments on the judgment, and the creditor is willing to subordinate the judgment to the insured mortgage. In the referenced matter, the borrower was making a regular and timely payment in excess of his existing monthly child support payment that would have satisfied the outstanding $442 balance within a 5-month period. Further, it was not necessary to obtain a verification that the Division of Child Services had agreed to subordinate their judgment, as their interest by operation of law was subordinate to the insured mortgage on the property that was secured by the Deed of Trust. We respectfully submit that the auditors finding is not supported.

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OIG EVALUATION OF AUDITEE COMMENTS: While the borrower's pay stubs do show a deduction for approximately $466 per month, the deduction is to "Acct R," which could be a retirement account based on IRA account documents located in the file. The file does not contain sufficient evidence that the borrower has been making regular and timely payments on the collection.

Inadequate Qualifying Ratios

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-12 requires lenders to compute the debt ratio, which should not exceed 41% unless significant compensating factors are listed in the remarks section of the underwriting worksheet. According to Paragraph 2-13, if the borrower has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage, it may be presented as a compensating factor.

OIG FINDING: The underwriting worksheet shows a debt ratio of 43.73% and lists the following compensating factors: "score 572; long term empl.; 17 mo. rental history on time; 1st time homebuyer." While rental history is an acceptable compensating factor, the 7/30/01 verification of rent indicates that the borrower's rent is currently due/unpaid and shows the rent amount as only $775 monthly, an amount not equal to or greater than the new monthly housing expense of $954.67. Gershman staff noted in an 4/2/2004 meeting that two additional compensating factors could have been listed on the underwriting worksheet: this was not a maximum financing loan and the borrowers put $14,000 down.

AUDITEE COMMENTS: The loan had a [debt] ratio of 43.73%. This loan was for new construction and the [debt] ratio guideline was 43%. Importantly, additional compensating factors were that the borrower made a large down payment to purchase the property and the child support debt used in the ratio was overstated because of the repayment of past due balance as noted above. The higher payment we counted in the ratios was reduced by $73.00 per month within 5 months of closing. We respectfully submit that this loan was underwritten consistent with HUD guidelines.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that this was a new construction energy efficient home. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-19 allows borrowers to exceed the qualifying ratios by up to two percent (31/43%) when purchasing or refinancing an energy-efficient home. Regardless, the loan exceeded the qualifying ratio guidelines, and Gershman failed to present adequate compensating factors on the underwriting worksheet to support the approval of this loan.

FHA CASE NUMBER: 292-3998744 DATE OF LOAN CLOSING: 8/7/2001
LOAN PURPOSE: Purchase INSURED AMOUNT: $49,608
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 26.00/28.00
STATUS AS OF 3/31/2004: Terminated (paid in full). First default reported after 12 payments.

Inconsistent/Unsupported Income

CRITERIA: The Desktop Underwriter Findings Report requires employment income be supported by the most recent year-to-date pay stub documenting one full month's earnings and a verbal confirmation of employment.

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OIG FINDING: The Desktop Underwriter Findings Report shows monthly base employment income of $1,733. While the verification of employment indicates a $400/week salary based on 40 hrs/week and $10/hour, both the year-to-date verification of employment income and four weeks of paystubs indicate average monthly income of only $1,315. Gershman based the $1,733 base income on the $400/week salary listed on a verification of employment, even though only $1,315 base income was verified through year-to-date income, paystubs, and W-2's.
AUDITEE COMMENTS: We used the borrower's base monthly income of $1,733 as properly verified on the employment verification. See Exhibit 2. Further, although the pay stubs and W-2's showed $1,315, the borrower had a part time job with average monthly income of $671 that we did not use in qualifying. The borrower also had other income from dividends and capital gains as reflected on his 1999 and 2000 tax returns not used to qualify. Had we used the lower income of $1,315 per month noted by the auditor, the qualifying ratios would have been 36%/38% and we would have manually approved the loan as it met fully HUD guidelines for approval.
OIG EVALUATION OF AUDITEE COMMENTS: Condition #8 of the Desktop Underwriter Findings Report required income be supported by the most recent year-to-date pay stub documenting one full month's earnings. As previously noted, the pay stubs provided did not support the income used to qualify. Additionally, information regarding secondary income referenced was not submitted to Desktop Underwriter, as the file did not contain adequate documentation to support the income. Last, the interest and dividends referenced are from an Edward Jones account, which was not adequately verified. The tax returns included do not evidence the account balance, the availability of the funds, or the likelihood of continued dividend income and capital gains. Furthermore, Gershman notes that had they only counted $1,315 monthly income, they would have manually underwritten this loan. However, and significantly, Gershman did not manually underwrite this loan; instead Gershman submitted the loan to Desktop Underwriter and failed to satisfy the condition listed on the Findings Report.

Inconsistent/Unsupported Assets
CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.
OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $1,500 and the borrower needed $3,583 to close. According to the settlement statement, the borrower only needed $1,228 to close after taking out gift funds and borrower prepaid expenses. According to the Desktop Underwriter Findings Report, the borrower's assets consisted of savings and checking accounts with respective balances of $676 and $6,286. However statements located in the Gershman case file show three unidentified deposits totaling $7,612 between 4/30/01 and 5/21/01, each in excess of two percent of the sales price. Without these deposits, there would not have been sufficient funds available to close the loan.
AUDITEE COMMENTS: It was the underwriter's judgment as permitted under the [Direct Endorsement] program, to accept the documentation regarding the verification of source of funds. The original loan application listed an account with Edward Jones at a value of $6,500. There is proper verification that the borrower had these funds because there were dividends and capital gains shown on his 1999 and 2000 tax returns. The bank statements also showed auto debit from his account to Edward Jones. The Desktop Underwriter Findings Report only required the most recent bank statement. There was no condition for verification of large deposits. We respectfully submit that this finding is not supported and that we properly verified the borrower's assets to close.

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OIG EVALUATION OF AUDITEE COMMENTS: Although the large deposits were not adequately verified, we concur with Gershman's assertion that the Desktop Underwriter Findings Report did not contain a condition for verification of large deposits. We have removed this deficiency from Finding 1 and adjusted Appendix B.

Inconsistent/Underreported Liabilities

CRITERIA: According to HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-11C, if a debt payment, such as a student loan, is scheduled to begin within twelve months of the mortgage loan closing, the lender must include the anticipated monthly obligation in the underwriting analysis unless the borrower can provide evidence that the debt may be deferred to a period outside this timeframe.

OIG FINDING: According to the borrower's credit report, a $16,768 student loan was in deferment status as of May 2001. However, Gershman did not verify the likelihood of continued deferment status. According to www.ed.gov, borrowers have a six-month grace period once they are no longer in deferment status. Using the graduated repayment plan and the current interest rate (which would probably project lower payment amounts than the borrower's rate), the borrower would owe $83 per month if in repayment status.

AUDITEE COMMENTS: The loan was underwritten using Desktop Underwriter. The credit report showed the student loan not in repayment. See Exhibit 3. The Desktop Underwriter Findings Report did not require any conditions regarding this student loan. Further, had we counted the $83 per month as a debt the ratios would have been 36%/44% using the lower income noted by the auditor. Significantly, the compensating factors to approve this loan would have been cash reserves in excess of 12 months mortgage payments and income not used to qualify as noted above. Based on these compensating factors, we would have manually approved this loan as it met fully HUD guidelines for approval. We respectfully submit that this finding is not supported.

OIG EVALUATION OF AUDITEE COMMENTS: According to Section VI of the Desktop Underwriter Government Underwriting Service User's Guide for FHA Loans, if the borrower has a liability that is exempt from qualifying based on FHA guidelines, the debt may be omitted provided the loan file contains documentation to support the omission based on FHA guidelines. Gershman failed to include the documentation required by HUD/FHA guidelines. Furthermore, Gershman notes that had the debt been included, they would have manually underwritten this loan and documented compensating factors. However, and significantly, Gershman did not manually underwrite this loan; instead Gershman submitted the loan to Desktop Underwriter and failed to follow the automated system's guidelines.

FHA CASE NUMBER: 292-4064761 DATE OF LOAN CLOSING: 8/23/2001
LOAN PURPOSE: Purchase INSURED AMOUNT: $71,379
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 15.58/45.09
STATUS AS OF 3/31/2004: Reinstated by Mortgagor. First default Reported after 11 payments.

Inconsistent/Unsupported Assets

CRITERIA: The Desktop Underwriter Findings Report required depository assets be verified using the most recent monthly or quarterly bank statement.

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OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $2,175 and the borrower needed $2,176 to close. According to the settlement statement, the borrower only needed $1,452 to close after taking out earnest money, seller paid expenses, and borrower prepaid expenses. The Desktop Underwriter Findings Report includes a checking account with a $390 balance and lists $390 cash reserves. A checking account printout, which does not have the depository name on it, shows a 7/5/01 ending balance of $358. While an 8/14/01 verification of deposit lists a $390 average account balance, it also lists a $0 current balance. It is unclear whether Desktop Underwriter would have approved the loan without the $390 checking account, as there would not have been cash reserves and the debt ratio was already above the 41% benchmark .
AUDITEE COMMENTS: The Borrower's needed $1,451 to close this transaction as needed on the [settlement statement]. There was documentation in the file evidencing that their uncle gave them a gift for $2,175. See Exhibit 4. The gift funds were given to the title company at closing. Since the amount needed was only $1,451, the difference of $724 was given to the borrowers. Our underwriter analyzed the bank verifications and it was evident that the average balance of $390 was reasonable for cash reserves. The underwriter determined that the amount of gift in excess of the funds needed to close was more than the $390 used for cash reserves. Therefore, this supported the Underwriter Findings.
OIG EVALUATION OF AUDITEE COMMENTS: According to the settlement statement, the borrower needed $1,451.88 to close. While Gershman is correct that the borrower received a $2,175 gift, which covered closing costs, they were still required to accurately submit the checking account balance. Gershman agrees that the average balance was submitted rather than the current available balance.

<u>Inconsistent/Underreported Liabilities</u>
CRITERIA: According to HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-11A, the borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. Paragraph 2-11A states that monthly payments on revolving accounts must be calculated at the greater of five percent of the balance or $10.
OIG FINDING: While the 8/20/01 credit report lists an account with a $60 balance and $10 monthly payments, an 8/3/01 borrower letter located in the Gershman case binder reveals a recent $1,300 increase in the account balance. This balance increase was not disclosed on the Desktop Underwriter Findings Report and would have increased the debt ratio from 45.09% to 46.65%. It is unclear whether Desktop Underwriter would have approved the loan as the debt ratio was already above the benchmark 41% and the additional debt may have caused the loan to exceed DU's internal risk threshold.
AUDITEE COMMENTS: Our credit report was run after the 8/3/01 letter from the borrower. The credit report showed Dillard's verified in July, and there was no indication of such a charge. The borrower's letter indicated that the Dillard's balance would be higher due to the purchase of airline tickets for $1,300. The letter also stated that this would be paid off using their tax refund. The letter further stated that the borrower had received an in-school deferment and was not paying his student loans since he was back in school full time. The student loan payments were counted as debts with monthly payments of $246. Consistent with HUD guidelines that provide the underwriter with discretion, the underwriter made the judgment call that a Dillard's payment of $10 counted in the ratios and the student loan payment of $246, there was no reason to count

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any additional payment for the airline tickets. The student loan deferral payments and the tax refund offset this and did not require any additional documentation. The Underwriter Findings would not have changed.

OIG EVALUATION OF AUDITEE COMMENTS: Because the 8/3/01 borrower letter indicated that the $1,300 Dillard's charge was recent, Gershman should have expected that the July verification would not include the charge. Additionally, HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-11C required Gershman to include the student loan payment unless they obtained evidence from the borrower that the payments would not begin within twelve months of the mortgage loan closing. As previously noted, the $1,300 balance increase would have increased the debt ratio to at least 46.65% and should have been included in the submission to Desktop Underwriter.

FHA CASE NUMBER: 292-4058693 DATE OF LOAN CLOSING: 8/30/2001
LOAN PURPOSE: Purchase INSURED AMOUNT: $89,195
UNDERWRITER TYPE: Manual HOUSING/DEBT RATIOS: 8.58/54.96
STATUS AS OF 3/31/2004: Delinquent. First default reported after 20 payments.

Questionable/Derogatory Credit History

CRITERIA: According to HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-5, if a borrower is presently delinquent on any Federal debt (e.g., Federal student loan), the borrower is not eligible until the delinquent account is brought current, paid or otherwise satisfied, or a satisfactory repayment plan is made between the borrower and the Federal agency owed and is verified in writing. Additionally, according to Paragraph 2-3A, the payment history of the borrower's housing obligations is of significant importance in evaluating credit. Lenders must determine the borrower's payment history of the housing obligations for the most recent 12-month period.

OIG FINDING: While all borrower debts shown on the credit report and application are consistently documented, there are not sufficient explanations for the 1999, 2000, or 2001 late payments or for the amount past due shown on the 7/8/01 student loan billing statement (note that four of these delinquencies were during the borrower's current employment). Also, the borrower's rental history is questionable. The borrower application indicates that the borrower has rented 1044 Provence Drive for 2.5 years ($430/month). While the 3/21/01 verification of rent indicates that the borrower rented from 10/8/98-7/31/01 for $430/month, the ending rent date is four months after the date on the verification of rent.

AUDITEE COMMENTS: The underwriter used the credit letters dated 3/20/01 and 7/13/01 for sufficient explanation of the 1999 thru 2001 late payments. These letters explained that gaps in the borrower's employment caused the late payments. The gaps in employment were evidenced by the various employment verifications in the loan file. The auditor also stated that four of the delinquencies occurred while the borrower was employed. But, clearly the lingering effects of previous gaps in employment were relevant to the delinquencies.

While there was no explanation for the past due amount shown on the 7/8/01 student loan billing statement, it is clearly reflected that payments were being made and accepted monthly. This was further supported by the credit report. The underwriter accepted the credit letter regarding employment history as sufficient explanation for the late payments on the student loans. In

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addition, the credit report stated that the student loan accounts had been transferred. It has been our experience that when accounts are transferred, there are frequently errors and/or issues with the payment posting.

The original loan application was taken 3/14/01. The rent verification dated 3/21/01 showed the borrower had rented since 10/8/98, which was 2.5 years. See Exhibit 5. The verification was completed showing the full term of the lease that ended 7/31/01. The auditor stated this is an issue, but rent verifications are often completed in this manner. In addition to the rent verification being dated 3/21/01, it was faxed to our office on the same date. The verification indicated that the rent was current and had been paid as agreed. The underwriter determined to weight the rental history more heavily than the credit card payments.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the lingering effects of previous gaps in employment were relevant to the later delinquencies. However, while Gershman's comments adequately address the late payments on the borrower's student loan, they do not address the amount shown as past due. Additionally, while Gershman's asserts that the 3/21/01 rent verification is sufficient, it dated more than 120 days prior to closing and is not sufficient according to HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 3-1.

<u>Inadequate Qualifying Ratios</u>

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-12 requires lenders to compute the debt ratio, which should not exceed 41% unless significant compensating factors are listed in the remarks section of the underwriting worksheet. Paragraph 2-13 notes that when the borrower receives compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, it can be used as a compensating factor. However, according to Paragraph 2-7D, individuals whose commission income shows a decrease from one year to the next require significant compensating factors to allow for loan approval. Additionally, unless adequate documentation to exclude the debt is obtained, Paragraph 2-11B requires contingent liabilities such as mortgage debts be included in qualifying ratios.

OIG FINDING: According to the underwriting worksheet, the debt ratio is 54.96% (4834.37/8795). Compensating factors listed include "income from only 1 co-signor used; gross from 1099 $7409 per mo 24 mo avg.; $825 mtg. pd by daughter = 37% ratio." The co-signor income not used to qualify is commission and bonus income from real estate sales; however, the monthly commission income had declined over $2,500 in the past year. Additionally, the only documentation found to support the claim that the co-signor's $825 monthly mortgage payment is paid by their daughter are four months worth of cancelled checks averaging only $420/month, which would have only decreased the debt ratio to 50.19%.

AUDITEE COMMENTS: The auditor indicated that the income of the co-signor not used to qualify had declined by $2,500 in the past year. This income not used to qualify was from real estate sales commissions and was not a significant decline. Importantly this income was used only as a compensating factor. The amount of her income using a 24-month average was $7,409 per month. Had we used this income, the [debt] ratio would have been well within the HUD guidelines and no compensating factors would have been required.

The other factor was that the co-signors had a mortgage obligation with their daughter where the daughter was paying either all or part of the payment. There was evidence in the file that she was making payments to them for this debt. We were unable to verify consistent payment from the daughter and therefore, we counted the entire debt and used this as a compensating factor.

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Not counting this mortgage debt would have made the [debt] ratio within HUD guidelines. We respectfully submit that this finding is not supported.
OIG EVALUATION OF AUDITEE COMMENTS: Gershman stated that the co-signor's commission income had declined by $2,500 in the past year when in fact it had declined $2,500 monthly to $5,755. Because HUD regulation requires significant compensating factors when commission income is included that shows a decrease from one year to the next, the commission income would not qualify as a significant compensating factor itself. As noted by Gershman, there was not sufficient evidence to show that the co-signor's daughter was paying one of the mortgage debts. The documentation provided by Gershman to show that the daughter pays the debt does not support a significant decrease in the debt ratio.

Inconsistent/Questionable Documentation
CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-2A says that neither a co-borrower nor a cosigner may be a party that has an interest in the transaction, such as the real estate agent. Exceptions may be granted if the seller and co-borrower/cosigner is a family member of the occupant owner. Furthermore, Paragraph 1-7b states that inducements to purchase result in a dollar-for-dollar reduction to the sales price before applying the appropriate Loan-to-Value ratio.
OIG FINDING: According to documentation located in the Gershman file, there are two co-signors on this loan. While Gershman claims that the non-occupying co-signers were the borrowers' parents, there was no documentation in the file to support a family relationship. However, documentation in the file indicates that the borrower may have rented from the co-signors in the past. Additionally, the sales contract lists one of the co-signers as a selling agent acting on behalf of the buyer/borrower, and the settlement statement shows a $2,386.80 commission to the agent's firm that could be construed as an inducement to purchase or cosign.
AUDITEE COMMENTS: We respectfully submit that the auditor's finding is incorrect. The loan file contained evidence that the co-signors were the borrower's mother and stepfather. There was [pre-approval] mortgage application completed by the Gershman loan officer stating that the [borrower] is the [co-signor's] son. See Exhibit 6.
OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the pre-approval document notes that the borrower is the co-signor's son. However, this document is not dated or signed and is not evidence that the co-signor, who had an interest in the transaction, was a family member of the owner occupant.

FHA CASE NUMBER: 292-4057783
DATE OF LOAN CLOSING: 8/31/2001
LOAN PURPOSE: Purchase
INSURED AMOUNT: $143,396
UNDERWRITER TYPE: Manual
HOUSING/DEBT RATIOS: 18.98/20.73
STATUS AS OF 3/31/2004: Delinquent. First default reported after five payments. Borrower declared bankruptcy on 7/12/2002.

Inconsistent/Unsupported Assets
CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.
OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $4,347 and the borrower needed $7,238 to close. According to the settlement

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statement, the borrower only needed $5,273 to close after taking out earnest money and borrower prepaid expenses. According to the application and underwriting worksheet, the borrowers' available assets consisted of a checking account ($9), savings account ($25), and proceeds from the sale of their prior residence ($15,998). However, the bank statement used to support the savings account balance was outdated, and the 8/8/01 printout used to support the checking account balance shows a $150 transfer from the savings account. Additionally, the settlement statement included to support the proceeds from the sale of the borrower's prior residence was not signed by the purchaser and was dated three months prior to closing. There is no documentation that the proceeds were still available when the loan was underwritten and closed.

AUDITEE COMMENTS: HUD guidelines state that a fully executed [settlement statement] must be provided as evidence of the cash sales proceeds accruing to the borrower. Our file contained a fully executed seller's [settlement statement]. The guidelines also state that documents may be up to 120 days old at the time the loan closes. The [settlement statement] in our file was dated 6/1/01 and this loan closed on 8/31/01. There was no reason for us to question that the proceeds were still available at the time of closing. We respectfully submit that this finding is not supported.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that they were not required to question the proceeds as the settlement statement was dated within 120 days of closing. While the checking and savings accounts were not eligible to be counted as available assets for qualifying purposes due to the $150 transfer, the amount ($34) is negligible. We have removed this deficiency from Finding 1 and adjusted Appendix B.

<u>Questionable/Derogatory Credit History</u>

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-3 describes the criteria for analyzing the borrowers credit, stating that if the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong offsetting factors will be necessary to approve the loan…A period of financial difficulty in the past does not necessarily make the risk unacceptable if a good record has been maintained since. Furthermore, Paragraph 2-3A notes, the payment history of the borrower's housing obligations is of significant importance in evaluating credit and requires lenders to determine the borrower's payment history of the housing obligations for the most recent 12-month period.

OIG FINDING: According to the 5/10/01 credit report, the borrower and co-borrower average credit scores are 507 and 553 respectively. The borrowers filed Chapter 13 Bankruptcy in 1995, and were discharged in February 2001. Since the bankruptcy, the borrowers' have had late payments as recent as February 2001, charge offs as recent as October 2000, account settlements, and collections. Also, the credit report shows that the borrowers' current mortgage was $1,556 past due. No offsetting factors were presented on the underwriting worksheet.

AUDITEE COMMENTS: The underwriter reviewed the borrower's credit and the credit explanation letter and made the underwriting decision to approve the loan. The Chapter 13 Bankruptcy was filed in December 1995. The borrowers explained that this was due to two business ventures that failed. The late payments after the bankruptcy were explained and some of the accounts were disputed by the borrowers. Further, the credit report showed accounts paid as agreed and the borrowers had re-established credit.

The borrower had been employed on his job for 16 years. The qualifying ratios were strong at 19% and 21%. The borrowers had worked diligently to pay off past credit accounts as evidenced by the repayment of the Chapter 13 Bankruptcy (as opposed to Chapter 7). At the time of

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application, the borrowers had minimal amount of outstanding credit. The borrowers were previous homeowners and had cash reserves of $9,837 after closing, therefore, the underwriter made the judgment call to approve this loan. HUD guidelines authorize the underwriter to judge the overall merits of the loan and determine what compensating factors apply in approving a loan.

According to the credit report dated 5/10/01, there were two payments due on the Countrywide Mortgage. The credit report showed there were no late payments since 1997 and the underwriter assumed that the borrower did not make payments while the house was under contract for sale. The sales contract for this sale was dated 3/28/01 and the [settlement statement] verified that this loan was paid off 6/1/01, which was 3 months prior to closing. We respectfully submit that the auditors finding is without basis.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the previous mortgage was paid off approximately three months prior to closing. However, we disagree with Gershman's assertion that the borrower had adequately re-established credit. Since filing bankruptcy in 1995, the borrowers have opened seven lines of credit. Five of these accounts have prior adverse ratings; additionally, one of the five was closed by the credit grantor, one was closed by the borrowers, two were settled, and one resulted in a charge off which the borrower claims was paid in full. The remaining two accounts, opened in 11/00 and 4/01, are in good standing. Since filing for bankruptcy, the borrowers have had a $1,145 charge off on an old account, which they dispute, and three collections totaling less than $200. The only other account listed on the credit report with activity since the bankruptcy is an overdraft protection account. Based on this analysis, we do not believe that Gershman demonstrated that the borrower adequately re-established credit.

FHA CASE NUMBER: 292-4067535	DATE OF LOAN CLOSING: 9/13/2001
LOAN PURPOSE: Purchase	INSURED AMOUNT: $60,181
UNDERWRITER TYPE: Automated	HOUSING/DEBT RATIOS: 20.26/32.23

STATUS AS OF 3/31/2004: Reinstated by mortgagor. First default reported after two payments.

<u>Inconsistent/Unsupported Income</u>

CRITERIA: According to the Desktop Underwriter Findings Report, employment income must be supported by recent pay stubs documenting one full month's earnings and a written, verbal, or electronic verification of employment acceptable to FHA. Also, unless the current employer confirms two-year employment, the lender must obtain either W-2(s), verifications of employment, direct IRS income verification, or electronic verification for the most recent two years.

OIG FINDING: While the monthly income used to qualify can be derived from verifications of employment, the total decreases by nearly $500 when computed from year-to-date borrower and co-borrower earnings. Because the borrowers' current employers did not confirm a two-year history, Gershman was required to obtain W-2's or verification(s) of employment for current and previous employers covering the last two years. However, they did not obtain documents covering the full two years and did not explain why several notes in the Gershman case file listed additional unverified employers for the borrowers. Additionally, they did not explain a three-month gap in borrower employment or the additional paystubs located in the Gershman case file that indicate the borrower possibly changed jobs just a month before closing. Gershman did not satisfy all conditions listed on the Desktop Underwriter Findings Report and did not adequately verify the stability of employment.

AUDITEE COMMENTS: We respectfully submit that in reference to the verification of employment, the original loan application dated 8/13/01 showed the borrower's employment history back to 5/99, which is more than the required two-year period. There were tax returns in the file obtained from the borrower and directly from the IRS to show income for this borrower for 1999 and 2000. The tax form for 2000 was discarded inadvertently. The borrows originally applied for a First Time Homebuyer loan through Missouri Housing and Development Commission that required the most recent three years of tax returns. Importantly, this would have included the 2000 tax return. The loan did not close using this First Time Homebuyer program. The tax return may have been discarded inadvertently.

According to the original loan application, there was not a gap in employment nor did the borrower change jobs before closing. The additional pay stubs in the file were from a part-time job that was also listed on the original loan application. There were two pay stubs in the file from [Employer B] showing the borrower worked 24 hours a week at $22.61 per hour. This income was not used to qualify. We respectfully submit that the borrower's income was properly determined.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertions that an 8/13/01 application showed the borrower's employment history back to 5/99. However, the file did not contain the required documents covering the two-year period.

We concur with Gershman's assertion that the additional borrower pay stubs were from a job listed on the original loan application. While a month worth of 24 hour week, $22.61 per hour pay stubs would more than cover the $500 overstatement in earnings shown above, the application shows only $260 monthly income from this position. Additionally, we note that because Gershman did not properly verify this income, it could not be used for qualifying purposes.

<u>Inconsistent/Unsupported Assets</u>

CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.

OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $1,860 and the borrower needed $5,480 to close. According to the settlement statement, the borrower did not need any funds to close after taking out secondary financing, earnest money, and borrower prepaid expenses. According to the 9/12/01 Desktop Underwriter Findings Report, the borrower's assets and reserves consisted of three bank accounts, totaling $1,797. The bank statements for these accounts reveal that one of the accounts started with a negative balance while the other two started with a zero balance. Bank statements covering 5/16/01-6/26/01 and 5/16/01-7/24/01 reveal six unidentified deposits, including two deposits for $2,681 and $1,000. Without the two unexplained deposits, the borrower would have had negative account balances and no reserves.

AUDITEE COMMENTS: We respectfully submit that the borrower's assets were supported. In a letter dated 5/14/01, the co-borrower received a notice from the IRS about her 2000 tax return being amended, and changing her tax refund to 3,881. On 5/16/01, the co-borrower deposited a total of $3,681 in two separate accounts. $2,681 was deposited into a new checking account. And $1,000 was deposited into a new savings account. Also, the loan application stated that the

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co-borrower received child support that was not used to qualify. This would account for the other unidentified deposits into their bank account.
OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the $3,881 tax refund is evidence of funds for the two deposits totaling $3,681. We removed this deficiency from Finding 1 and adjusted Appendix B.

FHA CASE NUMBER: 292-4076810 DATE OF LOAN CLOSING: 9/19/2001
LOAN PURPOSE: Purchase INSURED AMOUNT: $84,333
UNDERWRITER TYPE: Manual HOUSING/DEBT RATIOS: 10.92/17.92
STATUS AS OF 3/31/2004: Reinstated by mortgagor. First default reported after 19 payments.

Inconsistent/Unsupported Income
CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Chapter 2 requires that the lender establish the borrower's capacity to repay the mortgage debt. Income from a source that cannot be verified, is not stable, or will not continue should not be used when calculating the borrower's qualifying ratios. Paragraph 2-7A requires lenders to develop a two-year average of bonus or overtime income, and indicates that if the earnings trend indicates a continual decline, the lender must provide a sound rationalization for including the income of the borrower qualifying.
OIG FINDING: According to the underwriting worksheet and application, the borrower's monthly overtime income is $687. However, while the verification of employment indicates that overtime is likely to continue, it also indicates an average of only 40 hours per week and average monthly overtime income of $1,067 in 1999, $648 in 2000, and only $158 for 2001. The two-year average monthly overtime income is only approximately $560 and there is no explanation in the file for the continual decline.
AUDITEE COMMENTS: The underwriter made a decision consistent with the discretion permitted under the [Direct Endorsement] program to use the overtime of $687 per month. This was based on the fact that the difference in overtime from 1999 to 2000 was only $530. This was not a significant difference to concern the underwriter. The year to date overtime was used in the average even though the monthly average was less than the last 2 years. The underwriter was not able to determine when the borrower worked the overtime hours during the year and the last 2 full years were the best indication of the overtime worked. In addition to this, the [debt] ratio would have only increased to 20% if no overtime was used for the borrower's qualifying income. We respectfully submit that the borrower's income was properly determined.
OIG EVALUATION OF AUDITEE COMMENTS: According to the 8/28/01 verification of employment, while the difference in total income between 1999 and 2000 was only $537, the difference in overtime income between the two years was $5,032. An October 1999 raise in base pay made up for the decreased overtime in 2000. Regardless of the qualifying ratios, Gershman failed to properly verify the overtime income according to HUD guidelines as required by Desktop Underwriter.

Questionable/Derogatory Credit History
CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-3 describes the criteria for analyzing the borrowers credit, stating that past credit performance serves as the most useful guide in determining the attitude toward credit obligations that will govern the borrower's future

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actions...if the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong offsetting factors will be necessary to approve the loan. Furthermore, while minor derogatory information occurring two or more years in the past does not require explanation, major indications of derogatory credit, including judgments and collections, and any other recent credit problems, require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

OIG FINDING: While the borrowers filed Chapter 13 bankruptcy in 1998, they have completed their payout period and were discharged in March 2001. Their reasons for filing bankruptcy include loss of employment, unexpected legal costs and co-signing problems with a child, maintenance on a prior residence, and problems with a car they could not afford. They also noted that they now make more money than they ever have. However, the credit report shows that since filing for bankruptcy, the borrowers have only opened five accounts. While one of the accounts was in good standing, three have gone into collection, and the fifth has reported 30, 60, and 90-day late payments as recent as April 2001. While a borrower note indicates that the last account has been settled, the credit report indicates that its balance is still more than $850 over the credit limit.

AUDITEE COMMENTS: The underwriter reviewed the five accounts noted above and made an underwriting judgment call to approve this loan based on other positive factors. The borrower filed Chapter 13 Bankruptcy in 1999, which they successfully completed and was discharged in 3/01. The credit letter adequately explained the reasons for the bankruptcy. The underwriter considered the fact that the borrower filed a Chapter 13 bankruptcy and had repaid over $21,000 of debt to be a strong positive factor. Two of the accounts noted above by the auditor were for telephone service and were minimal amounts. A third account was for a credit card and sufficient explanation was provided by the borrower.

In addition, the underwriter considered the rent and auto loan, which were paid as agreed as evidence that the borrower had re-established credit. The borrower's rent verification indicated that the rent had been paid as agreed for 5 years with the current rent payment of $645. The new mortgage payment was $741. This was less than a 15% increase in housing expense. HUD guidelines permit the underwriter to judge the overall merits of the loan application and to determine what compensating factors apply. We respectfully submit that we made the appropriate underwriting decision regarding this loan.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the borrower had completed Chapter 13 Bankruptcy (paying approximately $140 weekly) and was properly making rental payments over the past 5 years. The borrowers have since opened an auto loan account. This increase in monthly debt combined with the increased monthly housing expense raise the borrower's monthly payments by $538, an amount approximately equal to what the borrower had been paying on the Chapter 13 Bankruptcy. Additionally, while it is true that two of the three recent collections are small amounts and that the borrower provided an explanation for the credit card account, these instances are still significant as they represent the borrower's credit activities since filing for bankruptcy. Gershman failed to present adequate compensating factors to support the approval of this loan.

FHA CASE NUMBER: 292-4076992 DATE OF LOAN CLOSING: 9/22/2001

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LOAN PURPOSE: Non-Streamline Refinance INSURED AMOUNT: $91,603
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 28.80/55.62
STATUS AS OF 3/31/2004: Property conveyed to Insurer. HUD incurred a loss of $22,495 on the sale of the subject property. First default reported after six payments.

Inconsistent/Unsupported Income

CRITERIA: The Desktop Underwriter Findings Report requires all overtime and bonus income be verified and documented according to current FHA standards. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-7A requires lenders to develop a two year average of bonus or overtime income, and indicates that if the earnings trend indicates a continual decline, the lender must provide a sound rationalization for including the income of the borrower qualifying.

OIG FINDING: According to the Desktop Underwriter Findings Report, the borrower's $2,778 gross monthly income included $438 overtime/bonus income. This amount was computed using a 20.4-month average with figures from the verification of employment; however, a 24-month average from the verification of employment indicates only $408 monthly overtime/bonus income. Further, a note in the file indicates a 19-month total monthly income average of $2,647 including overtime. Gershman failed to document overtime income according to current FHA standards as required by Desktop Underwriter. Additionally, because the debt ratio already exceeded 41%, it is unclear if Desktop Underwriter would have approved the loan had the correct amount been entered.

AUDITEE COMMENTS: We underwrote the loan as follows; we used the monthly base income as stated on the employment verification that was $2,340. See Exhibit 7. We also used other earnings consisting of overtime and bonus averaged over a 20.4 month period. The employment verification dated 9/12/01 had year-to-date overtime and bonus of $3,637 and overtime and bonus for 2000 was $5,292. This total of $8,929 averaged over 20.4 months equates to $438 per month which when added to the base pay totaled the monthly income used of
$2,778. The employment verification stated that the year-to-date earnings are through 8/31/01. Therefore, we could have used a 20-month average of the overtime and bonus for $448 per month. However, we used a conservative approach and chose to use the lower amount calculated above.

We compared our calculation above to the OIG auditor's calculation to determine why there is a variance. We broke the auditor's calculation into two parts, overtime and bonus. The OIG auditor calculated the overtime by taking overtime of $1,397 for 1999, $3,642 for 2000, and $1904 for year-to-date, for a total of $6,943, divided over 26 months equaled $267 per month. Our underwriter made the decision to use a period less than 24 months since the borrower started in June 1999 and we had no way of knowing when she started working overtime hours. The overtime used by our underwriter was a mere $5 more per month than that amount used by the OIG auditor.

The primary difference in our income calculation as compared to the OIG auditor's was bonus income. The Auditor calculated the bonus income using a 24-month average of the 2000 bonus income, and the year-to-date bonus as reflected on the employment verification for an average of $141. We respectfully submit that this is not accurate, because the employment verification, while dated 9/12/01, contained information that was valid through 8/31/01, and therefore, the auditor should have used a 20-month average which would have been $169. Our underwriter used the $165 per month, which is less than the average based on the verification. We were justified in using a less than 24-month average, because the file contained 2 pay stubs where the

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borrower's bonus income had increased from one month to the next. See Exhibit 8. The OIG Auditor's use of a 24-month average assumes that the borrower had received all bonus income as of 8/31/01. There is no basis for this assumption. We respectfully submit that this finding is not supported and the borrower's income was properly calculated.

OIG EVALUATION OF AUDITEE COMMENTS: Gershman incorrectly stated the method used to arrive at the $408 OIG calculation for overtime/bonus income. The verification of employment shows total bonus/overtime of $3,639 in 2001 (year-to-date for eight months), $5,292 in 2000 (for twelve months), and $1,397 in 1999 (for 6.5 months). Because we only needed to count the last four months of 1999 to arrive at the 24-month average, we only counted $860. Thus, the total overtime/bonus income earned in the 24-month period was $9,791, an average of $408 per month.

Gershman did not take a conservative approach. To support this assertion, we call attention to the note located in the Gershman file, which indicates a 19-month total monthly income of $2,647. This is lower than the $2,778 used by Gershman when submitting the loan to Desktop Underwriter.

This is significant because the 54.08 debt ratio submitted to Desktop Underwriter (based on $1,502 total expense payments) was already lower than the 55.62 debt ratio listed on the underwriting worksheet (based on $1,545 monthly expense payments). This ratio already exceeded 41% and Desktop Underwriter may not have approved the loan had either the increased monthly payments ($1,545) or decreased overtime/bonus income ($408) been used. With both of these factors taken into consideration, the ratio jumps to 56.22%. Gershman violated HUD regulation by using a shorter average in order to increase the overtime/bonus income, thus decreasing the debt ratio.

<u>Inconsistent/Unsupported Assets</u>

CRITERIA: The Desktop Underwriter Findings Report requires depository assets be verified by either a verification of deposit, the most recent statement showing the previous month's balance, or the most recent two months statements. Also, cash reserves must be verified.

OIG FINDING: According to the settlement statement, the borrower did not need funds to close and instead received $8,569 at closing. According to the Desktop Underwriter Findings Report, the borrower's assets included a retirement account ($4,187) and a checking account ($768). While a 6/30/01 retirement account statement supports the balance used, the statement was incomplete as only three of the five pages were included in the case binders. While a 6/15/01-7/20/01 statement supports the checking account balance, it shows over $4,000 in unidentified deposits. Gershman failed to adequately verify assets used to qualify and cash reserves. In a 4/27/04 meeting, Gershman noted that this was a refinance and that the assets were not needed for the investment. However, because the assets were included on the Desktop Underwriter Findings Report as cash reserves, they were required to be adequately verified.

AUDITEE COMMENTS: The auditor noted that the retirement bank account statement only contained 3 of 5 pages. However, and significantly, the 3 pages of the retirement account statement contained all the specific information that was required for underwriting purposes.

Regarding the bank statement, the auditor indicated that the checking account bank statement showed over $4,000 in unidentified deposits. This account was a joint bank account belonging to the borrower and her husband, who was not on the loan. The deposits were obviously for his payroll deposits on a weekly basis. In addition, the [Desktop Underwriter Findings Report] did not contain any condition requiring us to verify large deposits. Significantly, our file also

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contained a prior months' bank statement that showed a balance of $1,978 with similar deposits for the month. See Exhibit 9. Therefore, we adequately verified assets used to qualify and cash reserves. Gershman respectfully submits that this finding is not supported.

OIG EVALUATION OF AUDITEE COMMENTS: Gershman's claim that the incomplete retirement account statement contained all necessary information cannot be substantiated, as it is unclear if the additional pages would disclose important information such as loans. Additionally, while five of the thirteen unidentified deposits shown on the 7/20/01 checking account statement may be weekly payroll deposits, there is no documentation to support these or any the remaining deposits. Gershman failed to adequately verify the reserves submitted to Desktop Underwriter.

FHA CASE NUMBER: 292-4081385 DATE OF LOAN CLOSING: 10/10/2001
LOAN PURPOSE: Purchase INSURED AMOUNT: $73,841
UNDERWRITER TYPE: Manual HOUSING/DEBT RATIOS: 17.42/36.96
STATUS AS OF 3/31/2004: Reinstated by mortgagor. First default reported after 21 payments.

Questionable/Derogatory Credit History

CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.

OIG FINDING: The credit report lists the borrower and co-borrower credit scores as 572 and 539 respectively. It also reveals a judgment, several collections/charge-offs, and late payments as recent as 6/01, including an 8/00 90-day late payment on a federal education debt. Although a 6/28/01 borrower note offers explanations for the slow payments and claims that they are now in credit counseling, it also mentions that the borrower was laid off for parts of 1999 and 2001, calling into question the stability of income. According to the underwriting worksheet, the borrowers housing expense is "increasing less than 10%," and the borrowers have "paid as agreed for 4+ years" on their current housing; while a 6/29/01 verification of rent supports the claim that no late payments have occurred, the borrowers were not consistently meeting other obligations during that time period. Additionally, an undated note from the co-borrower indicates that the borrowers have moved to a new address not verified.

AUDITEE COMMENTS: The decision to approve this loan was a judgment call by the underwriter as permitted under HUD [Direct Endorsement] program requirements. It was determined that the borrowers provided sufficient explanations for their past credit deficiencies. The primary reasons for the credit deficiencies involved three separate medical situations involving surgeries for the co-borrower and an accident with her son and not a disregard for her financial obligations.

The borrower's employment was analyzed and the underwriter used the base income from the employment verification. Also, according to the employment verification, the borrower received overtime and other income that offset his earnings for time not worked. See Exhibit 10. The 2000 gross earnings and year to date average fully support the income used.

According to the borrowers' explanations, he was laid off and the co-borrower was out of work but they continued to meet their housing obligation. The landlord verification of the borrowers rent properly verified that the borrowers had paid $725 a month rent and had been tenants since 1996. See Exhibit 11. Given the fact that the borrower's mortgage payment was only increasing $7.00 per month, the underwriter did not require any additional information regarding their

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residency. We respectfully submit that we made an appropriate underwriting decision consistent with HUD guidelines regarding this loan.

OIG EVALUATION OF AUDITEE COMMENTS: We agree with Gershman's assertion that the credit deficiencies appear to have been due to extenuating circumstances rather than a disregard for financial obligations. Due to the explanations provided, we removed this deficiency from Finding 1 and adjusted Appendix B.

FHA CASE NUMBER: 292-4082499
DATE OF LOAN CLOSING: 10/18/2001
LOAN PURPOSE: Purchase
INSURED AMOUNT: $129,065
UNDERWRITER TYPE: Automated
HOUSING/DEBT RATIOS: 21.14/39.47
STATUS AS OF 3/31/2004: Partial reinstatement. First default reported after 14 payments.

Inconsistent/Unsupported Income

CRITERIA: The Desktop Underwriter Findings Report requires all overtime income be verified and documented according to current standard FHA documentation guidelines. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-7A indicates that if the bonus and overtime earnings trend indicates a continual decline, the lender must provide a sound rationalization for including the income of the borrower qualifying.

OIG FINDING: According to the application, the borrower has been with his current employer since June 2001 and was previously self-employed; while documents confirm the borrower's current employment and self-employment in 1999 and 2000, there is no documentation covering the first half of 2001. According to the Desktop Underwriter Findings Report, the co-borrower's gross monthly income included $185 overtime pay; however, the verification of employment indicates a continual decline in overtime income from January 1999 to September 2001.

AUDITEE COMMENTS: We were aware of the gap in employment but made the decision to accept the documentation provided. Since the borrower's earnings from self-employment for 1999 and 2000 averaged $363 per month, it was evident that he needed to find a job with more stable income. The underwriter made the assumption that the borrower was winding down his business during the first 5 months of 2001. Thus, an explanation would not have affected our underwriting decision.

We included monthly overtime income of $185 a month for the co-borrower's income. The auditor noted that the verification of employment indicated a continual decline in overtime income from January 1999 to September 2001. However, and significantly, the co-borrower's bonus income increased and the overall difference was minimal.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the gap in borrower employment could be adequately explained by his transition from self-employment to his current employment. However, Gershman's explanation for including the co-borrower overtime income is not sufficient. The monthly overtime income had decreased from $217 in 1999 to $192 in 2000 and $176 in 2001. HUD requires mortgagees to provide a sound rationalization for including overtime income, such as this, that is continually declining. Additionally, the increase in monthly bonus income from 1999 to 2000 was $12, and there was no bonus income listed for 2001 as of September 9th.

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Inconsistent/Unsupported Assets

CRITERIA: The Desktop Underwriter Findings Report required verification of the $24,415 assets claimed and verification of all cash, which should not include funds received as a gift. Additionally, Desktop Underwriter noted that the retirement account could only be listed at 60% of its value and required explanation/documentation for recent large deposits in excess of two percent of the property's sales price.

OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $3,903 and the borrower needed $5,626 to close. According to the settlement statement, the borrower only needed $3,138 to close after taking out earnest money and borrower prepaid expenses. According to the Desktop Underwriter Findings Report, the borrowers' assets included a retirement account valued at $18,864 , a checking account ($3,875), and a savings account ($1,676). Account statements and documents indicate that 60% of the retirement account balance is less than $9,000 when loans are taken into consideration. Bank statements and an Internet printout reveal that the bank accounts were overstated by $1,500 due to an 8/20/01 transfer between accounts and show unidentified deposits totaling over $8,800. While a borrower note explained that one $3,000 deposit was the return of money owed by her parents, there was no documentation to support her claim. Gershman failed to adequately verify the $24,415 assets claimed on the Desktop Underwriter Findings Report. With the correct retirement account balance and the $1,500 transfer and $8,800 unidentified deposits taken out, the borrower would have less than $4,200 available and $1,100 in reserves, and it is unclear if Desktop Underwriter would have approved the loan.

AUDITEE COMMENTS: The auditor noted that 60% of the retirement account statement dated 9/30/01 would have been less than $9,000 when loans against the retirement account were taken into consideration. The auditor refers to a 9/30/01 statement but the only statement in the file is a 6/30/01 statement. One of the loans against the retirement account was for $8,352 taken out in September of 2001. The proceeds were deposited into the checking account and the file contained evidence of this deposit and showed an account balance of $8,049 as of 10/16/01. See Exhibit 12. The assets available from the retirement account after taking out the loans using 60% would have been $8,934.

Of the $8,800 of unidentified deposits, only the one deposit for $3,000 exceeded 2% of the sales price. The file contained an explanation letter from the co-borrower that this was money owed to her from her parents. Although this was less than the $24,415 stated in the Underwriter Findings, the loan still would have received an approve/eligible.

The auditor indicates that it is unclear whether Desktop Underwriter would have approved this loan with the assets noted above. We strongly disagree with this because the qualifying ratios were within HUD guidelines, the borrower's credit scores were above 650 and they had sufficient assets to close. We would have approved this loan manually as it met HUD guidelines.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that there was no 9/30/01 statement and that the qualifying balance of the retirement account was $8,934; we deleted the reference to a 9/30/01 statement. Additionally, we concur with Gershman's assertion that using the 10/16/01 checking account document eliminates the $1,500 overstatement. While we concur with Gershman's assertion that only one deposit required explanation, we do not believe that the explanation provided is satisfactory. After removing the $3,000 deposit from the 10/16/01 checking account balance and adjusting the retirement account balance to $8,934, the available assets are $15,659 ($8,049 checking - $3,000 deposit + $1,676 savings + $8,934

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retirement). While it appears the borrower have had sufficient funds to close, the reserves would be $8,756 less than claimed in Desktop Underwriter. Because Desktop Underwriter is an automated system with risk thresholds dependent on a variety of factors, it is unclear whether the loan would have been approved had the correct amount of available assets been submitted.

Inconsistent/Underreported Liabilities

CRITERIA: The Desktop Underwriter Findings Report requires loans be resubmitted to the system when a debt or obligation with monthly liability greater than $100 is revealed during the loan process.

OIG FINDING: An additional application located only in the Gershman file lists an additional debt of $17,000 with $175 monthly payments. When included in the qualifying ratios, the debt ratio increases to 42.5%.

AUDITEE COMMENTS: This loan did not appear on the credit report and was not included in the Underwriter Findings. It is not clear if this debt was outstanding at the time of underwriting. However, if we had included this debt in the fixed monthly payments, the [debt] ratio would have been 42.5%. Importantly, this loan was for the purchase of a new construction home and 43% was the HUD guideline for this ratio. We believe Desktop Underwriter would have approved this loan. In addition, we would have manually underwritten and approved it as it complied with applicable HUD requirements.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that this was a new construction energy efficient home. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-19 allows borrowers to exceed the qualifying ratios by up to two percent (31/43%) when purchasing or refinancing an energy-efficient home. However, Gershman did not follow the Desktop Underwriter requirements. Because Desktop Underwriter is an automated system with risk thresholds dependent on a variety of factors, it is unclear whether the loan would have been approved had the additional debt been submitted.

FHA CASE NUMBER: 292-4079136 DATE OF LOAN CLOSING: 10/26/2001
LOAN PURPOSE: Non-Streamline Refinance INSURED AMOUNT: $126,875
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 37.46/49.76
STATUS AS OF 3/31/2004: Reinstated by mortgagor. First default reported after 12 payments.

Inconsistent/Unsupported Income

CRITERIA: According to the Desktop Underwriter Finding Report, employment income must be supported by the most recent year-to-date pay stub documenting one full month's earnings and written, verbal, or electronic verification acceptable to FHA. Additionally, overtime income must be verified and documented according to FHA guidelines. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-7A requires lenders to develop a two year average of bonus or overtime income, and indicates that if the earnings trend indicates a continual decline, the lender must provide a sound rationalization for including the income of the borrower qualifying.

OIG FINDING: According to the Desktop Underwriter Findings Report, the borrower's $2868 gross monthly income includes $355 overtime income. While the verification of employment indicates that overtime/bonus income is likely to continue, a 20.2-month average indicates monthly overtime/bonus income of only $190. Additionally, a 24-month average of all types of

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income indicates gross monthly income of only $2,761. Because the qualifying ratios already exceeded the 29%/41% benchmarks, it is unclear if Desktop Underwriter would have approved the loan had the correct amount been entered.

AUDITEE COMMENTS: Gershman properly underwrote this loan as follows; we took the hourly rate from the pay stub of $14.50, and used 40 hours per week, which equates to a monthly base pay of $2,513 or $30,160 annually. See Exhibit 13. We also gave the borrower credit for overtime in the amount of $355.00 per month. We calculated overtime by taking the total income earned from the employment verification for 2000 and subtracted the base pay of $30,160.

Importantly, this income was less than the 20.2 month average and the year-to-date 8.2 average shown on the employment verification. In addition, the hourly rate of $14.50 we used was lower than the amount verified on the employment verification of $15 per hour. We believe that our underwriting was conservative because the employment verification indicated that the borrower was working an average of 45 hours per week at a base hourly pay rate of $15.00. It does not appear that the auditors took these facts into consideration.

HUD Guidelines allow for a less than 24-month average of overtime income. In this case our underwriter determined that this was warranted as the borrower started employment in June 1999. The verification did not state her gross earnings for that year nor a breakdown between base pay and overtime. It was the underwriter's judgment call as permitted by HUD guidelines that the average of 20.2 months overtime and bonus was proper in this case. Gershman respectfully submits that the auditor's finding is not supported.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the employment verification shows a $15 hourly pay rate and a 45-hour average workweek. However, we disagree with Gershman's assertions that they properly underwrote this loan. While the verification does not show the 1999 income, a W-2 provided does; we used this W-2 along with the verification to arrive at the 24-month gross monthly income average of $2,761. Even if we took a less conservative approach, the documentation provided does not show that the borrower has received overtime income of $355 per month. Based on the verification, the average overtime income was $135 per month in 2000 and $256 per month for the first 8.2 months of 2001. While this does indicate that overtime is increasing, it does not adequately support the $355 overtime figure used.

FHA CASE NUMBER: 292-4105387	DATE OF LOAN CLOSING: 11/8/2001
LOAN PURPOSE: Purchase	INSURED AMOUNT: $163,922
UNDERWRITER TYPE: Automated	HOUSING/DEBT RATIOS: 27.00/38.00

STATUS AS OF 3/31/2004: Reinstated by mortgagor. First default reported after 11 payments.

<u>Inconsistent/Unsupported Income</u>

CRITERIA: According to the Desktop Underwriter Finding Report, employment income must be supported by the most recent year-to-date pay stub documenting one full month's earnings and written, verbal, or electronic verification acceptable to FHA.

OIG FINDING: According to the Desktop Underwriter Findings Report, the borrower's base monthly income is $3,138. While a verbal verification of employment for the borrower does not indicate the borrower's base pay, paystubs located in the HUD case binder indicate a $3,045

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year-to-date average monthly base pay; more recent paystubs located in the Gershman case binder show that the borrower only worked 55 hours in a three week time period and indicate a $2,911 year-to-date average monthly base pay. Additionally, the borrower's 2000 W-2 shows average monthly gross income of only $2,617. Gershman failed to verify the $3,138 borrower base monthly income.
AUDITEE COMMENTS: The borrower was a union carpenter whose hours worked fluctuated. The underwriter used a 20.67 average gross earning because the 2001 year to date monthly average gross earnings were higher than 2000. The auditor notes that the 2001 year to date base pay was $2,911. Had this amount been used, the qualifying ratios were 28%/39%. Further, we took a 32.67 month average including 1999 W-2 gross earnings and the borrower's average monthly income was $2820. The qualifying ratios were 29%/40%. In both of these analyses, the borrowers qualified and the loan would have been approved. We respectfully submit that this finding is not supported.
OIG EVALUATION OF AUDITEE COMMENTS: While Gershman's assertions regarding the debt ratio at various income amounts may be true, they failed to adequately support the income used to qualify when submitting the loan to Desktop Underwriter for endorsement. Desktop Underwriter requires all data entered, downloaded, or imported to be true, accurate, and complete.

Inconsistent/Unsupported Assets
CRITERIA: The Desktop Underwriter Findings Report requires depository assets be verified by a verification of deposit, the most recent statement showing the previous month's balance, or the most recent two months statements. Also, if the amount of earnest money appears excessive based on the borrower's history of accumulating savings, the lender must verify the deposit amount and the source of funds according to current FHA guidelines. Desktop Underwriter also requires that the lender verify all cash reserves after closing submitted to the system. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-10A says that satisfactory documentation of an excessive earnest deposit includes a copy of the cancelled check or a certification from the deposit holder acknowledging receipt of funds and separate evidence of the source of funds. Evidence of source of funds includes a verification of deposit or bank statement showing that the average balance at the time the deposit was made was sufficient to have included the earnest money deposit.
OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $5,157 and the borrower needed $12,432 to close. According to the settlement statement, the borrower only needed $3,398 to close after taking out $8,059 earnest money (4.7% of the sales price) and borrower prepaid expenses. According to the Desktop Underwriter Findings Report, the borrowers' assets consisted of a savings account ($3,804), a checking account ($837), and net equity from the sale of a previous residence ($6,033). However, bank statements reveal a $950 overstatement of assets due to several account transfers and documentation in the Gershman case binder indicates that the borrowers' savings account balance may have been as low as $2,603 on 11/7/01. These balance reductions mean there would not have been sufficient funds to close the loan. Also, it is not clear if the net proceeds from the sale of the borrowers' prior residence were already included in the accounts as the sale occurred several months prior to the bank statement dates. Additionally, while faxed copies of checks and a letter from the buyer indicate that the $8,059 earnest money deposit has been received, the check copies are not cancelled copies and there is no evidence of source of funds.

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While the $6,033 net proceeds may have been applied to the earnest money deposit, $2,026 of the deposit would remain unverified. It is unclear if Desktop Underwriter would have approved the loan had the correct amounts been entered.

AUDITEE COMMENTS: The borrowers had $4,903 in their bank account at Commerce Bank shortly before closing. See Exhibit 14. This included $2,603 in savings account and a $2300 gift from a parent that the auditors did not take into consideration. Since this verification is dated the day before closing, there was not overstatement of assets.

The borrowers paid the earnest money of $8,059 at two different times. The first amount was paid on April 18, 2001. The second check for $7,058.65 was written on May 16, 2001 but was not deposited until June 6, 2001. This is consistent with the borrowers receiving the proceeds from the sale of their previous home on June 5, 2001 of $6,033. In addition to this, we had the borrower's August and September bank statements for Commerce Bank showing balances of $2,833 and $3,804 in their personal investment savings account. This clearly evidenced that they had a history of accumulating savings to meet the asset requirement to pay $1,000 and $1,025 in earnest money over a 7-week period. This was in compliance with condition #23 of the Underwriter Findings. We respectfully submit that the borrowers assets were properly verified.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the November 7, 2001 checking account balance was $4,903 after depositing the $2,300 gift. Additionally, we agree that there was no overstatement of the bank accounts because the $4,903 checking account balance adequately covers the amount of the overstatement. Based on the amount verified, there were sufficient assets to cover the $3,398 due at closing.

However, Condition #23 of the Desktop Underwriter Findings Report states "If the amount of earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify the deposit amount and the source of funds." The earnest money deposit was 4.7% of the sales price. Gershman failed to adequately verify the source of funds for $2,026 of the deposit.

FHA CASE NUMBER: 292-4095609 DATE OF LOAN CLOSING: 11/9/2001
LOAN PURPOSE: Purchase INSURED AMOUNT: $81,200
UNDERWRITER TYPE: Manual HOUSING/DEBT RATIOS: 20.30/34.28
STATUS AS OF 3/31/2004: Partial reinstatement. First default reported after 14 payments.

Inconsistent/Unsupported Income

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Chapter 2 requires that the lender establish the borrower's capacity to repay the mortgage debt. Paragraph 2-8 requires borrowers employed by businesses owned by family members to provide additional income documentation, including evidence that he or she is not an owner of the business. This may be done with copies of the borrower's signed personal tax returns or a signed copy of the corporate tax return showing ownership percentages.

OIG FINDING: According to the underwriting worksheet, the borrower monthly base income is $2,600. While a verification of employment and paystubs support the $,2600 borrower base monthly income, it was completed by the borrower's brother. Additionally, had the borrower earned $600/week for the last eight months of 2000 as claimed on the verification of

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employment, his 2000 income would have been approximately $5,000 higher than that shown on the W-2. While the file contained no evidence that the borrower was not an owner of a family business, Gershman confirmed with the brother (president of the company) in April 2004 that the borrower was not an owner of the business.
AUDITEE COMMENTS: The underwriter used the base monthly income of $2,600 per month to qualify the borrower. This was supported by an employment verification and pay stubs. The employment verification stated past years earnings of $26,000. While the W-2 showed a lower amount, the borrower received a raise of $200 per week sometime in April of 2000. The underwriter did not question the variance because the borrower was making a cash down payment of $27,000. Importantly, if the lower income figure based on the 2000 W-2 of $1,933 per month was used, the ratios would have been 24/41. This loan would be approved under HUD guidelines. (We are in the process of obtaining a signed statement from James Owens that will confirm that Jeremy Owens had no ownership in a family owned business. If necessary, we will provide this to the auditors when received).
OIG EVALUATION OF AUDITEE COMMENTS: While Gershman's assertions may all be correct, they still failed to obtain evidence, prior to closing, that the borrower was not an owner of a family business.

Questionable/Derogatory Credit History
CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.
OIG FINDING: According to a fax from the borrowers, they submitted a pay history showing the past year of payments on their prior home. However, the pay history shows the borrower's father as the account holder and monthly payments of approximately $200, some of which were late. While the father had recently passed away and a letter of distribution shows the borrowers received the property, the late payments are not explained.
AUDITEE COMMENTS: The underwriter made the judgment call as permitted under HUD guidelines that the borrowers had adequately explained the late payments on the mortgage they were paying for the property they inherited from their father. Specifically, the co-borrower explained that she became ill in July of 2000 due to a pregnancy and problems continued until the baby was born in 2001. The application dated 8/1/01 confirmed that the borrowers had a three month old dependent. We respectfully submit that this finding is not supported.
OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the borrowers adequately explained the late payments on the mortgage. We have removed this deficiency from Finding 1 and adjusted Appendix B.

FHA CASE NUMBER: 292-4108675	DATE OF LOAN CLOSING: 11/26/2001
LOAN PURPOSE: Purchase	INSURED AMOUNT: $88,798
UNDERWRITER TYPE: Automated	HOUSING/DEBT RATIOS: 22.00/40.00

STATUS AS OF 3/31/2004: Reinstated by mortgagor. First default reported after nine payments.

Inconsistent/Unsupported Assets
CRITERIA: The Desktop Underwriter Findings Report requires depository assets be verified by either a verification of deposit, the most recent statement showing the previous month's balance, or the most recent two months statements. Additionally explanation and documentation must be

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obtained for recent large deposits (other than gifts) in excess of two percent of the property's sales price.

OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $2,697 and the borrower needed $4,216 to close. According to the settlement statement, the borrower only needed $867 to close after taking out gift funds, earnest money, seller paid expenses, and borrower prepaid expenses. According to the Desktop Underwriter Findings Report, the borrower's assets consisted of $666 in two bank accounts and $2,136 Certificate of Deposit (CD). While the CD is verified by a 10/7/01 slip showing interest paid, the document indicates that the borrower made the deposit, which is greater than two percent of the sales price, approximately four months prior to closing. Also, Gershman should have verified whether the funds from the CD were accessible. There is no indication that the funds were available for withdrawal prior to the maturity date, and the CD appears to be securing a debt (a check from the borrower is for a "CD loan"). Gershman failed to satisfy the requirements for asset verification established by Desktop Underwriter prior to closing. Without using funds from the CD, there would not have been sufficient assets to close the loan.

AUDITEE COMMENTS: With regards to the deposit made for the Certificate of Deposit, the loan file contained a copy of the borrower's 2000 tax returns that clearly shows a refund of $3,367 for taxes paid. See Exhibit 15. This return was prepared on 2/2/01. We accepted this as evidence that the borrower used these funds for the [Certificate of Deposit].

The Desktop Underwriter Findings Report included a loan with St. John's Bank with a balance due of $778 and a monthly payment of $159. This payment amount matches the amount on the check marked "CD loan" and was properly counted by us in the qualifying ratios. At the time of closing, the borrower owed only one more payment on this loan. The borrower's first payment on the HUD insured mortgage was January 1, 2002. With the CD maturing on January 7, 2002, just a few days later, we allowed this CD to be used for reserves and therefore, properly documented this account. We respectfully submit that the borrower's assets were properly supported and the loan was underwritten consistent with HUD guidelines.

OIG EVALUATION OF AUDITEE COMMENTS: Gershman agrees that there was still a loan on the CD as of the date of closing. Gershman failed to establish that the borrower could withdraw additional CD funds prior to the maturity date. Without using funds from the CD, there would not have been sufficient funds to close the loan.

FHA CASE NUMBER: 292-4119353	DATE OF LOAN CLOSING: 12/10/2001
LOAN PURPOSE: Purchase	INSURED AMOUNT: $147,793
UNDERWRITER TYPE: Manual	HOUSING/DEBT RATIOS: 19.26/37.67

STATUS AS OF 3/31/2004: Partial reinstatement. First default reported after five payments.

<u>Inconsistent/Unsupported Income</u>

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Chapter 2 requires that the lender establish the borrower's capacity to repay the mortgage debt. Income from a source that cannot be verified, is not stable, or will not continue should not be used when calculating the borrower's qualifying ratios. Additionally, Paragraph 2-7A requires lenders to develop a two-year average of bonus or overtime income used to qualify.

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OIG FINDING: The underwriting worksheet lists borrower and co-borrower base monthly income as $3,520 and $3,062 respectively. While the borrower verification of employment projects $3,111 base monthly income and indicates that overtime is likely to continue, it does not list the amount of overtime income earned in 2000 or 2001; Gershman obtained the $3,520 income amount from a borrower paystub, which included overtime. The borrower's overtime income was used to qualify but was not adequately verified or computed. While a verification of employment and W-2's support the $3,062 co-borrower monthly income, a paystub indicates average monthly income of only $2,361. In a 4/16/04 meeting, Gershman noted that co-borrower's year-to-date income was probably lower because of maternity leave (the application indicates she has a 1-year old child).

AUDITEE COMMENTS: The year to date average of the borrower's income was used in qualifying. Although the [verification of employment] did not provide an itemization as to the overtime income, the verification reflects clearly that overtime income would continue. The pay stub dated 12/3/01 reflects that the borrower had earned an average monthly income of $3527. In addition, this calculation of monthly income included the first 6 months of the year at the lower wage prior to his raise on 7/1/01. Regardless, using the Borrower's base pay of $3111 per month, the qualifying ratios would have been within HUD guidelines at 20.5/40.15.

We did not question the year to date earnings for the co-borrower because the application stated that they have a one year old child. With this being the case, co-borrower was on maternity leave for some portion of 2001. We respectfully submit that we made an appropriate decision consistent with HUD guidelines regarding this loan.

OIG EVALUATION OF AUDITEE COMMENTS: While we agree with Gershman's assertion that the loans qualifying ratios would still be within HUD guidelines if the borrower's overtime income were taken out, Gershman still failed to verify the overtime income that was used to qualify. We concur with Gershman's assertion that they adequately documented the co-borrower's income based on her circumstances. Consistent with HUD guidelines, Gershman's documentation showed that the borrower had been employed in her current job for at least six months and that the borrower had a two-year work history prior to the her absence from the work force.

<u>Inconsistent/Unsupported Assets</u>

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-10 requires all funds for the borrower's investment in the property be verified and describes the criteria for verifying gift funds. Paragraph 2-10C says that lenders must document the transfer of gift funds from the donor to the borrower (Donor: a withdrawal slip or cancelled check; Borrower: a deposit slip or bank statement showing the deposit); the lender must verify that funds not deposited prior to closing are received from the donor by the closing agent. Additionally, the file must contain a gift letter specifying the dollar amount, signed by the donor and borrower, stating no repayment is required, and showing the donor's name, address, telephone number, and relationship to the borrower.

OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $4,469 and the borrower needed $5,888 to close. According to the settlement statement, the borrower only needed $3,040 to close after taking out earnest money and borrower prepaid expenses. An undated application located in the Gershman file notes the down payment source as "checking/savings and gift," and a 12/8/01 letter in the HUD case binder indicates that the borrowers received a $1,000 cash gift for the purchase of their home. However, the letter does not state the donor's address or relationship to the borrower, there is no proof of transfer,

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and the underwriting worksheet and settlement statement located in the HUD case binder do not mention the gift.

AUDITEE COMMENTS: Upon review of the file prior to closing, the underwriter determined that the $1,000 gift was not needed for closing. Therefore, the donor and gift information was not obtained. We used computer printouts from St. John's Bank dated 12/8/01 for assets to close. See Exhibit 16. There were two accounts totaling $3,053 which was more than the $3,040 needed to close. One of the statements showed a last deposit of $1,611 which was not more than 2% of the sales price and in line with deposits made in previous months. The borrower's monthly income supported the ability to make a deposit of this amount. In addition, we also had evidence of an investment account with Paine Webber with an account balance of $3,017. See Exhibit 17. We respectfully submit that the borrower's assets were properly verified.

OIG EVALUATION OF AUDITEE COMMENTS: HUD regulation does not specify that only deposits in excess of 2% of the sales price be considered large deposits. However, our finding addresses the gift funds not properly documented. While we concur with Gershman's claim that the two accounts totaling $3,053 would have covered the $3,040 needed to close, it is not clear if the $1,000 gift funds were deposited prior to the 12/8/01 borrower bank verifications. Had the account balance been $1,000 less, there would not have been sufficient assets to close the loan.

<u>Questionable/Derogatory Credit History</u>

CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.

OIG FINDING: According to the underwriting worksheet, the borrowers have monthly payments for debts and obligations totaling $1,212. According to the 12/6/01 credit report, there have been several recent late payments on one account; while the file contains satisfactory explanations for the late payments and shows that the account was brought current, the documentation also shows that the balance is over the credit limit. Additionally, there are no explanations for three collections listed on the credit report. The underwriting worksheet shows four offsetting factors, "Good rent history verified 2 yrs; (cb) long term, stable employment; reserves in 401k; good ratios." However, the prior monthly rent was less than 40% of the proposed monthly mortgage payment, the co-borrower's year-to-date income projects a decline (which could indicate instability and a need to adjust the ratios), and there is a loan against most of the co-borrower's 401k.

AUDITEE COMMENTS: The one account with recent late payments was satisfactorily explained. According to the Providian statement, the account holder gave them flexibility for paying this account. The three unexplained collections were with NCO and were all medical related. Since the amounts were all small around $100 each, we did not require further explanation. The compensating factors listed clearly show that the borrower's credit within the last 2 years had been good. All of the derogatory credit except for the Providian account had occurred more than three years ago. This loan met HUD guidelines for approval.

OIG EVALUATION OF AUDITEE COMMENTS: Gershman agreed that the borrowers had some degree of a derogatory credit history, including recent late payments for which they obtained borrower explanations. It is our understanding that Gershman included the four compensating factors listed to offset this derogatory credit history. Our analysis of Gershman's comments for "Inconsistent/Unsupported Income" determined that the co-borrower's employment income and history was fully documented. Based on this compensating factor, we have removed this deficiency from Finding 1 and adjusted Appendix B.

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FHA CASE NUMBER: 292-4126430
DATE OF LOAN CLOSING: 12/18/2001
LOAN PURPOSE: Purchase
INSURED AMOUNT: $73,212
UNDERWRITER TYPE: Automated
HOUSING/DEBT RATIOS: 26.37/47.96
STATUS AS OF 3/31/2004: Foreclosure Completed. First default reported after nine payments. Borrower declared bankruptcy on 10/30/2003.

Inconsistent/Unsupported Income

CRITERIA: The Desktop Underwriter Findings Report requires employment income be supported by the most recent year-to-date pay stub documenting one full month's earnings and a written, verbal, or electronic verification acceptable to FHA.

OIG FINDING: The Desktop Underwriter Findings Report shows base monthly income of $2,527. Although the pay stubs in the file support the monthly income used, they do not appear to follow the criteria that "the most recent year-to-date pay stub documenting one full month's earnings" must be verified because they are not chronological and there should have been more recent pay stubs available at the time of application. A 12/17/01 bank statement printout shows smaller direct payroll deposits, averaging nearly $800 less net income per month than the pay stubs provided; this indicates that the borrower's income had substantially decreased as the date of underwriting/closing approached. Furthermore, on the last pay stub provided (dated 10/5/01), the year-to-date gross earnings is $20,699.80 while the 12/1/01 verification of employment shows an approximate year-to-date gross earnings of $32,900; this indicates that the borrower received increased income of approximately $6,000 per month between October and November 2001. Gershman failed to explain the conflicting documentation showing both increases and decreases to borrower income in the months prior to underwriting/closing.

AUDITEE COMMENTS: The original loan application was taken on 10/26/01 and we had the borrower's pay stub dated 10/5/01. We used a verification of employment along with this pay stub to document the borrower's income. See Exhibit 18. We did not use alternate documentation, therefore the most recent year to date pay stub documenting one full month's earnings was not needed. However, we did have the verification of the 10/19/01 payroll deposit as evidenced from the October bank statement. See Exhibit 19. We determined the borrower's income by taking the year to date income from the 10/5/01 pay stub of $20,699 over an 8.19 month average. This equaled $2,527. We did not use the higher year to date income on the employment verification dated 12/1/01 and as a result we had no reason to question the payroll deposits on the December bank statement. Further, we had no reason to question the amount of net payroll deposits when we had a standard verification of employment and we had no knowledge of the borrower's elected payroll deductions. We respectfully submit that this finding is not supported and that the borrower's income was properly determined and documented.

OIG EVALUATION OF AUDITEE COMMENTS: As noted in the Auditee comments under "Inconsistent/Unsupported Assets," this loan was underwritten and approved by Desktop Underwriter. Condition #13 on the Desktop Underwriter Findings Report states "[the borrower's] income must be supported by: 1) the most recent year-to-date pay stub documenting one full month's earnings and any one of the following to verify current employment: a) written verification of employment, 2) verbal verification of employment…or 3) electronic verification of employment." Gershman was required to obtain the most recent year to date pay stub

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documenting one full month's earnings. Additionally, HUD Handbook 4000.4, Revision-1, Change-2, Paragraph 2-5 requires mortgagees to obtain and verify information with at least the same care that would be exercised if originating a mortgage when the mortgagee would be entirely dependent on the property as security to protect its investment.

Inconsistent/Unsupported Assets

CRITERIA: The Desktop Underwriter Findings Report required the depository assets be verified with a verification of deposit, the most recent statement showing the previous month's balance, or the most recent two months statements. Additionally, lenders must obtain explanations for recent large deposits in excess of two percent of the sales price and verify all cash reserves after closing.

OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $2,250 and the borrower needed $4,013 to close. According to the settlement statement, the borrower only needed $334 to close after taking out gift funds, earnest money, and borrower prepaid expenses. The final Desktop Underwriter Findings Report lists the borrower's checking account balance as $1,287 while the underwriting worksheet shows the assets as $742 and $545 already paid ($1,287 total). While a 12/14/01 Internet printout confirms the $742 balance, it also indicates two unidentified deposits on 9/12/01 ($500) and 12/10/01 ($300). These two deposits warrant an explanation as almost all other deposits to this account have been from the borrower's employer, and the latter deposit substantially increased the bank balance just before closing. While neither deposit was greater than two percent of the sales price, without them, the borrower would not have been able to demonstrate sufficient assets to close and would not have the $202 in reserves claimed on the Desktop Underwriter Findings Report. It is unclear whether Desktop Underwriter would have approved the loan had the correct amounts been entered as the debt ratio was already above the 41% benchmark.

AUDITEE COMMENTS: This loan was underwritten and approved by Desktop Underwriter. Condition #20 on the Desktop Underwriter Findings Report states " If applicable, obtain an explanation and documentation for recent large deposits (other than gift) in excess of 2 percent of sales price. After reviewing the borrower's bank statements, there were not deposits made greater than 2% of the sales price. Further, and importantly, HUD guidelines do not require that we verify the source of any deposit made by the borrower that is less than 2% of the sales price, as was the case with this loan. The borrower had a credit score of 702. He demonstrated responsibility for managing his money and had a history of fulfilling his obligations. The borrower lived with his family prior to closing. It was reasonable that this money had been saved during this time. We respectfully submit that there was not reason to question any bank deposits and the auditor's finding is not valid.

OIG EVALUATION OF AUDITEE COMMENTS: HUD regulation does not specify that only deposits in excess of 2% of the sales price be considered large deposits. However, this loan is subject to Desktop Underwriter requirements. Condition #18 requires depository assets "be verified by one of the following: 1) verification of deposit, 2) most recent bank statement showing previous month's balance, or 3) most recent two months bank statements." Additionally, Condition #21 on the Desktop Underwriter Findings Report states "You must verify all cash reserves after closing submitted to Desktop Underwriter." The $1,287 checking account balance entered into Desktop Underwriter by Gershman was not properly verified as the bank statement listed a $742 ending balance. Additionally, without the two deposits cited, the borrower would not have had the amount of reserves claimed in Desktop Underwriter.

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FHA CASE NUMBER: 292-4123196
DATE OF LOAN CLOSING: 2/4/2002
LOAN PURPOSE: Purchase
INSURED AMOUNT: $52,937
UNDERWRITER TYPE: Manual
HOUSING/DEBT RATIOS: 11.40/41.96
STATUS AS OF 3/31/2004: Delinquent. First default reported after 18 payments. Borrower declared bankruptcy on 1/9/2004.

Questionable/Derogatory Credit History

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-3 states that past credit performance serves as the most useful guide in determining the attitude toward credit obligations that will govern the borrower's future actions. Major indications of derogatory credit, including judgments and collections, and any other recent credit problems, require sufficient written explanation from the borrower. According to Paragraph 2-3E, a chapter 7 bankruptcy will not disqualify a borrower if at least two years have passed since it was discharged and the borrower has re-established good credit (or has chosen not to incur new credit obligations), and has demonstrated an ability to manage financial affairs. A chapter 13 bankruptcy will not disqualify a borrower if one year of the payout period has elapsed with satisfactory performance and the court grants the borrower approval. Additionally, Paragraph 2-3A states that the payment history of the borrower's housing obligations is of significant importance in evaluating credit and requires lenders to determine the borrower's payment history of the housing obligations for the most recent 12-month period.

OIG FINDING: According to her credit report, the borrower filed for Chapter 7 bankruptcy in 1997 and Chapter 13 bankruptcy in 1999. While the file contains sufficient documentation showing the borrower has been making regular Chapter 13 bankruptcy payments and that the courts agreed to subordinate financing, the borrower's credit report indicates a current collection on an account opened since the bankruptcy. According to the application, the borrower has rented two different apartments/houses in the past two years. The verification of rent covering March 1999 to November 2001 shows one three-day late payment. Additionally, the verification of rent covering November 2001-January 2002 indicates that the money order for the December 2001 payment is currently lost in the mail; a photocopy of the money order lists both the borrower and her previous landlord as tenants. According to the borrower's driver license, her full name includes her previous landlord's last name. No explanation of these inconsistencies was found in the file.

AUDITEE COMMENTS: This loan was approved by Desktop Underwriter but was ineligible for a bankruptcy discharged of less than 2 years. The Desktop Underwriter Findings stated that this case was ineligible due to a review of the credit report indicated the presence of a bankruptcy within the most recent 2 years. A Direct Endorsement Underwriter must review the credit report and verify that the bankruptcy is within HUD guidelines. The underwriter reviewed the bankruptcy and determined it was a Chapter 13 and the borrower had made payments as scheduled. The Chapter 13 Bankruptcy was filed in 1999 and there was more than a 12-month payout under the bankruptcy. In addition, the underwriter verified that the Bankruptcy Court gave permission for the borrower to purchase the home while in bankruptcy. This was all the Direct Endorsement Underwriter was required to do according to the Desktop Underwriter Findings. The auditor's other comments regarding verification of rent and landlord

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discrepancies were not required to be addressed. Therefore, we respectfully submit that this finding is not supported.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertions that they were not required to verify rental history and that they adequately addressed the reasons the loan was tagged ineligible by Desktop Underwriter. However, the documents located in the file, including the rental verifications obtained, contain several inconsistencies regarding the borrower's identity and history. According to HUD Handbook 4000.4, Revision-1, Change-2, Paragraph 2-4C5, the underwriter should be aware of the warning signs that may indicate irregularities. Gershman failed to resolve the inconsistencies cited.

Inconsistent/Questionable Documentation

CRITERIA: According to HUD Handbook 4000.4, Revision-1, Change-2, Paragraph 2-4C5, the underwriter should be aware of the warning signs that may indicate irregularities and perform underwriting decisions with due diligence in a prudent manner.

OIG FINDING: According to the underwriting worksheet, there was a borrower and a cosigner. A note from the borrower indicates that the cosigner is her uncle, allowing the mortgage to be excluded from the 75% Loan-to-Value ratio rule. However, the settlement statement does not list the cosigner, and Form HUD-54111 Request for Insurance Endorsement does not list the cosigner even though it includes the cosigner income. In a 4/2/04 meeting, Gershman indicated that title companies sometimes have issues with cosigners signing the settlement statement, as they are not part of the contract. However, they did not explain why the cosigner was not listed on the Request for Endorsement.

AUDITEE COMMENTS: Although the [settlement statement] was not signed by the co-signor, and he was not listed on the Request for Endorsement, the co-signor did in fact sign the Note, termite inspection, Important Notice to Homebuyer and other relevant documents. Importantly, neither the collateral security nor the co-signors obligation on the loan were impaired as a result of his failure to sign the [settlement statement] or be listed on the Request for Endorsement.

OIG EVALUATION OF AUDITEE COMMENTS: Because Gershman failed to list the co-signor on the Request for Endorsement, the co-signor's name and social security number are not listed in HUD's Single Family Data Warehouse. This information is crucial as it to ensures that the both HUD and the loan servicer hold the co-signor accountable for his obligation on the loan.

FHA CASE NUMBER: 292-4153878	DATE OF LOAN CLOSING: 3/8/2002
LOAN PURPOSE: Purchase	INSURED AMOUNT: $129,073
UNDERWRITER TYPE: Manual	HOUSING/DEBT RATIOS: 21.82/49.00

STATUS AS OF 3/31/2004: Reinstated by mortgagor. First default reported after four payments.

Inconsistent/Unsupported Income

CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.

OIG FINDING: On the application, the borrower says he has been with his current employer for 22 years; however, an electronic verification of employment lists 1/23/96 as the service date. Furthermore, bank statements do not show direct payroll deposits during the five-week period of 1/25/02-3/5/02, even though the borrower's pay was direct deposited prior to 1/25/02. A note from the borrower indicates that while his employer had filed Chapter 11 bankruptcy and

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withheld payroll, it was now stable. In a 4/2/04 meeting, Gershman indicated that while they do not compare paystubs with bank statements, they would not have seen the ceasing of direct deposits as a problem because the borrower could have chosen to begin receiving paper checks.
AUDITEE COMMENTS: The underwriter did not question the difference in the dates of employment from the application and the electronic verification because the electronic verification showed significantly more than the 2-year employment history required by HUD.
Further, we respectfully submit that the auditor's comment regarding payroll deposits for the five-week period from 1/25/02 to 3/5/02 is incorrect. These bank statements are for 2 different accounts. The statement for his checking account ran for one-week period of 2/26 to 3/5. See Exhibit 20. According to previous deposits that showed his payroll to be on a bi-weekly basis, there would not have been a deposit for payroll that week. The savings account statement ran from 1/25/02 to 3/1/02. See Exhibit 21. The borrower had never had his paycheck direct deposited into his savings account.
The pay stub in the file for this borrower is dated 1/11/02 with year to date earnings of $2,365.38. His verification of employment was done on 2/28/02 with a year to date total income of $10,211.52. See Exhibit 22. With a salary of $61,500, his monthly income would be $5,125. As of 2/28/02 his monthly income averaged $5,105.76. This clearly indicates that there are no inconsistencies with his earnings and not receiving paychecks. We respectfully submit that this finding is not valid.
OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that there were no inconsistencies with the borrower's earnings. We have removed this deficiency from Finding 1 and adjusted Appendix B.

Inconsistent/Unsupported Assets
CRITERIA: According to Mortgagee Letter 98-29, the minimum cash investment is three percent of the sales price. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-10, requires all funds for the borrower's investment in the property be verified. Paragraph 3-1F allows checking and savings accounts to be verified by obtaining the two most recent consecutive bank statements (provided the bank statement shows the previous month's balance). By most recent, HUD means at the time the initial application is made. Provided the document itself is not more than 120 days old when the loan closes, there is no need to update. However, Paragraph 2-10B requires an explanation and evidence of source of funds when there is a large balance increase in checking or savings accounts. Additionally, Paragraph 2-10C requires verification of gifts with a gift letter specifying the dollar amount, signed by the donor and borrower, stating no repayment is required, and showing the donor's name, address, telephone number, and relationship to the borrower. Lenders must also document the transfer of gift funds from the donor to the borrower (Donor: a copy of the donor's withdrawal slip or cancelled check; Borrower: a copy of the deposit slip or bank statement showing the deposit); when funds are not deposited prior to closing, the lender must verify that the closing agent received funds from the donor for the amount of the gift.
OIG Findings: According to the underwriting worksheet, the statutory minimum required investment was $3,960 and the borrower needed $5,502 to close. According to the settlement statement, the borrower only needed $4,654 to close after taking out earnest money, seller paid expenses, and borrower prepaid expenses. According to the underwriting worksheet, the borrower's assets included a savings account ($300), a checking account ($594), and a gift ($4,000). The only statement obtained to support the savings account was dated more than 120

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prior to closing. While bank statements ending on 1/11/02 support the checking account balance, an additional Internet printout located in the Gershman file indicates a 3/5/02 balance of $2,695. Additionally, the documents reveal seventeen insufficient funds charges and almost $3,000 in unidentified deposits. The gift letter indicates that the gift is to the borrower's wife and lists the donor's relationship to the borrower as "mother." While a 3/8/02 $3,500 check to the borrower's wife and 3/8/02 withdrawal slip for $500 confirm the $4,000 amount, they do not adequately document the transfer of funds from the donor to the borrower. The borrower's wife was a non-purchasing spouse, and there is no proof that either the borrower or closing agent received the gift funds from the donor. If any of these assets were taken out of the funds available, the borrower would not have met the 3% requirement and there would not have been sufficient funds available to close.

AUDITEE COMMENTS: The borrower received a gift at closing from his wife's parents. We are submitting a copy of the cancelled check and a bank statement savings withdrawal to adequately document the transfer of funds for the gift. See Exhibit 23. The Internet printouts that the auditor is referring to were for 2 separate accounts. One is for a checking account showing a balance of $2,694 and savings account showing a balance of $322 for a total of $3,016. See Exhibits 20 and 21. These statements reflect deposits in excess of $4,000. Outside of his tax return refund of $3,158, there were 3 deposits. The first was on 2/11/02 for $441.58. The second was on 2/11/02 for $314.60, and the third on 2/25/02 for $261.03, for a total 1,017.21. See Exhibit 21. These deposits were all made into his savings account. Considering this borrower's yearly salary of $61,500, and the fact that he was living with relatives, this amount of money is not out of line, or even considered to be large deposits (less than 2% of sales price) under HUD requirements. We respectfully submit that the borrowers assets are fully supported.

OIG EVALUATION OF AUDITEE COMMENTS: On a closer review, Gershman's file contains documentation for two savings accounts and one checking account. However, only one savings account was eligible for qualifying purposes as the second is only supported by an outdated statement. We agree with Gershman's assertion that the combined balance of the eligible checking and savings accounts as of 3/5/02 was $3,016.

The additional gift documentation submitted by Gershman included a photocopied $3,500 check numbered 5304 while the photocopied check located in the HUD case binder is numbered 5400. Regardless of this discrepancy, Gershman failed to show that the borrower or closing agent received the gift funds from the donor as both check versions are made out to the borrower's non-purchasing spouse.

Because Gershman failed to document the transfer of gift funds to either the borrower or the closing agent, these funds were not properly verified. After removing the gift funds and adjusting the bank accounts to the $3,016 combined balance, the borrower would not have had sufficient funds to close the loan.

Inconsistent/Underreported Liabilities

CRITERIA: According to HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-11A, the borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt ratio, the lender must include the monthly housing expense, and all other additional recurring charges. Paragraph 2-12 instructs lenders to compute two ratios: the housing ratio and the debt ratio; these ratios should not exceed 29/41% respectively unless significant compensating factors are presented.

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OIG FINDING: One debt listed on the credit report shows a balance of $2,765 and no payment amount. While a borrower explanation indicates that the account is only open until the insurance settlement from an accident is complete, there is no proof that the account was settled. This account is listed on the application with $138 payments, but is not included on the underwriting worksheet. Had the $138 monthly payment been included, the 42.75% debt ratio would have exceeded the 41% threshold.

AUDITEE COMMENTS: Consistent with HUD guidelines that provide the underwriter with discretion, the underwriter made the judgment call not to count the payment for $138. According to the borrower's explanation letter, his wife was in a near fatal car accident totaling the car. They were waiting for an insurance settlement to pay the balance due of $2,765. Therefore, we respectfully submit that the underwriter was justified in not counting the payment since the account would be settled.

OIG EVALUATION OF AUDITEE COMMENTS: As noted in Gershman's comments for "Questionable/Derogatory Credit History," they claim that this debt will be covered by gap insurance. However, Gershman failed to provide evidence that the gap insurance coverage even existed. Gershman failed to properly support the exclusion of the $138 monthly payment.

<u>Questionable/Derogatory Credit History</u>

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-3 describes the criteria for analyzing the borrowers credit, stating that if the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong offsetting factors will be necessary to approve the loan. Further, Paragraph 2-3A states that the payment history of the borrower's housing obligations is of significant importance in evaluating credit and requires lenders to determine the borrower's payment history of the housing obligations for the most recent 12-month period.

OIG FINDING: On the 2/1/02 credit report, there are twenty-two 30-day late payments, nine 60-day late payments, and five 90-day late payments, the most recent of which was just a few months prior to closing. The borrower's explanations for the late/missed payments include his fiancé's car accident and subsequent surgery, priority of wedding bills, being misled by a car dealership finance department, overlooking accounts while catching up on car payments, and not knowing an account was late or still active because it belonged to his ex-wife. While 10 months of rental history are verified, three of the payments were 1-5 days late. Furthermore, while the application lists only two addresses covering the last two years, the credit report shows a third address reported during the two-year period prior to closing.

AUDITEE COMMENTS: There were three different late pay accounts in 2001. All of the others were prior to 1998. According to the borrowers, one of these accounts would be closed once the gap insurance was settled. This auto loan account was opened in September 2000 with a balance of $21,000. The account was last verified on 12/01, with a balance of $2,765. It has been our experience that it is typical for gap insurance not to pay until the refund of the unexpired warranty is also paid. The gap insurance will pay the remainder and it is common for creditors to tell borrowers not to make the payments and their credit will not be impacted during that period.

The other two accounts with late payments in 2001 were revolving accounts. All installment debt and rent were paid on time. The auditor noted that three of the rent payments were 1-5 days late. It is common that apartment leases give the tenant a 5-day grace period.

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The underwriter did not question the third address noted by the auditor. The file contained rent verifications from 1/1/00 to 10/31/01 and the borrower lived with family from 11/1/01 until the time of application. It is possible that the third address could have been for his father who has the same name.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertions that the documentation obtained adequately established the borrower's residence for the two year period prior to closing and that the three late rental payments were minor issues not requiring explanation. While we agree with Gershman that only three accounts had late payments in 2001, we disagree with their assertion that all other late payments were prior to 1998. Four accounts, including two of the three accounts with late payments in 2001, had late payments in 1999 or 2000. Additionally, Gershman failed to verify the existence of the gap insurance said to cover the auto loan account.

FHA CASE NUMBER: 292-4159228 DATE OF LOAN CLOSING: 3/14/2002
LOAN PURPOSE: Purchase INSURED AMOUNT: $100,365
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 20.00/49.00
STATUS AS OF 3/31/2004: First legal action to foreclose. First default reported after 13 payments. Borrower declared bankruptcy on 10/29/2003.

Inconsistent/Unsupported Income

CRITERIA: The Desktop Underwriter Findings Report required the lender to obtain signed borrower individual tax returns, including schedules, for the most recent two years to support self-employment income used to underwrite the case. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-7A requires lenders to develop a two year average of bonus or overtime income used to qualify.

OIG FINDING: The Desktop Underwriter Findings Report shows base monthly income for the borrower and co-borrower of $1,819 and $2,574 respectively. While several W-2's, a 1099, and tax returns support the borrower's $1,819 monthly self-employment income, the tax returns were not signed. While the co-borrower's verbal verification of employment does verify a 7/17/00 beginning date of employment, it does not address income. W-2's and employer printouts indicate $2,422 co-borrower gross monthly income, including overtime, when averaged over 18.35 months. Gershman used a 13-month average of gross income for the co-borrower and included overtime income not properly documented.

AUDITEE COMMENTS: Our loan file contained copies of what was sent to the investor. The signed tax returns were sent to the investor who purchased the loan. We did not make a copy of the signature page. The 2000 tax returns were prepared by H and R Block as indicated at the bottom of the signature page of the return.

As stated on the application, the co-borrower was a surgical technician. In this job, she was working less than 40 hours per week. It consisted of different hours worked and earnings paid such as days, evenings, weekends, and call pay based on need. These various hours worked is very typical in the medical profession. The underwriter used an average of 13 months and gave the co-borrower credit for the hours she worked during this time because it was more reflective of the average number of hours worked per week. The 2001 year to date report from her employer showed a very low number of hours and was not representative of the number of hours

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worked at the time of application. We respectfully submit that the auditors finding in this regard is not supported.
OIG EVALUATION OF AUDITEE COMMENTS: Gershman's asserts that the tax returns signed prior to closing were sent to the investor and has since obtained a signed copy for their records. However, Gershman's claim that the 2001 year to date report from the co-borrower's employer, which showed a very low number of hours, was not representative of the number of hours worked at the time of application further supports our finding that Gershman failed to properly verify the co-borrower income used to qualify. HUD requirements state that income that is not stable or will not continue may not be used in calculating the borrower's qualifying ratios.

Inconsistent/Unsupported Assets
CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.
OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $3,058 and the borrower needed $3,059 to close. According to the settlement statement, the borrower only needed $1,795 to close after taking out earnest money, seller paid expenses, and borrower prepaid expenses. The Desktop Underwriter Findings Report list $7313 assets available. However, an Internet printout covering 1/23/02-3/12/02 shows $9,650 in unidentified deposits to the borrower's checking account during the forty-day period, three of which are each approximately two percent of the sales price. Because the co-borrower's income is directly deposited, the only way to account for all of the unidentified deposits is with the borrower's income. While a note from the co-borrower indicates that two of the three questioned deposits were borrower payroll deposits, no supporting documentation was provided. Additionally, 2001 borrower self-employment receipts listed on a tax return only project approximately $7,588 receipts in a forty-day time period. Also, it is unclear whether Desktop Underwriter would have approved with lower reserves considering the debt ratio was already above the 41% benchmark.
AUDITEE COMMENTS: The only deposit that exceeded the 2% sales price was for $2,200. The borrowers' explanation for this was a gift from their father. This amount was subtracted from the total assets available because we were unable to properly document the transfer of the gift funds. We did have an explanation for the other deposits but did not require more documentation because the deposits did not exceed 2% of the sales price. The auditor stated that there was $9,650 in unidentified deposits. However, and significantly, the auditor failed to take the $2,200 gift from her father into consideration. With the gift subtracted from the deposits, the borrower's self-employed receipts were sufficient assets for the source of funds. We respectfully submit that the borrowers assets were fully supported and documented.
OIG EVALUATION OF AUDITEE COMMENTS: We agree with Gershman's assertion that the removal of the $2,200 deposit reduced the total of unidentified deposits to $7,450, an amount reasonably explained by the borrower's self-employment status. We have removed this deficiency from Finding 1 and adjusted Appendix B.

FHA CASE NUMBER: 292-4129226 DATE OF LOAN CLOSING: 3/26/2002
LOAN PURPOSE: Purchase INSURED AMOUNT: $50,115
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 17.27/39.54
STATUS AS OF 3/31/2004: Foreclosure started. First default reported after 16 payments.

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Inconsistent/Unsupported Income

CRITERIA: According to the Desktop Underwriter Findings Report, all overtime and bonus income must be verified and documented according to current FHA documentation guidelines. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-7 requires lenders to develop a two year average of bonus or overtime income, and indicates that if the earnings trend indicates a continual decline, the lender must provide a sound rationalization for including the income of the borrower qualifying.

OIG FINDING: According to the Desktop Underwriter Findings Report, the borrower's $2,539 total monthly income consists of $1,734 base pay, $260 overtime pay, and $545 social security pay. A verification of employment confirms a three-year employment history, base pay of 400/week, and average hours of 48/week. However, the verification of employment also indicates average monthly base/overtime income of $1,173/$357 in 2000, $1,472/$260 in 2001, and $1,651/$79 in 2002; none of the totals are even within $250 of the $1,994 total base and overtime income claimed. Additionally, recent paystubs project only $1,796 gross monthly income and indicate that the borrower averaged only 40.8 hours/week over six-weeks. While the borrower's recent promotion to management explains the large increase in base pay, there is no explanation for the continual decline in overtime income shown on the verification(s) of employment, W-2's, and paystubs.

AUDITEE COMMENTS: The [employment verification] confirmed the borrower's base pay of $1,734 and a 12-month average of the 2001 overtime earning of $260 to qualify. See Exhibit 24. The year to date overtime was for only a six week period (at most) and we did not put much weight on this since the [verification] confirmed that the borrower's average hours worked per week was 48 and the probability of employment was good. As such, we actually used a more conservative approach in calculating the overtime income of $260 by utilizing the 2001 average as the overtime income based on the [verification] would have amounted to $520 of monthly overtime income. Further, if the overtime income was calculated by utilizing the verified 110 week period (1/1/00-2/11/02), the monthly overtime income would have amounted to $296. In addition, there was additional Social Security income that was not used in calculating the applicable income. With the $1.00 per hour raise the borrower received 8/24/01, the total earnings over the past 2 years supported our income calculation. We respectfully submit that this finding is not valid.

OIG EVALUATION OF AUDITEE COMMENTS: Gershman failed to adequately verify income used to qualify. As previously stated, the file does not contain an explanation for the continual decline in overtime income shown on the verification(s) of employment, W-2's, and pay stubs.

Inconsistent/Questionable Documentation

CRITERIA: HUD Handbook 4000.4, Revision-1, Change-2, Paragraph 2-4C2 requires underwriters to review appraisal reports and compliance inspections performed by fee and staff personnel to ensure reasonable conclusions, sound reports, and compliance with HUD requirements. HUD Handbook 4150.1, Revision-1, Paragraph 6-10B states requires each appraisal report to contain at least one conventional comparable, if available, and says that the data should include comparable sales in competing neighborhoods and should not necessarily be limited to the subject neighborhood or subdivision or block.

OIG FINDING: Although the appraisal report notes that the appraiser used the best comparable properties available, all three comparable properties were FHA financed.

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AUDITEE COMMENTS: The appraiser addressed this fully in his report. Significantly, he did not use any conventional properties because they were not comparable. He stated clearly in his report that other sales would have resulted in larger and or less desirable adjustments. This property is located in an area that predominately has FHA financing for the source of mortgage money. The HUD guidelines state that conventional are to be used if available. Importantly, they were not available for this appraisal as stated by the appraiser. See Exhibit 25. We respectfully submit that this finding is not supported.

OIG EVALUATION OF AUDITEE COMMENTS: The appraisal does mention the word conventional when noting that other sales would have resulted in larger and or less desirable adjustments and does not state that conventional properties were not available.

FHA CASE NUMBER: 133-0103108 DATE OF LOAN CLOSING: 4/3/2002
LOAN PURPOSE: Purchase INSURED AMOUNT: $83,686
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 15.76/24.70
STATUS AS OF 3/31/2004: Foreclosure started. First default reported after 19 payments.

Inconsistent/Unsupported Assets

CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.

OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $2,550 and the borrower needed $3,824 to close. According to the settlement statement, the borrower only needed $2,472 to close after taking out earnest money and borrower prepaid expenses. According to the Desktop Underwriter Findings Report, the borrower's assets consisted of a checking account with a $4,805 balance. While one page of a 3/7/02 bank-stamped printout supports the balance used, the other pages were not provided. While a 2/27/02 bank statement reveals a $3,250 unexplained deposit on 2/15/02, documentation shows that the borrower owned several savings bonds with a total value in excess of the unexplained deposit. Also, it is not clear whether there were any large deposits between 2/27/02 and 3/7/02. In a 4/27/04 meeting, Gershman indicated that Desktop Underwriter does not require documentation when exchanged securities are sold.

AUDITEE COMMENTS: Gershman's loan file has copies of the borrowers' bank account statements and bank generated computer printouts for a period of 12/17/01-3/4/02. There was one deposit that was more than 2% of the sales price as conditioned on the Desktop Underwriter Findings. This deposit on 2/15/02 was for $3,249.60 and the source of funds is verified by the documentation of the borrower's ownership of U.S. Savings Bonds valued at $6,229.08. See Exhibit 26. There was a computer generated Savings Bonds calculator statement from the U.S. Treasury website showing the value of the Savings Bonds owned by the borrower. This statement was generated from the internet and was consistent with the copies of the savings bonds provided. It showed the value of the bonds as of 1/27/02 and confirmed the value of the bond cashed in for $3,249.60. See Exhibit 27. This statement was signed by the borrower's mother to use as verification of the value of the bonds. Consistent with HUD guidelines, Gershman accepted this as documentation and explanation for the large deposit. The bank-stamped printout was a total of 4 pages and shows the activity of the account from 1/29/02-3/4/02. See exhibit 28. There were no unexplained deposits reflected on this printout. The

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borrower's assets were properly documented. Gershman respectfully submits that the auditor's finding is not valid.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the borrower's assets were properly documented. We have removed this deficiency from Finding 1 and adjusted Appendix B.

FHA CASE NUMBER: 292-4169219 DATE OF LOAN CLOSING: 4/19/2002
LOAN PURPOSE: Purchase INSURED AMOUNT: $69,903
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 20.02/37.95
STATUS AS OF 3/31/2004: Delinquent. First default reported after five payments.

Inconsistent/Unsupported Income

CRITERIA: The Desktop Underwriter Findings Report requires employment income be supported by the most recent year-to-date pay stub documenting one full month's earnings and a written, verbal, or electronic verification acceptable to FHA. Desktop Underwriter allows income from a second job (part-time) to be used in qualifying if the borrower has worked the part-time job uninterrupted for the past two years and will continue to do so; if the income has been received for less than two years, it may be included provided the lender determines that the income's continuance is likely. Furthermore, if the current employer does not confirm a two-year employment history, Desktop Underwriter requires lenders to obtain W-2(s), verification(s) of employment, IRS income verification, or electronic verification for the most recent two years.

OIG FINDING: The Desktop Underwriter Findings Report lists the borrower's monthly base pay as $1,994 and other monthly earnings of $1,115. The $1,994 monthly base pay from Employer A was based on year-to-date gross income for 2.5 months and includes overtime without establishing a two-year pattern; the borrower's year-to-date base monthly income was only $1,636. The $1,115 other monthly earnings was based on the first pay stub from a job with Employer B that the borrower started approximately one month before closing; however, the verification of employment for this job stated that the likelihood of continuation was only 50/50. Additionally, while the underwriting worksheet notes, "using averages for two current jobs this average equals $3109/mo; 2001 average for all jobs worked = $5499/month," there were several inconsistencies in the verifications of the third source of monthly income and W-2's located in the case binders show only $1,959 average gross monthly income for the previous two years. Gershman did not adequately support the employment income used to underwrite this loan.

AUDITEE COMMENTS: Excluding any overtime income, based upon the [employment verification] for [Employer A] and [Employer B] the borrower's monthly base income was verified to be $1525 and $1776, respectively, for a total monthly base income of $3301. The $1115 computed for [Employer B], as inputted into Desktop Underwriter, was for less than the full pay period. After factoring her fixed expenses of $1161 her [debt] ratio equaled 35% which was acceptable pursuant to HUD guidelines.

The employment verification from [Employer B] indicated that there was a 50/50 chance on probability of continued employment, but it was also stated that the borrower seemed reliable and that she would probably receive a pay increase in 90 days. The underwriter determined that this income was acceptable because of the borrower's experience in the nursing field. We respectfully submit that the borrower's income was properly submitted.

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OIG EVALUATION OF AUDITEE COMMENTS: While we concur that Gershman adequately verified the income from Employer B, they did not properly verify the overtime income from Employer A. Desktop Underwriter requires all data entered, downloaded, or imported to be true, accurate, and complete. Gershman did not enter any overtime income into the system and instead entered all income from Employer A as base income. This is significant as Desktop Underwriter provides different messages for the various types of income and typically requires all overtime income be verified and documented according to current FHA standards (see FHA Case Number 292-3998744, 292-4076992, etc). HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-7A requires lenders to develop a two year average of bonus or overtime income. Periods of less than two years may be acceptable provided the underwriter adequately justifies and documents his or her reason for using the income for qualifying purposes. This loan did not contain the necessary documentation to support the income used to qualify. After removing the $469 overtime income ($1,994 total - $1,525 base), the remaining income totals $2,640 ($1,525 + $1,115). This amount corresponds to a 44% debt ratio, which exceeds the 41% threshold defined in HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-12.

<u>Inconsistent/Unsupported Assets</u>
CRITERIA: The Desktop Underwriter Finding Report requires that the lender verify the gift and document the transfer of gift funds in accordance with HUD ML 00-28. Mortgagee Letter 00-28 says that when the transfer of gift funds occurs at closing, the lender remains responsible for obtaining verification the closing agent received funds from the donor for the amount of the purported gift. Additionally the Findings Report requires lenders to verify cash reserves, which are not to include funds received as a gift.
OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $2,130 and the borrower needed $2,648 to close. According to the final settlement statement, the borrower needed $1,305 to close after taking out earnest money, seller paid expenses, and borrower prepaid expenses. According to the Desktop Underwriter Findings Report, the borrower's assets consisted of a $50 bank account and a $3,000 gift not yet deposited. However, the underwriting worksheet, settlement statement, and gift documents indicate that the gift amount was only $2,500.
AUDITEE COMMENTS: There was no impact in Desktop Underwriter regarding the borrower's reserves. Gift funds excess not included. At the time of closing, the actual amount of the gift was for $2,500. This would not have affected the Desktop Underwriter Findings Report because gift funds are not included as reserves. The cash reserves would have remained $50 and it would not have changed the underwriting decision. We respectfully submit that this finding is not valid.
OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that Desktop Underwriter does not include excess gift funds in cash reserves. However, Gershman agrees that the information submitted to Desktop Underwriter was incorrect. Desktop Underwriter requires all data entered, downloaded, or imported to be true, accurate, and complete.

FHA CASE NUMBER: 292-4171792
LOAN PURPOSE: Purchase
UNDERWRITER TYPE: Automated

DATE OF LOAN CLOSING: 5/24/2002
INSURED AMOUNT: $124,019
HOUSING/DEBT RATIOS: 32.77/47.93

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STATUS AS OF 3/31/2004: Reinstated by mortgagor. First default reported after eight payments.

<u>Inconsistent/Unsupported Income</u>
CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.
OIG FINDING: The Desktop Underwriter Findings Report lists co-borrower monthly base income of $1,993. While the year-to-date section on a recent paystub indicates average gross monthly income of $2,169, the current base pay projects a base monthly income of only $1,645. Additionally, W-2's and tax returns call into question the stability of the co-borrower's employment and income. In 2000, the co-borrower averaged $352 gross monthly income and had three employers and an unsuccessful attempt at self-employment. In 2001, she averaged $1,394 gross monthly income and was employed by only two employers during the year, including her current employer. Gershman failed to establish the stability of the co-borrower's employment and income.
AUDITEE COMMENTS: The co-borrower's pay stub dated 5/08/2002 shows straight time hours at 66 and PTO (paid time off) hours of 13.75 for a total of 79.75 hours. See Exhibit 29. The pay stub specifically reflects a benefit for PTO and thus should be properly counted when analyzing the co-borrower's income. The year to date earnings supported that the co-borrower was working at least 40 hours per week. It appears that the auditor did not take the PTO hours into consideration when projecting her base pay above.
There was no reason to question the stability of employment. The co-borrower had, in fact, worked consistently for the past 2 years. She attempted to work as a self-employed hairstylist and although she was not successful, she found subsequent employment within 1 month when she went to work for [Employer A]. This was supported by a W-2 and she remained in the service industry for over 2 years. Gershman underwrote this loan according to HUD guidelines.
OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's income calculations and explanations regarding the stability of income. We have removed this deficiency from Finding 1 and adjusted Appendix B.

<u>Inconsistent/Unsupported Assets</u>
CRITERIA: The Desktop Underwriter Findings Report required net equity from pending sales be verified with a fully executed settlement statement.
OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $3,750 and the borrower needed $7,289 to close. According to the settlement statement, the borrower only needed $5,870 to close after taking out earnest money and borrower prepaid expenses. According to the Desktop Underwriter Findings Report, the borrowers' assets consisted of $16,022 proceeds from the sale of their prior residence and a $351 bank account. However, the final settlement statement for the sale shows only $13,961 cash to the borrower at settlement. Had the correct amount of assets been entered, the borrower would have had different reserves than claimed on Desktop Underwriter, and it is not clear if Desktop Underwriter would have approved the loan. In a 4/16/04 meeting, Gershman noted that because the borrowers ended up having more reserves than claimed on the Desktop Underwriter Findings Report, they did not resubmit the loan.
AUDITEE COMMENTS: It is Gershman's policy and practice to carefully review all loans before loan closing to determine that the minimum cash investment has been made, the amount of cash needed to close is sufficient, and the cash reserve requirement from the Desktop Underwriter Findings Report has been met. The Underwriter Findings showed cash to close of $9,001. The

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[settlement statement] showed the actual cash required to close of $5,869 and cash paid outside of closing for homeowner's insurance of $524 for a total of $6,393. So, the actual amount to close was less than the amount used in Desktop Underwriter.

The Underwriter Findings reported net equity from sale of their home of $16,022. The actual proceeds from sale of their home was $13,961 which when added to their $351 cash gave them assets to close of $14,321. After deducting the actual cash requirement of $6,393, this left cash reserves of $7,928. This is more than the cash reserves stated on the Underwriter Findings of $7,372. Therefore, there was no reason to resubmit this loan through Desktop Underwriter. We respectfully submit that this finding is not supported.

OIG EVALUATION OF AUDITEE COMMENTS: Gershman's $6,393 actual cash requirement calculation did not include $343 for expenses paid outside closing or $500 for the borrower's cash deposit. According to Section VI of the Desktop Underwriter Government Underwriting Service User's Guide for FHA Loans, the loan file must contain evidence that deposits have cleared the borrower's account. With the corrected requirement of $7,236, the cash reserves would be $7,085, less than the amount used in Desktop Underwriter. Regardless, the asset information submitted to Desktop Underwriter by Gershman was incorrect.

FHA CASE NUMBER: 133-0103574 DATE OF LOAN CLOSING: 6/14/2002
LOAN PURPOSE: Purchase INSURED AMOUNT: $96,485
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 17.16/55.92
STATUS AS OF 3/31/2004: First legal action to foreclosure. First default reported after 13 payments.

<u>Inconsistent/Underreported Liabilities</u>

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-11A requires lenders to include all recurring charges, including real estate loans, when computing qualifying ratios. Paragraph 2-12 instructs that lenders to compute two ratios: the housing ratio and the debt ratio; these ratios should not exceed 29/41% respectively unless significant compensating factors are presented. Desktop Underwriter requires resubmission if any liabilities over $100 per month had been omitted.

OIG FINDING: The underwriting worksheet shows gross monthly income of $4,739, total fixed payments of $2,650, and ratios of 17.16% and 55.92%. The Desktop Underwriter Findings Report shows an additional $750 monthly income (rental income), total fixed payments of $2,108, and ratios of 14.82% and 38.41%. Gershman failed to explain the $542 total fixed payments difference between the two documents. While a lease agreement and sales contract confirm a $750/month 2-year lease agreement and a 6/7/04 closing date, the credit report shows a $97,509 current mortgage on the property with a monthly payment $228 more than the monthly rental income. Gershman underreported monthly liabilities by $978 by failing to include the mortgage payment in the Desktop Underwriter underwriting analysis. When the mortgage is included, debt ratio jumps to over 56%.

AUDITEE COMMENTS: After a careful review of this file and performing a manual underwrite, we determined that the housing ratio and the [debt] ratio were within the applicable HUD guidelines. The base monthly income of $4739 was actually understated and has been recalculated to be $4822. The debt stated on the underwriting worksheet and in Desktop Underwriter were both inaccurate as they overstated the recurring expenses. After review, the recurring expenses were $1495. This was computed by utilizing $728 of debt reflected on the

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credit report, $350 child support and $416 for the negative net rental income. The negative net rental income was computed by taking 75% of the lease payment ($750 x .75 = $562) and deducting that amount from the mortgage payment ($978). Therefore, the housing ratio was 17% and the [debt] ratio was 47.7%. After considering the applicable compensating factors the approval of this loan was fully warranted. The applicable compensating factors were the following: 1) The borrowers had successfully demonstrated the ability to pay housing expenses greater than the proposed monthly housing expense for the new mortgage over the past 12-24 months. The credit report shows no late payments for the past 12 months and the borrowers had this loan for 2 years, 2) The borrower has substantial documented 11 months of cash reserves available after closing, 3) The borrower had a long-term employment history (21 years) with the government. We respectfully submit that we made an appropriate underwriting decision consistent with HUD guidelines regarding this loan.

OIG EVALUATION OF AUDITEE COMMENTS: Desktop Underwriter requires all data entered, downloaded, or imported to be true, accurate, and complete. Gershman agrees that the information entered into Desktop Underwriter was inaccurate and incomplete. Additionally, Gershman agrees that the qualifying ratios were calculated incorrectly and inconsistently. Gershman did not manually underwrite this loan. Regardless, the underwriting worksheet did not document significant compensating factors as required by HUD to exceed qualifying ratios on a manually underwritten loan. Additionally, while we did not verify the base monthly income or all recurring expenses now claimed by Gershman, we observed that the reduction in monthly child support from $475 to $350 is not sufficiently documented and that Gershman's $416 negative net rental income calculation failed to include $48 homeowner's insurance ($575 annual premium / 12 months = $48) and should have been $464.

FHA CASE NUMBER: 132-1565888	DATE OF LOAN CLOSING: 6/14/2002
LOAN PURPOSE: Purchase	INSURED AMOUNT: $54,150
UNDERWRITER TYPE: Automated	HOUSING/DEBT RATIOS: 14.62/32.83

STATUS AS OF 3/31/2004: First legal action to foreclose. First default reported after nine payments.

<u>Inconsistent/Unsupported Assets</u>

CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.

OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $1,650 and the borrower needed $3,063 to close. According to the settlement statement, the borrower only needed $2,540 to close after taking out earnest money and borrower prepaid expenses. According to the 6/12/02 Desktop Underwriter Findings Report, the borrower's assets included a checking account ($3341) and two savings accounts ($31). While a 6/11/02 verification of deposit confirms the three balances, the lender portion shows that they were only trying to verify a $358 checking account balance. Additionally, a 5/13/02 Desktop Underwriter Findings Report lists the checking account balance as $358, lists a $3,000 gift not yet deposited, and has a handwritten note on it saying "will take Gift off. All will be in SAV. No Gift." In a 4/16/04 meeting, Gershman noted that the 5/13/02 Desktop Underwriter Findings Report was created the day the application was taken; because they later realized that there was no gift, they did not list a gift on the 6/12/02 Desktop Underwriter Findings Report. Gershman

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failed to adequately verify cash reserves and explain/document the large checking account balance increase.

AUDITEE COMMENTS: On the original loan application, the borrower stated that he had $4,500 in his bank accounts. There is no mention of a gift on the application. The loan processor made an input error when loading the assets into our processing system, and subsequently downloaded into desktop underwriter. Our processing system prepares the deposit verification with the information loaded by the processor. Therefore, the deposit verification was sent out with an understated amount in the checking account. The verification of deposit received back from the bank on 6/11/02 indicated the borrower had $3,341 in his checking account. See Exhibit 30. The average balance for the previous two months was $4,480, therefore, there was no increase in the balance, and the amount of cash reserve was properly documented and actually understated. When the desktop underwriter findings were reviewed and compared to the initial application, the processor corrected the assets on the application to match the assets verified. The initial and final application signed by the borrower states that the source of funds for closing was from savings and checking accounts. Our loan file was properly documented. Gershman respectfully submits that the audit finding is incorrect.

OIG EVALUATION OF AUDITEE COMMENTS: We concur that the loan file was properly documented, as the average checking account balance for the previous two months was $4,480 and the source of funds was listed as savings and checking accounts on the applications. We have removed this deficiency from Finding 1 and adjusted Appendix B.

FHA CASE NUMBER: 292-4194032 DATE OF LOAN CLOSING: 6/21/2002
LOAN PURPOSE: Purchase INSURED AMOUNT: $78,764
UNDERWRITER TYPE: Manual HOUSING/DEBT RATIOS: 22.68/41.22
STATUS AS OF 3/31/2004: Repayment. Borrower declared bankruptcy on 7/11/2003.

Inadequate Qualifying Ratios

CRITERIA: According to the Desktop Underwriter Findings Report, this case was referred because the risk exceeds the risk threshold for automated approval for an FHA loan. An FHA registered direct endorsement underwriter must analyze the loan and determine if the borrower meets FHA standard capacity and credit policy guidelines. Desktop Underwriter required documentation to support the omission of several debts and required a direct endorsement underwriter to determine that any short term debt, including those omitted by Desktop Underwriter, would not negatively affect the borrower's ability to make mortgage payments during the early months of the loan following loan settlement. The Desktop Underwriter Findings Report indicates that the direct endorsement approval form requires a direct endorsement underwriter signature and says that only a direct endorsement lender could submit the loan for endorsement. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-12 instructs that lenders must compute two ratios: the housing ratio and the debt ratio; these ratios should not exceed 29/41% respectively unless significant compensating factors are presented.

OIG FINDING: While the direct endorsement approval form has a direct endorsement underwriter signature, the underwriting worksheet does not. The underwriting worksheet also

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shows Desktop Underwriter as the underwriter and lists the debt ratio as 41.22% without including compensating factors. There is no documentation to support the omission of a debt with Toyota ($14,749/$375); with this debt included, the debt ratio is 54.44%. Additionally, there is no documentation proving that an FHA registered direct endorsement underwriter determined whether short-term debt would negatively affect the borrower's ability to make the early mortgage payments. In a 4/27/04 meeting, Gershman noted that this loan would have been approved if manually underwritten.

AUDITEE COMMENTS: This file was reviewed and underwritten by a Direct Endorsement underwriter. The [underwriting worksheet] and direct endorsement approval were incorrectly completed showing Desktop Underwriter. The approval form was also signed by a Direct Endorsement underwriter, certifying the loan was rated refer and was manually underwritten. See Exhibit 31.

It has always been our policy when manually underwriting FHA loans to round ratios down which in this case would have been 41% and thus we would not have listed the compensating factors. However, several compensating factors did exist. Specifically, the borrower earned commission income not used to qualify, bonus income was not used to qualify, and additional child support income was not used to qualify. Using any one of these would have lowered the qualifying ratio under 41%.

After carefully reviewing the file, we have determined the Toyota debt was properly omitted because the applicant had sold this vehicle. The credit report dated 4/25/02 showed the last date verified as May 2000 and the account was closed. The credit report also showed an auto loan that was taken out in March of 2001. She acquired a new vehicle at that time and as a single person did not have a need for 2 cars. The borrower confirmed that she sold the Toyota car in 2000 and the debt was paid off. (Borrower will provide confirmation in writing if necessary). We respectfully submit that the auditor's finding is not supported.

OIG EVALUATION OF AUDITEE COMMENTS: The underwriter signed direct endorsement approval serves as documentation to support that the underwriter determined whether short-term debt would negatively affect the borrower's ability to make the early mortgage payments. However, Gershman failed to include documentation to support the omission of the debt with Toyota when underwriting the loan as required by the Desktop Underwriter Findings Report. It should also be noted that while the credit report indicates the account is closed to further purchases, it shows a balance due.

FHA CASE NUMBER: 133-0104240	DATE OF LOAN CLOSING: 8/23/2002
LOAN PURPOSE: Purchase	INSURED AMOUNT: $65,472
UNDERWRITER TYPE: Automated	HOUSING/DEBT RATIOS: 20.51/47.37

STATUS AS OF 3/31/2004: Case no longer active. While HUD paid a claim of $71,010, the amount of the loss is not known at this time. First default reported after one payment.

<u>Inconsistent/Unsupported Income</u>

CRITERIA: The Desktop Underwriter Findings Report requires all employment income be supported by paystubs documenting one full month of income and a written, verbal, or electronic

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verification of employment acceptable to FHA. HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-6 requires lenders to examine the borrower's past employment record, qualifications for the position, previous training and education, and the employer's confirmation of continued employment. Additionally, Paragraph 2-7Q indicates that projected or hypothetical income is acceptable for qualifying purposes only when verified with the employer.

OIG FINDING: The Desktop Underwriter Findings Report lists the borrower's monthly income as $2,279. A 7/31/02 paystub indicates gross monthly income average of only $1,843. While an 8/12/02 letter from the employer indicates that the borrower will get a 6% raise on 2/28/03, a second 8/12/02 letter located only in the Gershman file indicates that because the borrower recently completed Certified Physician Assistant training "in the top 5% of her class, on the September of 2002 paycheck will show her new salary of $27,360.00 annually that is rewarded for all students who score this high." While there were no explanations for the conflicting letters, the $2,279 monthly income used to underwrite this loan corresponds to the letter located only in the Gershman file. Gershman failed to adequately verify the borrower's employment and income.

AUDITEE COMMENTS: This loan was underwritten using Desktop Underwriter. The loan processor accepted a letter from an Assistant Professor at [University A] stating that the borrower's income would be $27,360 a year because of placement in her class in the top 5%. The file also contained a letter from the same person dated the same day that the processor felt contained incorrect information and asked for a new letter.

OIG EVALUATION OF AUDITEE COMMENTS: Desktop Underwriter requires all data entered, downloaded, or imported to be true, accurate, and complete. This file did not contain adequate documentation that Gershman attempted to resolve the discrepancies noted. Gershman submitted to HUD the employment verification that its processor felt contained incorrect information.

<u>Inconsistent/Unsupported Assets</u>

CRITERIA: The Desktop Underwriter Finding Report requires depository assets be verified by either a verification of deposit, the most recent statement showing the previous month's balance, or the most recent two months statements.

OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $1,995 and the borrower needed $3,113 to close. According to the settlement statement, the borrower only needed $1,178 to close after taking out earnest money, seller paid expenses, and borrower prepaid expenses. The Desktop Underwriter Findings Report includes a checking account with a $2,630 balance as an available asset. While the 7/31/02 checking account statement shows previous and new balances of $2,705 and $2,630 respectively, the 2 (representing $2,000) on these balances is crooked and is not present on any of the transaction date balances. Direct verification with the credit union indicated 7/1/02 and 7/31/02 balances of $705 and $630 respectively, confirming that the bank statement submitted in the HUD case binder was altered, causing assets to be overstated by $2,000.

AUDITEE COMMENTS: This loan was approved by Desktop Underwriter. The documentation for the asset verification submitted by the borrower was accepted. The processor checked the verification for the beginning and ending balances and used the ending balance for the bank account balance. The balance totals were not checked and the statement was not questioned. If the bank statement was altered, it was without our knowledge.

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OIG EVALUATION OF AUDITEE COMMENTS: Desktop Underwriter requires all data entered, downloaded, or imported to be true, accurate, and complete. This file did not contain adequate documentation that Gershman attempted to resolve the discrepancy noted.

FHA CASE NUMBER: 292-4218860 DATE OF LOAN CLOSING: 8/29/2002
LOAN PURPOSE: Purchase INSURED AMOUNT: $63,462
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 28.39/31.79
STATUS AS OF 3/31/2004: Reinstated by mortgagor. First default reported after 12 payments.

Inconsistent/Unsupported Income

CRITERIA: The Desktop Underwriter Findings Report requires explanation for gaps in employment of two months or longer. Additionally, employment income be supported by the most recent year-to-date pay stub documenting one full month's earnings and a written, verbal or electronic verification of employment acceptable to FHA.

OIG FINDING: The application indicates that the borrower has been with his current employer since 5/1/01 and was employed with his previous employer from 6/00-2/01. While W-2's indicate two additional employers during the past two years, the three-month gap in employment is not explained.

AUDITEE COMMENTS: According to the loan application, the borrower was 19 years old when he applied for the loan in August of 2002 and his driver's license confirmed his age. He would have graduated high school in May of 2001. Jobs previous to May of 2001 would have been part time jobs while he was in high school. Therefore, we respectfully submit that there was no gap in employment requiring an explanation.

OIG EVALUATION OF AUDITEE COMMENTS: While the borrower may have been a student prior to May 2001, Gershman did not obtain verification of prior student status for the borrower.

Inconsistent/Underreported Liabilities

CRITERIA: According to HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-11A, the borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations.

OIG FINDING: The Desktop Underwriter Findings Report lists borrower debts including a $4,550 student loan with $15 monthly payments. However, neither the credit report nor the loan statements show a monthly payment amount, and the loan statement shows a different balance. According to the direct loans home page (www.ed.gov/DirectLoan), the minimum monthly payment for the standard or extended repayment plan is $50. Gershman failed to document how it arrived at the monthly payment amount used in the underwriting analysis.

AUDITEE COMMENTS: The student loan statement in our loan file showed no payment due date. This was confirmed by the credit report. We did not obtain information about the length of deferment so we counted a student loan payment $15 per month as a payment estimated from the

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statement in our file. Importantly, if we had counted a payment of $50, the [debt ratio] would have been 33.6%. This loan would have been approved by Desktop Underwriter.
OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the correct monthly payment would not increase the ratios substantially. Regardless, Gershman did not submit accurate and complete data as required by Desktop Underwriter.

FHA CASE NUMBER: 133-0104569
DATE OF LOAN CLOSING: 10/1/2002
LOAN PURPOSE: Purchase
INSURED AMOUNT: $95,044
UNDERWRITER TYPE: Manual
HOUSING/DEBT RATIOS: 24.54/42.53
STATUS AS OF 3/31/2004: Delinquent. First default reported after 0 payments.

Inconsistent/Unsupported Income
CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Chapter 2 requires that the lender establish the borrower's capacity to repay the mortgage debt. Specifically, Paragraph 2-7 requires lenders to develop a two-year average of bonus or overtime income.
OIG FINDING: According to the underwriting worksheet, the borrower's monthly base income is $3,624. W-2's indicate average monthly income of only $3,064 in 2000 and $3,073 in 2001. While paystubs show only $3,035 base monthly income, a handwritten note on one paystub indicates, "Base = 3,035 mo; ytd = 4,559 mo avg.; ytd+2001 = 3,624 mo." The base monthly income computed by Gershman included overtime income when it was not adequately verified.
AUDITEE COMMENTS: We underwrote the loan using alternative documentation for income verification as permitted by HUD guidelines. According to HUD guidelines, we were required to obtain pay stubs covering the most recent 30-day period, along with IRS W-2 forms from the previous 2 years. We properly obtained pay stubs for 7/19/02 and 8/02/02 and W-2's from 2000 and 2001. The pay stubs provided by the employer covered the most recent 30-day period. Since this was the method of income verification required by HUD for alternative documentation, we did not have a breakdown detail of the overtime worked for 2000 and 2001. Thus, we took a 19.06 month average of the borrower's earnings to determine her monthly income. We respectfully submit that we made the proper income determination consistent with HUD guidelines.
OIG EVALUATION OF AUDITEE COMMENTS: While the loan file did contain alternative documentation, Gershman was still required to follow HUD requirements for including overtime income for qualifying purposes. HUD Handbook 4155.1, Revision-4, Change-1, Chapter 2 states that overtime income may be used to qualify if the borrower has received such income for approximately the past two years and there are reasonable prospects of its continuance. Periods of less than two years may be acceptable provided the underwriter adequately justifies and documents his or her reason for using the income for qualifying purposes. Based on the borrower's W-2's and base income amount, it appears that overtime has been received for less than eight months. Gershman failed to adequately justify and document its reason for including the overtime income for qualifying purposes.

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Inconsistent/Unsupported Assets

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-10 requires all funds for the borrower's investment in the property be verified. Paragraph 2-10B requires an explanation and evidence of source of funds be obtained when there is a large increase in a checking or savings account balance.

OIG FINDING: According to the underwriting worksheet, the statutory minimum required investment was $2,940 and the borrower needed $4,492 to close. According to the settlement statement, the borrower only needed $1,367 to close after taking out earnest money, seller paid expenses, and borrower prepaid expenses. According to the underwriting worksheet, the borrower's assets included three bank accounts with balances of $2,647, $150, and $2,748. While bank statements and printouts located in the HUD and/or Gershman case files support the account balances, they also reveal five unidentified deposits totaling $7,812. According to a note located in the HUD Case Binder, the borrower took $3,500 out of a joint account and $4,000 out of a personal account after her divorce, and has since re-deposited some of the money for closing costs. While there is a $4,000 withdrawal from one of the borrower's accounts, there is no documentation to support the remaining $3,812 in unexplained deposits. Documentation is necessary as the borrower always deposited the full amount of her payroll . In a 4/2/02 meeting, Gershman noted that they only confirm large deposits when they are needed for the investment.

AUDITEE COMMENTS: The auditor indicated there were $3,812 of unexplained deposits. This consisted of four deposits of $838, $363, $500, and $510 along with $1600 that was part of a $5600 deposit. We respectfully submit that none of these deposits are in excess of 2 percent of the sales price and therefore, would not have been considered large deposits requiring an explanation under HUD guidelines. Despite the fact that we were not required to obtain such documentation, the borrower did provide a letter of explanation that accounted for $7,500. The $4000 deposit noted by the auditor was included in the $7,500 but the remaining $3,500 would account for most of the $3,812 deposited. See Exhibit 32. We respectfully submit that this finding is not supported.

OIG EVALUATION OF AUDITEE COMMENTS: HUD regulation does not specify that only deposits in excess of 2% of the sales price be considered large deposits. As documented above, the unexplained deposits represent a large increase in the borrower's account balances. While Gershman did obtain an explanation from the borrower, they failed to obtain evidence of the source of funds. Gershman should have obtained evidence such as prior bank statements as the borrower originally withdrew the $7,500 from personal accounts.

Inadequate Qualifying Ratios

CRITERIA: HUD Handbook 4155.1, Revision-4, Change-1, Paragraph 2-12 requires lenders to compute two ratios: the housing ratio and the debt ratio; these ratios should not exceed 29/41% respectively unless significant compensating factors are listed in the remarks section of the underwriting worksheet.

OIG FINDING: Even though the underwriting worksheet showed a 42.53% debt ratio, it did not list any compensating factors. In a 4/2/04 meeting, Gershman indicated that although they failed to list compensating factors on the underwriting worksheet, there were several including that the borrower has been with current employer for seven years, the borrower was a previous owner, the borrower put 5% down, and this loan is not a maximum financing loan.

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AUDITEE COMMENTS: While the compensating factors noted by the auditor were not specifically included on the [underwriting worksheet], the compensating factors did exist and justify the approval of this loan. HUD guidelines clearly anticipate and permit ratios to be exceeded where significant compensating factors exist. Based on the amount the borrower actually paid at the closing of $1,367, there were 5 months cash reserves after closing. Also, the borrower had a previous mortgage payment of $1,248 that was paid as agreed. The proposed housing payment was $889. She demonstrated the ability to make timely mortgage payments and had the responsibility of owning a home. We respectfully submit that we made the proper underwriting decision in accordance with HUD guidelines.

OIG EVALUATION OF AUDITEE COMMENTS: Gershman agrees that the required listing of compensating factors was not present on the underwriting worksheet. After reviewing the factors Gershman now states that they used, we found that they were unsupported. Because the borrower's previous home was acquired jointly and sold when she divorced, the borrower did not successfully demonstrate the ability to pay housing expenses equal to or greater than the proposed monthly housing expense over 12-24 months as required by HUD. Additionally, it is unclear how Gershman arrived at five months reserves, as the borrower's $4,178 reserves ($5,545 assets -$1,367 paid at closing) only cover 2.7 months of the monthly fixed payment listed on the underwriting worksheet.

<u>Inconsistent/Questionable Documentation</u>

CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.

OIG FINDING: There are multiple variations of the borrower's name found on various overlapping dates in the HUD and Gershman case files. Also, although the deed of trust only lists the borrower, it does not indicate her marital status. While a 10/1/02 application indicates that the title will be held as a marital waiver, a 7/26/02 application indicates that the borrower's husband/ex-husband will hold title and shows a crossed out co-borrower. Additionally, a note located in the Gershman file says "Separation or divorce decree; marital waiver?," and the settlement statement from the sale of the borrower's previous residence lists both the borrower and her husband/ex-husband as sellers.

AUDITEE COMMENTS: In regards to the "variations" of the borrower's name, our file properly contained a name affidavit certifying that these names were the same person. See Exhibit 33. According to the application taken on July 26, 2002, the borrower indicated she would be divorced. Her ex-husband was listed in case the divorce was not finalized and he had to provide a marital waiver. There was also another name on the initial application and that individual application and that individual decided not to buy the property with the borrower. Therefore, he was properly removed from the loan application. We respectfully submit that the auditors finding is without basis.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman assertion that the name affidavit and explanations provided address the inconsistencies noted. We have removed this deficiency from Finding 1 and adjusted Appendix B.

FHA CASE NUMBER: 292-4281408 DATE OF LOAN CLOSING: 12/19/2002

LOAN PURPOSE: Non-Streamline Refinance INSURED AMOUNT: $59,529
UNDERWRITER TYPE: Automated HOUSING/DEBT RATIOS: 18.88/29.44
STATUS AS OF 3/31/2004: Foreclosure started. First default reported after 10 payments.

Inconsistent/Unsupported Income

CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.
OIG FINDING: Tax returns used to support borrower self-employment income were not signed by the borrower.
AUDITEE COMMENTS: Gershman's loan file contains copies of all the documents that were sent to the investor. Accordingly, the signed tax returns were sent by Gershman to the investor who purchased the loan. We cannot determine with certainty the reason that we did not make a copy of the signature page. However, and importantly, we have been able to have the borrower re-sign the tax returns for our file. See Exhibit 34. Gershman respectfully submits that there was not material effect on the insurability of this loan and that the missing copy of the signature page of the tax returns in our file did not disqualify the borrower from obtaining a HUD-FHA insured mortgage.
OIG EVALUATION OF AUDITEE COMMENTS: Gershman asserts that the tax returns signed prior to closing were sent to the investor and has since obtained a signed copy for their records. We concur that the missing copy of the tax returns in Gershman's file did not disqualify the borrower. We have removed this deficiency from Finding 1 and adjusted Appendix B.

Inconsistent/Questionable Documentation

CRITERIA: Not Applicable. Deficiency has been removed from Finding 1.
OIG FINDING: The appraisal value in May 2001 was $45,500. According to the December 2002 appraisal included with this cash-out refinance, the property is valued at $69,000; this indicates that the property value increased by over 50% in approximately nineteen months. In a 4/27/04 meeting, Gershman noted that they did not have a problem with the appraisal as values tend to increase over time and the property could have been undervalued in 2001.
AUDITEE COMMENTS: As stated in the application, the borrower purchased this property in May 2001 for $45,500. The appraisal of December 2002 states a value of $69,000. In the supplemental addendum to the appraisal, the appraiser states, "This area has seen a steady increase in value in the last 24 months. Children of 'baby boomers' are of house buying age, and this area has affordable housing stock. As a result, there has been a steady influx of younger home buyers which is forcing prices upwards. The average days on the market in the subject's general area is 35 days, which is below the metro area of 53 days. Also impacting value are active listings/pending sales as they typically set the high end of the value range." See Exhibit 35. For these reasons, Gershman believes that the value was accurate and justified by the appraiser. Further a Gershman Direct Endorsement Underwriter reviewed the appraisal in accordance with HUD guidelines and determined the value to be accurate and reasonable. The appraised value is supported by comparable sales and there are no large or inconsistent adjustments. Gershman notes also that the auditors did not state an opinion as to a valuation different than set forth in the appraisal report, or indicate that any of the comparable sales are inaccurately reported and not a fair measure of the subject property. Our underwriter performed the necessary analysis to assure the value was reasonable. As further support that the value was

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reasonable, the property was sold in June 2004 for $99,000. Accordingly, Gershman respectfully submits that this finding is not supported and should be dismissed.

OIG EVALUATION OF AUDITEE COMMENTS: We concur with Gershman's assertion that the underwriter performed the necessary analysis to assure the value was reasonable. We have removed this deficiency from Finding 1 and adjusted Appendix B.

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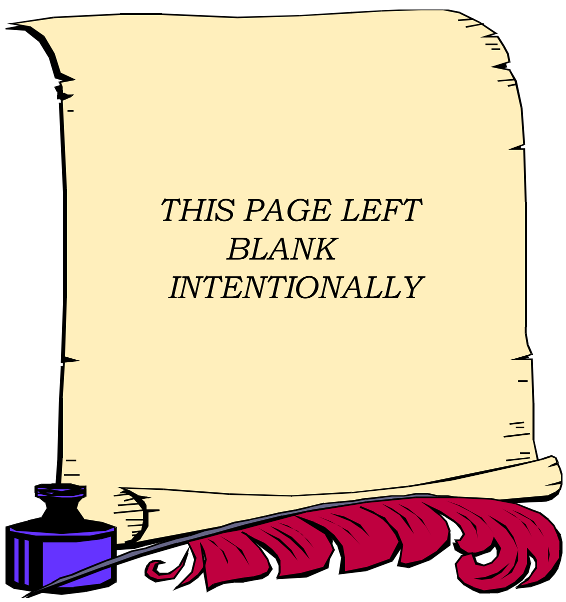

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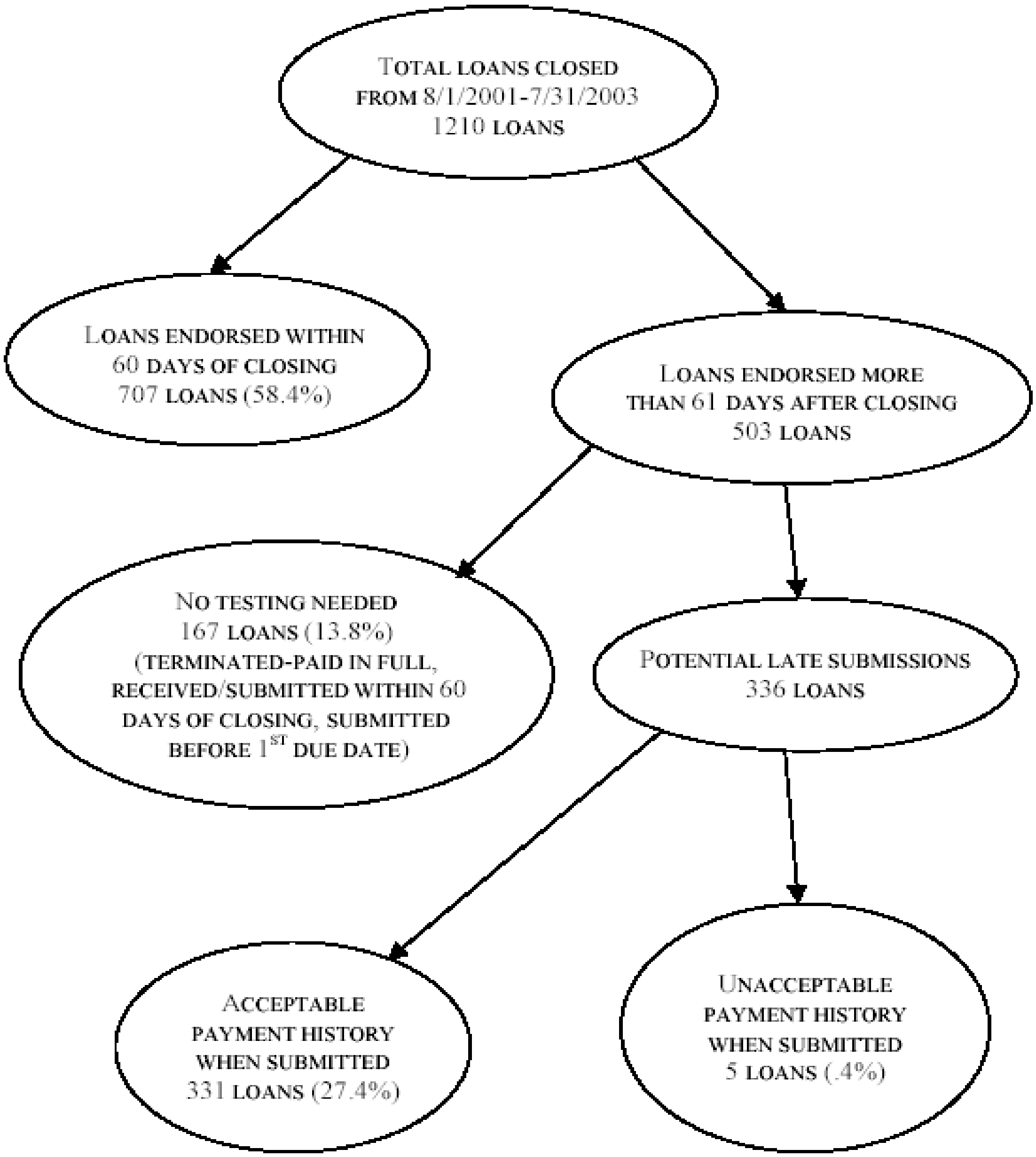
Chart of Loans Examined for Late Endorsement Scope and Methodology



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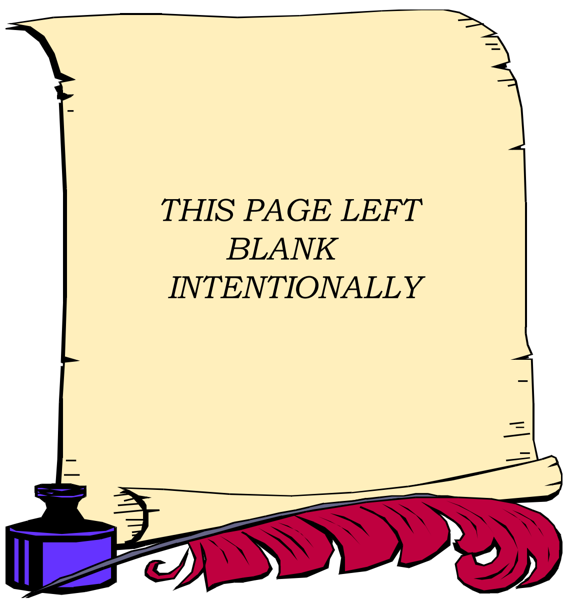

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Auditee Comments

This appendix contains the cover letter of Gershman's response to our draft report and their comments on Findings 2 and 3. Gershman's response to the deficiencies cited in Finding 1 was transcribed and inserted into Appendix C. While the 35 attachments referenced in Gershman's response are not included in this report, they are available upon request.

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July 8, 2004

Mr. Ronald J. Hosking
Regional Inspector General for Audit
U. S. Department of Housing and Urban Development
Region 7 Office of Audit
Gateway Tower II – 5th Floor
400 State Avenue
Kansas City, Kansas 66101-2406

Dear Mr. Hosking:

We are pleased to provide you with Gershman Investment Corp.'s ("Gershman") response to the Office of Inspector General's draft audit report regarding the HUD-FHA insured mortgage activities of Gershman. The draft audit report alleges that Gershman failed to comply with HUD-FHA requirements. Specifically, the draft audit report alleges that Gershman: (1) did not follow HUD requirements in originating 31 loans; (2) improperly submitted five loans for endorsement when the borrowers had delinquent payments prior to submission; and (3) was deficient in its quality control review activities.

This package sets forth in detail our response to each of the findings cited in the draft audit report. We take the draft audit findings very seriously and want to assure you that we continue to monitor our performance and modify policies and procedures as necessary and appropriate. Respectfully, however, we note that many of the alleged findings are not supported or represent a misunderstanding of the facts and we respectfully disagree with HUD's conclusions. Gershman has always been committed fully to strict compliance with HUD-FHA requirements and is committed to demonstrating this through our loan origination activities.

Again, Gershman appreciates this opportunity to respond to the draft audit report findings. Please do not hesitate to contact me if you have any questions.

Sincerely,

Albert J. Will
President

Insurance Endorsement

OIG Finding:

Gershman improperly submitted late requests for endorsement for five loans.

GIC response:

As stated by the auditors, Gershman's overall procedures for submitting late requests for endorsement were generally effective. An analysis of 336 loan payment histories revealed that only five loans were not properly submitted for late requests for endorsement.

As a responsible mortgagee, Gershman has subsequently strengthened its internal procedures for late requests for endorsement to further assure strict compliance with HUD guidelines. Gershman has implemented a new procedure in its insuring department to assure that loans are submitted to HUD for endorsement with the correct documentation. Specifically, all loans submitted for endorsement after 60 days of closing, or that are re-submitted for endorsement and require copies of pay histories are now required to have the insuring department supervisor review and initial the loan file to assure that the pay history is correct and the submission is in compliance with HUD guidelines. As a result of this change, Gershman believes that its late requests for endorsement will be fully consistent with HUD guidelines.

The auditors state that Gershman submitted five loans for insurance endorsement that did not have acceptable payment histories. Gershman's review of the loan files disclosed that in three cases, the monthly payments were made timely but one of the payments was returned on all three cases for insufficient funds. The borrowers replaced the insufficient funds check the month following the payment due date.

We address below each of the five loans.

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[redacted]

FHA Case #292-4263088

The April 2003 payment was made on April 16 but was returned for insufficient funds on May 6. The borrower replaced the check on May 21. Gershman was not able to send the file for insuring within 60 days of loan closing as the loan was missing documentation from the co-signor. Gershman's employee submitted the file for insuring with the pay history showing the returned check.

[redacted]

FHA Case #292-4083810

This file was submitted for insuring within 60 days of loan closing. It was returned for additional information. The February 2002 payment was made on March 1, 2002. Gershman's employee returned the file to HUD for insuring with the pay history showing the February payment made on March 1, 2002. The payment was made within 30 days of its due date, but was not made within the month due, as February only had 28 days.

[redacted]

FHA Case #292-4200558

This file was submitted to HUD within 60 days of loan closing but was returned for additional documentation. The case was resubmitted to HUD with a pay history showing the September 2002 payment made on October 29. Gershman's employee returned the file to HUD for insuring with the pay history showing the returned check.

[redacted]

FHA Case #292-4329421

This file was submitted to HUD within 60 days of loan closing but was returned because the zip code in HUD's system for the Condominium project did not match the property zip code on our documents. The remarks section of the Condominium detail in HUD Connection states there is a zip code discrepancy. We copied this page and returned the file to HUD and it was insured. Gershman's employee returned the file for insuring with the pay history showing the returned check.

[redacted]

FHA Case #292-4294692

This file was submitted to HUD after 60 days of loan closing and had an acceptable pay history. The file was returned for MIP payment. After this was paid and processed, the file was resubmitted. The May 2003 payment had been returned for insufficient funds and not made good until sometime in June. Gershman's employee returned the file for insuring with the pay history showing the returned check.

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Quality Control

OIG Finding:

Gershman was deficient in its Quality Control Review Activities.

GIC response:

Gershman has always maintained a comprehensive quality control plan for the origination of HUD-FHA-insured mortgages. Gershman is committed fully to quality control and strict compliance with HUD-FHA requirements. Gershman recognizes, however, that there were some shortcomings regarding the timelines and sample size of its quality control reviews. Importantly, however, these concerns were for the most part the result of the failure by Gershman's former outside quality control firm to conform fully with HUD requirements. Gershman properly and in good faith relied upon this experienced quality control firm to perform quality control reviews for Gershman in compliance with HUD requirements. As a responsible lender committed to strict compliance with HUD requirements, Gershman has implemented the necessary corrective action and is presently in full compliance with HUD's Quality Control Plan requirements.

Gershman has been subject to audits and reviews by HUD and OIG staff every 2-3 years since receiving its approval as a Direct Endorsement lender in 1983. The last audit conducted by the OIG was in March 1987 and the last HUD review was in June of 2002. These audits and reviews have always included a review of our Quality Control function. Significantly, Gershman's Quality Control has always received a favorable review by the auditors and HUD staff. Gershman has always been in compliance with HUD requirements. During an audit in the mid 1990's, Gershman was verbally advised by HUD staff that it was the "flagship" lender in the Midwest Region for its compliance with HUD guidelines and regulations given our status as the largest FHA lender in the St. Louis area. During this time, quality control was performed by Gershman through its

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Internal Audit Department. This department was responsible for selecting and reviewing the 10% sampling of the monthly closed loans. It also performed the Quality Control for Gershman's loan servicing area as well.

In December of 1999, Gershman made the business decision to outsource the Quality Control review of its closed loan files in anticipation of selling its single family loan servicing portfolio. This would involve downsizing its servicing department. Gershman decided to look at alternatives for the Quality Control review of closed loan files. Industry sources including the MBA of America and America's Mortgage Coalition recommended that we consider outsourcing the Quality Control file review. America's Mortgage Coalition is a group of 25 small to mid size lenders working together to develop ideas and pool resources to help us remain competitive in the mortgage business particularly the national mega lenders. Many mortgage companies in the industry especially the small to mid size lenders had chosen to outsource Quality Control as a means to reduce cost and assure compliance with HUD-FHA guidelines. Gershman management operated in the belief that the third party Quality Control Company responsible for performing Gershman's Quality Control reviews would assure that the reviews were completed in a timely manner and in accordance with HUD-FHA guidelines.

After considering several experienced quality control firms, Gershman selected Firm A to perform the Quality Control reviews. After several months, into the relationship with Firm A, America's Mortgage Coalition for various reasons recommended that we use Firm B rather than Firm A. Gershman made the decision to change to Firm B in the beginning of 2002. All during this time, the Quality Control reviews were being properly completed and management reports were issued. Gershman's management would analyze these reports and made necessary adjustments to its loan origination procedures.

Firm A conducted Gershman's Quality Control reviews for the period August 2001 – September 2001. The review process by them was started within 90 days of closing.

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During this period, the quality control review was completed timely on 11 of the 21 loans selected. The other files were sent to Firm A, upon receipt of the insuring certificate from HUD. Due to the historic low interest rates and volume of refinancing activity, Gershman's Insuring Department was backed up due to an extremely high volume of loan closings. This was also the case with HUD's own performance in insuring loans.

During the period Firm B was performing Quality Control for Gershman, there were approximately 12 months that the closing log was not sent to Firm B to begin the review within the 90 day time period. This occurred because Gershman's Quality Control employee was told by Firm B to wait for the prior month review to be completed before sending the next list. She would call Firm B once a week to get a status on the review of the loan files. She was told by Firm B that they were behind and to not send them more files until they completed what they had. During this time, she was asked by Firm B on numerous occasions to re-submit the monthly closing list that she had already sent. Firm B could not locate the list she had sent while prior month files were being reviewed. **Exhibit 1.** There were periods that Firm B elected to make reviews on a quarterly basis. Gershman in good faith believed that Firm B was in compliance with HUD guidelines. Again, Gershman believed that Firm B would notify Gershman if we were not in compliance with HUD requirements. When Gershman determined that the Quality Control reviews were not being conducted timely, Gershman promptly terminated its relationship with Firm B and changed its Quality Control provider.

In September of 2003, Gershman went back to using Firm A and has since brought the Quality Control reviews current. The September 2003 files were submitted to Firm A for review on December 5, 2003. The reviews for October 2003, November 2003, December 2003, January 2004, and February 2004 have been completed in compliance. The March 2004 files have been submitted for review.

During this period, Gershman, on a regular basis, conducted internal reviews of all early default loans. Gershman closely monitored the Neighborhood Watch reports to detect early defaults. From this review, Gershman has been able to substantially reduce its early

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default ratio. After Gershman sold its servicing portfolio and no longer serviced the loans originated, our early default ratio increased. Our early default ratio was equivalent to the HUD average for most of 2001. Our early default ratio was 171% of the HUD average in September of 2002 and varied through July of 2003. This was due to refinance activity. Our constant review of these early defaulted loans and changes to our underwriting procedures, have contributed to our early default ratio decreasing to 63% of the HUD average for our region. Gershman respectfully submits that this demonstrates clearly its commitment to quality control and quality loan origination.

There were 6 months that the OIG auditors indicated that the 10% sampling requirement had not been met. In September of 2001, Firm A had requested 6 files but the Gershman Quality Control staff only sent 5. The last file was not sent in error. For the months of March, April and May of 2002, the Quality Control review was conducted on a quarterly basis. The 10% sample that Firm B selected was based on the total number of FHA loans closed for the first and second quarter of 2002. Gershman believed that this was acceptable to HUD as we were following Firm B's instructions. In July of 2002, Firm B had counted 32 FHA loans and selected 3 for review. The actual number of FHA loans closed was 39. This was an error made by Firm B For October of 2002, we have confirmed that 5 FHA loans were reviewed. The auditors mentioned that the July 2003 Quality Control files were not available for review. Gershman respectfully submits that the auditors are incorrect in this regard. This review was completed by Firm A December 11, 2003 and the files were, in fact, available for review by the auditors.

Gershman has an effective Quality Control program in place and is in compliance with the HUD requirements. Gershman has taken the necessary steps to assure that the Quality Control reviews are being completed timely. This is evidenced by the fact that the Quality Control reviews have been started and completed within 90 days for the last 6 months. Further, the loan sample size for loans reviewed is in full compliance with HUD requirements. As stated previously, it also should be noted that the Quality Control has not been an issue in prior HUD audits or reviews. Gershman respectfully submits that the shortcomings cited by the auditors are not representative of Gershman's overall quality control review activities. This is further supported by the decrease in our early default ratio to a current level of 63% of the HUD average.

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