AUDIT REPORT

Fairfield Financial Mortgage Group, Inc., Danbury, Connecticut, Did Not Always Comply with Federal Housing Administration Requirements

2005-BO-1007

September 26, 2005

OFFICE OF AUDIT, REGION 1
Boston, MA

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TO: Brian D. Montgomery, Assistant Secretary for Housing-Federal Housing Commissioner, H

Michael A. Motulski

FROM: For John A. Dvorak, Regional Inspector General for Audit, 1AGA

SUBJECT: Fairfield Financial Mortgage Group, Inc., Danbury, Connecticut, Did Not Always Comply with Federal Housing Administration Requirements

HIGHLIGHTS

What We Audited and Why

We audited Fairfield Financial Mortgage Group, Inc. (Fairfield Financial), a nonsupervised lender approved by the U.S. Department of Housing and Urban Development (HUD) to originate Federal Housing Administration-insured single-family mortgages. We selected Fairfield Financial for review because of risk factors associated with defaulted loans, including higher risk multiunit properties, early payment defaults, and income-excessive obligations cited for several defaulted loans, which suggested potential problems with the qualifying documentation.

Our objectives were to determine whether Fairfield Financial complied with HUD regulations, procedures, and instructions in the origination of Federal Housing Administration loans and whether Fairfield Financial's quality control plan, as implemented, met HUD requirements.

What We Found

Fairfield Financial did not always comply with HUD regulations, procedures, and instructions in the origination of Federal Housing Administration loans. It improperly originated 4 of the 24 loans reviewed. These four loans contained deficiencies that affected the insurability of the loans, including unsupported income, underreported liabilities, excessive qualifying ratios, and derogatory credit information. As a result, HUD insured loans that placed the insurance fund at risk for $1,204,981. In addition, Fairfield Financial did not properly disclose to borrowers $11,390 for commitment fees in 20 of the 24 loans reviewed.

Further, Fairfield Financial's quality control plan, as implemented, did not meet HUD requirements. Its written quality control plan lacked required elements, and it did not implement procedures to ensure that reviews of early defaulted loans took place or that its operations complied with fair lending laws. As a result, HUD lacks assurance that Fairfield Financial is able to ensure the accuracy and completeness of its loan origination operations.

What We Recommend

We recommend that the assistant secretary for housing-federal housing commissioner require Fairfield Financial to (1) indemnify HUD against future losses on the four loans totaling $1,204,981 and (2) revise its procedures to ensure that each borrower charged a commitment fee is properly informed, in writing, of the fee, the amount of the fee, and the purpose of the fee, and that the actual fee charged coincides with the amount disclosed to the borrower. Additionally, HUD should require Fairfield Financial to implement controls to ensure that it follows HUD's quality control requirements and verify that it has implemented proper controls.

For each recommendation in the body of the report without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided Fairfield Financial a draft report on August 24, 2005, and held an exit conference with Fairfield Financial officials on August 31, 2005. Fairfield Financial provided written comments on September 21, 2005, in which it generally expressed disagreement with finding 1 and agreement with finding 2.

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

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BACKGROUND AND OBJECTIVES

The National Housing Act, as amended, established the Federal Housing Administration, an organizational unit within the U.S. Department of Housing and Urban Development (HUD). The Federal Housing Administration provides insurance for lenders against loss on single-family home mortgages.

HUD approved Fairfield Financial Mortgage Group, Inc. (Fairfield Financial), as a nonsupervised direct endorsement lender on September 4, 1998. As a HUD-approved direct endorsement lender, Fairfield Financial can underwrite and close Federal Housing Administration loans without prior HUD review or approval.

Fairfield Financial originated 423 Federal Housing Administration-insured loans with mortgages totaling $79.6 million, which had beginning amortization dates (defined as one month before the first principal and interest payments are due) between January 1, 2003, and December 31, 2004. According to HUD's Neighborhood Watch system, 14 of the loans defaulted within the first two years of origination, equating to an average default rate of roughly 3.3 percent. This default rate compared favorably to the national average default rate of 4.2 percent during that same two-year period. As of the latest reporting period ending June 30, 2005, Fairfield Financial's two-year average default rate has declined to 3.1 percent, while the national two-year average default rate has increased to 4.6 percent. Fairfield Financial sells 100 percent of the loans it originates to the secondary market.

The audit objectives were to determine whether Fairfield Financial complied with HUD regulations, procedures, and instructions in the origination of Federal Housing Administration loans and whether Fairfield Financial's quality control plan, as implemented, met HUD requirements.

RESULTS OF AUDIT

Finding 1: Fairfield Financial Did Not Follow HUD Requirements When Originating Four Loans

Fairfield Financial did not follow HUD requirements when originating and approving 4 of the 24 loans reviewed. The loans contained deficiencies that affected the credit quality (insurability) of the loans. Fairfield Financial approved the loans based on unsupported income, underreported liabilities, excessive qualifying ratios, and derogatory credit information. The deficiencies occurred because Fairfield Financial did not exercise due care in originating and underwriting loans and did not adequately implement its quality control plan. As a result, HUD insured four loans that placed the Federal Housing Administration insurance fund at risk for $1,204,981. In addition, Fairfield Financial did not properly disclose to borrowers $11,390 for commitment fees in 20 of the 24 loans reviewed.

Loans Did Not Comply with HUD Requirements

Fairfield Financial originated four loans totaling $1,204,981 that contained significant loan origination deficiencies. These loans contained material errors, including unsupported income, underreported liabilities, inadequate qualifying ratios, and derogatory credit. Fairfield Financial's quality control process contributed to the loan origination deficiencies (see finding 2).

As of August 31, 2005, HUD's data systems showed that all four of the loans were actively insured with Federal Housing Administration insurance. HUD has not incurred any claims associated with these loans. The following table summarizes the mortgage amounts and categories of loan deficiencies.

Case #	Mortgage amount	Unsupported income	Underreported liabilities	Excessive qualifying ratios	Derogatory credit
251-3097987	$446,067	X		X	
251-2928528	296,656	X	X		
251-3084029	265,828			X	X
352-5211304	196,430		X	X	X
Total	**$1,204,981**	**2**	**2**	**3**	**2**

All four loans contained more than one deficiency. Descriptions of the deficiencies noted are presented below. Appendix C contains detailed narrative case presentations for each loan.

Unsupported Income

Fairfield Financial relied on unsupported income for two loans, case numbers 251-3097987 and 251-2928528. The anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt. Lenders may not use income in evaluating the borrower's loan that it cannot verify, is not stable, or will not continue. Overstating income affects the debt-to-income ratios. The use of incorrect income information could result in an invalid underwriting decision.

For example, Fairfield Financial originated case number 251-3097987 using a calculated monthly income of $4,687, consisting of $2,542 in base pay and $2,145 in overtime income. Fairfield Financial calculated the monthly income using only one of the pay stubs provided by the borrower, although the borrower provided six pay stubs and Internal Revenue Service W-2 forms from the prior two years. HUD requires that lenders develop an average of overtime income over the last two years or otherwise justify and document the reason for using the income. A more accurate estimate of the borrower's monthly income would have been an average of his 2003 earnings and year-to-date earnings. That calculation resulted in an average monthly income of $3,916, well below the income Fairfield Financial used to qualify the borrower.

Underreported Liabilities

Fairfield Financial did not consider all relevant liabilities when approving two loans, case numbers 352-5211304 and 251-2928528. HUD requires lenders to consider all recurring obligations, contingent liabilities, and projected obligations that meet HUD's specific stipulations when evaluating a loan application. Underreported liabilities affect the debt-to-income ratios. The use of incorrect liability information could result in an invalid underwriting decision.

For example, for case number 251-2928528, Fairfield Financial omitted liabilities for the borrower when evaluating the loan. It requested tax returns to support the borrower's income. However, the borrower was self-employed and had neglected to prepare and submit federal tax returns. Although the borrower submitted proforma tax returns, Fairfield Financial did not consider more than $32,300 in federal taxes and penalties owed by the borrower for the prior two tax years, as indicated on the unfiled tax returns. It was Fairfield Financial's obligation to consider this significant liability in evaluating the loan application and its impact on the borrower's capacity to repay mortgage debt.

Excessive Qualifying Ratios

Fairfield Financial allowed excessive qualifying ratios without valid compensating factors in three loans, case numbers 251-3084029, 352-5211304, and 251-3097987. HUD requires debt-to-income ratios not to exceed 29 and 41 percent (mortgage payment-to-effective income and total fixed payment-to-effective income ratio, respectively). Ratios exceeding 29 and 41 percent may be acceptable only if significant compensating factors are present. HUD identifies 10 compensating factors that may be considered to justify approving mortgage loans with qualifying ratios exceeding HUD's established thresholds. The three loans approved by Fairfield Financial did not adequately document any of the 10 compensating factors recognized by HUD.

For example, case number 352-5211304 had a mortgage payment-to-income ratio of 38.09 percent and a total fixed payment-to-income ratio of 43.50 percent. Fairfield Financial should have documented compensating factors to justify the excess ratios; especially considering that the borrower's housing payment was increasing 600 percent from $300 per month to just over $2,100 per month.

Derogatory Credit

Fairfield Financial did not properly evaluate the borrowers' past credit performance and ensure that the borrowers demonstrated financial responsibility in two of the four loans, case numbers 251-3084029 and 352-5211304. HUD considers past credit performance of the borrowers to be the most useful guide in determining the attitude toward credit obligations that will govern the borrowers' future actions. If the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan. While minor derogatory information occurring two or more years in the past does not require explanation, major indications of derogatory credit—including judgments, collections, and any other recent credit problems—require sufficient written explanation from the borrower.

For example, the borrower's credit report for case number 251-3084029 identified six different accounts that went into collection. Shortly before the loan application, all six of these accounts were brought current, and they all had no balances. Derogatory credit, including accounts in collection, requires a sufficient written explanation from the borrower. The borrower provided a letter of explanation, citing a divorce as the reason for falling behind on payments. The letter further indicated that efforts had been made over the last several months to settle and pay off the debts. The divorce cited by the borrower occurred approximately eight years before the loan application, and five of the six accounts in collection were opened after the divorce finalization. This does not constitute a sufficient written explanation.

$11,390 Charged for Commitment Fees without Adequate Disclosure

Fairfield Financial charged $11,390 for loan commitment fees, without adequate disclosure, in 20 of the 24 loans reviewed. Commitment fees are an allowable charge if there is a lock-in or commitment agreement, in writing, that guarantees the rate or discount points for a period of not less than 15 days before the anticipated closing date. Fairfield Financial did not provide adequate disclosure of written lock-in or commitment agreements to its borrowers as required. While these deficiencies did not affect the overall credit quality (insurability) of the individual loans, they do indicate a lack of full commitment to quality underwriting. Lenders need to ensure that they follow all facets of HUD requirements when originating Federal Housing Administration loans. We provided details of these deficiencies to Fairfield Financial during our review. Appendix D presents a table summarizing the commitment fees charged to borrowers for each of the 20 loans.

Conclusion

Fairfield Financial did not always exercise due care in originating and underwriting loans and did not adequately implement its quality control plan. As a result, Fairfield Financial originated four loans containing deficiencies that placed the Federal Housing Administration insurance fund at risk for $1,204,981. In addition, Fairfield Financial charged $11,390 for loan commitment fees, without adequate disclosure, in 20 of the 24 loans reviewed.

Recommendations

We recommend that the assistant secretary for housing-federal housing commissioner

1A. Require Fairfield Financial to indemnify HUD against future losses on the four loans totaling $1,204,981.

1B. Require Fairfield Financial to revise its procedures to ensure that each borrower charged a commitment fee is properly informed, in writing, of the fee, the amount of the fee, and the purpose of the fee, and that the actual fee charged coincides with the amount disclosed to the borrower.

Finding 2: Fairfield Financial's Quality Control Plan Did Not Comply with HUD Requirements

Fairfield Financial did not establish and implement an adequate quality control process in accordance with HUD regulations. Fairfield Financial's quality control plan did not include all of the HUD-required elements. In addition, its staff did not ensure that loans going into early payment default were reviewed as part of the quality control process or that its operations complied with applicable fair lending laws. Further, Fairfield Financial's quality control plan lacks specific procedures regarding single-family loan servicing. These deficiencies existed because of Fairfield Financial's lack of understanding concerning its responsibility to ensure that it met HUD requirements when contracting with an outside firm to perform quality control reviews. As a result, it was unable to ensure the accuracy and completeness of its loan origination operations, contributing to an increased risk of loss to the Federal Housing Administration insurance fund.

Outside Firm Contracted to Perform Quality Control Reviews

HUD provides that a lender may engage outside sources to perform the quality control function.[1] A lender contracting out any part of its quality control function is responsible for ensuring that the outside source meets HUD's requirements. Fairfield Financial contracted with an outside firm to perform its quality control reviews. It relied on the quality assurance program prepared by the contractor (Fairfield Financial's quality control plan). However, Fairfield Financial did not ensure that this program contained all HUD-required elements or that it completed quality control reviews in accordance with the plan.

Written Quality Control Plan Did Not Contain Required Elements

HUD provides that as a condition of HUD-Federal Housing Administration approval, lenders must have and maintain a quality control plan for the origination and servicing of insured mortgages. The quality control plan must be a prescribed function of the lender's operations and assure that the lender maintains compliance

[1] HUD Handbook 4060.1, REV-1, CHG-1, paragraph 6-3(B)(2).

with HUD-Federal Housing Administration requirements and its own policies and procedures.[2]

Fairfield Financial's quality control plan was not dated and did not include the following elements:

- Determine whether there are sufficient and documented compensating factors if the debt ratios exceed Federal Housing Administration limits.

- Determine whether all conditions were cleared before closing.

- Determine whether the seller acquired the property at the time of or soon before closing, indicating a possible property "flip."

Additionally, Fairfield Financial's quality control plan lacked specific procedures regarding single-family loan servicing. We recognize that Fairfield Financial intended to sell 100 percent of the loans it originated. However, from time to time and in varying degrees, it serviced the loans it originated, including Federal Housing Administration-insured loans.

Early Default and Rejected Loans Not Reviewed

Fairfield Financial did not fully implement its quality control plan. It did not ensure that quality control reviews were performed on all loans defaulting within six months of closing, as required and as outlined in its own quality control plan. This occurred because Fairfield Financial did not submit the required loan listing of early payment defaults to its quality control contractor. It mistakenly believed that this function was part of the quality control process of the secondary lending market in which it sells its loans. Accordingly, the contractor did not perform the required reviews.

Further, Fairfield Financial did not provide a list of rejected loans to its quality control contractor to use in performing quality control reviews. Without these reviews, there was no assurance that Fairfield Financial's operations complied with applicable fair lending laws. We noted that, with the exception of the four months between January and April 2004, Fairfield Financial did not provide the required rejected loan listing to its quality control contractor. Therefore, the contractor was unable to perform the required fair lending review. Fairfield Financial stated that this was an oversight.

[2] HUD Handbook 4060.1, REV-1, CHG-1, paragraph 6-1.

Fairfield Financial, along with its quality control contractor, expressed an interest in ensuring that its quality control plan meets HUD requirements.

Conclusion

Fairfield Financial did not establish and implement a quality control process that complied with HUD requirements. Its quality control plan lacked required elements necessary to conduct proper quality control reviews, and it did not ensure that it routinely provided adequate information to its quality control contractor to ensure that it conducted reviews in accordance with HUD requirements. Without a properly implemented quality control process, Fairfield Financial cannot ensure that its loan originations comply with HUD requirements; that it is protecting itself and HUD from unacceptable risk; and that it is guarding against errors, omissions, and fraud.

Recommendations

We recommend that the assistant secretary for housing-federal housing commissioner

2A. Require Fairfield Financial to establish and implement an adequate quality control process.

2B. Verify that Fairfield Financial's quality control process is fully implemented in accordance with HUD regulations.

SCOPE AND METHODOLOGY

Fairfield Financial originated 423 Federal Housing Administration-insured loans, which had beginning amortization dates (defined as one month before the first principal and interest payments are due) between January 1, 2003, and December 31, 2004. To achieve our objectives, we chose a nonrepresentative method to select loans for review from that period. This method allowed us to select Federal Housing Administration-insured loans with certain characteristics, enabling us to focus our review efforts on Federal Housing Administration-insured loans in which there was a greater inherent risk to the Federal Housing Administration insurance fund and/or risk of noncompliance or abuse.

We selected all 14 loans that defaulted within the first two years of loan origination for review and, based on the high percentage of defaulted loans that were multiunit, we selected an additional 10 multiunit loans for review. The results of our detailed testing only apply to the 24 loans reviewed and may not be projected to the universe of 423 Federal Housing Administration-insured loans.

We reviewed HUD's rules, regulations, and guidance for proper origination and submission of Federal Housing Administration loans. We interviewed HUD staff to obtain background information on HUD requirements and on Fairfield Financial, and we reviewed the HUD case binders for the 24 loans selected.

We interviewed Fairfield Financial's management and staff to obtain information regarding its policies, procedures, and management controls. We reviewed Fairfield Financial's written policies and procedures to gain an understanding of how its processes are designed to function. We also reviewed Fairfield Financial's quality control plan, as well as the quality assurance program of its quality control provider, and available quality control reports. Additionally, we reviewed Fairfield Financial's origination binders for the 24 loans selected for review.

We relied upon computer-processed data contained in HUD's Single Family Data Warehouse system. We assessed the reliability of these data, including relevant general and application controls, and found them to be adequate for the data obtained. We also performed sufficient tests of the data, and based on the assessments and testing, we concluded that the data are sufficiently reliable to be used in meeting our objectives.

The audit generally covered the period from January 1, 2003, through December 31, 2004. We expanded this period, when applicable, to include the most current data through August 31, 2005, while performing the audit. We performed our fieldwork from January through July 2005.

We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Program operations. Policies and procedures that management has implemented to reasonably ensure that the loan origination process complies with HUD/Federal Housing Administration requirements and that the objectives of the program are met.

- Validity and reliability of data. Policies and procedures that management has implemented to reasonably ensure valid and reliable data are obtained, maintained, and fairly disclosed in reports.

- Compliance with laws and regulations. Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

- Safeguarding of resources. Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- Compliance with laws and regulations. Fairfield Financial did not follow HUD requirements when originating four Federal Housing Administration-insured loans (see finding 1).

- Compliance with laws and regulations. Fairfield Financial has not implemented its quality control plan in accordance with HUD requirements (see finding 2).

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use 1/
1A	$1,204,981

1/ ”Funds to be put to better use” are quantifiable savings that are anticipated to occur if an Office of Inspector General (OIG) recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

Fairfield Financial Mortgage Group, Inc.

Mr. Michael A. Motulski
Assistant Regional Inspector General for Audit
Thomas P. O'Neil Jr. Federal Blvd.
10 Causeway Street, Room 370
Boston, MA 02222-1092

Mr. Todd M. Hebert
Senior Auditor
One Corporate Center
19th Floor
Hartford, CT 06103

Dear Sirs,

I want to begin by thanking you for your time and effort in reviewing Fairfield Financial Mortgage Groups processes and procedures. We also appreciate that OIG recognized the fact that our default rate of 3.3% compared favorably to the national average of 4.2%.

Comment 1

Concerning the IG's findings as they pertain to our quality control plan ("QCP"), we appreciate the IG's comments. We at Fairfield Financial Mortgage Group strive to originate only high quality loans for sale on the secondary market. We appreciate your time and effort reviewing the QCP, and we certainly strive not for minimum requirements but for best practices. Therefore, we will gladly make the changes you suggest. However, we would like to note that our QCP is not deficient. For example, HUD Handbook 4060.1 provides that the QCP should be effective on a given date but does not specifically call lack of a date appearing on the cover a deficiency. Indeed, that handbook describes itself as guidance and allows individualized changes. With that goal in mind we utilize a third party quality control company, [redacted], to provide independent quality control reviews and assist with the QCP. In addition to using an outside firm we also hired [redacted], in March of this year, as the quality control manager. [redacted] is a licensed attorney with a back round in mortgage banking. She will be working directly with the quality control company from this point forward. She will be responsible for putting together the file list for the quality control company's use in selecting the files they will be reviewing. A copy of a revised cover sheet the company will be using is attached. These efforts both predate and postdate the period of the files you reviewed, and are part of our ongoing effort to check and maintain our overall favorable performance.

Below are our responses to the four loans cited in the draft audit report under heading Finding 1. Our responses are individualized to address each case involved .

1 (800) 370-6669 (203) 740-7411 Fax (203) 740-7441
2 National Place, Danbury, CT 06810

Comment 2

Comment 3

Comment 4

Comment 5

Comment 6

Fairfield Financial Mortgage Group, Inc.

Case Number 251-3097987, [redacted] response –

FFMGI respectfully disagrees that the Borrower's income was incorrectly calculated. A verbal verification with his employer confirmed that [redacted] probability of continued employment was "very good." It also indicated that he was promoted the previous year to shift supervisor. He had just received a raise at the beginning of 2004. There are actually six pay stubs in the file dated between 2 – 5/04. Hours worked per week were 71, 60, 60, 67, 69 & 76. All indications in the file were that [redacted] is an extremely valuable and dedicated employee whose earnings were steadily increasing with stable overtime amounts. An average of his earnings prior to his elevated position with its increased overtime demands (he was now second shift supervisor which required the additional overtime) would have been inappropriate in the underwriters opinion.

OIG states "the borrower only put down $500.00" and did not show the ability to save money. OIG also noted that the remaining down payment was a gift from his mother. In HUD 4155.1, Rev. 5, Chapter 2-10 ("Funds to Close"), Paragraph C, it states quite clearly "an outright gift of the cash investment is acceptable if the donor is the borrower's relative," so the gift was consistent with HUD instructions. Also, the Borrower had nearly $7,000 in his retirement account showing the ability to save.

This loan was underwritten and closed in 5/04. At that time, it was completely acceptable to qualify the Borrower at the first year bought-down rate. HUD did not change their policy with respect to temporary buy downs until they issued Mortgagee Letter 2004-28 on 7/21/04. Once again, FFMGI was underwriting to the then applicable HUD guidelines and should not be held to a standard that was not in place at that time. For these reasons, FFMGI should not be required to indemnify HUD for this loan.

It should be noted that the underwriter on this file is no longer employed with Fairfield Financial Mortgage Group, Inc.

Case Number 251-2928528, [redacted] response –

FFMGI disputes the fact that the Borrower's income was not sufficiently established. Also, there was no question as to his self-employment. There are two years signed Federal Tax Returns in the file. While the preparer did not sign the actual returns, there is a cover letter on company letterhead in the file that was signed by the preparer. There was also a year-to-date profit-and-loss statement in the file that was not required by the automated underwriting approval.

A copy of the business certificate from the [redacted] is in the file. It is here that the social security is not our Borrowers. This is not a conflict, however because this is [redacted] business partner, and it appears the signature below the number is the partners's signature. [redacted] correct social security number and signature is present on page two of the business certificate..

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2 National Place, Danbury, CT 06810

Comment 7

There are statements in the file from a business checking account for [redacted]. [redacted] name is on this account. There are cancelled checks from [redacted] that clearly show [redacted] as a signer on this account. There is an affidavit from his accountant in the file regarding this account and [redacted] free access to it. There is evidence in the file that [redacted] sold some business equipment as an officer of this company. There is certainly more than enough evidence that the Borrower was, in fact, self-employed.

Comment 8

Other than the explained signatures on the business certificate, there are no discrepancies with the Borrower's social security number in the file. There is also no warning on the credit report. This warning would presumably occur if there was any question as to the accuracy of the social security number. Such a warning would have prompted further research from the underwriter.

Comment 9

In response to the underreported liabilities, we refer you to 4155.1, Rev. 5, Chapter 2-5b, which provides a Borrower is eligible if a satisfactory repayment plan is made between the borrower and the Federal agency owed and is verified in writing. Fairfield had no knowledge that the bower had not filed his previous tax returns nor that he had not paid any tax liability due the IRS. It appears to me that the IG's auditor may have a question on the closing stip placed in the closing instructions to the closing agent which states "Completed/Signed IRS 1040's for 2001 and 2002. The stipulation appearing on the closing instructions is a routinely used stipulation instructing the closing agent to have the previously supplied returns signed along with all the other closing documents. This stipulation is a pre set stipulation appearing in our loan origination system, see exhibit 1.

Comment 10

The Borrower had no additional liabilities other than this mortgage. He could have handled up to $350.00 in additional monthly debt and still have been within HUD's guideline of a 41% debt ratio. This amount would generally far exceed what his liability would be with the IRS. Had FFMGI documented this tax liability, this loan would have still been approved.

Comment 11

We checked Neighborhood Watch this morning and his loan does not appear in the early warning default section. Under these circumstances, FFMGI should not have to indemnify this loan.

It should be noted that the underwriter on this file is no longer an employee of Fairfield Financial Mortgage Group.

Case Number 251-3084029, [redacted] response –

Upon review of this file, there were compensating factors present to exceed the standard FHA ratios of 29/41%. The Borrower had over four months in reserves, exclusive of gift funds.

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2 National Place, Danbury, CT 06810

Comment 12

Comment 13

Comment 14

Fairfield Financial Mortgage Group, Inc.

The Borrower had accounts at [redacted] as follows: $15,752, which included $7,882 from her 401(k) and a $3,000 gift from her mother; and various other accounts totaling $192. From the [redacted] account with $15,752 in it, a deposit check of $13,500 was written. This left a balance of $2,252. The underwriter appropriately applied the gift funds toward the down payment, leaving only her own funds as reserves. In HUD 4155.1, Rev. 5, Section 2-10 ("Funds to Close"), Paragraph C indicates "an outright gift of the cash investment is acceptable if the donor is the Borrower's relative."

After closing, the Borrower was left with the following assets: $2,252 in checking; $192 in the other [redacted] accounts; $2,515 left in retirement after the $7,882 loan; 60% of this was used for reserves as is standard practice for retirement accounts, giving her $1,509 for reserves; $4,840 in excess deposit returned to the Borrower at closing. Total reserves were $8,793. Based on her monthly payment of $2,023, this would give her 4.3 months in reserves.

In reviewing the compensating factors in HUD 4155.1, Rev. 5, Chapters 2-12(A) and 2-12(B), a case can be made that compensating factor C also applies. It states "The Borrower has demonstrated an ability to accumulate savings and a conservative attitude toward the use of credit." The Borrower had over $10,000 in retirement and another $4,000 in checking prior to the deposits. This level of savings is not typical of an FHA Borrower.

A closer review of the collection accounts on the credit report show that five out of the six accounts actually went into collection within 12-24 months of the Borrower's divorce. Her explanation does adequately explain the circumstances that led to these collections. There are no recent derogatory accounts on her credit report. A review of the past 24 months shows that the Borrower was successfully managing her liabilities.

[redacted] provided a letter explaining that she was left with all the debt form a previous marriage, which can take many years to resolve and can have a cascade effect on further borrowing. However, the savings rate and recent credit seemed to offset these concerns. It is also important to make clear that no account was charged off with any remaining outstanding balance. That is to say, the borrower never settled for less than the full balance owed. She may have taken a long time paying some things off but she never quit making payments insuring complete restitution to her creditors. The accounts the OIG sites as being after her divorce are [redacted]. All accounts were settled prior to our loan closing. Her letter does address the fact that some of the prior debts were due to the divorce but in general it states further that she was the sole provider for herself and three children. This accounts for the trouble she had paying off some debts in a timely manner. It does not specifically say all the debts were taken out prior to the divorce. [redacted] always had the option of claiming bankruptcy but she never took that route.

The underwriter who underwrote this file is no longer employed by this company.

1 (800) 370-6669 (203) 740-7411 Fax (203) 740-7441
2 National Place, Danbury, CT 06810

Comment 15

Comment 16

Comment 17

Comment 18

Comment 19

Fairfield Financial Mortgage Group, Inc.

An additional note to this file is that [redacted] sold the subject property on 8/31/05. Accordingly, there is no need to provide any indemnification for this loan, nor do we believe it would be appropriate.

Case number 352-5211304, [redacted] response –

In reexamining the file it provides documentation of the two loans. We've spoken to the prior underwriter, [redacted] (no longer employed at FFMGI), and he did not recall much of the information in the file. We also spoke to the originator, [redacted] (also no longer with FFMGI), who had a clear recollection of the files. One concern the IG raises is in the event other properties are owned, the qualifying process must include the analysis of that information. We believe the file reflects the two properties at issue, but agree that the file documentation should be improved and the analysis should have been contained in the file documentation. We believe that this was an isolated issue and might recommend additional training to assure best practices, but as they are no longer employed by FFMGI that seems outside of FFMGI's control.

We understand that the IG raised a concern over the borrowers' debt ratios and not using a debt in the amount of $190.00 per month when calculating that ratio. That debt was an installment loan with a balance of $520.00. The credit report is dated 03/09/2004. The first payment due on this mortgage was 08/01/04. Based upon the monthly payment of $190.00 and the balance being only $520.00, this loan would be paid off before our mortgagees first payment was even due. Therefore, we do not believe this debt adversely affected the borrowers' ability to make his new mortgage payment.

The IG cited a concern about the increase in the borrowers' monthly housing payment as it relates to his previous monthly housing payment. The new monthly mortgage payment is $2,119.91. The borrowers' previous monthly housing payment was $300.00 However, we would like to point out that the property purchased was a three family dwelling. The gross rental income for the other two units is $1,450.00 per month. Using a vacancy factor of 15%, the monthly rental income to the borrower would be $1,232.50 leaving a net mortgage payment of $887.41. Using a gross rental amount of $1,450.00, which would be what a borrower would look at when making a purchase decision; they would be left with a net mortgage payment of just $669.91. Given these facts the percentage of increase in the borrowers' monthly housing expense is significantly less than the 600 percent cited in the report.

About the issues brought up concerning the charging of commitment fees. Attached is a list of the 20 loan cited in the draft audit report. The data on the spread sheet we provided is taken from our loan origination system. It shows when the loans were locked for the customers, committed by us and the closed date. We have also attached with the spread sheet copies of 12 commitment letters evidencing that each borrower was locked in for a minimum of 15 days. As far as the other 8 files we have included copies of our

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Fairfield Financial Mortgage Group, Inc.

investor locks showing the borrowers were locked in prior to or on the day of the issuance of their commitment letters. It is clear to me that whenever a borrower is issued a commitment letter that commitment contains a rate lock that is in force for a minimum of 15 days. We feel that given the commitment letter contains the language "Rate Lock Expiration" and lists the date of the expiration the borrower is properly informed of their lock in protection.

If you have any questions concerning any of my responses to the draft audit please contact me directly at 203-740-7411 ext 111 or email at clevesque@ffmgi.com.

Sincerely,

Charles L. Levesque
President / CEO

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OIG Evaluation of Auditee Comments

Comment 1 Fairfield Financial agreed to make the recommended changes, but noted that their Quality Control Plan (QCP) was not deficient. As detailed in this report, Fairfield Financial's QCP is deficient, as it lacks HUD-required elements and procedures regarding single-family loan servicing.

Comment 2 Fairfield Financial disagreed that the borrower's income was incorrectly calculated. We agree that the loan file contained six pay stubs. The loan file also contained Internal Revenue Service W-2 forms for 2002 and 2003. Fairfield Financial, however, only used one of those pay stubs and none of the W-2 forms to calculate the borrower's base income, as well as the borrower's overtime income. This is not adequate and does not meet HUD/FHA requirements. Fairfield Financial stated that, an average of the borrower's earnings prior to his elevated position, with its increased overtime demands, would have been inappropriate in the underwriters opinion. We agree, and that's why we indicate in the report that a more accurate estimate of the borrower's monthly income would have been an average of his 2003 earnings (the year of his promotion) and his year-to-date earnings; not a single a pay stub.

Comment 3 We did not present this issue in the audit report. Fairfield Financial is referring to comments we made in an earlier OIG letter, dated June 9, 2005, in which we detailed our preliminary concerns and provided Fairfield Financial an opportunity to respond. Fairfield Financial did not revise its comments prepared in response to that letter to reflect only the issues presented in the audit report. As we did not carry this issue forward to the audit report, we offer no response.

Comment 4 We agree that the loan closed in May 2004, and that it was completely acceptable to qualify the borrower at the first year bought-down rate. Regardless of whether the loan closed prior to, or subsequent to May 2004, Fairfield Financial was required to establish that the eventual increase in mortgage payments would not adversely affect the borrower and lead to default. Fairfield Financial did not establish, or document as required, that the eventual increase would not adversely affect the borrower.

Comment 5 Fairfield Financial disagrees that the borrower's income was not sufficiently established. Prior to his mortgage application, the borrower failed to prepare Federal tax returns for the prior two years and, most likely, for prior years as well. The Federal tax returns included in the loan file indicated that they were prepared by a "paid preparer" on March 26, 2003, but did not include the paid preparer's signature. Further, the borrower did not sign and date the tax returns until the day of his loan closing. There is no indication that those returns were ever filed or accurately reflect the borrower's self-employment income. Our main concern lies with the $32,000 plus owed for taxes and penalties reflected on the 2001 and 2002 tax returns and not considered by Fairfield Financial during the underwriting process (see comment 10).

Comment 6 The loan file does contain a conflicting Social Security number for the borrower. The loan file contains two separate certificates from the City of Brockton; one from 1998 and one from 2002. Both certificates include the borrower's printed name and signature, but reflect two different Social Security numbers. There is nothing in the loan file indicating that the conflicting Social Security number is that of the borrower's business partner.

Comment 7 We do not dispute that the borrower appears to be self-employed.

Comment 8 We agree that the loan file does not contain any other Social Security discrepancies and that the credit report did not contain a warning.

Comment 9 We disagree that Fairfield Financial was unaware that the borrower had not filed previous tax returns or that he had not paid any tax liability to the Internal Revenue Service. The tax returns for 2001 and 2002 are both dated by the "paid preparer" on March 26, 2003, providing evidence that they were prepared at the time of the borrower's application for a mortgage loan. The tax returns clearly indicate the tax liability and penalties of over $32,000 and there is no indication in the loan file that Fairfield Financial considered this, as required. Fairfield Financial correctly pointed out that the borrower would be eligible if the delinquent account was brought current, paid, or otherwise satisfied or a satisfactory repayment plan was made between the borrower and the Federal agency owed and verified in writing. There is no indication that Fairfield Financial made any effort to determine if this occurred. Further, our concern did not lie with the closing stipulations or instructions, but with the timeliness of the returns and the significant liability owed by the borrower that was not addressed by Fairfield Financial.

Comment 10 Fairfield Financial did not consider the borrower's significant liability in evaluating the loan application and its impact on the borrower's capacity to repay mortgage debt, as required. Neither the loan file nor the HUD case binder provided any justification for moving forward with this loan or any evidence that the borrower brought current, paid, or otherwise satisfied the delinquent account. Further, Fairfield Financial presumes to know what the borrower's liability with the Internal Revenue Service would be. In the absence of a repayment agreement, the borrower's liability is unknown. The tax returns in question represent only two years and the borrower was self-employed prior to that. Therefore, it is likely that the borrower's liability to the Internal Revenue Service may far exceed the $32,000 owed for the 2001 and 2002 tax years.

Comment 11 We agree with Fairfield Financial that, as of August 31, 2005, the loan does not appear in the early warning default section of HUD's Neighborhood Watch system. This does not excuse Fairfield Financial from adhering to HUD/FHA regulations in the origination and underwriting of FHA-insured loans.

Comment 12 Again, Fairfield Financial is referring to comments we made in an earlier OIG letter, dated June 9, 2005, in which we detailed our preliminary concerns and provided Fairfield Financial an opportunity to respond. Fairfield Financial did not revise its comments prepared in response to that letter to reflect only the issues presented in the audit report. We agree that the borrower had three months of reserves, as reflected in the audit report. The borrower's fixed payment to effective income ratio, however, was 49.90, well above the HUD/FHA threshold.

Comment 13 Fairfield Financial presented the argument that an additional compensating factor was present. The loan file, however, only included two compensating factors on the Mortgage Credit Analysis Worksheet (MCAW); "3-months reserves" and "job longevity." We agree that the borrower had three months of reserves. Job longevity, though, is not recognized as a compensating factor. The loan file does not contain any other information or documentation regarding compensating factors present. If Fairfield Financial felt other compensating factors were relevant, they should have documented those factors on the MCAW as required.

Comment 14 Fairfield Financial stated that five of the six accounts actually went into collection within 12-24 months of the borrower's divorce. This is incorrect. In fact, four of the six accounts were not opened by the borrower until October 1999 or later, over three years after the divorce. Only one of the accounts was open prior to the divorce. This is why the borrower's explanation that the divorce caused her to fall behind on payments was inadequate, as five of the six accounts were opened subsequent to the divorce. It was not until the borrower applied for a mortgage loan that she made an effort to clear her delinquent accounts.

Comment 15 Fairfield Financial stated that the borrower sold the subject property on August 31, 2005 and that it would be inappropriate to indemnify the loan. A check of HUD's Neighborhood Watch system, as of August 31, 2005, showed that foreclosure was started on the subject property. If the property was in fact sold, we would still recommend that Fairfield Financial indemnify HUD from paying any claims or costs associated with this loan.

Comment 16 Fairfield Financial stated they no longer employ the underwriter or the originator of this loan. Fairfield Financial believes that the file reflects the two properties, but concedes that the file documentation should be improved and that the analysis should have been contained in the file documentation. We did not find that the loan file reflected both properties. The initial application included both properties, whereas, the final application reflected only the FHA-insured property. There was no explanation regarding the discrepancy between the initial and final application, as required. The borrower stated that the originator was well aware of his intent to purchase both properties, but he could not recall why the final application did not reflect this.

Comment 17 Fairfield Financial stated that the $190 debt was an installment loan with a balance of $520, based on a March 9, 2004, credit report. Fairfield Financial further stated that the loan would have been paid off prior to the first mortgage payment due August 1, 2004. This is incorrect. The credit report was ordered on March 9, 2004, but was revised as of June 7, 2004 and still reflected the $520 balance. We stand by our conclusion that the $190 monthly payment would have adversely affected the borrower's ability to make his mortgage payment in consideration that his monthly housing payment was increasing 600 percent.

Comment 18 Fairfield Financial stated that the property purchased was a three family dwelling and that, when the potential rental income is considered as an offset to the housing payment, the net increase to the borrower's monthly housing expense is significantly less than the 600 percent cited in the report. We disagree. As Fairfield Financial correctly stated, the borrower's previous monthly housing payment was $300. The new monthly housing payment was $2,120. This equates to over a 600 percent increase. Fairfield Financial is quick to point out that the potential rental income would reduce the burden on the borrower of meeting this increase, but neglects to mention the second property purchased by the borrower that also required a monthly housing payment. The fact remains that the borrower's monthly housing payment was increasing from $300 a month to over $2,100 a month, regardless of any other potential income sources.

Comment 19 Fairfield Financial provided twelve commitment letters evidencing that they locked in each borrower for a minimum of 15 days. For the remaining eight loans in question, Fairfield Financial provided copies of their investor locks showing the borrowers were locked in prior to or on the day of the issuance of their commitment letters. Fairfield Financial contends that the borrowers were properly informed of their lock in protection.

The commitment letters provided, in most cases, were not included in the loan files or the HUD case binders at the time of our review. We recognize that the borrowers received a rate lock for the commitment fees paid. We disagree, however, that the borrowers were properly informed. Of the twelve commitment letters, only seven included the correct commitment fee amount charged to the borrower. Furthermore, of the twelve commitment letters: two were not dated by the borrower; one was not signed or dated by the borrower; and the remaining nine were all signed on the date of the closing. We have no way of knowing whether the borrowers received any notification for the eight loans where Fairfield Financial was unable to provide commitment letters. Accordingly, we disagree that the borrowers were properly informed considering the inconsistent amounts listed on the commitment letters to what was actually charged and that the borrowers, in most cases, did not sign the commitment letters until the day of closing.

As this was the first review of Fairfield Financial, and it appears that the borrowers received a rate lock for the commitment fees paid, we revised our recommendation. We revised the recommendation from requesting repayment of the $11,390 charged, to require Fairfield Financial to ensure it properly discloses the fee to each borrower.

Appendix C

NARRATIVE OF LOAN DEFICIENCIES

Case number:	**251-3097987**
Mortgage amount:	**$446,067**
Date of loan closing:	**May 28, 2004**
Current status (as of August 31, 2005):	**Current**
Cause of default:	**Not applicable**
Number of payments before first default reported:	**Not applicable**
Unpaid principal balance (as of August 31, 2005):	**$439,634**

Summary:

Unsupported Income

The application indicated the borrower's total monthly employment income was $4,687, which consisted of $2,542 in base income and $2,145 in overtime income. Fairfield Financial computed the income during its verification process by using one of the borrower's pay stubs. While the year-to-date earnings reflected on the pay stub were sufficient to establish the borrower's base income, considering a recent raise, they were not sufficient to establish the overtime income of the borrower. HUD allows overtime income in qualifying a borrower so long as the borrower has earned overtime income for approximately two years. Otherwise, the lender must adequately justify and document its reasons for using the income.

The borrower's historical income data revealed that the borrower averaged only $3,153 per month in 2002, the year of his last promotion. In 2003, the borrower averaged $3,626 per month. A more accurate estimate of the borrower's monthly income would have been an average of his 2003 earnings and year-to-date earnings. That calculation resulted in an average monthly income of $3,916, including overtime, well below the $4,687 monthly income Fairfield Financial used to qualify the borrower. Using that income, the mortgage payment-to-effective income ratio increased from 39.10 to 43.78 percent, and the total fixed payment-to-effective income ratio increased from 44.00 to 49.20 percent.

Excessive Qualifying Ratios

Fairfield Financial exceeded HUD's allowable limits without compensating factors. The mortgage credit analysis worksheet showed the borrower's mortgage payment-to-effective income ratio as 39.10 percent and total fixed payment-to-effective income ratio as 44.00 percent. The worksheet indicated "credit an isolated situation" and "job longevity" as compensating factors. These are not included in the 10 compensating factors recognized by HUD. Also, as pointed out above, we calculated the debt ratios to be 43.78 percent and 49.20 percent based on the revised income calculation, further illustrating the need for compensating factors.

Other Deficiencies

Contrary to HUD requirements, Fairfield Financial approved a buydown interest rate loan without establishing and documenting that the eventual increase in mortgage payment would not adversely affect the borrower's ability to make higher mortgage payments in the future. As noted above, Fairfield Financial improperly calculated the borrower's monthly income, resulting in lower debt-to-income ratios. The debt-to-income ratios were actually much higher, which would have an adverse impact on the borrower's ability to make higher mortgage payments in the future.

Case number:	**251-2928528**
Mortgage amount:	**$296,656**
Date of loan closing:	**April 18, 2003**
Current status (as of August 31, 2005):	**Reinstated by borrower who retains ownership; December 1, 2003**
Cause of default:	**Other**
Number of payments before first default reported:	**Two**
Unpaid principal balance (as of August 31, 2005):	**$288,571**

Summary:

Unsupported Income

The application indicated the borrower was self-employed with total monthly employment income of $4,167. To support this income, Fairfield Financial requested federal tax returns for the past two years and learned that the borrower had not prepared the required tax returns. Fairfield Financial allowed the borrower to have the federal tax returns prepared. Although the borrower signed and dated the prepared tax returns, the preparer did not sign the tax returns, and there is no indication that the borrower ever filed the tax returns with the Internal Revenue Service. Further, the loan file contains a conflicting Social Security number for the borrower, as reported on the certificate he signed as the owner of the business. Fairfield Financial did not address this conflicting Social Security number and did not sufficiently establish the borrower's reported self-employment income.

Underreported Liabilities

In addition, Fairfield Financial omitted liabilities for the borrower when evaluating the loan. As noted above, Fairfield Financial requested tax returns to support the borrower's income. However, the borrower was self-employed and had neglected to prepare and submit federal tax returns. Although the borrower submitted proforma tax returns, Fairfield Financial did not consider more than $32,300 in federal taxes and penalties owed by the borrower for the prior two tax years, as indicated on the unfiled tax returns.

When a borrower is delinquent on any federal debt, HUD declares that 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 verified in writing. It was Fairfield Financial's obligation to consider this significant liability in evaluating the loan application and its impact on the borrower's capacity to repay mortgage debt. As there is no repayment agreement in place for the borrower's tax liability, we were unable to calculate the effect on the debt-to-income ratios.

Case number:	**251-3084029**
Mortgage amount:	**$265,828**
Date of loan closing:	**April 1, 2004**
Current status (as of August 31, 2005):	**Foreclosure started; August 1, 2005**
Cause of default:	**Inability to rent property**
Number of payments before first default reported:	**Four**
Unpaid principal balance (as of August 31, 2005):	**$261,357**

Summary:

Excessive Qualifying Ratios

Fairfield Financial exceeded HUD's allowable limits without compensating factors. The mortgage credit analysis worksheet showed the borrower's mortgage payment-to-effective income ratio as 42.94 percent and total fixed payment-to-effective income ratio as 49.90 percent. The worksheet indicated "job longevity" and "3-months reserves" as compensating factors. HUD does not recognize job longevity as a compensating factor. Although the borrower did have three months of reserves, HUD requires that the lender judge the overall merits of the loan application when determining to what extent the ratios may be exceeded. Considering the excessive ratios and the derogatory credit detailed below, the one compensating factor cited by Fairfield Financial was not sufficient to qualify the borrower.

Derogatory Credit

The borrower's credit report identified six different accounts that went into collection. Derogatory credit, including accounts in collection, requires a sufficient written explanation from the borrower. The borrower provided a letter of explanation, citing a divorce as the reason for falling behind on payments. The letter further indicated that efforts had been made over the last several months to settle and pay off the debts. The divorce cited by the borrower occurred approximately eight years before the loan application, and five of the six accounts in collection were opened after the divorce finalization. This did not constitute a sufficient written explanation.

Case number:	**352-5211304**
Mortgage amount:	**$196,430**
Date of loan closing:	**June 14, 2004**
Current status (as of August 31, 2005):	**Reinstated by mortgagor who retains ownership; December 31, 2004**
Cause of default:	**Curtailment of borrower income**
Number of payments before first default reported:	**One**
Unpaid principal balance (as of August 31, 2005):	**$194,304**

Summary:

Underreported Liabilities

The borrower's initial loan application indicated rental income from a single-family residence suggesting that he owned another residence. The final loan application did not include the rental income from this single-family residence and further indicated that the borrower did not own any other real estate. HUD requires a satisfactory letter of explanation from the borrower addressing any significant variances between the initial application and final application. Fairfield Financial did not document how this discrepancy was resolved and should have asked the borrower about this potential other property so that it could consider the asset and corresponding liability in the qualifying process.

We learned that the borrower purchased two properties from the same seller, including the Federal Housing Administration property. The borrower closed on the other single-family property in the month before closing on the Federal Housing Administration property. The borrower stated that Fairfield Financial was aware of his intent to purchase both properties, but he was supposed to close on the Federal Housing Administration property first. Regardless of the order of closings on the properties, Fairfield Financial was obligated to include this liability in its analysis.

Additionally, the borrower's credit report included a $190 monthly payment to one creditor. Fairfield Financial excluded the debt because there were fewer than 10 monthly payments left on the obligation. HUD requires that lenders include debts lasting less than 10 months if the amount of the debt will affect the borrower's ability to make the mortgage payment during the months immediately after loan closing. In this instance, the borrower's monthly housing payment was increasing from $300 per month to more than $2,100 per month, a 600 percent increase. The borrower also owned another property on which he was making mortgage payments. Considering this substantial increase and the borrower's obligations to his other property, the additional $190 monthly payment would adversely affect the borrower's ability to make his mortgage payments.

Excessive Qualifying Ratios

Fairfield Financial exceeded HUD's allowable limits without compensating factors. The mortgage credit analysis worksheet showed the borrower's mortgage payment-to-effective income ratio as 38.10 percent, requiring compensating factors, and total fixed payment-to-effective income ratio as 40.10 percent. Including the $190 monthly payment excluded by Fairfield Financial (detailed above), we calculated the total fixed payment-to-effective income ratio at 43.50 percent, also requiring compensating factors. Fairfield Financial did not document compensating factors. We were unable to determine what effect the borrower's other property would have on the debt-to-income ratios.

Derogatory Credit

The borrower's credit report identified a past judgment, various late payments, and six different accounts that went into collection. Derogatory credit, including accounts in collection, requires a sufficient written explanation from the borrower. The borrower provided a letter of explanation citing that the derogatory credit items were due to address changes and extended vacations and that he was a victim of identity theft. Address changes and extended vacations were not sufficient explanations, and there was nothing in the loan file or otherwise documented by Fairfield Financial substantiating that the borrower was a victim of identity theft.

Other Deficiencies

Fairfield Financial did not ensure the loan complied with HUD's self-sufficiency requirements, as required. As a result, the monthly mortgage payment exceeded the property's monthly net rental income, resulting in an over-insured loan.

Appendix D

COMMITMENT FEES CHARGED TO BORROWERS

Case #	Description of fee	Fee charged
061-2594624	Commitment fee; inadequate disclosure	$180
251-2948755	Commitment fee; inadequate disclosure	500
061-2662310	Commitment fee; inadequate disclosure	595
061-2672274	Commitment fee; inadequate disclosure	595
251-2877993	Commitment fee; inadequate disclosure	595
251-2928528	Commitment fee; inadequate disclosure	595
251-2978060	Commitment fee; inadequate disclosure	595
251-2987969	Commitment fee; inadequate disclosure	595
251-2992447	Commitment fee; inadequate disclosure	595
251-3040714	Commitment fee; inadequate disclosure	595
251-3041749	Commitment fee; inadequate disclosure	595
251-3059409	Commitment fee; inadequate disclosure	595
251-3066191	Commitment fee; inadequate disclosure	595
251-3084029	Commitment fee; inadequate disclosure	595
251-3097987	Commitment fee; inadequate disclosure	595
251-3099102	Commitment fee; inadequate disclosure	595
352-5211304	Commitment fee; inadequate disclosure	595
352-5303820	Commitment fee; inadequate disclosure	595
374-4333229	Commitment fee; inadequate disclosure	595
374-4399067	Commitment fee; inadequate disclosure	595
Total		**$11,390**

Appendix E

AUDIT CRITERIA

HUD Handbook 4060.1, REV-1, CHG-1, "Mortgagee Approval Handbook," Chapter 6, "Quality Control Plan," provides guidelines and requirements to be implemented by all lenders.

Paragraph 6-1 requires all Federal Housing Administration-approved lenders, including loan correspondents, to implement and continuously have in place a quality control plan for the origination and/or servicing of insured mortgages as a condition for receiving and maintaining Federal Housing Administration approval. The quality control plan must be a prescribed and routine function of the lender's operations and assure that the lender maintains compliance with HUD-Federal Housing Administration requirements and its own policies and procedures.

Paragraph 6-3 contains the basic elements that are required in all quality control programs. The lender must properly train its staff involved in quality control and provide them with access to current guidelines relating to the operations that they review. It is not necessary for lenders to maintain these guidelines in hard copy format if they are accessible in an electronic format. Many of the statutes, regulations, HUD handbooks, and mortgagee letters that establish the requirements for Federal Housing Administration programs may be accessed through HUD's home page on the World Wide Web.

Paragraph 6-6C, "Sample Size and Loan Selection," states that a lender originating 7,000 or fewer Federal Housing Administration loans per year must review 10 percent of the Federal Housing Administration loans it originates.

Paragraph 6-6D, "Early Payment Defaults," provides that in addition to the loans selected for routine quality control reviews, lenders must review all loans going into default within the first six payments. Early payment defaults are loans that become 60 days past due.

Paragraph 6-7 prescribes minimum elements for the production portion of a quality control program. The lender must address the following elements, among others:

- Determine whether there are sufficient and documented compensating factors if the debt ratios exceed Federal Housing Administration limits (paragraph 6-7J).
- Determine whether all conditions were cleared before closing (paragraph 6-7 L).
- Determine whether the seller acquired the property at the time of or soon before closing, indicating a possible property "flip" (paragraph 6-7P).

HUD Handbook 4000.4, REV-1, CHG-2, “Single Family Direct Endorsement Program,” paragraph 2-1, states that a lender must conduct its business operations in accordance with accepted sound mortgage lending practices, ethics, and standards.

Paragraph 2-4C states that lenders are expected to exercise due diligence in the underwriting of loans to be insured by the Federal Housing Administration.
HUD Handbook 4155.1, REV-4, CHG-1 (September 1995) and HUD Handbook 4155.1, REV-5 (October 2003), “Mortgage Credit Analysis for Mortgage Insurance on One- to Four-Family Properties,” requires lenders to determine the borrowers’ ability and willingness to repay the mortgage debt and, thus, limit the probability of default or collection difficulties. Lenders should evaluate the stability and adequacy of income, funds to close, credit history, qualifying ratios, and compensating factors. Lenders must ensure the application package contains sufficient documentation to support their decision to approve the mortgage loan.

Paragraph 1-8C imposes self-sufficiency requirements on three- and four-unit properties as follows:

> “THREE- AND FOUR-UNIT PROPERTIES, regardless of occupancy status, must be self-sufficient, i.e., the maximum mortgage is limited so that the ratio of the monthly mortgage payment divided by the monthly net rental income does not exceed 100 percent.”

Paragraph 2-3 states that 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 information in the file.

Paragraph 2-5B states if the borrower, as revealed by public records, credit information, or HUD’s Credit Alert Interactive Voice Response System, is presently delinquent on any federal debt (e.g., U.S. Department of Veterans Affairs-guaranteed mortgage, Title I loan, federal student loan, Small Business Administration loan, delinquent federal taxes) or has a lien, including taxes, placed against his or her property for a debt owed to the United States, 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 verified in writing. Tax liens may remain unpaid provided the lien holder subordinates the tax lien to the Federal Housing Administration-insured mortgage. If any regular payments are to be made, they must be included in the qualifying ratios.

Section 2 and paragraph 2-7 require the lender to establish the anticipated amount of income and the likelihood of its continuance to determine a borrower’s capacity to repay the mortgage debt.

Paragraph 2-7A states that overtime may be used to qualify if the borrower has received such income for approximately two years and the employment verification must not state categorically that such income is not likely to continue. Periods of less than two years may be acceptable provided the underwriter adequately justifies and documents his or her reasons for using the income.

Paragraph 2-9B prescribes documentation requirements for self-employed borrowers as follows:

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

Paragraph 2-11A indicates 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-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more, including payments on installment accounts, child support, or separate maintenance payments, revolving accounts and alimony, etc. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing.

Paragraph 2-11C states if a debt payment, such as a student loan, is scheduled to begin within 12 months of the mortgage loan closing, the lender must include the anticipated monthly obligation in the underwriting analysis unless the borrower provides written evidence that the debt will be deferred to a period outside this timeframe.

Section 5, "Borrower Qualifying," states that HUD does not set an arbitrary percentage that ratios may never exceed. However, it is left up to the lender to judge the overall merits of the loan application and determine what compensating factors apply and to what extent the ratios may be exceeded. Establishing that a loan transaction meets minimal standards does not necessarily constitute prudent underwriting.

Paragraph 2-12 states that debt-to-income ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. The lender must compute two ratios: (1) mortgage payment expense-to-effective income, which is considered acceptable if it does not exceed 29 percent of gross effective income, and (2) total fixed payment-to-effective income, which is considered acceptable if it does not exceed 41 percent of gross effective income. However, these ratios may be exceeded if significant compensating factors are presented.

Paragraph 2-13 establishes the 10 compensating factors that may be used in justifying approval of the loan with ratios exceeding HUD benchmark guidelines. Underwriters must state on the "remarks" section of the mortgage credit analysis worksheet the compensating factors used to support loan approval.

Paragraph 2-14 permits lenders to provide borrowers with interest rate buydowns. Interest rate buydowns are designed to reduce the borrower's monthly payment during the early years of the mortgage. It also requires the lender to establish that the eventual increase in mortgage payments will not adversely affect the borrower and likely lead to default. The underwriter must document which of four criteria the borrower meets.

1. The borrower has a potential for increased income that would offset the scheduled payment increases, as indicated by job training or education in the borrower's profession or by a history of advancement in the borrower's career with attendant increases in earnings.

2. The borrower has a demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expenses. This criterion also may include borrowers whose long-term debt, if any, will not extend beyond the term of the buydown agreement.

3. The borrower has substantial assets available to cushion the effect of the increased payments.

4. The cash investment made by the borrower substantially exceeds the minimum required.

Paragraph 3-6 requires a satisfactory letter of explanation from the borrower addressing any significant variances between the initial application and final application.