Issue Date August 11, 2005	
Audit Report Number 2005-PH-1015	

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

John P. Buck

FROM: John P. Buck, Regional Inspector General for Audit, Philadelphia Regional Office, 3AGA

SUBJECT: Gateway Funding Diversified, Cherry Hill, New Jersey – Lender Review Gateway Funding Diversified Issued and Submitted for Endorsement Loans with an Increased Risk of Defaults and Claims

HIGHLIGHTS

What We Audited and Why

We audited the Cherry Hill branch of Gateway Funding Diversified (Gateway), a non-supervised direct endorsement lender approved to originate Federal Housing Administration single-family mortgage loans because it had a high default rate. Our objective was to determine whether Gateway complied with the U.S. Department of Housing and Urban Development's (HUD) regulations, procedures, and instructions in the origination of Federal Housing Administration loans.

What We Found

Gateway's Cherry Hill branch did not originate all Federal Housing Administration loans in accordance with HUD's loan origination requirements. Of the 32 loans we selected for review,[1] the branch did not fully comply with Federal Housing Administration requirements for 7 of the loans valued at $690,241. Gateway did not exercise due diligence in the review of assets, liabilities, and income; did not verify rental history; and approved loans with excessive debt to income ratios. These deficiencies were caused by a lack of due professional care and contributed to an increased risk to the Federal Housing Administration insurance fund.

What We Recommend

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner request indemnification from Gateway on Federal Housing Administration loans valued at $690,241, which it issued contrary to HUD's loan origination procedures, and require Gateway to develop internal procedures to more closely monitor its underwriting procedures.

For each recommendation 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

The complete text of the auditee's response, along with our evaluation of that response, can be found in Appendix B of this report.

[1] Originally valued at $3,234,940

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BACKGROUND AND OBJECTIVES

The U.S. Department of Housing and Urban Development's (HUD) strategic plan states that part of its mission is to increase homeownership, support community development, and increase access to affordable housing free from discrimination.

The National Housing Act, as amended, established the Federal Housing Administration, an organizational unit within HUD. The Federal Housing Administration provides insurance for lenders against loss on single-family home mortgages.

Beginning in 1983, HUD implemented the direct endorsement program, which authorized approved lenders to underwrite loans without HUD's prior review and approval. HUD can place them on credit watch status or terminate their approval if their rate of defaults and claims exceeds the normal rate for the area. Many sanctions are available for taking actions against lenders or others who abuse the program.

The Cherry Hill branch of Gateway Funding Diversified (Gateway) is one of its 25 active branches with direct endorsement approval. Gateway, whose main office is located in Horsham, Pennsylvania, issued 3,626 Federal Housing Administration loans worth $424,829,158 between October 1, 2002, and September 30, 2004, of which 1,787 were issued by the Cherry Hill branch at a value of $208,122,409. Of the 1,787 loans issued, 73 loans worth $7,805,765 went into default within the first two years. Of these, we reviewed 32 loans worth $3,234,940 that were in default status with six payments or fewer after closing.

The objective of our review was to determine whether Gateway originated Federal Housing Administration-insured loans in accordance with prudent lending practices and HUD requirements. We reviewed case files from both the Homeownership Center and the lender and reviewed Gateway's oversight of its branches.

RESULTS OF AUDIT

Finding 1: Gateway's Cherry Hill Branch Did Not Fully Comply with HUD/Federal Housing Administration Requirements

Gateway did not always originate Federal Housing Administration-insured loans in accordance with HUD requirements. For 7 of the 32 loans we reviewed, originally valued at $3,234,940, Gateway did not exercise due diligence in the review of assets, liabilities, and income; did not verify rental history; and approved loans with excessive debt to income ratios. The deficiencies stem from the lack of due professional care at the branch. These deficiencies contributed to an increased risk to the Federal Housing Administration insurance fund. Therefore, Gateway should indemnify the 7 loans with remaining balances of $690,241.

Gateway Did Not Verify the Rental History of All Borrowers

HUD requires[2] the lender to determine the borrower's payment history of housing obligations covering the most recent 12-month period. For four of the cases reviewed, Gateway did not properly verify the previous rental history of the mortgagor. For case number 351-4565556, the borrower claimed a rental history of 1.4 years at a stated location but rental verification provided by the landlord only supported six months rental history at that location.

Gateway Did Not Verify Borrowers' Income or Capacity to Repay the Mortgage

HUD requires the lender to verify the borrower's employment for the most recent two full years[3] and establish the borrower's capacity to repay mortgage debt.[4] In

[2] HUD Handbook 4155.1, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-3A
[3] HUD Handbook 4155.1, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-6
[4] HUD Handbook 4155.1, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-2

addition, the income must be expected to continue through at least the first three years of the mortgage loan.[5]

For three of the cases reviewed, Gateway did not adequately verify the income. For case number 351-4499168, Gateway did not obtain adequate documentation to support the self-employment salary claimed.

Gateway Allowed the Use of Overtime When It Could Not Be Determined to Be Likely to Continue

HUD allows the use of overtime when the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of overtime income for the past two years. [6]

For two of the cases reviewed, Gateway allowed the use of overtime when it could not be determined to be likely to continue. For case number 351-4346794, Gateway did not average the overtime for the past two years. Instead, it used the overtime earned for the past year, even though the overtime jumped significantly from the first year to the second (approximately $3,793 one year to $18,624 the following year with the borrower working upward of 65 hours per week). Such an increase could not be guaranteed to continue and even averaging the two would not provide an accurate reflection of expected income. Gateway should have attempted to determine a more realistic expectation of overtime from the employer.

Gateway Did Not Verify Borrowers' Assets

HUD requires the lender to verify savings and checking accounts. A verification of deposit, along with the most recent bank statement, may be used to accomplish this. If there is a large increase in an account or the account was opened recently, the lender must obtain a credible explanation of the source of those funds.[7]

For three of the cases reviewed, Gateway did not adequately verify the assets stated on the loan application. For case number 351-4499168, there was an unexplained large deposit and only one complete bank statement in the file.

[5] HUD Handbook 4155.1, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-7
[6] HUD Handbook 4155.1, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-7A
[7] HUD Handbook 4155.1, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-10B

Gateway Did Not Consider All Liabilities of the Borrower

According to HUD guidance, past credit performance helps determine a borrower's attitude toward credit obligations. A borrower who has made payments on previous and current obligations in a timely manner represents reduced risk. Conversely, 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. Further, 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. The borrower's explanation must make sense and be consistent with other credit information in the file.[8]

For four of the cases reviewed, Gateway did not accurately reflect all liabilities or in some cases, did not accurately reflect the monthly payment requirements listed on the credit report on the loan application and the mortgage credit analysis worksheet. Further, Gateway did not obtain explanations for open judgments or a history of late payments. For case number 351-4293712, there were several late payments of more than 120 days for a revolving account that was noted on the credit report. These late payments were made during the same year as closing. Another account was also past due several times, the last time being 10 months before closing. In addition, there were other accounts that are now paid in full but had numerous past due statuses. There was nothing in the file from the mortgagor to explain any of the late payments.

Gateway Issued Loans in Which the Debt to Income Ratios Exceeded HUD Requirements

HUD requires debt to income ratios not to exceed 29 and 41 percent (mortgage to income and all fixed payment to income, respectively). Ratios exceeding 29 and 41 percent may be acceptable only if significant compensating factors are present. HUD provides examples of compensating factors such as a good rental history or a large downpayment.[9]

[8] HUD Handbook 4155.1, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-3
[9] HUD Handbook 4155.1, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraphs 2-12 and 2-13

For three of the cases reviewed, Gateway allowed excessive ratios with no valid compensating factors provided. For case number 351-4346794, the fixed payment to income ratio was 50 percent with no compensating factors listed.

Miscellaneous Items

In addition to the above-mentioned issues, we identified three case files valued at $340,900, in which HUD requirements were not met. Although these issues do not require an indemnification, they did not follow the loan origination requirements of HUD. The issues include

- An unsigned lock rate agreement,
- Bank statement faxed from the realtor, and
- Earnest money on the sales contract did not follow through to the settlement statement.

Conclusion

The above cases illustrate that HUD assumed unnecessarily high risk when insuring the loans originated by Gateway. The deficiencies associated with Gateway's loan origination activities stem from the lack of due care in applying HUD loan requirements. Therefore, Gateway should indemnify the 7 loans with remaining balances of $690,241.

Recommendations

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

1A. Request indemnification from Gateway on 7 loans issued with current unpaid balances of $690,241, in which Gateway's loan origination procedures did not comply with HUD requirements.

1B. Require Gateway to develop internal procedures to more closely monitor its underwriting procedures.

SCOPE AND METHODOLOGY

To accomplish our objectives we

- Reviewed Federal Housing Administration-insured loans (32 cases) originated by Gateway's Cherry Hill branch between October 1, 2002, and September 30, 2004, that had gone into default at least once. The 32 loans were part of a universe of 1,787 loans originated by the Cherry Hill branch during that time. The results of the detailed testing apply to the 32 loans reviewed only and cannot be projected to the universe of Federal Housing Administration-insured loans.

- Examined records and related documents of Gateway.

- Reviewed applicable HUD handbooks and mortgagee letters.

- Conducted interviews with officials and employees of Gateway and the HUD Quality Assurance Division.

In addition, we relied, in part, on data maintained by HUD in the Single Family Data Warehouse and Neighborhood Watch systems. We did not perform a detailed analysis of the reliability of these programs.

Gateway's quality control plan was reviewed by HUD's Quality Assurance Division in January 2005. The Quality Assurance Division recommended Gateway update its quality control plan to comply with HUD Handbook 4060.1. No further review was performed by the Office of the Inspector General (OIG).

The audit generally covered the period from October 1, 2002, to September 30, 2004. This period was expanded to include the most current data while performing our audit. Therefore, when applicable, the audit period was expanded to include current data through May 31, 2005. We conducted our fieldwork from January through May 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:

- Loan origination process – Policies and procedures that management has in place to reasonably ensure that the loan origination process complies with HUD program requirements.

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 Gateway did not operate in accordance with HUD requirements as they relate to loan issuance.

The deficiencies are discussed in detail in the Results of Audit section of this report.

APPENDIXES

Appendix A

FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use 1/
1A	$690,241

1/ "Funds to be put to better use" are quantifiable savings that are anticipated to occur if an 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**

GATEWAY FUNDING
Diversified Mortgage Services

July 21, 2005

FACSIMILE AND EXPRESS MAIL

U.S. Department of Housing & Urban Development
Attention: Daniel G. Temme
Regional Inspector General for Audit
Wanamaker Building, Suite 1005
100 Penn Square East
Philadelphia, PA 19107-3380

Reference: Gateway Funding Diversified Mortgage Services, LP
Cherry Hill, New Jersey Branch

Dear Daniel:

Thank you for giving Gateway Funding Diversified Mortgage Services, L.P., ("Gateway Funding") the opportunity to comment and provide feedback concerning the findings and/or recommendations presented based upon your audit of the Cherry Hill New Jersey Branch.

Gateway Funding supports the effort that FHA has invested in its affordable housing programs that work through private lenders to extend financing for homes and rental properties. FHA has historically been an innovator; and, over the past several decades its mission has increasingly focused on expanding homeownership and affordable rental opportunities for those families, areas and projects that would otherwise not obtain financing or not obtain financing with affordable terms. We recognize the challenges that FHA faces in its efforts to manage its resources and programs. And, we believe FHA recognizes the challenges we face as lenders to provide financing to low/moderate income borrowers, minorities and underserved markets. We must work together to find ways to meet the homeownership and affordable housing needs of those families who continue to be unserved or underserved.

"Opening Doors to Homeownership"

300 Welsh Road, Bldg.5 • Horsham, PA 19044 • Office: 215.591.0222 • Fax: 215.591.0221

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OIG FINDINGS

In your report, Gateway Funding issued 3,626 FHA loans worth $424,829,158 between October 1, 2005 and September 30, 2004 of which 1,787 were issued by the Cherry Hill Branch with a value of $208,122,409.

Of the 1,787 loans issued, 73 loans (less than 5%), with a value of $7,805,765 (less than 4%) went into default within the first two (2) years. Default that could include curtailment of income,

Thirty-two (32) of the 73 loans that were reviewed went into default with six (6) or fewer payments after closing. Out of your audit, eight (8) of the 32 loans valued at $3,234,940 and with remaining balances of $861,462 have deficiencies warranting Gateway Funding signing an indemnification.

EXIT MEETING

We communicated in our exit meeting that we take our relationship with HUD very seriously. Mortgage bankers, like Gateway Funding, willingly partner with HUD in taking the risks associated with providing mortgages to low/moderate income and first time homebuyers. In taking those risks, our underwriters are empowered to make sound underwriting decisions based upon all the risk factors of the loan in putting first-time homebuyers, single moms, or young couples in a home.

During our exit meeting, we discussed several loans that we felt did not warrant Gateway Funding signing an indemnification agreement. We further discussed that sometimes the underwriter is unable to provide all of the required documentation but that does not mean that the overall loan is a bad one. For example, if the underwriter is unable to obtain a credit letter for a mortgagor with 3 children with ratios of 27/27 and the overall factors of the loan are sound, it is unfair to decline that loan based on those factors. These are the very borrowers that are best served by FHA's programs rather than a loan in the sub prime market. (*See attached charts – FHA compared to Conventional and Nonprime Products)*

In our exit meeting, we also advised that six (6) of the eight (8) OIG believed deficiencies warranted Gateway Funding signing an indemnification were underwritten by an underwriter who no longer works for the company.

After that meeting and based upon your review with Julie Schaffer, Quality Assurance Division of HUD, you agreed to remove one (1) loan from your indemnification request and while we appreciate your consideration of that loan there are still several loans recommended for indemnification and we set forth below our comments relative to these loans.

Comment 1

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GATEWAY FUNDING COMMENTS TO OIG FINDINGS

Case No. 351-4406694

OIG Comment: Gateway did not obtain required documentation to approve the loan. There is no explanation in the file from the mortgagor explaining the more-than-120-day late payment, which was made four months before closing.

Gateway Funding Comment: Gateway Funding disagrees with the finding that it did not obtain required documentation to approve this loan. The only credit that the borrower had was a loan she co-signed for someone else and it was paid off on 3/27/03. Documentation was provided relative to the loan being co-signed by the borrower. Gateway Funding feels the documentation adequately provided enough information for the underwriter to assess whether the late payments were based on a disregard for financial obligations, an inability to manage debt or factors beyond the control of the borrower. There were no other major indications of derogatory credit that required sufficient written explanation from the borrower. There was documentation that established other credit that was paid on time by the borrower.

This borrower is the principal mortgagor with three (3) children, of which two (2) were disabled. The borrower received a grant from the City of Vineland Home Ownership Assistance Program for a second mortgage on the property to be purchased, interest free and no payments required until the borrower no longer used the property as a principal place of residence.

The borrower's ratio was 27/27. Increase in housing was $15.00. Borrower had a working history and the borrower's income was documented along with receiving social security for the disabled children.

This is the type of borrower FHA serves. While credit was a weak characteristic, looking at the whole complexion of the loan, there was no layering of risk and Gateway Funding chose to accept the risk in putting this borrower in a home.

Gateway Funding does not believe it should indemnify this loan.

Case No. 351-4565556

OIG Comment: Gateway did not include in the loan origination file or case binder a proper determination of the borrower's payment history of housing obligations. The most current rental was claimed to be for 1.4 years, but the rental verification only supported six months at this location. The previously claimed rental had no support.

Comment 2

Gateway Funding Comment: In its exit meeting with OIG, Gateway Funding advised that the underwriter who underwrote the loan is no longer with the company. A review of the file showed that in looking at the original application there was an error in transposing numbers. The borrower had lived at the most current rental housing for .4 years and not 1.4 years. The underwriter should have documented clearly the most recent 12-month period in accordance with HUD Handbook 4155.1).

While we agree that the underwriter should have documented the file, the borrower's ratio was 22/22. It appears that the borrower had a curtailment of income that caused the default.

Gateway Funding does not believe it should indemnify this loan.

Case No. 351-4379314

OIG Comment: Gateway did not (1) include in the loan origination file or case binder a proper determination of the borrower's payment history of housing obligations, (2) properly verify the borrower's income, (3) properly verify the borrower's funds to close, and (4) properly document the borrower's qualifying ratios.

Comment 3

Gateway Funding Comment: In its exit meeting with OIG, Gateway Funding advised that the underwriter who underwrote the loan is no longer with the company.

Payment of Housing Obligations Was Not Determined – A review of the file did not show where that the underwriter documented the borrower's payment history of housing obligations covering the most recent 12-month period. (HUD Handbook 4155.1)

Gateway Did Not Properly Verify the Borrower's Income – The OIG comment was that Gateway used overtime pay that it could not verify as having been received for the past two years and as likely to continue. A review of the file shows that the underwriter did not provide a tape or document the MCAW on how the income was derived. We can not with certainty say that overtime pay was used to verify the borrower's income. However, we do believe the underwriter was conservative on income.

Funds to Close Were Not Properly Verified or Supported – The OIG comment was that all funds for the borrower's investment in the property were not properly verified. There was only one complete bank statement to support the funds listed on the loan application. In addition, the tax return listed as an asset on the loan application was not supported. Our review of the file showed that there was documentation that the borrower was entitled to a tax refund of $5,500. A review of the file shows that the underwriter did not provide any other comments in the file or the MCAW.

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Qualifying Ratios Were Not Properly Documented – The OIG comment was that Gateway did not identify compensating factors to justify approval of the loan. Using the supportable income, the mortgage payment to income ratio is 32 percent and the total fixed payment to income ratio is 43 percent with no compensating factors identified. Our review of the file shows that the underwriter did not provide any other comments in the file or the MCAW relative to any compensating factors.

*Neighborhood Watch does not list the number of payments before the first default was reported.

Gateway Funding acknowledges that without the underwriter's comments, the deficiencies noted in the file are noted and understand the request for indemnification.

Case No. 351-4499168

OIG Comment: Gateway did not (1) include in the loan origination file or case binder a proper determination of the borrower's payment history of housing obligations, (2) properly verify the borrower's income, (3) properly verify the borrower's funds to close, (4) properly account for all debts listed on the credit report, and (5) properly document the borrower's qualifying ratios.

Comment 4

Gateway Funding Comment: In its exit meeting with OIG, Gateway Funding advised that the underwriter who underwrote the loan is no longer with the company.

Payment of Housing Obligations Was Not Determined – The OIG comment was that the borrower claims to own, but there is no housing payment on the credit report or proof of ownership. Gateway Funding's review of the file shows that the borrower owns the present home but appears to have no mortgage.

Gateway Did Not Properly Verify the Borrower's Income – The OIG comment was that Gateway did not use the income calculated on Schedule C to determine the monthly income listed on the loan application. The source for Gateway's income calculation could not be determined. Gateway Funding's review of the file shows that it is unable to determine, with certainty, how the underwriter calculated the income.

Funds to Close Were Not Properly Verified or Supported – The OIG comment was that all funds for the borrower's investment in the property were not properly verified. There were unexplained large deposits, and there was only one complete bank statement in the file to support the assets claimed on the loan application. Gateway Funding's review of the file showed that there was $17,000 in deposits. The underwriter did not provide any other comments in the file or the MCAW relative to funds to close.

Qualifying Ratios Were Not Properly Documented – The OIG comment was that using the supportable income and supportable liabilities, the mortgage payment to income ratio is 33 percent, and the total fixed payment to income is 65 percent with no compensating factors identified. Gateway Funding's review of the file shows that the underwriter did not provide any other comments in the file or the MCAW relative to any compensating factors.

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Gateway Funding acknowledges that without the underwriter's comments, the deficiencies noted in the file are noted and understand the request for indemnification.

Case No. 351-4293712

OIG Comment: Gateway did not obtain required documentation to approve the loan. In this case, there were several late payments of more than 120 days for a revolving account. These late payments were made the same year as closing. Another account was past due several times less than a year before closing. In addition, there were other accounts that are now paid in full but had numerous past due statuses. There was nothing in the file from the mortgagor to explain any of the late payments.

Comment 5

Gateway Funding Comment: In its exit meeting with OIG, Gateway Funding advised that the underwriter who underwrote the loan is no longer with the company.

Gateway Funding did review the file and while there was no credit letter, it did not indicate that the borrowers had a disregard for financial obligations, an inability to manage debt. There were a couple of accounts that had been delinquent. The borrowers did not have horrendous credit where they ignored their obligations.

In looking at the whole complexion of the loan, these were two (2) young borrowers starting out. There was stability of income, good ratios (19/30); had some credit whereby they paid on time. Income, assets and gift of funds were verified. Both borrowers had a good working history going back five (5) years.

Gateway Funding believes it should not indemnify this loan. There was an acceptable 12-month payment history and there was no layering of risk in this transaction.

Case No. 351-4346794

OIG Comment: Gateway did not (1) determine whether overtime could be expected to continue, (2) properly document the borrower's qualifying ratios, and (3) ensure documents were not accepted from an individual involved in the sale.

Comment 6

Gateway Funding Comment: In its exit meeting with OIG, Gateway Funding advised that the underwriter who underwrote the loan is no longer with the company.

Overtime Income Was Used to Qualify without Determining Whether the Overtime Could Be Expected to Continue – The OIG comment was that only $3,290 monthly income was allowable out of the $3,885 monthly income claimed on the loan application because the $3,885 contained excessive overtime payments that could not be expected to continue. The overtime jumped significantly from one year to the next (approximately $3,793 one year to $18,624 the following year with the borrower working upward of 65 hours per week). Such an increase could not be guaranteed to continue. Gateway Funding's review of the file shows that the underwriter did not provide any other comments in the file or the MCAW relative to how the income was calculated.

Qualifying Ratios Were Not Properly Documented – The OIG comment was that using supportable income, the recalculated total fixed payment to income ratio goes from 42 percent to 50 percent, which exceeds the HUD requirement of 41 percent. Gateway Funding's review of the file shows that with no comments from the underwriter in the file or the MCAW relative to compensating factors, it will assume that the calculations by the auditors are correct. The underwriter should have documented compensating factors to support the decision made relative to this loan.

Rental History Was Sent from the Realtor – The OIG comment was that the rental payment history was sent from the realtor. Gateway Funding's review of the file does not show that the rental payment history was sent by a third party involved in the sale. Gateway Funding stresses the importance to the underwriters that documents from third parties, such as realtors, should be reverified even though we understand that borrowers will go to their realtors to have documents faxed for them as there has been a relationship established between the borrower and the realtor in the sale of the property.

Case No. 351-4391207

OIG Comment: Gateway (1) accepted a gift letter that was faxed from the realtor and (2) did not verify the source of nontraditional credit provided from the buyer.

Comment 7

Gateway Funding Comment: In its exit meeting with OIG, Gateway Funding advised that the underwriter who underwrote the loan is no longer with the company. Gateway Funding's review of the file shows that while there were weak characteristics of this loan the ratios for this loan is 25/30, the borrower had a three (3)-year work history and documented rental history for two-years. It appears this was a first-time homebuyer and while the underwriter did not properly document her reasons for approving the loan, there is no layering of risk.

Gateway Funding does not believe it should indemnify this loan.

INTERNAL CONTROLS

Gateway Funding believes that internal controls are an integral part of any organization's operation to provide reasonable assurance that its operation is efficient and effective; financially sound and in compliance with applicable laws and regulations. Gateway Funding acknowledges that while we have internal policies and procedures to guide our underwriters in following HUD mortgagee guidelines, our underwriters are empowered to make sound underwriting decisions based upon all the risk factors of the loan. As underwriters we believe that at the time the loan is underwritten the decision is a sound judgment decision based on HUD guidelines. However, the issue is that the underwriter must document well his/her decision and/or make sure that all documents support the decision.

Gateway Funding, in addition to its policies and procedures, provide continual communication and training to its employees regarding changes and best practices within our industry in order to provide them with additional tools to do their jobs. We encourage networking and mentoring with/of counterparts to share information relative to standards and unusual situations. Gateway Funding implemented regularly scheduled conference calls not only with our underwriters but processors and closers to discuss issues, concerns and audits such as these, for continuous improvement. We continually remind our underwriters to document in the MCAW the reasons for supporting their decision. And, recently we developed an internal report card on our underwriters to have a better snapshot of their overall performance.

SUMMARY

Again, we appreciate the opportunity to provide our comments to your audit. We respectfully request that you reconsider the above loans for indemnification.

Gateway Funding will continue to strive to be a steward of the FHA programs. FHA plays an important role in increasing homeownership and affordable rental opportunities. However, FHA's role is diminishing due to the growing obsolescence of its processes. We believe that FHA has an opportunity to free itself of overly burdensome processes and restrictions. FHA can adopt important private sector efficiencies that can help to increase its market share.

Sincerely,

Michael Cosentino, Vice President
Quality Control

Donna Herre, Vice President
Operations

Emma Richmond, Senior Vice President
Human Resources & Legal Affairs

Attachments: Chart

FHA compared to Conventional and Nonprime Products

The 203(b) product offered by the Federal Housing Administration (FHA) compares very favorably against conventional and nonprime products that serve a similar borrower profile.

FHA vs. Conventional

Rate and Fee Comparison:

FHA is priced at a discount in comparison to Fannie Mae's My Community 97 and Expanded Approval: EA 1, EA 2 and EA 3. Expanded Approvals are good comparisons, because oftentimes a borrower requiring an expanded approval could be served by FHA.

Pricing Components	**FHA** 97% LTV 30 yr. FRM	**Conventional** My Community 97 30 yr FRM	**EA I**	**EA II**	**EA III**
Interest Rate	6.00%	6.00%	7.125%	7.375%	7.625%
Origination Points	1.000%	0%	0%	0%	0%
Discount Points	-1.000%	.750%	1.000%	1.000%	1.000%

Rates from national lender, January 2005

Impact of MI Premium on Loan Affordability:

In addition to the interest rate charged the borrower, the mortgage insurance charged by FHA compares favorably to that charged under the Fannie Mae's My Community 97, especially at lower ends of the credit quality spectrum.

Pricing Components Credit Score Range	**FHA** 97% LTV 30 yr. FRM A Paper	**Conventional** My Community 97 30 yr FRM A Paper	**EA I** A- Paper	**EA II** A- Paper	**EA III** A- Paper
MI Premium:	.50%* .61%**	1.050%*** FICO below 659 1.430%			
/w EA credit score grids:					
620 and up			1.430%	1.430%	1.430%
580 to 619			2.580%	2.580%	2.580%
0 to 579			4.190%	4.190%	4.190%

Source: National Lender, January 2005
**Credit scores are not used by FHA to determine MI cost.*
***For annual premium comparison. UFMIP is financed increasing effective cost of MI premium 11 bps.*
****A credit score of 660 and above is required for A pricing.*

Attachment

Debt to Income Ratio and Closing Costs:

Combining the interest rate comparison and mortgage insurance comparison, the table below illustrates the benefits of FHA financing to the borrower in closing costs and monthly housing expense. The table data assumes a loan balance of $125,000 and a household income of $40,000. It should be noted that, under Fannie Mae's Desktop Underwriter, borrowers not approved under MyCommunity 97 are then easily scored under Expanded Approval without the need to add any additional information.

Products	FHA 97% LTV 30 yr. FRM A Paper	Conventional My Community 97 30 yr FRM A Paper	EA I A- Paper	EA II A- Paper	EA III A- Paper
Interest Rate	6.00%	6.00%	7.125%	7.375%	7.625%
Discount Points %	0%	.750%	1.000%	1.000%	1.000%
Discount Points $	$0	$938	$1,250	$1,250	$1,250
P and I	$801	$801	$842	$863	$884
MI Premium:	$63	$109			
/w EA credit score grids:					
620 and up			$149	$149	$149
580 to 619			$269	$269	$269
0 to 579			$436	$436	$436
Total Payment with Highest MI Premium	$864	$910	$1,278	$1,299	$1,320
Debt to Income Ratio	26%	27%	38%	39%	40%

2

FHA vs. Nonprime

FHA is better for borrowers in comparison to a typical nonprime 100% LTV product. The savings dramatically increases as credit score declines.

Savings are more dramatic on fixed-rate products, though nonprime originations more heavily consist of 3/1 hybrid ARMS and therefore FHA's 3/1 hybrid ARM may be a fairer comparison.

Nonprime

Loan amt.: $200,000
TI = 1.5% of UPB
Prepayment Penalty

3yr Hybrid Arm

Credit Score	Rate	Mtg Pmt	T&I	Total Pmt
680	7.000	$1,331	$250	$1,581
660	7.350	$1,378	$250	$1,628
640	7.700	$1,426	$250	$1,676
620	7.750	$1,433	$250	$1,683
600	7.900	$1,454	$250	$1,704
580	8.250	$1,503	$250	$1,753

30yr Fixed

Credit Score	Rate	Mtg Pmt	T&I	Total Pmt
680	8.500	$1,538	$250	$1,788
660	8.850	$1,588	$250	$1,838
640	9.200	$1,638	$250	$1,888
620	9.250	$1,645	$250	$1,895
600	9.400	$1,667	$250	$1,917
580	9.750	$1,718	$250	$1,968

FHA

Loan amt: $203,000 (UfMIP rolled in)
MMI of 0.5% added to rate, TI = 1.5% of UPB,
UfMIP calcuated into rate

3yr Hybrid Arm

Credit Score	Rate	Mtg Pmt	T&I	Total Pmt	Savings
680	5.875	$1,201	$254	$1,455	$126
660	5.875	$1,201	$254	$1,455	$173
640	5.875	$1,201	$254	$1,455	$221
620	5.875	$1,201	$254	$1,455	$228
600	5.875	$1,201	$254	$1,455	$249
580 and below	5.875	$1,201	$254	$1,455	$298

30yr Fixed

Credit Score	Rate	Mtg Pmt	T&I	Total Pmt	Savings
680	6.375	$1,266	$254	$1,520	$268
660	6.375	$1,266	$254	$1,520	$318
640	6.375	$1,266	$254	$1,520	$368
620	6.375	$1,266	$254	$1,520	$375
600	6.375	$1,266	$254	$1,520	$397
580 and below	6.375	$1,266	$254	$1,520	$448

Source: National lender, January 2005

3

OIG Evaluation of Auditee Comments

Comment 1 Gateway contends that the borrower's credit problems were due to late payments on a co-signed loan and that the documentation adequately provided enough information for the underwriter to assess whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower. However, the only documents submitted to HUD involved a loan statement, written in Spanish, stamped that the loan was paid in full. There are no notes in the file or comments on the Mortgage Credit Analysis Worksheet indicting the underwriter's analysis of the late payments or of the borrower's credit worthiness.

Gateway also contends that documentation was provided that established other credit for the borrower. Gateway did provide several letters from non-traditional credit sources as examples of the borrower's payment history. However, the underwriter never verified the sources. In fact, the underwriter stated that they never verify non-traditional credit because they do not put a lot of weight into their validity.

The case will remain in the report.

Comment 2 Gateway contends that there was a transposed number in the loan application and that is the cause of the difference between the application claiming 1.4 years at the previous location and the letter from the landlord stating only six months of rental history. Gateway agrees the underwriter should have clearly documented the most recent 12-month rental history in accordance with HUD 4155.1.

The case will remain in the report.

Comment 3 Gateway agrees with the indemnification request.

The case will remain in the report.

Comment 4 Gateway agrees with the indemnification request.

The case will remain in the report.

Comment 5 Gateway contends that, although there was no credit letter, the borrowers' credit did not indicate that they had a disregard for financial obligations or an inability to manage debt. They had a couple of delinquent accounts but not horrendous credit.

Upon re-reviewing the file, we noted that the case was rated as Refer/Eligible under Fannie Mae's Government Underwriting Service using PMI Scorecard.

The case was referred (a Federal Housing Administration registered Direct Endorsement underwriter must analyze the loan and determine if the borrower meets Federal Housing Administration standard capacity and credit policies and guidelines) because the risk exceeded the threshold for automated approval for a Federal Housing Administration loan. One of the approval conditions of the referral was the requirement to "obtain an explanation for major indication of derogatory credit, such as judgments and collections, as well as any minor indications within the past two years." Gateway did not obtain an explanation for several late payments made less than a year before closing.

The case will remain in the report.

Comment 6 Gateway did not provide any additional information to support the income used in the loan calculation.

Gateway agrees the underwriter should have documented compensating factors to support the excessive ratios.

Gateway contends that the rental payment history was not sent by an interested third party. Upon re-review of the file, we found the rental history was indeed faxed by the borrower's real estate agent.

The case will remain in the report.

Comment 7 Gateway did not provide any additional information to support the gift to the borrower. Without the gift funds, the borrower would not have had the funds to close the loan. Adequate documentation of the source and existence of the funds is required by HUD 4155.1.

Gateway did not provide any additional information to support the non-traditional credit.

The case will remain in the report.

Appendix C

SCHEDULE OF CASE FILE DISCREPANCIES

	Sales Price	Unpaid Principal Balance**	Inadequate Rental History	Unsupported Income	Unsupported Assets	Credit Problems	High Ratios With No Supporting Factors
351-4379314	$118,000.00	$114,535.00	X	X	X		X
351-4499168	$157,900.00	$154,173.00	X	X	X	X	X
351-4565556	$ 66,800.00	$ 65,958.00	X				
351-4293712	$115,000.00	$111,977.00				X	
351-4406694	$ 99,000.00	$ 96,428.00				X	
351-4346794	$ 87,000.00	$ 85,720.00	X	X			X
351-4391207	$ 62,900.00	$ 61,450.00			X	X	
	$706,600.00	$690,241.00					
**Neighborhood Watch - Default Information Provided by the Servicer							

Appendix D

NARRATIVE CASE PRESENTATIONS

Case number: 351-4379314

Mortgage amount: $117,000

Date of loan closing: April 25, 2003

Status: Repayment

Payments before first default reported: n/a *

Unpaid principal balance: $114,535

Summary:

Gateway did not (1) include in the loan origination file or case binder a proper determination of the borrower's payment history of housing obligations, (2) properly verify the borrower's income, (3) properly verify the borrower's funds to close, and (4) properly document the borrower's qualifying ratios.

Pertinent Details:

Payment History of Housing Obligations Was Not Determined

Gateway did not include in its loan origination file or case binder a determination of the borrower's payment history of housing obligations through either the credit report, directly from the landlord or mortgage servicer, or through canceled checks covering the most recent 12-month period (HUD Handbook 4155.1, paragraph 2-3A).

Gateway Did Not Properly Verify the Borrower's Income

The income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage loan. Both overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue (HUD Handbook 4155.1, paragraphs 2-7 and 2-7A). Gateway used overtime pay that it could not verify as having been received for the past two years and as likely to continue.

Funds to Close Were Not Properly Verified or Supported

A verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase, the lender must verify the source of funds (HUD Handbook 4155.1, paragraph 2-10B). All funds for the borrower's investment in the property were not properly verified. There was only one complete bank statement to support the funds listed on the loan application. In addition, the tax return listed as an asset on the loan application was not supported.

Qualifying Ratios Were Not Properly Documented

For ratios exceeding the benchmark guidelines of 29 percent (mortgage payment to income) and 41 percent (total fixed payment to income), the underwriters must record the compensating factors in the "remarks" section of the mortgage credit analysis worksheet, and they must be supported by documentation (HUD Handbook 4155.1, paragraphs 2-12 and 2-13). Gateway did not identify compensating factors to justify approval of the loan. Using the supportable income, the mortgage payment to income ratio is 32 percent, and the total fixed payment to income ratio is 43 percent with no compensating factors identified.

* Although Neighborhood Watch does not list the number of payments before the first default was reported, data indicate six or fewer payments were made.

Case number: 351-4499168

Mortgage amount: $154,300

Date of loan closing: August 18, 2003

Status: Foreclosure complete

Payments before first default reported: One

Unpaid Principal Balance: $154,173

Summary:

> Gateway did not (1) include in the loan origination file or case binder a proper determination of the borrower's payment history of housing obligations, (2) properly verify the borrower's income, (3) properly verify the borrower's funds to close, (4) properly account for all debts listed on the credit report, and (5) properly document the borrower's qualifying ratios.

Pertinent Details:

> Payment History of Housing Obligations Was Not Determined
>
> Gateway did not include in its loan origination file or case binder a determination of the borrower's payment history of housing obligations through either the credit report, directly from the landlord or mortgage servicer, or through canceled checks covering the most recent 12-month period. The borrower claims to own, but there is no housing payment on the credit report or proof of ownership (HUD Handbook 4155.1, paragraph 2-3A).
>
> Gateway Did Not Properly Verify the Borrower's Income
>
> The income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage loan. For self-employed borrowers, the sole proprietorship income should be calculated on IRS Form Schedule C (HUD Handbook 4155.1, paragraph 2-9). Gateway did not use the income calculated on Schedule C to determine the monthly income listed on the loan application. The source for Gateway's income calculation could not be determined.

Funds to Close Were Not Properly Verified or Supported

A verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase, the lender must verify the source of funds (HUD Handbook 4155.1, paragraph 2-10B). All funds for the borrower's investment in the property were not properly verified. There was an unexplained large deposit, and there was only one complete bank statement in the file to support the assets claimed on the loan application.

Liabilities Listed on the Credit Report Were Not Listed on the Loan Application, Mortgage Credit Analysis Worksheet, or the Automatic Underwriting System

The borrower's liabilities should include all installment loans, revolving charge accounts, real estate loans, and all other continuing obligations. In computing the debt to income ratios, the lender must include all recurring charges extending 10 months or more. 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 (HUD Handbook 4155.1, paragraph 2-11A). The credit report of the borrower showed a large debt ($10,207 with monthly payments of $664). Handwritten notes on the credit report claim the debt was paid down to $6,600, making it less than 10 months. The debt was not listed on the loan application, mortgage credit analysis worksheet, or the Automatic Underwriting System and, thus, was not considered a factor in the loan analysis. However, there was no documentation to support the payoff down to $6,600. Even if the debt were paid down to the 10-month mark, the required payments of $664 per month would have increased the borrower's total fixed payment to income ratio to 65 percent and, thus, should have been included in the loan analysis.

Qualifying Ratios Were Not Properly Documented

For ratios exceeding the benchmark guidelines of 29 percent (mortgage payment to income) and 41 percent (total fixed payment to income), the underwriters must record the compensating factors in the "remarks" section of the mortgage credit analysis worksheet, and they must be supported by documentation (HUD Handbook 4155.1, paragraphs 2-12 and 2-13). Using the supportable income and supportable liabilities, the mortgage payment to income ratio is 32 percent, and the total fixed payment to income is 65 percent with no compensating factors identified.

Case number: 351-4565556

Mortgage amount: $66,200

Date of loan closing: March 10, 2004

Status: First legal action to commence foreclosure

Payments before first default reported: One

Unpaid principal balance: $65,958

Summary:

Gateway did not include in the loan origination file or case binder a proper determination of the borrower's payment history of housing obligations

Pertinent Details:

Payment History of Housing Obligations Was Not Determined

Gateway did not include in its loan origination file or case binder a determination of the borrower's payment history of housing obligations through either the credit report, directly from the landlord or mortgage servicer, or through canceled checks covering the most recent 12-month period (HUD Handbook 4155.1, paragraph 2-3A). In this case, the buyer claimed to rent for four years at two different locations. The most current rental was claimed to be for 1.4 years, but the rental verification only supported six months at this location. The previously claimed rental had no support.

Case number: 351-4293712

Mortgage amount: $114,050

Date of loan closing: October 4, 2002

Status: Delinquent

Payments before first default reported: Four

Unpaid principal balance: $111,977

Summary:

Gateway did not obtain required documentation to approve the loan.

Pertinent Details:

Required Documentation Was Not Obtained

When delinquent accounts are revealed, the lender must document its analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower. 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 (HUD Handbook 4155.1, paragraph 2-3). In this case, there were several late payments of more than 120 days for a revolving account. These late payments were made the same year as closing. Another account was past due several times less than a year before closing. In addition, there were other accounts that are now paid in full but had numerous past due statuses. There was nothing in the file from the mortgagor to explain any of the late payments.

Case number: 351-4406694

Mortgage amount: $98,200

Date of loan closing: June 6, 2003

Status: Partial reinstatement

Payments before first default reported: Three

Unpaid principal balance: $96,428

Summary:

Gateway did not obtain required documentation to approve the loan.

Pertinent Details:

Required Documentation Was Not Obtained

When delinquent accounts are revealed, the lender must document its analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower. 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 (HUD Handbook 4155.1, paragraph 2-3). There is no explanation in the file from the mortgagor explaining the more than 120-day late payment, which was made four months before closing.

Case number: 351-4346794

Mortgage amount: $86,250

Date of loan closing: January 23, 2003

Status: Default – forbearance

Payments before first default reported: Five

Unpaid principal balance: $85,720

Summary:

Gateway did not (1) determine whether overtime could be expected to continue, (2) properly document the borrower's qualifying ratios, and (3) ensure documents were not accepted from an individual involved in the sale.

Pertinent Details:

Overtime Income Was Used to Qualify without Determining Whether the Overtime Could Be Expected to Continue

Both overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of bonus or overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes (HUD Handbook 4155.1, paragraph 2-7A). Only $3,290 monthly income was allowable out of the $3,885 monthly income claimed on the loan application because the $3,885 contained excessive overtime payments that could not be expected to continue. The overtime jumped significantly from one year to the next (approximately $3,793 one year to $18,624 the following year with the borrower working upward of 65 hours per week). Such an increase could not be guaranteed to continue.

Qualifying Ratios Were Not Properly Documented

For ratios exceeding the benchmark guidelines of 29 percent (mortgage payment to income) and 41 percent (total fixed payment to income), the underwriters must record the compensating factors in the "remarks" section of the mortgage credit analysis worksheet, and they must be supported by documentation (HUD Handbook 4155.1, paragraphs 2-12 and 2-13). Using the supportable income, the recalculated total fixed payment to income ratio goes from 42 percent to 50 percent, which exceeds the HUD requirement of 41 percent.

Rental History Was Sent from the Realtor

HUD regulations strictly prohibit the lender from receiving documents from third party participants (HUD Handbook 4155.1, paragraph 3-1). The rental payment history was sent from the realtor.

Case number: 351-4391207

Mortgage amount: $62,350

Date of loan closing: March 31, 2003

Status: Default - first legal action to commence foreclosure

Payments before first default reported: Three

Unpaid principal balance: $61,450

Summary:

Gateway (1) accepted a gift letter that was faxed from the realtor and (2) did not verify the source of nontraditional credit provided from the buyer.

Pertinent Details:

Gateway Accepted a Gift Letter Faxed from the Realtor and Did Not Verify the Deposit

No document used in the processing or underwriting of a loan may be handled or transmitted by or through an interested third party to the transaction (e.g., real estate agents, builders, sellers) or by using its equipment (HUD Handbook 4155.1, paragraph 3-1). Gateway accepted a gift letter that was faxed from the realtor.

Gateway Did Not Verify Nontraditional Credit Submitted with the Loan Package

The lender must document that the providers of nontraditional credit exist and verify the credit information. To verify the credit information, lenders must use a published address or telephone number for that creditor (HUD Handbook 4155.1, paragraph 2-3). Gateway did not consider the nontraditional credit to be important in the overall acceptability of the loan and, thus, did not verify the existence of nontraditional creditors. OIG auditors were unable to re-verify the information.