



Issue Date January 27, 2005
Audit Case Number 2005-AT-1005

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

FROM: Sonya D. Lucas  
Acting Regional Inspector General for Audit, 4AGA

SUBJECT: Pan American Financial Corporation  
Non-Supervised Direct Endorsement Lender  
Guaynabo, PR

## HIGHLIGHTS

### What We Audited and Why

We audited Pan American Financial Corporation (Pan American) in Guaynabo, PR. Pan American is a non-supervised lender approved by the U.S. Department of Housing and Urban Development (HUD) to originate and approve Federal Housing Administration-insured single-family mortgages. We selected Pan American for review because of its high default rate.

The audit objectives were to determine whether Pan American: (1) complied with HUD regulations, procedures, and instructions in the origination of Federal Housing Administration-insured single-family mortgages; and (2) implemented its quality control plan as required. We reviewed a sample of 25 Federal Housing Administration-insured loans to accomplish our objectives.

## What We Found

Pan American did not follow HUD requirements when originating and approving 17 Federal Housing Administration-insured loans totaling \$2,782,706. In 10 loans, Pan American did not exercise the care expected of a prudent lender in the analysis of the borrower's assets, earnings, and debts. Pan American also approved seven loans that did not comply with HUD's self-sufficiency requirement, and were over-insured by \$209,889<sup>1</sup>. The deficiencies occurred because Pan American did not establish and implement adequate controls to ensure its employees followed HUD requirements when processing and underwriting loans. These deficiencies contributed to Pan American's high default rate and increased HUD's risk to the Federal Housing Administration insurance fund.

Pan American did not fully implement its quality control plan as required. It has not implemented procedures or controls to ensure all Federal Housing Administration-insured loans that default within 6 months of closing undergo a loan origination quality control review. We attribute this deficiency to Pan American's disregard of HUD requirements and instructions. As a result, HUD has no assurance of the accuracy, validity, and completeness of Pan American's loan origination operations.

Pan American's authority to endorse Federal Housing Administration-insured loans is currently under Departmental suspension.

## What We Recommend

We recommend the Assistant Secretary for Housing-Federal Housing Commissioner require Pan American to indemnify HUD against future losses on nine loans totaling \$1.39 million and pay down the mortgages of the seven over-insured loans by \$209,889. We further recommend HUD take appropriate monitoring measures to ensure Pan American establishes and implements appropriate controls so that its employees follow HUD requirements when processing and underwriting loans, if HUD allows Pan American to continue as a non-supervised direct endorsement lender. Finally, we recommend HUD require Pan American to take the needed action to ensure the required quality control plan reviews are conducted, if HUD allows Pan American to continue as a non-supervised direct endorsement lender.

---

<sup>1</sup> HUD limits the maximum mortgage loan amount for three- and four-unit properties so that the monthly mortgage payment does not exceed the property's monthly net rental income.

## **Auditee's Response**

We discussed our review results with Pan American and HUD officials during the audit. We provided a copy of the draft report to Pan American officials on December 7, 2004, for their comments and discussed the report with the officials at the exit conference on December 10, 2004. Pan American provided written comments on December 17, 2004.

Pan American's response did not state whether they agreed or disagreed with our audit recommendations. The response included a brief statement for each loan discussed in finding 1 and provided additional documents for our evaluation. Pan American did not provide comments for finding 2.

The complete text of Pan American's response, along with our evaluation of that response can be found in appendix B of this report.

# TABLE OF CONTENTS

---

Background and Objectives	5
Results of Audit	
Finding 1: Pan American Did Not Follow HUD Requirements When Originating Loans	6
Finding 2: Pan American Did Not Fully Implement Its Quality Control Plan as Required	11
Scope and Methodology	13
Internal Controls	14
Appendixes	
A. Schedule of Questioned Costs and Funds To Be Put to Better Use	16
B. Auditee Comments and OIG's Evaluation	17
C. Summary of Loan Deficiencies	35
D. Active Loans Pan American Should Indemnify	36
E. Narrative Loan Deficiencies	37
F. Criteria	52

## BACKGROUND AND OBJECTIVES

---

Pan American Financial Corporation (Pan American) was incorporated under the laws of the Commonwealth of Puerto Rico on November 25, 1996. The U.S. Department of Housing and Urban Development (HUD) approved Pan American as a Title II non-supervised direct endorsement lender on June 13, 1997. Pan American originates Federal Housing Administration, Department of Veteran Affairs, and conventional loans. Pan American's main office is located in Guaynabo, PR, with branch offices in Caguas, Manati, and Rio Grande.

Pan American originated 726 Federal Housing Administration-insured single-family loans, with mortgages totaling \$77.2 million, which had beginning amortization dates between January 1, 2002, and December 31, 2003. According to HUD's Neighborhood Watch system, 74 of the loans defaulted within the first 2 years of origination.

On July 12, 2004, HUD notified Pan American of its intent to suspend the HUD approval agreement to originate Federal Housing Administration-insured single-family mortgages, citing Pan American's high default rate as the basis for the proposed termination. HUD suspended Pan American's approval as a Title II non-supervised direct endorsement lender on October 5, 2004.<sup>2</sup> Pan American has the right to reapply at the end of the 6 month exclusion period for a new origination approval agreement, provided that Pan American is still an approved lender, meeting the general approval requirements under Title 24 of the Code of Federal Regulations, Part 202, and the underlying causes for termination have been satisfactorily remedied.

The audit objectives were to determine whether Pan American: (1) complied with HUD regulations, procedures, and instructions in the origination of Federal Housing Administration-insured single-family mortgages; and (2) implemented its quality control plan as required.

---

<sup>2</sup> The suspension applies only to the main office.

# RESULTS OF AUDIT

---

## Finding 1: Pan American Did Not Follow HUD Requirements When Originating Loans

Pan American did not follow HUD requirements when originating and approving 17 Federal Housing Administration-insured loans totaling \$2,782,706. In 10 loans, Pan American did not exercise the care expected of a prudent lender in the analysis of the borrower's assets, earnings, and debts. Pan American also approved seven loans that did not comply with HUD's self-sufficiency requirement, and were over-insured by \$209,889. The deficiencies occurred because Pan American did not establish and implement adequate controls to ensure its employees followed HUD requirements when processing and underwriting loans. These deficiencies contributed to Pan American's high default rate and increased HUD's risk to the Federal Housing Administration insurance fund.

---

### Pan American Did Not Exercise Due Care

Our examination of 10 loans approved by Pan American disclosed that Pan American did not exercise the care expected of a prudent lender in the analyses of the borrower's assets, earnings, and debts. The review found that Pan American did not:

- ❑ Document the stability of borrower income in accordance with HUD requirements,
- ❑ Ensure compliance with HUD borrower credit requirements,
- ❑ Obtain information directly from the source allowing third parties to handle key documents,
- ❑ Document the source of borrower investment in accordance with HUD requirements,
- ❑ Provide valid or supported compensation factors when HUD's debt to income ratios of 29 and 41 percent were exceeded,
- ❑ Ensure compliance with HUD maximum mortgage requirements, or
- ❑ Clarify and/or adequately document important file discrepancies.

We identified processing and underwriting deficiencies in all 10 loans as shown below.

Deficiencies	Number of Loans
Inadequate asset analysis	8 of 10
Inadequate earnings analysis	8 of 10
Inadequate debt analysis	5 of 10

The deficiencies noted above are not independent of one another as many of the loan files contained more than one deficiency. Appendix C provides a chart summarizing the loan processing deficiencies. Details of the deficiencies identified on each loan reviewed, including specific HUD requirements not met, are included in appendix E.

Specific examples of Pan American's poor processing and underwriting include:

- ❑ **Case File Number 501-6581138.** Pan American approved the loan without properly verifying the borrower's earnings and assets. The review disclosed that Pan American used copies of tax returns to validate income information and qualify the borrower for the loan. We noted the tax returns were faxed, apparently from the seller's real estate agent. The borrower stated that Pan American never asked for tax returns and could not explain where the documents came from. The tax returns used by Pan American were never filed with the Puerto Rico Treasury Department.

The Settlement Statement reflected \$7,300 in earnest money. According to information in the loan file, the source of the earnest money was the borrower's savings, and it was deposited with the seller's real estate agent. We noted the saving account statements and other documents related to the earnest money were faxed, apparently from the real estate agent. The borrower informed us the amount on the statements was not correct and the fund balance was overstated. The borrower also advised us that only \$1,000 was provided as earnest money, not the \$7,300 shown on the Settlement Statement. According to the borrower, all required documents were provided to the real estate agent, who forwarded them to Pan American. Contrary to requirements in HUD Handbook 4155.1, Revision 4, paragraph 3-1, Pan American allowed an interested third party to handle key documents. In addition, the date of closing was the only time the borrower had contact with Pan American officials.

- ❑ **Case File Number 501-6549444.** Pan American approved the loan without properly verifying the borrower's income and assets. Tax returns were used to validate income information and qualify the borrower for the loan. The borrower informed us the tax returns were prepared by the seller's real estate agent and could not explain where the agent obtained the information. The tax returns used by Pan American reflected earnings of \$58,000, while the official tax return filed with the Puerto Rico Treasury Department showed \$18,000.

The Settlement Statement reflected \$7,000 in earnest deposit. According to information in the loan file, the borrower provided the earnest money from his own savings, and it was deposited with the seller's real estate agent. We noted that savings account statements and other documents related to the earnest money were faxed, apparently from the real estate agent. The borrower informed us the savings statements in the loan file did not reflect the correct amount of funds in the account and only \$1,000 was provided as

earnest money. The borrower stated that all documents were provided to the real estate agent, who made them available to Pan American. Pan American allowed an interested third party to handle key documents in violation of HUD requirements contained in Handbook 4155.1, Revision 4, paragraph 3-1. In addition, the date of the loan closing was the only time the borrower had contact with Pan American officials.

- **Case File Number 501-6713435.** Pan American did not properly evaluate the borrower's employment. The Request for Verification of Employment, dated September 27, 2002, stated the borrower commenced working at the Puerto Rico House of Representatives in October 2001. However, a certification, dated October 14, 2002, stated the borrower commenced working in February 1998. There was no documentation in the loan file showing Pan American resolved this inconsistency. We contacted the employer and found the personnel office did not originate the October 2002 certification and the borrower had less than a year on the job at the time the Request for Verification of Employment was completed.

Pan American miscalculated effective income by overstating earnings and understating the borrowers' debt. The coborrower's verification of employment reflected a monthly salary of \$800. However, a copy of a wage statement included in the loan file showed a monthly salary of \$754. Pan American used the higher amount to approve the loan, but there was no support clarifying the inconsistency. We contacted the employer and found the personnel office did not prepare the verification. The director of the school where the coborrower worked apparently completed the verification. According to the personnel office, the correct monthly salary was \$754 as reflected in the earning statements. Pan American also excluded from the debt analysis monthly payments, totaling \$205, the borrowers had with two creditors. This debt was included in the credit report, but there was no explanation or support for the understatement. Had Pan American used the correct amounts, it would have calculated the fixed obligations to effective income ratio at 54 percent, which exceeds HUD's permissible rate of 41 percent.

**Pan American Did Not Comply  
With Self-Sufficiency  
Requirement**

Our examination of 15 loans approved for three- and four-unit properties showed Pan American did not take steps to ensure these were self-sufficient as required by HUD Handbook 4155.1, Revision 4, paragraph 1-8(C). We found seven loans with monthly mortgage payments exceeding the property's monthly net rental income in violation of HUD requirements. Although Pan American officials stated they properly evaluated each loan to ensure compliance with HUD's self-

sufficiency requirement, we did not find support in the loan files. As a result, the loans approved by Pan American were over-insured by \$209,889 as shown below.

Case Number	Mortgage Amount		Overinsured Amount
	Approved by Pan American	Determined by OIG	
501-6538799	\$ 198,432	\$ 140,077	\$58,355
501-6649973	277,805	235,961	41,844
501-6806123	143,863	107,751	36,112
501-6820863	153,784	125,289	28,495
501-6604881	158,746	135,748	22,998
501-6618527	114,098	99,644	14,454
501-6817864	136,416	128,785	7,631
<b>Total</b>	<b>\$ 1,183,144</b>	<b>\$ 973,255</b>	<b>\$209,889</b>

We also reviewed the case files to determine whether borrowers had sufficient funds to close the loans, had Pan American enforced the self-sufficiency requirement. The Mortgage Credit Analysis Worksheets showed that borrowers did not have sufficient funds to cover the over-insured amounts as shown below.

Case Number	Overinsured Amount	Borrower's	
		Funds Available	Possible Shortage
501-6538799	\$58,355	1,302	\$ 57,053
501-6649973	41,844	5,140	36,704
501-6806123	36,112	5,113	30,999
501-6820863	28,495	26,315	2,180
501-6604881	22,998	19,269	3,729
501-6618527	14,454	3,004	11,450
501-6817864	7,631	1,045	6,586

## Conclusion

Contrary to requirements contained in HUD Handbook 4155.1, "Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Family Properties," Pan American did not exercise sound judgment and due diligence in the processing and underwriting of loans to be insured by the Federal Housing Administration. In 10 loans, Pan American did not exercise the care expected of a prudent lender in the analysis of the borrower's assets, earnings, and debts. Pan American failed to properly evaluate borrowers' earnings and debts, allowed interested third parties to handle key documents, did not properly document the source of borrower investment, did not provide valid or supported compensation factors for excessive debt to income ratios, and did not clarify important file discrepancies. Pan American also approved seven loans that did not comply with HUD's self-

sufficiency requirement and, thus, were over-insured by \$209,889. The deficiencies occurred because Pan American did not establish and implement adequate controls to ensure that its employees followed HUD requirements when processing and underwriting loans. These deficiencies contributed to Pan American's high default rate and increased HUD's risk to the Federal Housing Administration insurance fund.

## Recommendations

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

- 1A. Require Pan American to indemnify HUD against future losses for the nine actively insured loans totaling \$1,391,208, for which Pan American did not follow HUD loan origination requirements.<sup>3</sup> Appendix D lists case numbers for the loans included in this recommendation.
- 1B. Require Pan American to pay down the over-insured amount, totaling \$209,889, for the seven loans in which Pan American did not follow HUD's self-sufficiency requirement.
- 1C. Take appropriate monitoring measures to ensure Pan American establishes and implements appropriate controls so that its employees follow HUD requirements when processing and underwriting loans if HUD allows Pan American to continue as a non-supervised direct endorsement lender.

---

<sup>3</sup> According to Neighborhood Watch, as of August 2004, 1 of the 10 loans has terminated FHA insurance without a claim (Case #501-6839882). Because this loan no longer represents a risk to the insurance fund, we have removed it from our recommendation.

## Finding 2: Pan American Did Not Fully Implement Its Quality Control Plan as Required

Contrary to HUD requirements, Pan American did not fully implement its quality control plan as required. It has not implemented procedures or controls to ensure that all Federal Housing Administration-insured loans that default within 6 months of closing undergo a loan origination quality control review. We attribute this deficiency to Pan American's disregard of HUD requirements and instructions. As a result, HUD has no assurance of the accuracy, validity, and completeness of Pan American's loan origination operations.

---

### Early Default Loans Not Reviewed for Quality Control

Although HUD Handbook 4060.1, "Mortgage Approval Handbook," requires performing quality control reviews of all loans defaulting within 6 months of closing; our audit showed that Pan American did not perform all the required reviews. For example, of the eight early defaulted loans in our sample, Pan American only reviewed one loan. This loan was reviewed as part of the monthly review of loans, not as an early default case.

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

### Required Corrective Actions Were Not Taken

In April 2002, HUD conducted a review, found that Pan American failed to maintain and implement a quality control plan in compliance with HUD requirements, and instructed management to revise and implement procedures to correct the deficiencies. HUD found Pan American did not review 28 loans that went into default within the first 6 months of closing. Pan American was instructed to conduct the reviews and provide a summary, along with copies of reports provided to senior management. As of the date of our review, Pan American did not take corrective actions, and the finding remains unresolved.

Since HUD had previously instructed Pan American of its responsibilities to maintain and implement a quality control plan, management was knowledgeable of the requirements, yet Pan American management failed to fulfill its responsibilities. Pan American's Quality Control Manager explained she did not know about the loans that defaulted within the first 6 months, since the loans are sold, and believed the responsibility of performing the reviews fell upon the entity that purchased the loans. A former Quality Control Manager also informed us she was not aware of the contents and/or requirements included in HUD Handbook 4060.1. This was not an acceptable explanation for not performing an integral component of its Federal Housing Administration loan program responsibilities.

## **Conclusion**

Contrary to HUD requirements, Pan American has not implemented procedures or controls to ensure that all Federal Housing Administration-insured loans that default within 6 months of closing undergo a loan origination quality control review. We attribute this deficiency to Pan American's disregard of HUD requirements and instructions. As a result, HUD has no assurance of the accuracy, validity, and completeness of Pan American's loan origination operations.

## **Recommendation**

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

- 2A. Take appropriate monitoring measures to ensure Pan American conducts the required quality control plan reviews and that corrective action is taken and documented for all reported deficiencies if HUD allows Pan American to continue as a non-supervised direct endorsement lender.

## SCOPE AND METHODOLOGY

---

To achieve our audit objectives we reviewed

- Applicable laws, regulations, and other HUD program requirements;
- Procedures established by Pan American in originating Federal Housing Administration-insured loans;
- Quality control plan of Pan American and its implementation; and,
- Files and documents from HUD and Pan American.

We also reviewed 10 Federal Housing Administration-insured loans that had defaulted within the first 2 years from origination. In addition, we reviewed 15 loans of three- and four-unit properties to determine whether Pan American complied with HUD's self-sufficiency requirement.

In addition, we interviewed appropriate officials and staff from Pan American and HUD's Atlanta Single Family Homeownership Center. We also interviewed borrowers to verify the information in the files.

We performed our review between February and October 2004. The audit covered the period January 1, 2002, through December 31, 2003, but we extended the period as necessary to achieve the audit objective.

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 in place to reasonably ensure that the loan origination process complies with HUD program 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 that valid and reliable data are obtained, maintained, and used during the mortgage loan origination process.
- **Compliance with Regulations.** Policies and procedures that management has implemented to reasonably ensure that its loan origination process is carried out in accordance with applicable regulations.

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:

- Pan American did not follow HUD requirements when originating and approving 17 Federal Housing Administration-insured loans (see finding 1).
- Pan American has not implemented its quality control plan in accordance with HUD requirements (see finding 2).

# APPENDIXES

## Appendix A

### SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

<u>Recommendation Number</u>	<u>Ineligible 1/</u>	<u>Funds To Be Put to Better Use 2/</u>
1A		\$ 1,391,208
1B	\$ 209,889	

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local polices or regulations.

2/ 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.

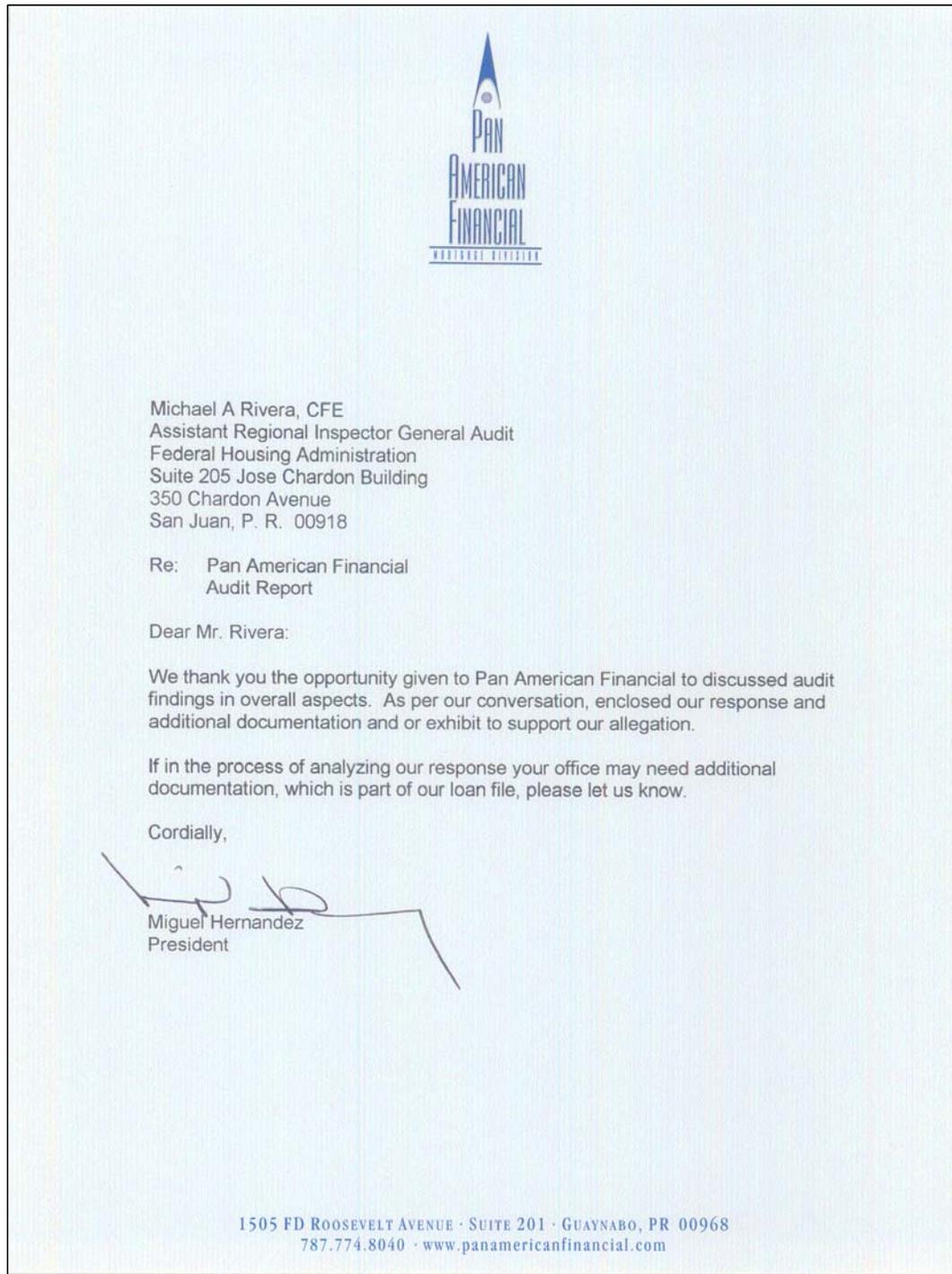
## Appendix B

# AUDITEE COMMENTS AND OIG'S EVALUATION

---

### Ref to OIG Evaluation

### Auditee Comments





December 17, 2004

Michael A. Rivera, CFE  
Assistant Regional Inspector General Audit  
Federal Housing Administration  
Suite 205 Jose Chardon Building  
350 Chardon Avenue  
San Juan PR 00918

Re: Pan American Financial  
Audit Report

Dear Mr. Rivera:

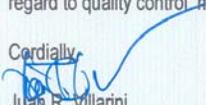
We thank you the opportunity given to Pan American Financial to discussed audit findings in overall aspects. As per our conversation, enclosed our response and additional documentation and or exhibits to support our allegation.

For each loan in which we discussed your audit, in a brief summary, we insert an exhibit identified with a corresponding number, which clear the detected defficiency or expand the view of the underwriting process made by our institution. In the situations, that the discussion is related to an exception, we briefly state our non compliance jointly with our exhibits, please find the following documentation :

1-Letter from FHLMC, which is self explanatory as to Pan American Financial Compliance with their quality control procedures.

2-Letter from Tenna explaining their audit coverage and past performance in last months.

3-Exhibits which we used in our internal quality control procedures and seminars, held with managers and employees on schedule basis and communications given to our personnel in regard to quality control measures.

Cordially,  
  
Juan R. Villarini  
Executive Vice-President

1505 FD ROOSEVELT AVENUE · SUITE 201 · GUAYNABO, PR 00968  
787.774.8040 · www.panamericanfinancial.com

Comment 1

Comment 2

**Re: [\* Borrower 1]-FHA No.: 501-6839882-703**

Letter issued by authorized representative of [\* Savings and Loan Cooperative].  
[\* Cooperative employee] indicated that [\* Borrower 1] is fully authorized to withdrawn funds from this account (**Exhibit 1**).  
Page 18 of the Appraisal Report indicates that property was sold by original owner that lives within one-year time frame. Property evidentiates several improvements made by owner as indicated by fee appraiser (**Exhibit 2**).  
Property flipping regulation was effective as of June 2, 2003 (**Exhibit 3**).

Comment 3

**Re: [\* Borrower 2]-FHA No.: 501-6549444-703**

Earnest deposit given to realtor was verified using the following procedure; photocopy of money order #31-003005819 issued by [\*Bank] for the amount of \$7,000.00 and dated January 30, 2002 was provided, jointly with deposit ticket this funds were redirected to realtor account. Photocopy of savings account was provided evidencing the retirement of the funds as of January 30, 2002 (**Exhibit 1**).

Comment 4

Sales contract provided by the realtor those not mentioned nor detailed earnest deposit received, because this action was after the signature of the Sales Contract (**Exhibit 2**). Income Tax Returned provided by borrower were dully signed by [\* Borrower 2] covering two years of business operation.  
The statement included contained all corresponding exhibit and schedule M applicable (**Exhibit 3**).

Comment 5

Value conclusion was reached by the appraiser after reviewing which comparable have less adjustments; comparable #2 percent adjustment is only 1 %; and represent the best value for this type of property; final value

[\*] Name of borrowers, family members, financial institutions, employees, and real estate agent were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

Comment 5

\$195,000.00 as of January 29, 2002. First page of the Appraisal Report the appraiser stated that property has appropriate water heater (**Exhibit 4**).

Comment 6

Pan American Financial to verify the existence of the business owned by [\* Borrower 2] requested a Field Inspection to the Credit Agency; when inspected the site verifying the inspector notice a good flow of clients in a time frame of an hour and a half (**Exhibit 5**).

Comment 7

**Re: [\* Borrower 3]-FHA No.: 501-6710133-703  
Mortgage Letter 00-28**

Bank confirmation as of 10/31/02 issued by [\*] reflects funds disbursements of \$9,308 from donor savings account; certified check 276717 issued in the amount \$9,300 on October 31, 2002 and funds deposited in Pan American Financial the same date (**Exhibit 1**). Funds were retired from the donor account according to Mortgage Letter 00-28 (**Exhibit 1A**). Title Letter Study in file clearly evidenced that our applicant does not have any blood relationship with sellers (**Exhibit 2**). Income substantiation was determined and obtained from the Income Tax Return for the year 2001, verification of employment was used as a point of reference of applicant employment in the absent of check pay stubs (**Exhibit 3**). Credit reference from different vendors were fax by our applicant using the services of Office Max of Caguas, phone number 258-1410. Applicant furnished documentary evidence that he paid the amount of \$530.00 monthly as rent payment. See enclosed copies of receipt (**Exhibit 4 and 5**).

[\*] Name of borrowers, family members, financial institutions, employees, and real estate agent were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

**Re: [\* Borrower 4]-FHA No.: 501-6581138-703**

Comment 8

Three successive photocopies of bank statements in file reveals that applicant have sufficient funds in his savings account for withdrawal from savings account of 01/16/02 in the amount of \$7,311.71. To corroborate available funds to close we requested a savings history as of 02/12/02 evidencing funds sufficient for the issuance of check in the amount of \$7,300.00 tendered to real estate broker in certified check on February 23, 2002 and deposited in his account on February 25, 2002 (**Exhibit 1**). Based on the evidence of funds received by real estate broker we identified this amount as earnest deposit in the Settlement Statement. At closing our applicant did not content the amount reflected as earnest deposit and stamps his signature in the Settlement Statement (**Exhibit 2**). Income Tax Returned for last two years contained exhibit M and which are the ones required by the Department of Treasury for this type of business (**Exhibit 3**). Field Inspection to applicant business was made to corroborate source of income (**Exhibit 4**).

Comment 9

HUD Form 92564-VC, which is part of the Appraisal Report, the fee appraiser is requesting three water and two electric meters so unit will have independent services of water and electricity for all units (**Exhibit 5**). Compliance Inspection Report indicates all repairs were dully completed (**Exhibit 6**). Comparable #3 is the nearest to the subject and most recent sale; even though this situation the appraiser rendered value conclusion based on comparable #1. Estimate market rent income considered by the appraiser of \$1,700.00 monthly only take in consideration income for three units; income considering the four units should read \$2,300.00 multiplying by 85%=net rental income of \$1,955.00 monthly (**Exhibit 7**).

[\*] Name of borrowers, family members, financial institutions, employees, and real estate agent were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

Comment 10

**Re: [\* Borrower 5]-FHA No.: 501-6665346-703**

According to pay stub in applicant file funds advance from employer to employee were for the concept of vacation advance in the amount of \$4,330.00 and salary advance for \$2,165.00 (**Exhibit 1**). The employer advance this benefit to our applicant prior to loan closing; if we considered this part as an unsecured loan still client qualification parameters are within FHA guidelines. Applicant funds with [\* Bank A] in stocks is for \$11,848.62, less personal loan for \$8,615.69 leaves funds available for closing \$3,232.93 (**Exhibit 2**) if you add [\* Bank B] available funds of \$7,571.97 (**Exhibit 3**) this will sum the amount of \$10,804.90. Pay stub in the file reveals that applicant is recipient of a monthly pension from [\* Employer] in the amount of \$952.00 (**Exhibit 4**); please note that the exclusion of this benefit will not affect loan qualification for this case. Lease Contract in this file evidences Lives Rental income for all units ascending to \$2,160.00; multiply by .85, equal net Rental Income of \$1,836.00 monthly (**Exhibit 5**).

Comment 11

**Re: [\* Borrower 6]-FHA No.: 501-6620514-703**

Borrower open a recent account as of April 18, 2002, the face of the VOD from [\* Bank] indicates that applicant closed savings account number [\*] and open account [\*] with a balance of \$1,733.94; to substantiate this action applicant provided photocopy of his bank statement (**Exhibit 1**). Income evaluated for credit analysis purposes were based on applicant last two years Income Tax Returned; this average income determination will show a most standard income determination (**Exhibit 2**). Tax Certification in file indicates that property annual tax liability were \$8.90 yearly, when the Underwriter approved the application in May 31, 2002 that was the fact evaluated in the loan

[\*] Name of borrowers, family members, financial institutions, employees, and real estate agent were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

Comment 11

application. The tax assessment made by our Closing Section was made after the loan approval (**Exhibit 3**). The application signed by borrower on March 25, 2002 reflects a selling price of \$90,000.00 (**Exhibit 4**); Sales Agreement dated March 4, 2002 (21 days prior the loan origination) between applicant and realtor speaks of a selling price of \$90,000.00 (**Exhibit 5**). Upon receipt the appraisal value the realtor adjust the price (**Exhibit 6**). [\* Agent] Contract with applicant does not cover the inclusion of any appliances. At the moment of the appraisal execution driveway was in place (**Exhibit 7**).

**Re: [\* Borrower 7]-FHA No.: 501-6758930-734**

Comment 12

Gross up percent used in this case was 16%; computation of gross-up could be within a range of 15% to 25% percent (**Exhibit 1**). Credit Report reveals that applicant satisfied 19 accounts in an excellent manner (**Exhibit 2**). Tenant occupying his real estate owned was responsible to satisfied mortgage payment; see Legal Contract in file in this regard (**Exhibit 3**).

Comment 13

Occupancy Certification in file signed by our client whom is a lawyer; said that he intent was to occupy the unit as his principle residence; needless to say that our personnel was not aware of applicant position of non residing unit purchase (**Exhibit 4**).

**Re: [\* Borrower 8]-FHA No.: 501-6526790-703**

Comment 14

Applicant provided us original form 310-05; this is a certification issued by the Treasury Department, which reflects applicant income reflected on his Income Tax Returned for the year 1999, 2000 and for year 2001 we considered applicant income from his W-2 form (**Exhibit 1**). For the month of January we have

[\*] Name of borrowers, family members, financial institutions, employees, and real estate agent were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

Comment 14

completed pay stub covering the whole month. Please note that form 310-05 is a form that when issued by the government agency they affix to the document a stamp paid by the client. Definitely there is an eight months gap in applicant prior employment. Applicant entered in a family related transaction when he transferred his car to one of his family component the action of applicant requiring possession of the car and assuring car payment, upon gathering the where about of the delinquency; reflects positive and responsible attitude in part of applicant to sustained an affordable payment history. Also we considered in applicant's debt service ratio in loan payment (**Exhibit 2**). At the moment of loan approval hazard insurance premium monthly reserve was estimated, because final flood and hazard cost insurance was not received as yet (**Exhibit 3**). Out of court Child Support Payment Agreement in our area it is quite customarily, especially when two singles in a mutual relationships procreate. Income stream was not considered for qualification purpose, it mentioning on the analysis was made with purposes of indicating additional immediate source of cash available by our client (**Exhibit 4**). The appraiser incorrectly stated that the property was not located in a flood zone area. Independently of its location in a zone area name flooded, this will not affect the value of the unit; value conclusions are based on recent comparable found from similar properties characteristics. The appraiser did not mention the format of the report the reason for positive adjustments in the location item for \$5,000.00; as per location map, subject location is superior than comparable #1 and 2 (**Exhibit 5**). Documents fax by the realtor was retained in our file, borrower income was made using alternate documents as mentioned in previously.

**Re: [\* Borrower 9]-FHA No.: 501-6684590-703**

Comment 15

Donors savings account history as of 08/29/2002 provided reflects sufficient funds available for the issuance of manager check #2408158 from [\*]

[\*] Name of borrowers, family members, financial institutions, employees, and real estate agent were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

Comment 15

in the amount of \$4,000.00; kindly note that this account pertain to [\* family member]. Funds were deposited in our institution on September 3, 2002 (**Exhibit 1**). The Comptroller from [\* Employer] on August 30, 2002 by means of a VOE he stated that applicant monthly income is \$4,500.00. For further review of income earned please check pay stub dated 08/15/2002. We have in file two-income verification from same employer ratifying same information. Form 480 and Income Tax Return for last year and analysis of pay stub coincide that applicant annual income is more than \$29,473 (**Exhibit 2**). [\* Financial institution] account identified with loan number [\*] appears 3 time in the Credit Report, please note that credit information rated credit experience for this account in two times as good and one time as the account been driven to collection. Evidently applicant paid in full the account before two years period (**Exhibit 3**). According to different seminars taken with FHA officials the guidelines does not to intent to exclude other positive compensating factors contained in the loan application.

Comment 16

Property located in a suburban area; we accompany supporting document that will help your office to comprehend real value for this location (**Exhibit 4**).

**Re: [\* Borrower 10]-FHA No.: 501-6713435-703**

Comment 17

Seller certified that property needs repairs and absorbed by buyer; not withstanding we do not have bills paid for the repairs; however value conclusion of the unit reached the amount of \$87,000.00, \$2,000.00 over the selling price. Evidently repairs were completed before the Appraisal report made, for the benefit of purchaser and improved appraise value of the property (**Exhibit 1**).

Comment 18

[\*Coborrower] date of employment with the [\* Employer] started on August 2002, as of the date of the completion of her income

[\*] Name of borrowers, family members, financial institutions, employees, and real estate agent were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

Comment 18

verification she was still pending of receipt of the first paycheck, which was provided to our institution. Verification of Employment stated the amount \$800.00 as her base monthly salary, upon receipt of the pay stub the reduction of the income was noted. School Directors are dully authorized to verify employment information for personnel attached to their section. Pan American Financial was suppose to adjust her income in FHA Form 92900 (Worksheet) and omit to do so (**Exhibit 2**).

Comment 19

Certification provided and dated October 14, 2002 was forwarded to our institution by the House of Representative upon request made to applicant regarding length of employment, to substantiate two years period in same employment, please note that the letter was provided in a letter head pertained to this government agency (**Exhibit 3**).

Comment 20

Comment on worksheet pertaining to applicant temporary on employment were made with the purpose of indicating that applicant income perspective was expected to increase in forthcoming future (**Exhibit 4**).

[\*] Name of borrowers, family members, financial institutions, employees, and real estate agent were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

Comment 21

**PROPERTIES 3-4 UNITS**

1. **501-6538799-[\* Borrower 11]**  
Market Rent = 2,100 (Including subject for 700.00 aprox.) - 15%=1785.00  
PITI = 1513.59-1785-Ratio=.87 (Appraiser estimated 1400.00 for 2 units equivalent to 700.00 per unit). See attached supporting documents (appraisal) that help to comprehend real market rent for this area.
2. **501-6649973-[\* Borrower 12]**  
Market Rent = 2,100 (+1,000 aprox. Subject Property) =3,100-15%=2635  
PITI =2,117.60  
Ratio=.80  
(For the analysis, we did not use the Rental Income.)
3. **501-6806123-[\* Borrower 13]**  
Market Rent =1,900-15%=1615  
PITI =1058.32  
Ratio =.66  
(For the analysis we estimate \$600.00 only for rent -25% vacancy [Safe y Conservative]). See attached estimate Rental Income for all units
4. **501-68208-[\* Borrower 14]**  
Market Rent = 1,085 ( + 500 Subject Prop. = 1585-15%=1347.25  
PITI = 1069.41  
Ratio = .79  
(Rent Contracts = 900.00 for only two units) Subject is bigger and we are adding \$500.00 approximately.
5. **501-6604881-[\* Borrower 15]**  
Market Rent = 1,200(+500 Subject)-15%=1445. See attached suporting documents.  
PITI = 1184.58  
Ratio = .81  
Contracts = 1290  
                  319.75  
                  648.75
6. **501-6618527 -[\* Borrower 16]**  
Market Rent = 1 , 100 + 300-Subject Property-15% = 1,190  
PITI = 870.26  
Ratio = .73  
(Contracts for 3 units = \$1,020.00. (Average Unit \$350.00 approx. We use \$765.00 for Net Rent)

[\*] Name of borrowers, family members, financial institutions, employees, and real estate agent were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

Comment 21

7. **501-6817864-[\* Borrower 17]**  
Market Rent = 1,150-15%=977.50. See attached supporting documents.  
PITI = 948.21  
Ratio = .97%  
(We did not use Rental Income for qualification. )

[\*] Name of borrowers, family members, financial institutions, employees, and real estate agent were redacted by OIG to preserve their privacy. In some instances, titles were inserted to preserve the meaning of the text.

## OIG Evaluation of Auditee Comments

**Comment 1**

Pan American's response did not state whether they concur or not with our audit recommendations. The response included a brief statement for each loan discussed in finding 1, and provided additional documents for our evaluation. Pan American did not provide comments to finding 2.

FHA Case Number 501-6839882-703

**Comment 2**

Pan American did not verify assets in accordance with HUD requirements. The letter from the financial institution indicating the borrower could withdraw funds from the account is not sufficient to meet HUD requirements, or to ensure funds did not originate from an unallowable source. The appraisal report did not disclose that the subject property was sold less than 1 year before the appraisal date.

FHA Case Number 501-6549444-703

**Comment 3**

Pan American states it properly verified the borrower's earnest money, and that using copies of key documents was proper. However, this is inconsistent with what we found in the files and with what the borrower told us. Pan American did not comment on our concern that all required documents were provided by the real estate agent (interested third party), which violates HUD requirements.

**Comment 4**

The tax returns were not complete because Schedule A was missing. In addition, Pan American did not obtain a year-to-date profit and loss statement and balance sheet.

**Comment 5**

Pan American did not comment on the issue that one of the comparables was superior to the subject property. We were able to identify properties sold within the vicinity of the subject property at prices below the appraised value of the subject property.

**Comment 6**

Lenders must establish that the borrower has the ability to repay the mortgage debt and it must be supported by sufficient documentation. A field inspection is not sufficient to assess the financial strength, and properly determine if the business can be expected to generate sufficient income.

**Comment 7**

FHA Case Number 501-6710133-703

Pan American did not obtain sufficient documentation to ensure gift funds were not provided from an unacceptable source and were the donor's personal funds. We found a relationship existed between the borrower and the seller. This was confirmed through an interview with the seller. Pan American acknowledges the borrower faxed letters that were used to support the credit history. Pan American did not comment on our concern that the borrower completed the Verification of Employment. In addition, Pan American did not explain the inconsistencies pertaining to the borrower's employment date and monthly rent.

**Comment 8**

FHA Case Number 501-6581138-703

Pan American states it properly verified the borrower's earnest money. However, this is inconsistent with what was in the files and with what the borrower told us. Pan American did not verify assets in accordance with HUD requirements, and cannot ensure the funds were not from an unacceptable source. Pan American did not comment on the fact that an interested third party provided all required documents, which violates HUD requirements. Contrary to Pan American's claim, the tax returns were not complete since Schedule A was missing. Pan American did not obtain a year-to-date profit and loss statement and balance sheet from the borrower.

Lenders must establish that the borrower has the ability to repay the mortgage debt and must be supported by sufficient documentation. The field inspection is not sufficient to assess the financial strength and properly determine if the business can be expected to generate sufficient income.

The borrower told us the electrical and other needed repairs were never completed although the inspection report reflected the repairs were done. Therefore, the property does not comply with HUD property standards.

**Comment 9**

Pan American claims the estimated rental income of \$1,700 used by the appraiser only considered the income of three units, and the correct rental income should be \$2,300 for all four units. Contrary to Pan American's claim, the appraiser's estimate of \$1,700 did consider all units within the property. In addition, Pan American did not provide any support showing how the \$2,300 was determined. Pan American did not ensure the loan complied with HUD's self-sufficiency requirement.

Pan American states the appraiser used comparable number 1 to determine the value of the subject property. However, Pan American did not comment on the fact that such comparable was superior to the subject property.

**Comment 10**

FHA Case Number 501-6665346-703

Pan American claims that even considering the advances as an unsecured loan; the borrower would still qualify. Pan American did not adhere to HUD requirements by considering the advances.

Pan American states that the borrower had \$10,805 available for closing. This information is not consistent with the information we obtained. The \$10,805 included \$5,303 in ineligible advances. In addition, the \$11,848 in the savings account was not available since all the funds in the account were securing a loan the borrower had with the financial institution. Pan American did not properly determine whether assets could be included as cash reserves or cash to close.

Pan American states that the property's contracted monthly rental income was \$2,160; therefore, it exceeded the monthly mortgage payment. This is not in accordance with HUD Handbook 4155.1, Revision 4. The handbook provides that lenders must use the appraiser's estimate of fair market rent, in this case \$1,975, and not the contracted rent as claimed by Pan American. The monthly mortgage payment exceeded the monthly net rental income, which violates HUD requirements.

**Comment 11**

FHA Case Number 501-6620514-703

Pan American claims the funds came from another account previously closed by the borrower. However, the documentation provided by Pan American did not support the alleged transfer of funds. Pan American did not properly verify or document the source of funds to close.

Pan American states that it evaluated the borrower's tax returns for credit analysis. The information obtained was not sufficient and HUD guidelines were not followed. Pan American did not obtain a year-to-date profit-and-loss statement and a balance sheet.

Pan American did not comment on the borrower's claim that he signed documents that were blank. The borrower informed us that he signed various applications that were blank and signatures on various documents were not his. The borrower told us he signed the documents on the closing date, despite the increase in price, because he already constructed a paved driveway, and had already moved out of the rental unit.

The appraisal report contained inconsistencies related to the equipment reported as in place and considered to assess the property's value. The borrower informed us that the appliances were not in the property. In relation to the property's driveway, Pan American did not comment on the borrower's claim that it was not paved and he made the improvements before the closing. The information provided by the borrower was consistent with a plot plan dated April 2002, that showed the property without a paved driveway.

FHA Case Number 501-6758930-703

**Comment 12**

Pan American "grossed-up" the borrower's earnings by 16 percent, and claims it was within the allowable range of 15 to 25 percent. This position is not in agreement with guidelines contained in Mortgagee Letter 97-26. Furthermore, Pan American did not provide documentation that could show how the "grossed-up" amount was determined.

Pan American did not comment on our concern that adequate explanation for recent indications of credit problems was not obtained. Responsibility for satisfying mortgage payments lies with the borrower. The contract between the lender and the borrower has precedence over any other agreement the borrower might have with a tenant. Therefore, the borrower was still responsible to satisfy the mortgage payments.

**Comment 13** We acknowledge the borrower incorrectly certified he would occupy the property as his principal residence.

**Comment 14** [FHA Case Number 501-6526790-703](#)

Pan American did not verify earnings in accordance with HUD requirements. The most recent earning statements only covered a 15-day period instead of the required 30-day period. In addition, an interested third party handled key documents. Pan American did not obtain adequate explanation for recent indications of credit problems, and the compensating factor was not properly supported. In addition, the appraisal report should have reflected an adjustment because the property was located in a flood zone area.

[FHA Case Number 501-6684590-703](#)

**Comment 15** Pan American did not address our concern that a withdrawal document was not obtained to support the source of funds, as required by HUD. The earnings overstatement was uncovered through direct verification with the employer. This occurred because of a breakdown in the controls that allowed an interested third party to provide Pan American key documents containing misrepresentations. Pan American did not obtain an explanation for the debt that went into collections, and it did not use valid compensating factors.

**Comment 16** Although the property is located in a suburban area, comparables in the appraisal report were not similar to the subject property. The comparables used by the appraiser were developments located in urban areas, located between 5 and 7 miles away from the subject.

**Comment 17**

FHA Case Number 501-6713435-703

The fact the property's appraised value exceeded the selling price, does not diminish Pan American's failure to follow HUD requirements. Although Pan American claims the repairs were made before the appraisal, it did not provide any documents to support this statement or the nature of the alleged repairs.

**Comment 18**

Pan American acknowledges it miscalculated effective income by overstating earnings.

**Comment 19**

Pan American did not resolve the inconsistencies on the borrower's date of employment. Had Pan American verified this information, it would have found the borrower had less than a year on the job. Contrary to Pan American's claim, the employer did not originate the October 2002 certification. The certification was faxed from the office of the real estate agent (interested third party).

**Comment 20**

Pan American did not provide an acceptable compensating factor to approve the loan. The compensating factor used did not support Pan American's claim the applicant income was expected to increase.

**Comment 21**

Pan American did not take steps to ensure the loans complied with HUD's self-sufficiency requirements. Although Pan American claims the appraiser's estimate of market rent does not consider the rental income of property's main unit, the documents provided did not show the basis for the claim. Our assessment followed guidelines contained in HUD Handbook 4155.1, Revision 4. The appraiser's estimate of fair market rent included all units within the subject's property. Furthermore, the appraiser's estimate is used to determine the property's value using the income approach. For seven loans, the monthly mortgage payment exceeded the property's monthly net rental income.

## Appendix C

### SUMMARY OF LOAN DEFICIENCIES

---

Case Number	Inadequate Asset Verification	Inadequate Earnings Verification	Key Documents with Misrepresentations	Key Document Handled by Interested Third Party	Inadequate Debt Verification	Excessive Ratios	Other Deficiencies and/or Inconsistencies
501-6665346	X	X					X
501-6581138	X	X	X	X			X
501-6549444	X	X	X	X		X	X
501-6684590	X		X		X	X	X
501-6758930		X	X	X	X		
501-6526790		X		X	X		X
501-6710133	X	X		X			
501-6620514	X	X	X	X	X	X	X
501-6713435	X	X	X	X	X	X	
501-6839882	X						X
Total	8	8	6	7	5	4	7

## Appendix D

### ACTIVE LOANS PAN AMERICAN SHOULD INDEMNIFY

---

<b>Case Number</b>	<b>Loan Amount</b>	<b>Settlement Date</b>	<b>Status</b>
501-6665346	\$233,157	06/28/02	In default
501-6581138	191,983	03/14/02	In default
501-6549444	185,908	02/12/02	In default
501-6684590	181,565	09/04/02	Reinstated by mortgagor
501-6758930	171,050	01/24/03	In default
501-6526790	158,746	03/20/02	In default
501-6710133	99,216	11/01/02	In default
501-6620514	85,250	06/03/02	In default
501-6713435	84,333	12/02/02	In default
<b>Total</b>	<b>\$1,391,208</b>		

## Appendix E

### NARRATIVE LOAN DEFICIENCIES

---

Case number: 501-6549444  
Mortgage amount: \$185,908  
Section of Housing Act: 203B  
Date of loan closing: 2/12/02  
Current status: In default as of 8/31/04 - first legal action  
to commence foreclosure  
Cause of default: Excessive obligations

#### **Summary:**

##### Assets Analysis

The borrower's earnest money was not properly verified. The savings account statements and other documents used to support \$7,000 in earnest money were faxed, apparently from the real estate agent. The borrower informed us the amount in the statements was not correct and the fund balance was overstated. The borrower also advised us that only \$1,000 was provided as earnest money, not the \$7,000 shown on the Settlement Statement. The loan file did not contain verification of deposit or originals of the two most recent bank statements. This is contrary to requirements of HUD Handbook 4155.1, Revision 4, paragraph 3-1F. According to the borrower, all required documents were provided to the real estate agent (interested third party), who forwarded them to Pan American. In addition, the date of closing was the only time the borrower had contact with Pan American officials.

##### Earnings Analysis

Pan American used tax returns to validate income information and qualify the borrower for the loan. However, these did not include all corresponding schedules, as required by HUD Handbook 4155.1, Revision 4, paragraph 2-9B. Also, the lender did not obtain a year-to-date profit and loss statement and balance sheet. The borrower informed us the tax returns were prepared by the seller's real estate agent and could not explain where the agent obtained the information. The 2001 tax returns used by Pan American reflected earnings of \$58,000, while the official tax return filed with the Puerto Rico Treasury Department showed \$18,000.

## Other

The appraisal report contained items that could affect the value of the property. One of the comparables included in the appraisal report was superior to the subject property. The appraisal report included a statement indicating there were no comparables in the immediate vicinity of the subject property. However, we were able to identify properties sold within the vicinity of the subject property at prices below the appraised value of the subject property.

In addition, the property did not have a water heater in working condition in violation of property standards contained in HUD Handbook 4000.2, Revision 2, paragraph 2-8F.

---

Case number: 501-6839882  
Mortgage amount: \$208,354  
Section of Housing Act: 203B  
Date of loan closing: 4/17/03  
Current status: Terminated (paid in full) as of 8/31/04  
Cause of default: Excessive obligations

**Summary:**

Asset Analysis

Pan American did not obtain a verification of deposit or originals of the two most recent bank statements, violating requirements of HUD Handbook 4155.1, Revision 4, paragraph 3-1F. The documentation used to verify the assets by Pan American consisted of copies. As a result, Pan American cannot ensure the funds were not from an unacceptable source and were the borrower's own funds. We consider that such assurance was imperative since the account was in the name of the borrower's sister-in-law.

Other

The appraisal report did not disclose the subject property was sold less than 1 year before the appraisal date, violating Uniform Standards of Professional Appraisal Practice.

According to Neighborhood Watch, as of August 2004, this loan has terminated Federal Housing Administration insurance without a claim. Because this loan no longer represents a risk to the insurance fund, we have removed it from our recommendation.

---

Case number: 501-6713435  
Mortgage amount: \$84,333  
Section of Housing Act: 203B  
Date of loan closing: 12/02/02  
Current status: In default as of 8/31/04 - first legal action  
to commence foreclosure  
Cause for default: Curtailment of borrower income

## Summary

### Assets Analysis

Pan American did not properly verify borrower's cash investments. The Settlement Statement reflected initial deposits totaling \$1,550. This pertained to materials (sweat equity) allegedly furnished by the borrower for repairs on the property and considered as the equivalent of a cash investment by Pan American. The loan file included a letter from the seller, acknowledging the borrower made \$1,550 in improvements. Contrary to HUD Handbook 4155.1, Revision 4, paragraph 2-10(O), Pan American did not obtain evidence of the nature of the repairs, the source of the funds used to purchase the materials, and the market value of the materials. In addition, the appraisal report did not list any repairs or improvements needed on the property.

### Earnings Analysis

Pan American miscalculated effective income by overstating earnings. The coborrower's verification of employment reflected a monthly salary of \$800. However, a copy of a wage statement showed a monthly salary of \$754. Pan American used the higher amount to approve the loan, but there was no support clarifying the inconsistency. We contacted the employer and found the personnel office did not prepare the verification. The director of the school where the coborrower worked apparently completed the verification. According to the personnel office, the correct monthly salary was \$754 as reflected in the earning statements.

Pan American did not properly resolve conflicting information within the loan file in relation to the borrower's employment. The Request for Verification of Employment, dated September 27, 2002, stated the borrower commenced working at the Puerto Rico House of Representatives in October 2001. However, a certification, dated October 14, 2002, stated the borrower commenced working in February 1998. There was no documentation in the loan file showing Pan American resolved this inconsistency. We contacted the employer and found the personnel office did not originate the October 2002 certification. Had Pan American verified this information, it would have found the borrower had less than a year on the job at the time the Request for Verification of Employment was completed. Accordingly, Pan American did not verify the borrower's employment for the most recent 2 full years, as required by HUD Handbook 4155.1, Revision 4, paragraph 2-6.

### Debt Analysis

Pan American also excluded from the debt analysis monthly payments, totaling \$205, the borrowers had with two creditors. This debt was included in the credit report, but there was no explanation or support for the understatement. Had Pan American used the correct amounts, it would have calculated the fixed obligations to effective income ratio at 54 percent, which exceeds HUD's permissible rate of 41 percent, as prescribed in HUD Handbook 4155.1, Revision 4, paragraph 2-12B.

### Other

In addition, Pan American did not use or provide a significant compensating factor to approve the loan, although the calculated fixed obligations to effective income ratio was 46 percent, which exceeds HUD's permissible rate of 41 percent. The compensating factor used by Pan American indicated the borrower rejoined the work force and was currently working in public relations. This was not an acceptable compensating factor, as prescribed in HUD Handbook 4155.1, Revision 4, paragraph 2-13.

---

Case number: 501-6710133  
Mortgage amount: \$99,216  
Section of Housing Act: 203B  
Date of loan closing: 11/01/2002  
Current status: In default as of 08/31/04 - first legal action  
to commence foreclosure  
Cause of default: Other

## Summary

### Assets Analysis

Contrary to requirements of Mortgagee Letter 00-28, Pan American did not obtain sufficient documentation to ensure \$9,300 in gift funds were not provided from an unacceptable source and were the donor's own funds. We consider that such assurance was imperative since there was a relationship among the borrower, seller, employer, and gift donor.<sup>4</sup> Pan American did not obtain bank statements that could show a history of the account and the existence of the donor's funds. Therefore, Pan American cannot assure the gift funds did not come from the seller or other unacceptable source.

### Other

Our review disclosed that key documents were handled by the borrower or were not obtained directly from the source. For example, we found the borrower completed the Verification of Employment in violation of HUD Handbook 4155.1, Revision 4, paragraph 3-2B. The verification was faxed from an entity named V.V.O. Investment, but Pan American could not explain what this entity was. In addition, letters from three vendors supporting the borrower's credit history were faxed from the same place, showing that documents were not obtained from the source.<sup>5</sup> Further, Pan American did not follow up or clarify other inconsistencies pertaining to the borrower's employment date and monthly rent. The borrower refused to be interviewed by OIG.

---

<sup>4</sup> The seller was also the borrower's employer, and the gift donor was the seller's mother. In addition, the borrower is the daughter-in-law of the seller.

<sup>5</sup> In one of the vendor letters, the handwriting was similar to the borrower's.

---

Case number: 501-6581138  
Mortgage amount: \$191,983  
Section of Housing Act: 203B  
Date of loan closing: 3/14/02  
Current status: In default as of 8/31/04 - delinquent  
Cause of default: Curtailment of borrower income

## Summary

### Assets Analysis

The borrower's earnest money was not properly verified. The Settlement Statement reflected \$7,300 in earnest money. The savings account statements and other documents used to support the earnest money were faxed, apparently from the real estate agent. The borrower informed us the amount in the statements was not correct and the fund balance was overstated. The borrower also advised us that only \$1,000 was provided as earnest money, not the \$7,300 shown in the Settlement Statement. The loan file did not contain a verification of deposit or originals of the two most recent bank statements. This is contrary to requirements of HUD Handbook 4155.1, Revision 4, paragraph 3-1F. According to the borrower, all required documents were provided to the real estate agent (interested third party), who forwarded them to Pan American. In addition, the date of closing was the only time the borrower had contact with Pan American officials. Contrary to requirements contained within HUD Handbook 4155.1, Revision 4, paragraph 3-1, Pan American allowed an interested third party to handle key documents.

### Earnings Analysis

Pan American used copies of tax returns to validate income information and qualify the borrower for the loan. However, these do not include all corresponding schedules as required by HUD Handbook 4155.1, Revision 4, paragraph 2-9(B)(2). We also noted the tax returns were faxed, apparently from the seller's real estate agent. The borrower stated that Pan American never asked for tax returns and could not explain from where the documents came. The tax returns used by Pan American were never filed with the Puerto Rico Treasury Department.

### Other

Pan American did not ensure the loan complied with HUD's self-sufficiency requirement, as included in HUD Handbook 4155.1, Revision 4, paragraph 1-8(C). As a result, the monthly mortgage payment exceeded the property's monthly net rental income. We estimated the loan was overinsured by \$13,018.

The appraisal report contained information that could adversely affect the value of the property. One of the comparables included in the report was superior to the subject property. We also found the property did not comply with property standards requirements contained in HUD Handbook 4000.2, Revision 2, paragraph 2-8. The utilities (water and electricity) were not independent for each unit.

---

Case number: 501-6665346  
Mortgage amount: \$233,157  
Section of Housing Act: 203B  
Date of loan closing: 06/28/2002  
Current status: In default as of 08/31/04 - delinquent  
Cause of default: Curtailment of borrower income

## **Summary**

### Asset Analysis

Pan American did not properly determine whether assets could be included as cash reserves or cash to close. Contrary to requirements contained in HUD Handbook 4155.1, Revision 4, paragraph 2-10(I), Pan American allowed the use of \$5,303 in salary advances to meet investment requirements. A salary advance cannot be considered as assets to close since it represents an unsecured loan.

In addition, Pan American improperly included \$11,848 in a savings account as assets available to the borrower, when all the funds in the account were securing a loan with the financial institution. These restricted assets were included in the Mortgage Credit Analysis as assets available in violation of HUD Handbook 4155.1, Revision 4, paragraph 2-10(D). We also determined the borrower did not have a reserve of 3 months' mortgage payments after closing, required under HUD Handbook 4155.1, Revision 4, paragraph 1-8(C)(4).

### Earnings Analysis

Pan American did not adequately verify retirement income. Pan American did not obtain verification from the source or a tax return as required by HUD Handbook 4155.1, Revision 4, paragraph 2-7.

### Other

Pan American did not ensure the loan complied with HUD's self-sufficiency requirement, as included in HUD Handbook 4155.1, Revision 4, paragraph 1-8(C). As a result, the monthly mortgage payment exceeded the property's monthly net rental income. We estimated the loan was overinsured by \$21,547.

---

Case number:	501-6620514
Mortgage amount:	\$85,250
Section of Housing Act:	203B
Date of loan closing:	06/03/02
Current status:	In default as of 08/31/04 - first legal action to commence foreclosure
Cause of default	Other

## Summary

### Asset Analysis

Pan American did not properly verify or document the source of funds to close. The borrower opened a bank account on April 18, 2002, with a balance of \$1,734. The loan was settled on June 3, 2002, with cash at closing of \$1,734 from the borrower. HUD Handbook 4155.1, Revision 4, paragraph 2-10(B), requires lenders to obtain an explanation and evidence of source of funds on recently opened bank accounts. Pan American did not obtain such documentation.

### Earnings Analysis

Pan American used tax returns to verify earnings and qualify the borrower for the loan. However, the information obtained was not sufficient to determine the borrower's financial strength. For example, Pan American did not obtain a year-to-date profit-and-loss statement and a balance sheet, as required by HUD Handbook 4155.1, Revision 4, paragraph 2-9(B).

### Debt Analysis

Pan American did not properly determine debt to income ratios. The Mortgage Credit Analysis Worksheet reflected the mortgage payment to income ratio at 27 percent and the fixed payment to income ratio at 41 percent. We determined the correct mortgage payment to income ratio at 34 percent and the fixed payment to income ratio at 47 percent, both exceeding HUD's permissible rates. This occurred because Pan American did not consider in its analyses monthly property taxes totaling \$148.

### Other

The appraisal report contained inconsistencies in relation to equipment included in the subject property. Although the appraisal reflected the property was equipped with refrigerator, range/oven, dishwasher, etc., the borrower informed us the property did not have a refrigerator, screens, washer, and dryer. The borrower also informed us he constructed a paved driveway in order for Pan American to approve the loan. The appraised value should have been adjusted downward because the property lacked a paved driveway.

Furthermore, the borrower informed us he signed between three and four loan applications that were in blank and that the signatures on some of the documents were not his. The borrower indicated he verbally agreed on a purchase price of \$70,000 and did not realize the price had increased to \$86,000 until the closing date.

---

Case number: 501-6684590  
Mortgage amount: \$181,565  
Section of Housing Act: 203B  
Date of loan closing: 09/04/2002  
Current status: Reinstated by mortgagor as of 08/31/04  
Cause of default: Curtailment of borrower income

## **Summary**

### Asset Analysis

Contrary to requirements included in Mortgagee Letter 00-28, Pan American did not obtain sufficient documentation to ensure \$4,000 in gift funds were not provided from an unacceptable source and were the donor's own funds. Pan American did not obtain a withdrawal document to support the source of the funds.

### Earnings Analysis

Documents used by Pan American to determine the eligibility of the borrower contained gross misstatements. The Verification of Employment, tax returns, and earnings statements all overstated the borrower's earnings. These documents reflected the borrower had annual earnings of \$54,463. However, we found the correct annual earnings were \$29,473. Although the employer confirmed he signed the Verification of Employment, he could not explain why or how the earnings were overstated. We determined the fixed obligations to effective income to be 88 percent and the mortgage payment to effective income at 54 percent. Both ratios exceeded HUD's permissible rates. Had Pan American obtained the correct earnings information; it should have determined the borrower did not qualify for the loan.

### Debt Analysis

Pan American did not obtain an explanation for major derogatory information included in the borrower's credit report. The credit report reflected a \$5,040 debt that went into collections. Pan American did not obtain an explanation from the borrower for the adverse statement as required by HUD Handbook 4155.1, Revision 4, paragraph 2-3.

Pan American did not properly document a valid compensating factor when the mortgage credit ratios exceeded HUD's guidelines. According to the Mortgage Credit Analysis Worksheet, the total fixed payment to income ratio was 48 percent, exceeding HUD's permissible rate of 41 percent. The compensating factors Pan American used were a) "First Time Homebuyer" and b) "He Has Good Score 623/654." These are not valid compensating factors to justify the mortgage approval as contained in HUD Handbook 4155.1, Revision 4, paragraph 2-13.

## Other

We noted the properties used as comparables in the appraisal report were not similar to the subject property. The subject property is in a suburban area while the comparables used by the appraiser were housing developments in urban areas, located between 5 and 7 miles away from the subject.

---

Case number: 501-6526790  
Mortgage amount: \$158,746  
Section of Housing Act: 203B  
Date of loan closing: 3/20/02  
Current status: In default as of 9/28/04- first legal action  
to commence foreclosure  
Cause of default Other

## Summary

### Earnings Analysis

Pan American failed to obtain an explanation for an 8-month gap in the borrower's employment, as required by HUD Handbook 4155.1, Revision 4, paragraph 2-6. In addition, the coborrower's verification of income did not comply with HUD Handbook 4155.1, Revision 4, paragraph 3-1(E). For example, earning statements obtained covered a 15-day period instead of the most recent 30-day period. In addition, there was no indication within the loan file showing Pan American verified by telephone all current employers. Also, we noted many documents were photocopied but there was no certification the original documents were examined.

### Debt Analysis

Pan American failed to obtain an adequate explanation for recent indications of credit problems, as required by HUD Handbook 4155.1, Revision 4, paragraph 2-3. The coborrower's credit report reflected 18 instances in which car loan payments were past due. According to a letter from the coborrower, the car was given to a family member with the condition that the family member continues with the monthly payments of the loan. However, the family member was not making the monthly payments, forcing the coborrower to reclaim the car and assume the loan. This was not an acceptable explanation for not fulfilling the borrower's responsibility and pay obligations in a timely manner.

Pan American did not properly determine debt to income ratios. The Mortgage Credit Analysis Worksheet reflected the mortgage payment to income ratio at 32 percent and the fixed payment to income ratio at 42 percent. We determined the correct mortgage payment to income ratio at 34 percent and the fixed payment to income ratio at 44 percent. This occurred because Pan American underestimated the monthly hazard insurance amount by \$83. Since the property is located in a flood zone area, the monthly hazard insurance premium was \$206. In addition, one of the compensating factors used by Pan American to justify approval of the loan was not adequately supported. The compensating factor used stated the coborrower received monthly child support totaling \$240, which was not included in the effective income. However, the only support was a letter from the child's father acknowledging he makes the payments. This is not sufficient evidence to support the alleged additional income.

## Other

Although the property was located in a flood zone area, the appraisal report did not reflect a flood hazard adjustment. In addition, the appraisal report reflected an upward adjustment of \$5,000 in the “location” line item in all three comparables. This adjustment may be unwarranted since comparables are located in areas with similar characteristics

We noted key documents related to the borrower’s income that were faxed to Pan American by a real estate agent involved in the transaction. Among the documents faxed were earning statements, Internal Revenue Service W-2 forms, rental income verification, letters evidencing the status of certain debts, and copies of bank statements. HUD Handbook 4155.1, Revision 4, paragraph 3-1, establishes that verification forms must pass directly between the lender and provider without being handled by any third party.

---

Case number: 501-6758930  
Mortgage amount: \$171,050  
Section of Housing Act: 234C  
Date of loan closing: 1/24/03  
Current status: In Default as of 9/28/04 - first legal  
action to commence foreclosure  
Cause of default: Illness of principal mortgagor

## Summary

### Earnings Analysis

Pan American did not properly document and support the adjustment made to the borrower's nontaxable income as required by HUD Handbook 4155.1, Revision 4, paragraph 2-7(P). Based on loan file documents, the borrower received monthly Social Security income (nontaxable within Puerto Rico) totaling \$1,417. Pan American "grossed-up" the earnings by \$227 without documenting and supporting how this amount was determined. The Mortgage Credit Analysis Worksheet included a statement incorrectly indicating \$227 was 15 percent of the \$1,417 in Social Security earnings.<sup>6</sup> We determined this amount was overstated by at least \$14; the correct amount was \$213. We could not find any other information that could explain or show how the "gross-up" of \$227 was determined.

### Debt Analysis

Pan American failed to obtain an adequate explanation for recent indications of credit problems, as required by HUD Handbook 4155.1 Revision 4, paragraph 2-3. The borrower's credit report reflected six instances in which mortgage payments (\$529) on another property were past due. According to a letter from the borrower, the property was offered to a family member with the condition that he takes over the responsibility of the mortgage payments. However, the family member made no payments during this period. This was not an acceptable explanation for not fulfilling the borrower's responsibility and pay obligations in a timely manner.

### Other

The borrower was not a bona fide occupant of the property as required by HUD Handbook 4155.1, Revision 4, paragraph 1-2. Although the borrower certified he would occupy the property as his principal residence, he never moved in. According to the borrower, he never intended to occupy the property, and Pan American officials were aware of his intentions. The property was not purchased for purposes of primary residence use but, rather, to help his friend (seller) refinance the property. The borrower also indicated the seller provided the earnest money, and was the one making the monthly mortgage payments.

---

<sup>6</sup> According to Mortgagee Letter 97-26, lenders have the option of using either the published Internal Revenue Service tax tables for calculating the amount that may be "grossed-up" or using the minimum current tax rate of 15 percent. The lender is responsible for justifying the amount used and ensuring the income is exempt from Federal taxation.

## Appendix F

### CRITERIA

---

Handbook 4000.2, Revision 2, paragraph 2-8, “General Acceptability Standards for Property” provides a general outline of minimum property standards.

Section F describes utilities each property must include as follows:

F. Services and Facilities. Utilities and other facilities should be independent for each unit and must include

- a. a continuing supply of safe, potable water,
- b. sanitary facilities and a safe method of sewage disposal,
- c. heating adequate for health and comfort,
- d. domestic hot water, and
- e. electricity for lighting and equipment.

HUD Handbook 4060.1, Revision 1, Change 1, “Mortgagee Approval Handbook,” Chapter 6, “Quality Control Plan,” provides guidelines and requirements in relation to quality control procedures to be implemented by all lenders.

Section 6-1 requires that all Federal Housing Administration-approved mortgagees, including loan correspondents, must implement and continuously have in place a quality control plan for the origination and/or servicing of insured mortgages as a condition of receiving and maintaining Federal Housing Administration approval. Also, section 6-1 requires that quality control must be a prescribed and routine function of each lender’s operations whether performed by a lender’s staff or an outside source.

Section 6-3 contains the basic elements that are required in all quality control programs. Paragraph 6-3C requires that the lender properly train staff involved in quality control and provide them 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.

Section 6-6 contains basic requirements for quality control of single-family production. Paragraph 6-6D requires that “In addition to the loans selected for routine quality control reviews, mortgagees must review all loans going into default within the first six payments. As defined here, early payment defaults are loans that become 60 days past due.”

Section 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 the appraised value was established using reasonable comparables, reasonable adjustments, and in expectation of repairs required to meet minimum safety and soundness requirements. Determine whether a field review was performed if the value of the property increased 20 percent or more within 12 months of a previous sale (paragraph 6-7B).
- Determine whether there are sufficient and documented compensating factors if the debt ratios exceed Federal Housing Administration limits (paragraph 6-7 J).
- Determine whether the loan was submitted for insurance within 60 days of closing or included a payment history showing the loan was current when it was submitted for mortgage insurance (paragraph 6-7O).
- Determine whether the seller acquired the property at the time of or soon before closing, indicating a possible property “flip” (paragraph 6-7P).
- If possible, determine whether the mortgagor transferred the property at the time of closing or soon after closing, indicating the possible use of a “strawbuyer” in the transaction (paragraph 6-7Q).

HUD Handbook 4155.1, Revision 4, “Mortgage Credit Analysis for Mortgage Insurance on One-to Four-Family Properties” provides updated instructions on qualifying borrowers for HUD-insured mortgages. It describes the basic mortgage credit underwriting requirements for single-family mortgage loans insured under the National Housing Act. It 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 are expected to exercise both sound judgment and due diligence in the underwriting of loans to be insured by the Federal Housing Administration.

Paragraph 1-2 requires that “At least one borrower must occupy the property and sign the security instrument and mortgage note for the property to be considered as owner-occupied.”

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. (The mortgage calculations described below are in addition to those detailed in paragraphs 1-6 and 1-7.)

- 1) The monthly payment is defined as principal, interest, taxes, and insurance, including mortgage insurance (PITI), as well as any homeowners’ association dues, computed at the note rate (no consideration for buydowns may be given).

- 2) Net rental income is the appraiser's estimate of fair market rent from all units, including the unit chosen by the borrower for occupancy, less the FHA [Federal Housing Administration] office's allowance for vacancies and maintenance (or 25 percent if the local FHA has not established a separate allowance).
- 3) The above calculation is used only to determine the maximum loan amount. Borrowers must still qualify for the mortgage based on income, credit, cash to close, and the projected rents received from the remaining units. The projected rent may only be considered as gross income for qualifying purposes; it may not be used to offset the monthly mortgage payment.
- 4) The borrower must have a reserve of three months' mortgage payments (PITI) after closing on purchase transactions."

Paragraph 2-3 provides 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 credit information in the file."

Paragraph 2-6 establishes that "the lender must verify the borrower's employment for the most recent two full years. If a borrower indicates he or she was in school or in the military during any of this time, the borrower must provide evidence supporting this, such as college transcripts or discharge papers. The borrower must also explain any gaps in employment of a month or more. Allowances for seasonal employment, such as is typical in the building trades, etc., may be made."

Paragraph 2-7E states: "Retirement and Social Security income. Such income requires verification from the source (former employer, Social Security Administration) or through federal tax returns. If any benefits expire within the first full three years, the income source may only be considered as a compensating factor."

Paragraph 2-7P states: "Non-taxable Income. If a particular source of regular income is not subject to federal taxes (e.g., certain types of disability and public assistance payments, military allowances, etc.), the amount of continuing tax savings attributable to the non-taxable income source may be added to the borrower's gross income. The percentage of income that may be added may not exceed the appropriate tax rate for that income amount and no additional allowances for dependents are acceptable. The lender must document and support the adjustments made (i.e., the amount the income is "grossed-up") for any nontaxable income source."

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 2 years;
- 2) Signed copies of Federal business income tax returns for the last 2 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 2-10 establishes that “All funds for the borrower’s investment in the property must be verified.”

Paragraph 2-10B states: “Savings and checking accounts. A verification of deposit (VOD) may be used to verify these accounts, along with the most recent bank statement. If there is a large increase in an account, or the account was opened recently, an explanation and evidence of source of funds must be obtained by the lender.”

Paragraph 2-10D states: “Collateralized loans. Funds can be borrowed for the required investment as long as satisfactory evidence is provided that they are fully secured by existing marketable assets. Such assets may include stocks, bonds, automobiles, real estate (other than the property being purchased), etc.”

In addition, certain types of loans secured against deposited funds, such as signature loans, the cash value of life insurance policies, loans secured by 401(k)s, etc., in which repayment may be obtained through extinguishing the asset, do not require consideration of a repayment for qualifying purposes. However, in such circumstances, the asset securing the loan may not be included as assets to close or otherwise considered as available to the borrower.

The borrowed funds must be provided by an independent third party. The seller, real estate agent or broker, lender, etc., may not provide such funds. Unacceptable borrowed funds include signature loans, cash advances on credit cards, and similar unsecured financing.

Paragraph 2-10I establishes that “A salary advance, however, cannot be considered as assets to close since it represents an unsecured loan.”

Paragraph 2-10O establishes requirements for sweat equity in lieu of a cash investment on property. Among these, “only the repairs or improvements listed on the appraisal or conditional commitment are eligible for sweat equity. Any work completed or materials provided before the appraisal is made are not eligible.” Also, “The borrower’s labor may be considered as the equivalent of cash if the borrower can demonstrate his or her ability to complete the work in a satisfactory manner. The lender must document the contributory value of the labor through either the appraiser’s estimate or through a cost estimating service.”

Paragraph 2-12B states: “Total fixed payment to effective income. If the total mortgage payment and all recurring charges does not exceed 41 percent of gross effective income, the relationship of total obligations to income is considered acceptable. A ratio exceeding 41 percent may be acceptable if significant compensating factors are presented.”

Paragraph 2-13 states: “COMPENSATING FACTORS that may be used in just approval of mortgage loans with ratios exceeding our benchmark guidelines include those listed below. Underwriters must state on the ‘remarks’ section of the HUD-92900-WS the compensating factors used to support loan approval.

- A. The borrower has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage. If the borrower over the past 12-24 months has met his or her housing obligation as well as other debts, there should be little reason to doubt the borrower's ability to continue to do so despite having ratios in excess of those prescribed.
- B. The borrower makes a large downpayment toward the purchase of the property.
- C. The borrower has demonstrated a conservative attitude toward the use of credit and an ability to accumulate savings.
- D. Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses.
- E. The borrower receives compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and similar public benefits.
- F. There is only a minimal increase in the borrower's housing expense.
- G. The borrower has substantial cash reserves after closing.
- H. The borrower has substantial non-taxable income (if no adjustment made previously in the ratio computations).
- I. The borrower has potential for increased earnings, as indicated by job training or education in the borrower's profession.
- J. The home is being purchased as a result of relocation of the primary wage-earner and the secondary wage-earner has an established history of employment, is expected to return to work, and there is reasonable prospects for securing employment in a similar occupation in the new area. The underwriter must address the availability of such possible employment."

Paragraph 3-1 establishes that "Credit documents may be up to 120 days old at the time the loan closes (180 days for proposed construction). Updated, written verifications must be obtained when the age of the documents exceed these limits. Verification forms must pass directly between lender and provider without being handled by any third party."

Paragraph 3-1E requires the mortgagee to obtain a Verification of Employment and the most recent pay stub. Paragraph 3-1E also provides that "As an alternative to obtaining a VOE [verification of employment], the lender may choose to obtain from the borrower original pay stub(s) covering the most recent thirty-day period, along with original copies of the previous two years' IRS [Internal Revenue Service] W-2 forms. The pay stub(s) must show the borrower's name, social security number, and year-to-date earnings. The "original" of the W-2 may be any of the copies of the form not submitted with the borrower's income tax returns. (These original

documents may be photocopied and returned to the borrower.) The lender must also verify by telephone all current employers. The loan file must include a certification from the lender that original documents were examined and the name, title, and telephone number of the person with whom employment was verified. The lender must also obtain a signed copy of form IRS 4506, Request for Copy of Tax Form, form IRS 8821, or whatever document is appropriate for obtaining tax returns directly from the Internal Revenue Service for all loans processed in this manner. The lender may also use an electronic retrieval service for obtaining W- 2 and tax return information.”

Paragraph 3-1F requires the lender to obtain a Verification of Deposit and most recent bank statements, or “As an alternative to obtaining a verification of deposit, the lender may choose to obtain from the borrower original bank statement(s) covering the most recent three month period. Provided the bank statement shows the previous month’s balance, this requirement is met by obtaining the two most recent consecutive statements.”

Paragraph 3-2B provides that “So as not to delay mortgage closings, verifications may also be transmitted by facsimile machine. However, the lender’s file must contain the original verification form that was mailed to and returned from the employer or creditor.”

#### Mortgagee Letter 00-28, “Gift Transfer Documentation”

If the donor purchased a cashier’s check, money order, official check, or any other type of bank check as a means of transferring the gift funds, the donor must provide a withdrawal document or canceled check for the amount of the gift, showing the funds came from the donor’s personal account.