audit report

Issue Date
June 19, 2006
Audit Report Number
2006-NY-1007

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

Edgar Moore

FROM: Edgar Moore, Regional Inspector General for Audit, 2AGA

SUBJECT: First Suffolk Mortgage Corporation, North Babylon, New York, Did Not Always Comply with HUD Underwriting Requirements

HIGHLIGHTS

What We Audited and Why

We audited First Suffolk Mortgage Corporation (First Suffolk), a nonsupervised direct endorsement lender located in North Babylon, New York, because its default and claim rate for loans with a beginning amortization date between July 1, 2003 and June 30, 2005 was more than twice the New York State average rate.

The audit objectives were to determine whether First Suffolk (1) approved insured loans in accordance with U.S. Department of Housing and Urban Development (HUD)/Federal Housing Administration requirements, which include following prudent lending practices, and (2) developed and implemented a quality control plan that complied with HUD requirements.

What We Found

First Suffolk did not always comply with HUD underwriting requirements. Consequently, three of eight loans we reviewed exhibited significant underwriting deficiencies, such as failure to ensure that the minimum cash investment was made, and that employment, other assets, and debt were properly verified. The remaining five loans contained technical violations. As a result, the HUD/Federal Housing Administration insurance fund paid claims associated with two loans and continues to assume a risk with the one other loan. These deficiencies occurred because First Suffolk lacked adequate controls to ensure that loans were processed in accordance with HUD requirements.

First Suffolk had weaknesses in the implementation of its quality control plan. It did not always comply with HUD's and its own quality control requirements to (1) ensure that all HUD-insured loans that went into default within the first six payments were reviewed and (2) document that corrective action was taken on all material findings identified in quality control reviews. This noncompliance occurred because First Suffolk did not have procedures to obtain default data from HUD's Neighborhood Watch system and/or its servicers and to ensure that its corrective action process addressed all identified deficiencies. Consequently, the effectiveness of First Suffolk's quality control plan, which is designed to ensure accuracy, validity, and completeness in its loan origination process, was lessened.

What We Recommend

We recommend that the assistant secretary for housing - federal housing commissioner require First Suffolk to (1) reimburse HUD for the amount of claims and associated fees paid on two loans with significant underwriting deficiencies, (2) indemnify HUD against future losses on the one loan with significant underwriting deficiencies, (3) establish procedures to ensure that HUD underwriting requirements are properly implemented and documented, and (4) implement procedures to ensure compliance with HUD's and its own quality control requirements.

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

Auditee's Response

We provided a copy of the draft report to the auditee on May 5, 2006, and discussed the findings with the auditee during the audit and at the exit conference held on May 19, 2006. The auditee provided written comments on May 31, 2006, and generally disagreed with our findings.

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

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BACKGROUND AND OBJECTIVES

First Suffolk Mortgage Corporation (First Suffolk) was incorporated in the state of New York in June 1983. First Suffolk is a licensed mortgage banker in New York and Connecticut, a U.S. Department of Housing and Urban Development (HUD)-approved Title II lender (one to four family first mortgages), and an approved Federal National Mortgage Association seller/servicer. First Suffolk originates conventional and Federal Housing Administration mortgages to be sold in the secondary market. It operates in the New York metropolitan area, with the predominant portion of its business being conducted on Long Island.

First Suffolk originated 211 HUD-insured loans between July 1, 2003, and June 30, 2005. During this period, its default and claim rate was 4.74 percent. We selected First Suffolk for audit because this rate was more than twice the New York State average default and claim rate of 1.82 percent. First Suffolk contracted its quality control function to an independent firm.

The objectives of the audit were to determine whether First Suffolk (1) approved insured loans in accordance with HUD/Federal Housing Administration requirements, which include following prudent lending practices, and (2) developed and implemented a quality control plan that complied with HUD requirements.

RESULTS OF AUDIT

Finding 1: First Suffolk Did Not Always Comply with HUD's Underwriting Requirements

First Suffolk did not follow prudent lending practices and HUD regulations in the origination and underwriting of eight[1] loans we reviewed. As a result, three loans exhibited significant underwriting deficiencies, such as failure to ensure that the minimum cash investment was made and that employment, other assets, and debt were properly verified. The remaining five loans contained technical violations. Consequently, the HUD/Federal Housing Administration insurance fund paid claims totaling $526,944 and continues to be at risk for $256,750. In addition, three borrowers were charged ineligible fees. These deficiencies occurred because First Suffolk lacked adequate controls to ensure that loans were processed in accordance with HUD requirements.

Significant Underwriting Deficiencies

Paragraph 3-1 of HUD Handbook 4155.1, REV-4, entitled "Mortgage Credit Analysis for Mortgage Insurance," requires that the loan application package contain sufficient documentation to support a lender's decision to approve a loan. While this decision involves some subjectivity, our examination of eight loans approved by First Suffolk disclosed significant underwriting deficiencies in the approval of three loans. First Suffolk did not always (1) ensure that the minimum cash investment was provided, (2) sufficiently analyze borrowers' credit, (3) adequately document and/or verify gifts, and (4) properly verify borrowers' employment. The frequency of these deficiencies is noted in the chart below. The deficiencies noted are not independent of one another, as one loan may have contained more than one deficiency.

Deficiency	***Number of loans***
Minimum cash investment not provided	2 of 3 loans
Inadequate credit analysis	2 of 3 loans
Inadequate documentation and/or verification of gift	2 of 3 loans
Inadequate verification of borrower's employment	2 of 3 loans

[1] We originally reviewed nine loans; however, one of the loans was paid-in-full and the Federal Housing Administration insurance was terminated prior to completion of the draft audit report. As a result, we are reporting on eight loans for which either a claim was paid or that still represent a risk to the FHA insurance fund.

Specific examples of these significant underwriting deficiencies follow:

- For loan number 374-4317363, the minimum cash investment was not met, and a gift letter was not provided. Mortgagee Letter 98-29, dated October 22, 1998, provides that the National Housing Act requires the minimum cash investment to be 3 percent of the secretary of HUD's estimate of the cost of acquisition. While the minimum cash investment for this loan was $8,383, the borrower invested $6,888, representing a shortage of $1,495. In addition, there was no gift letter documented to support the $8,000 gift listed on the mortgage credit analysis worksheet. Mortgagee Letter 00-28, dated August 7, 2000, requires that the lender obtain a gift letter specifying, among other things, the dollar amount given and that no repayment is required.

- For loan number 374-4297672, the loan was approved with inadequate analysis and verification of the borrower's employment and credit. HUD Handbook 4155.1, REV-4, CHG-1, paragraph 3-1, requires that when standard documentation does not provide enough information to support a decision to approve a loan, the lender must provide additional explanatory statements to clarify or supplement the documentation. First Suffolk did not resolve a significant discrepancy in the borrower's reported wages. It obtained a verification of employment from the borrower's first employer reporting year-to-date wages of $24,085, while the borrower's most recent pay stub reported year-to-date wages of $13,275 for the same period. Further, First Suffolk did not resolve an inconsistency in an explanation for a derogatory account. HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-3, requires that major indications of derogatory credit have sufficient written explanation from the borrower that makes sense and is consistent with other credit information in the file. The account, opened in November 2000, was late five times during the period February through June 2003. The borrower explained that only one payment was late, yet the creditor kept reporting it late. Documentation in the file indicated the late designation occurred because the borrower consistently paid less than the minimum required payment.

Technical Underwriting Violations

The remaining five loans contained technical underwriting violations that, while they resulted in noncompliance with HUD requirements, did not cause conditions serious enough to negatively impact approval of the loans.

These violations are summarized in the chart below.

Deficiency	Number of loans
Inadequate justification for exceeding HUD's benchmarks for debt-to-income ratios	3 of 5 loans
Incorrect debt-to-income ratios	1 of 5 loans
Inadequate verification of alternative employment documentation	1 of 5 loans
Inadequate analysis of borrowers' credit	4 of 5 loans
Inadequate verification of faxed income/employment or asset documentation	2 of 5 loans

Specific examples of these violations follow:

In three loans, First Suffolk listed compensating factors that were inconsistent and/or were not documented in accordance with HUD Handbook 4155.1, REV-5, paragraph 2-3. For instance, job stability, job history, and good credit were cited as compensating factors, and good cash reserves and rental income were cited but were not supported by adequate documentation. In four loans, the borrowers' credit was not adequately analyzed as required by HUD Handbook 4155.1, REV-5, paragraph 2-11. For example, in one case, a $1,005 debt was not included in the debt-to-income ratio analysis. In the remaining three loans, First Suffolk did not obtain written explanations for derogatory accounts and/or recent inquiries as required. In two loans, First Suffolk did not verify the authenticity of faxed asset and employment documents as required by Mortgagee Letter 2001-01.

Ineligible Fees Charged to Borrowers

First Suffolk charged borrowers ineligible appraisal and credit report fees. HUD Handbook 4000.2, REV-2, paragraph 5-3, issued July 30, 1991, allows a lender to collect customary and reasonable fees for appraisals and credit reports; however, the fees may not exceed the actual cost to the lender. As shown below, First Suffolk charged three borrowers fees in excess of actual appraisal and/or credit report costs.

Loan number	Ineligible credit report fee collected	Ineligible appraisal fee collected	Total
374-4337742	$100	$50	$150
374-4360910	$ 50		$ 50
374-4396775	$ 30		$ 30
Total	$180	$50	$230

Title Issue Unresolved

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 3-12, states the lender is responsible for resolving all problems regarding title to real estate. First Suffolk took $2,500 from the seller (loan number 374-4317363) and held it in escrow as assurance that modifications were made to the property in order that clear title could be obtained. The loan subsequently went into default and HUD paid a claim on the loan. However, First Suffolk did not resolve the title issue, and retains the $2,500 escrow.

Conclusion

First Suffolk did not always follow HUD regulations in the approval of loans. As a result, it approved three loans for which HUD paid claims totaling $526,944 and remains at risk for $256,750 in potential claims. The final loss that HUD incurs on loans for which a claim was paid depends upon what HUD realizes when it disposes of the property. HUD's most recent data discloses that its loss rate is 29 percent.[2] Net sales proceeds after considering carrying and sales expenses may mitigate the amount of the claim paid. Loans for which HUD remains at risk can be mitigated by requesting that the lender indemnify HUD. In this case, the lender reimburses HUD for any insurance claim, taxes, interest and other expenses connected with the disposition of the property, reduced by any amount recouped by HUD via sale or other disposition. First Suffolk also approved five other loans with technical underwriting deficiencies and charged borrowers ineligible appraisal and credit report fees.

Appendix C provides a summary of the significant underwriting deficiencies, while appendix D provides the detailed case narratives.

Recommendations

We recommend that the assistant secretary for housing - federal housing commissioner require First Suffolk to

[2] Based upon HUD's current 29 percent defaulted loss experience, the amount of unsupported costs for the two loans for which a claim was paid is estimated at $152,814 (29 percent of $526,944). The amount of cost savings or funds to be put to better use on the loan for which indemnification is recommended is estimated at $74,458 (29 percent of $256,750).

1A. Reimburse HUD for losses on the two loans that had significant underwriting deficiencies for which claims and associated fees were paid.

1B. Indemnify HUD against future losses on the one loan with significant underwriting deficiencies.

1C. Establish procedures to ensure that all HUD underwriting requirements are properly implemented and documented.

1D. Confirm that clear title can be conveyed on the loan for which a claim was paid, and then determine who should receive the $2,500 held in escrow.

1E. Reimburse borrowers charged $230 in ineligible fees.

1F. Develop procedures to ensure that charges to borrowers do not exceed actual costs.

Finding 2: First Suffolk Had Weaknesses in the Implementation of Its Quality Control Plan

Our review disclosed that First Suffolk had weaknesses in the implementation of its quality control plan. It did not always comply with both HUD's and its own quality control requirements to (1) ensure that all HUD-insured loans that went into default within the first six payments were reviewed and (2) document that corrective action was taken on all material findings identified in quality control reviews. This noncompliance occurred because First Suffolk did not have procedures to obtain default data on HUD-insured loans from HUD's Neighborhood Watch system and/or its servicers and its corrective action process did not address all identified deficiencies. Consequently, the effectiveness of First Suffolk's quality control plan, which is designed to ensure accuracy, validity, and completeness in its loan origination process, was lessened.

Loans Defaulting within Six Payments Not Reviewed

Loans that defaulted within the first six payments (early payment defaults) were not reviewed as required by paragraph 6-6 D of HUD Handbook 4060.1, REV-1, CHG-1, and First Suffolk's quality control plan. We found that quality control reviews were not performed on 7 of the 12 early payment default loans. Three of these loans were reviewed after our request for copies of the reviews, which did not comply with the required timeframe for review. Further, while two other loans were reviewed, the reviews were performed as random routine reviews and not because of early default.

An official of the quality control contractor stated that First Suffolk did not have an established policy for conducting reviews of early defaulted loans. First Suffolk did not implement procedures to obtain early payment default data from Neighborhood Watch and/or its servicer(s). First Suffolk's president stated that privacy rules prohibit servicers from providing First Suffolk with information on defaulted loans once they are sold. However, Mortgagee Letter 00-20, dated June 2, 2000, announced the availability of Neighborhood Watch to allow all Federal Housing Administration-approved lenders to analyze their early default loans and claims. Therefore, First Suffolk should have used Neighborhood Watch to obtain data on the early default loans. An official of the quality control contractor stated that First Suffolk established a policy in November 2005 in which the contractor would notify First Suffolk each month to check Neighborhood Watch so that First Suffolk could obtain a list of early defaulted loans, which the contractor would then review.

Corrective Action Not Documented

Our testing of 16 Federal Housing Administration loans selected for random review under First Suffolk's quality control plan disclosed that First Suffolk's quality control reviews were generally adequate, were performed in a timely manner, and included a method for followup and resolution of deficiencies noted. However, First Suffolk did not always document that corrective action was taken to address all material findings identified in the quality control reviews of the loans we reviewed.

Paragraph 6-3 I of HUD Handbook 4060.1, REV-1, CHG-1, requires management to take prompt action to deal appropriately with any material findings and document in the final report or addendum the actions being taken, the timetable for their completion, and any planned followup activities. While we found that the quality control reports identified the deficiencies to be addressed, management's corrective action reports did not document the specific action to be taken for all material deficiencies, the timeframe for the action, or the followup measures taken. For example, two quality control reviews conducted in the second quarter of 2004 identified the following material deficiencies: (1) credit documents faxed by a third party and (2) misrepresentation of income based upon pay stubs, W-2 forms, and tax returns. These material deficiencies were not addressed by management in its corrective action memorandum reports for the second quarter. As a result, we cannot determine the corrective action taken, if any; the timetable for the completion of the corrective action; or if there were any planned followup activities for these deficiencies.

Conclusion

First Suffolk had weaknesses in the implementation of its quality control plan because it did not review all HUD-insured loans that went into default within the first six payments and did not document that corrective action was taken on all material findings identified in quality control reviews. As a result, the effectiveness of First Suffolk's quality control process was lessened.

Recommendations

We recommend that the assistant secretary for housing - federal housing commissioner require First Suffolk to

2A. Establish procedures to ensure that data pertaining to HUD-insured defaulted loans are obtained from Neighborhood Watch and/or the loan servicer(s) and properly reviewed.

2B. Implement controls and procedures to ensure that all loans that go into default within the first six payments are reviewed in accordance with HUD's requirements and its own quality control plan.

2C. Document in its reports the action being taken, timetable for completion, and any planned followup activities in response to any material findings resulting from quality control reviews.

SCOPE AND METHODOLOGY

To accomplish our audit objectives, we reviewed applicable laws, regulations, HUD handbooks, mortgagee letters, and reports from HUD's Quality Assurance Division. We reviewed independent audit reports from First Suffolk's independent auditor, and we interviewed First Suffolk's staff and quality control contractor to obtain an understanding of the auditee's internal controls.

We selected a nonstatistical sample of 10 defaulted loans from Neighborhood Watch that were originated by First Suffolk with a beginning amortization date between June 1, 2003, and July 31, 2005. The 10 loans in our sample were HUD-insured loans that totaled more than $2.6 million. We used the following criteria to select the loans: (1) currently in default with a first default report with 12 or fewer payments, (2) a claim paid, and (3) not reviewed by HUD or subject to an indemnification agreement. Three of the loans were terminated after our selection. Therefore, we sampled an additional three loans that were currently in default with a first default report with six or fewer payments. These three loans had a beginning amortization date between December 21, 2002, and October 31, 2005, and totaled $806,450. One of these loans was also terminated. Therefore, our detailed testing was performed on nine loans, and the results of our detailed testing only apply to the nine[3] loans tested and cannot be projected.

We performed detailed testing and review of the underwriting procedures performed for the nine loans. We reviewed documentation from both HUD's Homeownership Center loan endorsement files and loan files provided by the auditee. Our detailed testing and review included (a) analyses of borrowers' income, assets, and liabilities; (b) verification of selected data on the settlement statements; and (c) confirmation of employment, gifts, and rental history. We discussed issues with HUD and First Suffolk staff.

We reviewed First Suffolk's quality control plan as well as documentation provided to us by the quality control contractor. We selected two samples, consisting of 16 loans, to test First Suffolk's quality control plan and to determine compliance with HUD requirements.

We performed audit fieldwork from November 2005 through March 2006.

The audit was conducted in accordance with generally accepted government auditing standards.

[3] One of the nine loans was paid-in-full and the Federal Housing Administration insurance was terminated prior to completion of the draft audit report. As a result, we are reporting on eight loans for which either a claim was paid or that still represent a risk to the FHA insurance fund.

INTERNAL CONTROLS

Internal controls are an integral component of an organization’s management that provides reasonable assurance that the following objectives are being achieved:

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

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

Relevant Internal Controls

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

- Program operations - Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

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

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

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

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:

- First Suffolk did not ensure that certain loans were processed in accordance with all applicable HUD underwriting requirements (see finding 1).

- First Suffolk did not always comply with HUD's and its own quality control requirements (see finding 2).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A		$152,814	
1B			$74,458
1D			$ 2,500
1E	$ 230		

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/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ "Funds to be put to better use" are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. Implementation of our recommendation to indemnify loans that were not originated in accordance with FHA requirements will reduce FHA's risk of loss to the insurance fund. The amount above reflects that, upon sale of the mortgaged property, FHA's average loss experience is about 29 percent of the claim amount, based upon statistics provided by HUD.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

FIRST SUFFOLK MORTGAGE CORPORATION

Licensed Mortgage Banker • N Y S Banking Department • FHA/VA Conventional Direct Lender

Attention:

Edgar Moore, Regional Inspector for Audit, 2AGA

Re: Draft Response 2006-NY-10XX

During the period of November 2005 through March 2006, Auditors reviewed 10 loan files as well as a sampling of quality-controlled loans First Suffolk Mortgage Corporation originated. Citied in the draft report prepared by OIG auditors are alleged non-compliance in underwriting and quality control procedures by FSMC.
FSMC does not agree with these findings based on loan file documentation and preponderance of evidence fully supporting FSMC diligent compliance with all established HUD/FHA guidelines.

Specifically, FSMC originates mortgage loans in underserved low to moderate-income tract areas and under no circumstances does FSMC cause direct circumstances for borrowers to default on their mortgage loans after closing.

The observance of minor technical differences in underwriting opinion or human error plausibility is a matter of facts as presented in each loan file. Each loan file on a case-by-case basis is underwritten, adjusting individually to each borrower's needs or circumstances.

Comment 1

Let us address first the period in time when tri-merge credit reports became acceptable for mortgage underwriting purposes. FSMC established a credit cost charge in conjunction with its bookkeeping department to facilitate the cost of credit reports charged to borrowers because FSMC it self noticed the occurrence. Said chart was submitted to auditors in response to what actions FSMC had taken in the past to assure over charge where not occurring. FSMC submitted to auditors this very same documentation and explanation and agrees to reimburse those borrowers who were slightly overcharged. Copies of 3 checks in the total amount of $230.00 are enclosed. (Exhibit 1)

FSMC has a difference of opinion with auditors as to the escrow for a missing certificate of occupancy of a deck where the seller agreed to provide the missing certificate and to date has not done so. FSMC differs in opinion with auditors as to who is responsible for obtaining the certificate and to whom the reimbursement shall be made. Only owners past or present may open and close building permits, it is the responsibility of the seller and or

MBA MEMBER

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Ref to OIG Evaluation	**Auditee Comments**
Comment 2	current owner to allow for the Town of Brookhaven access to the property so that the certificate of occupancy post inspection can be issued. Non-compliance on the sellers end or the purchaser for allowing access has caused the certificate not to be resolved. FSMC will release the escrow for $2500.00 to pay down the existing lien on the property per the executed agreement, by the sellers' attorney in fact who did not follow through with the agreement. The question remains; does the purchasers servicing lenders receive these funds, or does HUD. Attempts to verify the payment history with the current servicer under the privacy act have been futile and despite repeated requests, FSMC has not been able to verify an open balance. A check for $2500.00 is available to the appropriate party. (Exhibit 2) Please advise FSMC as to how to proceed and FSMC will gladly do so.
	(Findings #1 will be further in this response to allow closure)
Comment 3 Comment 4 Comment 3	With respect to Findings #2 Quality Control Plan, FSMC puts forth that it is policy to quality control all EPD'S in a timely manner. While auditors allude to an official from the QC contractor stating to the contrary; FSMC does have policy in place of conducting reviews of EPD loans. The contractor is clearly contracting the very Quality Control Plan contractor prepared for FSMC. Auditors have reviewed the plan and found it to be HUD compliant. The period for the loans in question is taking place during the Privacy Act implementation of October 2003, thus affecting 2003 and 2004 loans directly. The sheer merit of sound business plan action to consolidate FSMC operations to one large office location attests to the fact that while FSMC is a small company, FSMC recognized the necessity to due diligence of its own Quality Control Plan. While auditors found 7 loans where completed in a satisfactory manner, 5 more where located and promptly sent for QC with the QC report arriving November of 2005. FSMC took extreme action bearing in fact that FSMC decided in mid 2004 to move its entire operations to a new location from Lindenhurst, NY to North Babylon, NY. Beyond the scope of planning during the second half of 2004, the actual move commenced June 2005 and completed by end of month July 2005. Under peak loan closing volume condition, all storage files were unpacked with personnel pulled from other departments assisting during business hours. Once consolidated under one roof, reorganization of off-site storage files allowed FSMC to locate 5 files past due for QC. Further FSMC distributes all QC review reports to all personnel with mandatory reading required and a signature confirmation from each employee to be returned back to management with in two weeks release of same plan. FSMC's *Comply Eye* bulletin is corrective action memorandum, designed to address material differences found in loan files for quality control issues (Exhibit 3). FSMC recognizes that auditor recommendations as noted in 2a, 2b, and 2c, are a reiteration of what FSMC has worked to accomplish in moving to a larger location. The following memorandum to post closing department has been previously issued: Neighborhood Watch monitoring will be reinforced, staff is aware that all EPD'S are to be sent for QC as soon as Neighborhood Watch posts adverse data, a printed report shall be kept on a monthly basis folder. Each loan file found to be EPD is to be immediately QC'D. Findings returned must be addressed for deficiencies noted by FSMC staff. Staff shall documented follow-up of revealed findings in the actual loan file folder. This memorandum has be redistributed to appropriate personnel (Exhibit 4)
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Ref to OIG Evaluation **Auditee Comments**

Findings 1. Alleged Underwriting Deficiencies

374-4297672 Chillogallo, Disagreement of Findings:

Comment 5

A. Cash Investment Disagreement of Findings: FSMC has clearly demonstrated the cash investment met. Included is the former response and the Copy of the FHA MAXIMUM MORTGAGE and CASH NEEDED CALCULATOR available to all lenders from HUD/FHA's web site. As noted in the data entry, the purchaser met and exceeded the cash requirement, and as previously noted in methodology for arriving at borrowers' ability to meet these cash expenses (Exhibit 5).
FSMC requests that this finding be removed from the final Auditors Draft.

Comment 6

B. Credit Analysis Disagreement of Findings: Credit report in the file shows a rolling 30-day late. Under the terms of an installment purchase plan, the borrower explained he was consistently marked late after he missed one payment. This does not constitute inadequate credit analysis. Rather, FSMC communicated to the borrower that the account was to be brought current prior to closing since his doubling up in 12/03 for $136.00 did not credit the missing payments, rather it was applied as principal balance reduction, and the missing payments still had to be made. Based on the payment history (Exhibit 6) the next statement cycle was to show the additional $204.00 received on 09/23/03, which FMSC required of the borrower to bring the account current, which he did. The loan file closed 10/01/2003. More evident in the pay history is the customers frustration at understanding how his account worked in so that even after closing he sent $297.42 to pay it all off when his minimum payment was only $68.00 and sent too much, receiving a credit back of $2.98 further documents a willingness to pay.
FSMC requests that this finding be removed from the final Auditors Draft.

Comment 7

C. Employment Verification Disagreement of Findings: On December 14, 2005 FSMC re followed- up the VOE. Telephone conversation conducted with the employer Helene Vecchia, available at same telephone# on VOE. The employer communicated an error was made by her on the VOE year to date in which she stated she must of transferred the wrong employees column total to the VOE document as she had three people employed with the same last name. The borrowers' year to date is accurate on the pay stub for 08/06/03 ending pay period. The low year to date is due to the seasonal nature of asphalt work and the prolonged rains that year. The busy season picked up thru August 2003. For example, by the end of 9/30/03 pay period the actual year to date totals jumped up to $17,375.78 and so forth. The borrowers 12/31/03 ending year to date total was $30, 755.64. All other annual totals are accurate on the VOE 2002 & 2001. The pay stub in the file was period ending 08/06/03 $12,525.00, if we recalculate the 2001 & 2002 plus 2003

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Ref to OIG Evaluation **Auditee Comments**

year to date 31.25 month average we arrive at 41.69 and 42.98 ratios. Compensating factors cited in exceeding the front and back ratios are documented in the file and appropriately stated on the MCA PUR.
FSMC requests that this finding be removed from the final Auditors Draft.

Comment 8

D. Escrow of Borrowers funds Disagreement of Findings: FSMC credited cash in kind as documented on the HUD1 for a $450.00 in cash good faith deposit given by the borrower at time of application. At no time did FSMC have an open escrow account set up for this borrower. No taxes or interest collected at the time of application.
FSMC requests that this finding be removed from the final Auditors Draft.

374-4317363 Stanford, Disagreement of Findings:

Comment 9

A. Cash Investment: The settlement agent, who on this occasion closed his first FHA loan, did not adhere to the amount calculated at time of underwriting. (Exhibit 7) Under FHA the origination fee is not arbitrary, and cannot be moved over to sellers' column due to concession credit that will be applied on pg 1 of the HUD1. On this loan file, the origination fee was moved to the sellers' column in error. In turn, this caused the origination fee be twice credited to the borrower effectively reducing the cash investment. Loans with maximum LTVs in high cost areas such as New York allow for 97.75% are particularly affected. While errors can and do happen, it is imperative to remember this it not done on purpose. People can and do occasionally make mistakes. It is FSMC policy to point out mistakes immediately and make sure loan closings are monitored more closely ensuring these mistakes not be repeated onwards. To date, FSMC can state this mistake has not reoccurred. In addition, FMSC began requiring maximum 97% loan amount calculations for all loans where seller contributions are present.
FSMC requests that this finding be removed from the final Auditors Draft.

Comment 10

B. Gift Documentation Disagreement of Findings: FSMC had the gift letter for this loan in its original loan binder and perhaps sent them to HOC as has to be the case since no NOR notice was returned on the case binder. This follows logic since the gift is well mentioned and documented in the file, yet replacing copies with the originals at closing causes both sets to go missing. FSMC then profusely apologizes for having no copy available in our closed loan folder yet maintains at one time or another during the loan process FSMC had reviewed an acceptable gift letter, and required original be brought to closing.
FSMC requests that this finding be removed from the final Auditors Draft.

Comment 11

C. Employment Verification Disagreement of Findings: The verification of employment obtained at the time of loan review was adequate and supported by borrower provided documentation. If re-verification occurs and same employer reports an error, it is beyond the control of FSMC. FSMC qualified the borrower based on documentation as reviewed by the auditors and the same documentation as found in the file. Although the gross pay

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letter indicated a deduction of child support in the amount of $321.00 the inclusion of that debt brings the bottom ratio to a 40.81, still with in loan guidelines. Based on the paystubs' in the file the VOE information supported the debt to income calculated. ***FSMC requests that this finding be removed from the final Auditors Draft.***

Comment 12

D. Compensating Factors Disagreement of Findings: The MCAPUR for this loan case had clearly stated compensating factors typed on the form. The same compensating factors mentioned are found in the loan file. Job stability, length of employment, good ratios, minimum reliance on consumer credit, all these are evident based on the documentation in the loan file. FSMC adhered to all 4155.1 standard guidelines in considering loan approval. Despite the due diligence of FSMC in underwriting the loan applicant, factors affecting the borrower after closing cannot be foreseen. ***FSMC requests that this finding be removed from the final Auditors Draft.***

Comment 2

E. Title Issues: FSMC has addressed this issue previously in this response and requires further information by the current loan servicer, in order to credit the correct entity. ***FSMC agrees with this finding.***

374-433772 Guzman/Matute, Disagreement of Findings:

Comment 13

A. Credit Analysis Disagreement of Findings: FSMC verifies existence of alternative credit providers via reverse directory lookup. Had the auditors requested the reverse directory FSMC would have gladly provided it (Exhibit 8). FSMC has already explained the co-borrower is married but not to the primary borrower on the loan application. Neither FSMC or the auditors can pretend to know the # of said persons contributing to the dollar amount of a $1700.00 monthly rental on solely the basis of co-borrower monthly income being $1213.00. If indeed a borrower is requesting a rental reference from a landlord, can he pretend to know what amount each person contributes to the whole? The industry standard rental reference does not ask, "What % portion of the total rental amount is paid by you" the borrower. If a revised rental reference form by the industry as a whole is then adopted, and the percent paid by a borrower was left blank, only then, does FSMC have a basis for requesting further information. Knowing the co-borrower is married to someone other than the borrower she is applying with seems explanation enough. Likewise, FSMC shall not require borrowers to write inquiry explanation letters for inquiries on their credit report when FSMC clearly recognizes the inquirers as the very same companies FSMC uses for their in file credit reports at the time of pre-qualification. The 2nd borrower had a previous inquiry from a mortgage lender and it credit provider. The underwriter apparently felt the mortgage inquiry was not additional credit granted as the application for mortgage was now with FSMC. ***FSMC requests that this finding be removed from the final Auditors Draft.***

B. Gift Documentation Disagreement of Findings: The documentation of a $3900.00 gift

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Comment 14

in the file fully complies with ML 00-28. FSMC contends that on many occasions it has contacted HOC for further guidance as has been assured that the interpretation of the spirit of ML00-28 is that donor ability to give the gift must be documented. The donor wrote a personal check #131 to which purchase an official bank check dated 01/25/04, on the same bank statement that shows #131 withdrawn. The official check shows the donors name as remitter. The donors' official check was later deposited in to the borrowers account on 01/26/04 along with $100.00 cash at hand for a total deposit of $4000.00. None of these issues mentioned have non-compliance with ML00-28. The issue Auditors have is with a large deposit on the donors' bank statements on 12/29/03. The 12/29/03 deposit is of the same amount later given by the donor to the borrowers. FSMC is unaware that FHA guidelines have been expanded to require donor ability statements to show gift funds are seasoned in the donors source account for 3 months prior to gifting them. FSMC "conclusive" evidence in sourcing donors' funds would then require 3 months donor statements. If this is accomplished, then FSMC will have the authority under the program to require donors show trail transfers from other bank accounts prior to transfers in to source account.
The published guidelines to date are found in the FHA guide 4155.1.

Excerpt from HUD Handbook 4155.1:

"C. Gift Funds. An outright gift of the cash investment is acceptable if the donor is the borrower's relative, the borrower's employer or labor union, a charitable organization, a governmental agency or public entity that has a program to provide homeownership assistance to low- and moderate-income families or first-time homebuyers, or a close friend with a clearly defined and documented interest in the borrower. The gift donor may not be a person or entity with an interest in the sale of the property, such as the seller, real estate agent or broker, builder, or any entity associated with them. Gifts from these sources are considered inducements to purchase and must be subtracted from the sales price. No repayment of the gift may be expected or implied. ***(As a rule, we are not concerned with how the donor obtains the gift funds provided they are not derived in any manner from a party to the sales transaction. Donors may borrow gift funds from any other acceptable source provided the mortgage borrowers are not obligors to any note to secure money borrowed to give the gift.)*** This rule also applies to properties of which the seller is a government agency selling foreclosed properties, such as the Veterans Administration or Rural Housing Services. Only family members may provide equity credit as a gift on a property being sold to other family members. These restrictions on gifts and equity credit may be waived by the jurisdictional HOC provided that the seller is contributing to or operating an acceptable affordable housing program." End of excerpt.
Enough said.

FSMC requests that this finding be removed from the final Auditors Draft.

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Comment 15

C. Social Security # Discrepancy Disagreement of Findings: At the time of application the only known social security # for this borrower was 573-80-7545. The borrower presented his card upon request for proof of SS#. All supporting documents concurred. Although a riders of contract of sale contained a different SS#, FSMC was satisfied of the correct # when all other supplied documentation supported in the file agrees with the application social security# i.e. pay stubs', W2s, ID docs .
FSMC requests that this finding be removed from the final Auditors Draft.

Comment 16

D. Adequate Compensating Factors Disagreement of Findings: FSMC 92900PUR for this loan listed Job stability, excellent credit [rental payment history], not heavy [credit] users, no late payments; rental payment [is good]. These written phrases are concise and straight to the point.

Job stability refers to A-J item: I due to each borrower at their respective jobs 4 years, earnings expected to increase. Comments on credit refer to A-J items C, D, & F.
C. due to the borrowers conservative attitude towards use of consumer credit (has zero debt), with D. therefore has greater ability to devote a greater portion of income to housing expense and F. due to the rental payments history of no lates in which the combined amount of rent paid is $2450.00, greater than the $2337.40 new proposed housing payment for exceeding 2nd ratio.
FSMC requests that this finding be removed from the final Auditors Draft.

Reference Source 4155.1:
2-13 COMPENSATING FACTORS. Compensating factors that may be used to justify approval of mortgage loans with ratios exceeding our benchmark guidelines are those listed below. Underwriters must record on the "remarks" section of the HUD 92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation.

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 over the past 12-24 months.

B. The borrower makes a large downpayment (ten percent or more) toward the purchase of the property.

C. The borrower has demonstrated an ability to accumulate savings and a conservative attitude toward the use of credit.

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 documented compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and similar public benefits.

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F. There is only a minimal increase in the borrower's housing expense.

G. The borrower has substantial documented cash reserves (at least three months' worth) after closing. In determining if an asset can be included as cash reserves or cash to close, the lender must judge whether or not the asset is liquid or readily convertible to cash and can be done so absent retirement or job termination. Also see paragraph 2-10K. Funds borrowed against these accounts may be used for loan closing, but are not to be considered as cash reserves. "Assets" such as equity in other properties and the proceeds from a cash-out refinance are not to be considered as cash reserves. Similarly, funds from gifts from any source are not to be included as cash reserves.

H. The borrower has substantial non-taxable income (if no adjustment was made previously in the ratio computations).

I. The borrower has a 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 reasonable prospects exist for securing employment in a similar occupation in the new area. The underwriter must document the availability of such possible employment.

374-4468054 Difo, Disagreement of Findings:

Comment 17

A. Cash Investment Disagreement of Findings: Unfailingly borrowers are being categorized as short to close in this instance $73.00. Auditors continue to disregard the outlay of the one-year hazard policy expense borrower incurs upon bringing their policy to closing pre-paid in an effort to have 97% LTV loans appear short cash to close. FSMC realizes HUD1 preparation is partly the problem. To this end, FSMC will include the full cost on pg 2 of the HUD1 for the 1-year policy. This pg 2 total will allow borrowers seller contribution total to cover the 1 year policy outlay by the borrower. FSMC credit the borrower his or her invoice on pg 1 credits, effectively reimbursing the borrower and freeing up his previously verified funds as funds to close. FSMC has clearly demonstrated the cash investment met. Included is the copy of the FHA MAXIMUM MORTGAGE and CASH NEEDED CALCULATOR available to all lenders from HUD/FHA's web site. As noted in the data entry, the purchaser met and exceeded the cash requirement, and as previously noted in methodology for arriving at borrowers' ability to meet these cash expenses (Exhibit 9)
FSMC requests that this finding be removed from the final Auditors Draft.

Comment 18

B. Credit Analysis Disagreement of Findings: FSMC shall not require borrowers to write inquiry explanation letters for inquiries on their credit report(s) when FSMC clearly recognizes the inquirers as the very same companies FSMC uses for their in file credit reports at the time of pre-qualification.
FSMC requests that this finding be removed from the final Auditors Draft.

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Comment 19

C. Gift Documentation Disagreement of Findings: FSMC in reviewing the file checks that donor is not on contract of sale or a realtor to the transaction. Although donor ability statements are not a requirement by the ML00-28 for gifts already in a borrowers account, donor ability statement is provided as conclusive evidence that the funds are indeed from the donor. The donor upon affixing his signature to the gift letter is reaffirming to the lender that *"These funds are not being made available to the donor from any person or entity with an interest in the sale of the property including the seller, real estate agent or broker, builder, loan officer, or any entity associated with them."*
FSMC requests that this finding be removed from the final Auditors Draft.

Comment 20

D. Adequate Funds to Close Disagreement of Findings: Borrowers stamped & signed print out on 04/04/05 shows available balance of $6105.00. Since that time borrower had 4 remaining April calendar pay weeks and 2 more in May. Six weeks net pay @ $878.42 is $5720.52. Assuming he paid Mays rent and the homeowners 1 year policy - ($985.00+$1700.00) leaves $3035.52, more than sufficient to cover the additional formerly $1340.47 and now in this draft version $1235.00 in question. Refer to answer A Exhibit 9 for further evidence of adequate cash to close.
FSMC requests that this finding be removed from the final Auditors Draft.

Comment 21

E. Adequate Compensating factors Disagreement of Findings: The applicable compensating factors in exceeding the front ratio at 36% while not typed exactly as in the 4155.1 on the MCAPUR are: 1) C. The borrower has demonstrated conservative attitude toward the use of credit. 2)D. Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses. 3)I. The borrower has a potential for increased earnings, as indicated by job training or education in the borrower's profession: 8 years job stability. 4)F. There is only a minimal increase in the borrower's housing expense: in this case a $674.40 increase which will be off set by tax benefit of homeownership. Noteworthy is that per ML 05-16 back ratios of 43% are acceptable with out 4 compensating factors as listed for this borrower. Please refer to reference source 4155.1 Section 2-13 in previous answer 374-433772 D.
FSMC requests that this finding be removed from the final Auditors Draft.

Ref to OIG Evaluation	Auditee Comments

FIRST SUFFOLK MORTGAGE CORPORATION
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CONCLUSION:

Comment 22

Comment 3

In conclusion, FSMC respectfully submits that mention of other technical differences in opinion mention by auditors such as a debt that may not have been included when there was clearly a lease to offset the payment or assumptions by auditors of circuitous rhetoric based on information not readily presented in files, is non-warranted. FSMC maintains and has documented each loan is precisely underwritten to HUD/FHA standards, as published at the time for each loan origination period. All due diligence is documented accordingly by FSMC in its loan files. FSMC thence submits that auditors findings 1 be removed from its report. Audit findings 2 should also be modified for the final report. FSMC respectfully requests that all further supporting evidentiary documentation enclosed be included in auditee comments further illustrating the facts of each loan file. FSMC concedes that corrective action has been taking place prior to, during and will continue to be willingly put in place when developing best business practices.

FSMC adheres to Fair Lending practices without regard to race, color, creed, marital status, or economic-socio-status. Circumstances beyond the control of FSMC have affected borrowers after closing for which FSMC is not accountable. Therefore, FSMC believes two future loans that are now current require no indemnification. FSMC will therefore await determination of losses incurred in for actual amounts to consider for indemnification. (Exhibit 10)

Sincerely,

By:
Maria M. Podraza
President
First Suffolk Mortgage Corporation
05/24/2006

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Comment 1 First Suffolk concurs that three borrowers were charged $230 in ineligible fees and agrees to reimburse the borrowers.

Comment 2 First Suffolk concurs that the $2,500 escrow should be released. HUD Handbook 4155.1, REV-4, CHG-1, paragraph 3-12, states the lender is responsible for resolving all problems regarding title to real estate. First Suffolk remains in possession of a $2,500 escrow deposit provided by the seller at closing. The seller agreed to deposit the $2,500 in escrow until the Certificate of Occupancy for the two sheds and a deck listed on the title report was obtained.

Comment 3 Our review of the auditee files and discussion with the Quality Control contractor disclosed that during our audit period loans were not specifically selected for review based upon their early default status as required by HUD regulations. We acknowledged in the report that First Suffolk had established such a policy after the start of our review.

Comment 4 First Suffolk maintains that the Comply Eye Bulletin is a corrective action memorandum. This Bulletin, which was not provided to us during our audit, states that it provides information that may be helpful to processors and underwriters, and does not support that correction action was taken to address all material findings identified in the quality control reviews of the loans we reviewed. Further, alternative documentation to support that corrective action was taken was not provided during the audit.

Comment 5 First Suffolk maintains that the $8,406 ($7,314 earnest money deposit, $450 appraisal fee and $642 hazard insurance) exceeded the 3 percent minimum required investment of $7,314. However, when this loan was originated, hazard insurance was not considered as part of the minimum cash investment as per HUD-FHA Single Family Housing Homeownership Center Reference Guide, Chapter 2-15. Further, the HUD-1 reported $1,019 cash back to the borrower; therefore, the borrower's total investment consisted of $7,764 ($7,314 earnest money deposit and $450 cash deposit) minus $1,019 cash back to the borrower, resulting in a total investment of $6,745 ($7,764 less $1,019). As a result, the minimum required investment was short $615 ($7,360 less $6,745).

Comment 6 First Suffolk provided additional information to show that, while the borrower attempted to bring the debt current by making additional payments, the creditor applied the payments to principal, rather than reducing the late payments. As a result, the credit report continued to show the borrower delinquent and finance charges continued to accrue monthly. The payment history provided by First Suffolk reported that the borrower paid $68 monthly, even though the minimum payment was $204. Therefore, First Suffolk did not obtain a sufficient explanation from the borrower to explain why the borrower was paying $68 instead of the minimum required payment of $204.

Comment 7 There was no evidence in the loan file that First Suffolk attempted to resolve the inconsistent employment data prior to closing the loan.

Comment 8 First Suffolk deposited the borrower's $450 cash deposit into its petty cash account to be used for the mortgagee's general operating purposes, which is prohibited by HUD Handbook 4330.1, REV-5, Chapter 2-4.

Comment 9 First Suffolk concurs that the minimum cash investment was not made per the HUD-1, and attributes it to an error by the settlement agent.

Comment 10 Neither the FHA case binder nor the lender's file contained an actual gift letter to support the gift from the borrower's fiancée as required by Mortgagee Letter 00-28.

Comment 11 First Suffolk obtained a Verification of Employment and faxed copies of the borrower's two most recent paychecks, but did not verify the authenticity of the faxed copies as required by Mortgagee Letter 2001-01. Further, First Suffolk maintains that the debt to income ratio calculated was supported by the paystubs in the file. This is incorrect because the employer provided itemization of pay and deductions reported $321 child support, which was not included in First Suffolk's debt to income ratio. While including this increases the back ratio to 40.8 percent, which is within FHA guidelines to not require compensating factors, First Suffolk did not include the $321 for child support in underwriting the loan as required.

Comment 12 The loan file noted compensating factors on the MCAW of (1) stability of income established due to profession, applicant at time of underwriting was a driver and a warehouse supervisor, (2) stability of employment established due to 24 years on the job, (3) applicant able to devote more of his income for housing expenses since there were no other recurring monthly debts or obligations, and (4) applicant able to devote more income to housing due to a small family. However, three of these are not valid compensating factors per HUD Handbook 4155.1 REV-4 Chapter 2-13 to justify approving this loan with a front ratio that exceeds HUD established benchmark. Further, the compensating factor that the applicant is able to devote more income for housing expenses since there were no other recurring monthly debts or obligations, is not supported because the borrower did have a recurring debt of $321 for child support.

Comment 13 First Suffolk provided information for development of a credit history for the borrower and co-borrower. However, there was no explanation for two of four inquiries on the co-borrower's credit report within the last 90 days, one from another mortgage lender and one from an unknown source. Consequently, First Suffolk did not obtain a written explanation as required by HUD Handbook 4155.1, REV-5, Chapter 2-3. In addition, First Suffolk maintains that it did not clarify the co-borrower's rent verification indicating monthly rental expenses of

$1,700 and reported monthly wages of $1,213 because the co-borrower is married to someone other than the primary borrower. However, the loan application reports that the co-borrower is unmarried and the rental verification listed only one tenant.

Comment 14 The donor's bank statement disclosed that $3,900, the amount of the gift, was deposited on the same day that the gift was made. Prior to that deposit, the donor had an account balance of $706. Consequently, there was no conclusive evidence that the funds given to the borrower came from the donor's own funds as required by Mortgagee Letter 00-28.

Comment 15 Based upon the auditee's comments, we removed this issue.

Comment 16 First Suffolk presented support for a compensating factor of not being a heavy credit user; therefore, we have deleted reference to a deficiency related to the adequacy of compensating factors.

Comment 17 Mortgagee Letter 98-29, dated October 22, 1998, requires a borrower to provide minimum cash investment of three percent of the estimated cost of acquisition. The HUD-1 documents that the borrower paid an earnest money deposit of $2,000, a $450 cash deposit outside of closing, and $7,340 at closing, for a total investment of $9,790**.** Therefore, the borrower was short $73 ($9,790 less $9,863). However, the FHA insurance on this loan was terminated on February 24, 2006; therefore, we have removed this case from the audit report.

Comment 18 HUD Handbook 4155.1, REV-5, Chapter 2-3 requires a written explanation from the borrower explaining all inquiries shown on the credit report in the last 90 days. First Suffolk demonstrated that one of three recent inquiries was from a company used by First Suffolk for the pre-qualification of the co-borrower; consequently, we agree that First Suffolk would not need a written explanation from the borrower for this inquiry. However, First Suffolk should have obtained a written explanation from the borrower for the remaining two inquiries shown on the credit report. Nevertheless, the FHA insurance on this loan was terminated on February 24, 2006; therefore, we have removed this case from the audit report.

Comment 19 First Suffolk did not obtain conclusive evidence from the donor that the gift funds were indeed the donor's own funds as required by Mortgagee Letter 00-28. The donor's bank statement for the period March 5, 2005 through April 6, 2005 showed a negative balance on March 5, 2005. Then on April 4, 2005, the same day the gift was given, a $4,000 deposit was made. However, since the FHA insurance on this loan was terminated on February 24, 2006, we have removed this case from the audit report.

Comment 20 The HUD-1 showed cash from borrower of $7,340, however, the loan file disclosed that First Suffolk documented $6,105; the additional $1,235 needed to close was not documented. However, the FHA insurance on this loan was terminated on February 24, 2006; therefore, we have removed this case from the audit report.

Comment 21 First Suffolk computed front and back ratios of 42.95% and 43.23%, respectively, and noted the following compensating factors on the MCAW: (1) one credit card is used, (2) no late payments, (3) good job stability, and (4) good comment on how he works. However, these items are not valid compensating factors per HUD Handbook 4155.1 REV-4 Chapter 2-13. Nevertheless, since the FHA insurance on this loan was terminated on February 24, 2006; we have removed this case from the audit report.

Comment 22 The technical underwriting deficiencies we found, such as failure to consider a debt, inadequate credit analysis, and inadequate documentation of, and erroneous, compensating factors were not serious enough to negatively impact the decision to approve a loan. Nevertheless, reporting of these deficiencies is warranted so that First Suffolk can improve its underwriting procedures to ensure full compliance with all HUD requirements.

Appendix C

SUMMARY OF UNDERWRITING DEFICIENCIES

Case number	Minimum cash investment not provided	Inadequate credit analysis	Inadequate documentation and/or verification of gift	Inadequate verification of borrower's employment	Other deficiencies	Appendix reference
374-4297672	X	X		X	X	**D-1**
374-4317363	X		X	X	X	**D-2**
374-4337742		X	X			**D-3**
Total	**2**	**2**	**2**	**2**	**2**	

Appendix D

CASE SUMMARY NARRATIVES

Case number:	374-4297672
Loan amount:	$240,000
Settlement date:	October 1, 2003
Status:	Claim paid
Claim amount:	$254,787

Pertinent Details

A. Minimum Cash Investment Not Provided

Mortgagee Letter 98-29, dated October 22, 1998, provides that the National Housing Act requires a borrower to provide minimum cash investment of 3 percent of the estimated cost of acquisition. HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-10, requires that the cash investment in the property equal the difference between the amount of the insured mortgage, excluding any upfront mortgage insurance premium, and the total cost to acquire the property, including prepaid expenses. The borrower did not make the minimum cash investment of $7,360. The borrower made a cash deposit of $450 and an earnest money deposit of $7,314 for a total cash investment of $7,764. However, the HUD-1 settlement statement reported cash to the borrower of $1,019, resulting in a cash investment of $6,745, or $615 less than the required investment.

B. Inadequate Credit Analysis

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-3, requires that sufficient written explanation from the borrower, that makes sense and is consistent with other credit information in the file, be obtained for major indications of derogatory credit, including judgments, collections, and any other recent credit problems. The borrower's credit report listed one derogatory account, for which First Suffolk did not obtain sufficient explanation. The account, which was opened in November 2000, was late five times during the period February 2003 through June 2003. While the borrower provided a written explanation, it was inconsistent with the basis for the derogatory credit. The borrower explained that only one late payment was made; yet the creditor kept reporting it late. The documentation in the file indicated that the creditor reported it late because the borrower was paying an amount less than the minimum required payment. First Suffolk did not address this inconsistency.

C. Inadequate Employment Verification

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 3-1, requires that when standard documentation does not provide enough information to support the lender's decision to approve the mortgage, the lender must provide additional explanatory statements, consistent with other information in the application, to clarify or supplement the documentation submitted by the borrower. First Suffolk did not adequately follow up on inconsistent data regarding employment income. A verification of employment from the borrower's first employer reported year-to-date wages of $24,085 as of August 13, 2003. However, First Suffolk also obtained the borrower's most recent pay stub, which reported year-to-date wages of $13,275 for the pay period ending August 13, 2003. The file contained no evidence of action to resolve this discrepancy. Further, a verification of employment, which we sent to the employer, confirmed that the correct wages were as stated on the pay stub. Consequently, the wages used to approve this loan were overstated. As a result, we determined that the mortgage payment-to-effective income ratio and total fixed payment-to-income ratio of 36.9 and 38.1 percent calculated by First Suffolk would increase to 45.2 and 46.6 percent, respectively. Such ratios would have required First Suffolk to document compensating factors to justify loan approval.

D. Inadequate Bank Account Documentation

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 3-1F, provides that as an alternative to obtaining a verification of deposit, the lender may obtain from the borrower original bank statement(s) covering the most recent three-month period. First Suffolk chose the alternative but only obtained one month's bank statement.

E. Excessive Ratio without Compensating Factors

HUD Handbook 4155.1, REV 4, CHG-1, paragraphs 2-12 and 2-13, require that compensating factors justify approval of loans in which the mortgage payment-to-effective income ratio and total fixed payment-to-income ratio exceed 29 and 41 percent, respectively. Mortgagee Letter 2005-16, dated April 13, 2005, raised the qualifying front and back ratios to 31 and 43 percent, respectively; however, the lender must describe the compensating factors if either or both ratios exceed the guidelines on a manually underwritten mortgage. First Suffolk calculated the front ratio as 36.9 percent without documenting significant compensating factors.

F. Improper Escrow of Borrower's Funds

HUD Handbook 4330.1, REV-5, paragraph 2-4, prohibits commingling (even temporarily) of escrow funds with funds used for the lender's general operating purposes. First Suffolk received $450 in cash from the borrower to pay for the appraisal report and placed this cash into its petty cash account; therefore, it improperly escrowed funds received from the borrower.

Case number:	374-4317363
Loan amount:	$259,800
Settlement date:	November 10, 2003
Status:	Claim paid
Claim amount:	$272,157

Pertinent Details

A. Minimum Cash Investment Not Provided

Mortgagee Letter 98-29, dated October 22, 1998, provides that the National Housing Act requires a borrower to provide minimum cash investment of 3 percent of the estimated cost of acquisition. HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-10, requires that the cash investment in the property equal the difference between the amount of the insured mortgage, excluding any upfront mortgage insurance premium, and the total cost to acquire the property, including prepaid expenses. The borrower did not make the required cash investment of $8,383. The borrower invested $6,888, consisting of a cash deposit of $450, an earnest money deposit of $5,000, and $1,438 paid at closing according to the HUD-1 settlement statement. Therefore, the borrower was short $1,495.

B. Inadequate Gift Documentation

Mortgagee Letter 00-28, dated August 7, 2000, requires the lender to document any gift funds with a gift letter that specifies the dollar amount of the gift and the donor's name, address, telephone number, and relationship to the borrower, is signed by the donor and the borrower, and states that no repayment is required. The mortgage credit analysis worksheet listed a gift of $8,000 from the borrower's fiancée; however, neither the case binder nor the lender's file contained a gift letter as required.

C. Inadequate Employment Verification

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 3-1, provides that when standard documentation does not give enough information to support a decision, the lender must provide additional explanatory statements, consistent with other information in the application, to clarify or supplement the documentation submitted by the borrower. Mortgagee Letter 2001-01 provides that if income/employment or asset documents are faxed to the lender, the documents must clearly identify the employer or depository/investment firm's name and source of information, and the lender must determine the authenticity of the document by examining, among other things, the information included at the top or banner portion of the fax received by the lender. First Suffolk obtained a verification of employment and faxed copies of the borrower's two most recent computerized paychecks without verifying the authenticity of the faxed paychecks. A confirmation that we sent to the borrower's employer indicated that the wages on the verification of employment were incorrect. The verification of employment reported earnings of $78,000 for 2001 and 2002 and $57,000 through September 26, 2003, whereas the confirmation showed earnings of $29,294 for 2001, $29,484 for 2002, and $23,698 through September 26, 2003.

D. Incorrectly Calculated Ratios and Excessive Qualifying Ratios without Adequate Compensating Factors

HUD Handbook 4155.1, REV-4, CHG-1, paragraphs 2-12 and 2-13, provide that if the borrower's mortgage payment-to-effective income ratio and total fixed payment-to-income ratio exceed 29 and 41 percent, respectively, the underwriter must present significant compensating factors supported by documentation to justify mortgage approval. Mortgagee Letter 2005-16, dated April 13, 2005, raised the qualifying ratios to 31 and 43 percent, respectively; however, the lender must describe the compensating factors if either or both ratios exceed the guidelines on a manually underwritten mortgage. First Suffolk computed the ratios to be 35.87 and 35.87 percent, respectively, and noted the following compensating factors: (1) stability of income was established due to profession at the time of underwriting (the applicant was a driver and a warehouse supervisor), (2) stability of employment was established due to 24 years on the job, (3) the applicant was able to devote more of his income for housing expenses since there were no other recurring monthly debts or obligations, and (4) the applicant was able to devote more income to housing due to a small family. However, these items were not valid compensating factors according to HUD requirements, nor were they supported by adequate documentation. In addition, the lender did not include a $321 monthly child support payment in its calculation, which would have raised the total fixed payment-to-income ratio to 40.80 percent.

E. Unresolved Title Issues

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 3-12, states the lender is responsible for resolving all problems regarding title to real estate. First Suffolk is holding $2,500 in escrow provided by the seller at closing to be held in escrow until issues with the title of the property were resolved. The title report identified two sheds and a deck that did not have the proper Certificate of Occupancy and an escrow agreement indicated that the seller agreed to deposit $2,500 in escrow and obtain the Certificate of Occupancy. HUD paid a claim on this loan and First Suffolk is still holding the $2,500 in escrow and the title issues are unresolved.

Case number:	374-4337742
Loan amount:	$256,750
Settlement date:	March 11, 2004
Status:	Current - Reinstated by borrower who retains ownership

Pertinent Details

A. Inadequate Credit Analysis

HUD Handbook 4155.1, REV-5, paragraph 2-3, requires that if borrowers have not established a credit history or used traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider. Paragraph 2-3 further states that documents confirming the existence of a nontraditional credit provider may include a public record from state, county, or city records or other means providing a similar level of objective confirmation. First Suffolk did not follow these HUD requirements in developing credit histories for the borrower and coborrower. The credit reports obtained by the lender reported no activity for either the borrower or the coborrower. Therefore, First Suffolk developed credit histories by obtaining a verification of rent and a letter from an insurance agency for the borrower and a verification of rent and a letter from a travel agency for the coborrower. There was no documentation indicating that First Suffolk confirmed the existence of the credit providers (insurance agency and travel agency) as required. Additionally, the verification of rent for the coborrower does not appear to be reasonable because the monthly rent indicated is $1,700 and the coborrower's monthly wages are $1,213. HUD Handbook 4155.1, REV-5, paragraph 3-1, states that when standard documentation does not provide enough information to support a decision, the lender must provide additional explanatory statements, consistent with other information in the application, to clarify or to supplement the documentation submitted by the borrower. Since the coborrower's documented monthly wages were only $1,213 and the documented monthly rent was $1,700, First Suffolk should have obtained an explanatory statement from the coborrower. Also, the coborrower's credit report showed a recent inquiry, from a mortgage lender, for which there was no written explanation from the coborrower as required by HUD Handbook 4155.1, REV-5, paragraph 2-3B.

B. Inadequate Documentation and Verification of Gift

Mortgagee Letter 00-28, dated August 7, 2000, requires the lender to document the transfer of any gift funds from the donor to the homebuyer by obtaining a copy of the canceled check or other withdrawal document showing the withdrawal is from the donor's personal account, along with the homebuyer's deposit slip or bank statement showing the deposit. Further, regardless of when the gift funds are made available to the homebuyer, the lender must be able to determine that the gift funds were not ultimately provided from an unacceptable source and were the donor's own funds. First Suffolk documented the gift with a customer's copy of an official bank check in the amount of $3,900, dated January 25, 2004, a copy of the donor's bank statement, and a copy of the borrower’s bank statement. However, the customer’s copy of the official check did not contain the bank routing number, which should be on both the official check and the customer’s copy. Therefore, this customer copy of an official bank check is not adequate supporting documentation for the $3,900 gift. Additionally, the copy of the donor’s bank statement shows check number 131 for $3,900 clearing the bank account on January 26, 2004, with a handwritten note stating “gift out.” The lender did not obtain a copy of check number 131 to document the gift as required. The donor’s January 28, 2004, bank statement showed a zero beginning balance and deposits of $103, $604 and $3,900 on December 29, 2003, January 20, 2004, and January 26, 2004, respectively. However, the lender did not obtain conclusive evidence to support the source of the $3,900 deposit. While First Suffolk obtained a bank printout for the borrower’s bank account showing a $4,000 deposit on January 26, 2004, the lender did not document the transfer of funds from the donor to the homebuyer and did not obtain conclusive evidence that the $3,900 was indeed the donor’s own funds as required.