Issue Date	August 14, 2006
Audit Report Number	2006-NY-1009

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

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

SUBJECT: First Residential Mortgage Services Corporation, Englewood Cliffs, New Jersey, Did Not Always Comply With HUD/Federal Housing Administration Loan Origination Requirements

HIGHLIGHTS

What We Audited and Why

We audited First Residential Mortgage Services Corporation (First Residential), a non-supervised lender located in Englewood Cliffs, New Jersey because its default rate of 6.73 percent for loans with beginning amortization dates between October 1, 2003, and September 30, 2005, was higher than the default rate for the State of New Jersey, which was 4.95 percent.

The audit objectives were to determine whether First Residential (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/FHA requirements.

What We Found

First Residential did not always comply with HUD underwriting requirements. Seven of 11 loans we reviewed exhibited significant underwriting deficiencies such as inadequate credit analysis, inadequate verification of funds to close, minimum cash investment not met, and inadequate verification of income and/or employment. The remaining four loans contained technical violations. In addition, one borrower was charged a $495 ineligible commitment fee. These deficiencies occurred because First Residential lacked adequate controls to ensure that loans were processed in accordance with HUD requirements.

First Residential did not ensure that its quality control plan was implemented in accordance with both HUD and its own requirements. First Residential did not ensure that (1) quality control reviews were conducted for all loans that defaulted within six months of closing, (2) at least ten percent of the closed and rejected loans were always selected for quality assurance reviews, (3) quality control reviews were performed timely, (4) management follow-up was provided for the quality control reviews of the loans from the wholesale division, and (5) HUD was informed of significant deficiencies that it discovered with one of its loan correspondents. This noncompliance occurred because First Residential did not establish procedures to ensure that its quality control plan was properly implemented. Consequently, the effectiveness of First Residential's quality control plan, which is designed to ensure accuracy, validity, and completeness in its loan underwriting process, was lessened.

What We Recommend

We recommend that the assistant secretary for housing – federal housing commissioner require First Residential to: (1) reimburse HUD for the amount of claims and associated fees paid on one loan with significant underwriting deficiencies, (2) indemnify HUD against future losses on the six loans with significant underwriting deficiencies, (3) establish procedures to ensure that HUD underwriting requirements are properly implemented and documented, (4) implement procedures to ensure compliance with HUD and its own quality control requirement, and (5) reimburse the borrower for the $495 ineligible commitment fee found in one case.

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

Auditee's Response

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

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BACKGROUND AND OBJECTIVES

First Residential Mortgage Services Corporation, (First Residential) became an approved U.S. Department of Housing and Urban Development lender in 1994. The company originates loans, which it then sells to investors, banks and other mortgage bankers.

The main office of First Residential is located in Englewood Cliffs, New Jersey. There are separate branch offices located in Weston, Florida; Silver Spring, Maryland; and Whitestone, New York.

Between October 1, 2003 and September 30, 2005 First Residential underwrote 1,203 Federal Housing Administration-insured mortgages in New Jersey. We selected First Residential for audit because its 6.73 percent default rate for loans with a beginning amortization date between October 1, 2003, and September 30, 2005 was higher than the average default rate for the State of New Jersey, which was 4.95 percent.

The objectives of this audit were to determine whether First Residential (1) approved insured loans in accordance with the 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.

RESULTS OF AUDIT

Finding 1: First Residential Mortgage Service Corporation Did Not Always Comply with HUD's Underwriting Requirements

First Residential Mortgage Services Corporation (First Residential) did not follow prudent lending practices and HUD regulations in the origination and underwriting of the 11 loans we reviewed.[1] As a result, loans were approved for potentially ineligible borrowers and these deficiencies contributed in causing the HUD/Federal Housing Administration (FHA) to assume an unnecessary insurance risk. Seven loans contained significant underwriting deficiencies such as inadequate credit analysis, inadequate verification of funds to close, minimum cash investment not met, and inadequate verification of income/employment. The remaining four loans contained technical violations. Consequently, the HUD/Federal Housing Administration Insurance fund paid a claim for one loan totaling of $221,445, and continues to be at risk for $1,463,394. These deficiencies occurred because First Residential did not have adequate controls to ensure that loans were processed in accordance with HUD/FHA requirements.

Significant Underwriting Deficiencies

Our review of 11 loans with amortization dates between October 01, 2003, and September 30, 2005, disclosed significant underwriting deficiencies in seven loans. These deficiencies occurred because First Residential did not follow prudent lending practices and regulations prescribed by HUD in its origination and underwriting of the seven loans.

HUD Handbook 4155.1, REV-5, entitled " Mortgage Credit Analysis for Mortgage Insurance," prescribes basic underwriting requirements for Federal Housing Administration-insured single-family mortgage loans. The lender must ensure that the borrower has the ability and willingness to repay the mortgage debt. This assessment must be based on sound underwriting principles in accordance with the guidelines, rules, and regulations described in this handbook and be supported by sufficient documentation. In addition, Chapter 3-1 of the Handbook requires that the application package contain sufficient documentation to support a lender's decision to approve a mortgage. While this decision involves some subjectivity, our examination of 11 loans approved by First Residential disclosed significant underwriting deficiencies in the approval of seven loans. First Residential did not always (1) sufficiently analyze borrowers' credit, (2) adequately verify the source of funds to close, (3) ensure that the minimum cash

[1] We originally reviewed 12 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 11 loans for which either a claim was paid or that still represent a risk to the FHA insurance fund.

investment requriement was met, and (4) properly verify the borrowers' employment and/or income.

The deficiencies are noted in the chart below and in appendix C. The deficiencies noted are not independent of one another, as one loan may have contained more than one deficiency.

Areas of deficiencies	***Number of loans***
Inadequate credit analysis	6 of 7 loans
Inadequate verification of funds to close	6 of 7 loans
Minimum cash investment not met	4 of 7 loans
Inadequate verification of employment and/or income	2 of 7 loans

Specific examples of these significant underwriting deficiencies follow:

- For FHA case # 352-5230020, the lender did not obtain an adequate explanation for the employment gap from August 2002 to March 2003 for the co-borrower. HUD Handbook 4155.1, REV-5, section 2-6 requires that the lender must verify the borrower's employment for the most recent two full years. The borrower also must explain any gaps in employment spanning one month or more. In addition, the borrower made numerous excessive deposits and overdrafts to his bank account without explanation. Also, the lender did not (1) conduct an adequate credit analysis, and (2) adequately describe the compensating factors used to justify mortgage approval.

- For FHA case # 352-5213442, the lender did not verify if the borrower had cash reserves equivalent to three months' principal, interest, taxes, and insurance (PITI). HUD Handbook, 4155.1, REV-5, section 1-8 C requires that the borrower must have reserves equivalent to three months' PITI after closing on the purchase transactions for three and four unit properties. Reserves cannot be derived from a gift. The Mortgage Credit Analysis Worksheet showed that the cash reserve was $79.71, which was less than one month's (PITI) costs of $2,313. In addition, the lender did not adequately (1) conduct a credit analysis and (2) evaluate the borrower's savings pattern.

- For FHA case # 352-5167847, the lender did not conduct an adequate credit analysis. HUD Handbook 4155.1, REV-5, section 2-3, provides that major indications of derogatory credit require a sufficient written explanation from the borrower. The borrower's credit report indicated 48 instances of late payments for one of the creditors, of which numerous late payments were recently incurred. The borrower also incurred numerous delinquencies with another creditor. The explanations on file did not make sense. Section 2-3C requires that the borrower must explain in writing all collections and judgments. The file did not contain a written explanation for one judgment incurred for $4,213 and for two other judgments. The lender did not obtain any explanations for numerous credit inquiries. In addition, the lender did not (1) verify the source of the funds for the earnest money deposit of $3,500, (2) ensure that the minimum investment requirement was met, and (3) obtain verification of deposits.

- For FHA case # 352-5217394, the lender did not obtain a credible explanation for the source of the funds of $9,000. According to documentation on file, it indicated that the borrower's bank account was opened recently. HUD Handbook 4155.1, REV-5, section 2-10B states that if there is a large increase in an account, or the account was opened recently, the lender must obtain a credible explanation of the source of the funds. The bank account showed one deposit for $9,000 on February 9, 2004. The co-borrower had $9,000 in assets available at her private savings club. Section 2-10R of the handbook provides that while private savings clubs are not supervised banking institutions, at a minimum, the clubs must have account ledgers, receipts from the club, verification from the club treasurer, and identification of the club so that the lender can re-verify the information provided. The underwriter must be able to determine that it was reasonable for the borrower to have saved the money claimed, and that there is no evidence that these funds were borrowed with an expectation of repayment. The file only contained a verification and an affidavit that provided that the borrower started contributing to the club in October 2003. The verification indicated that contributions to the account are made bi-weekly for $900, while the affidavit that was signed by the club treasurer listed the contributions as $900 monthly. Moreover, the co-borrower's credit report indicated that the private savings club treasurer was also the co-borrower's landlord and paid commitment fees on behalf of the borrower and co-borrower. In addition, the lender did not (1) adequately verify and/or document earnest money, 2) ensure the minimum cash investment requirement was met, (3) conduct an adequate credit analysis, and (4) verify costs paid out of closing.

Technical Underwriting Violations

The remaining four 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 deficiencies are summarized in the chart below.

Technical Underwriting Violations	***Number of loans***
Verification of paid-out-of-closing costs not obtained	1 of 4 loans
Inadequate compensating factors	3 of 4 loans
Verification of deposits not obtained	3 of 4 loans
Inadequate credit analysis	2 of 4 loans
Inadequate underwriting procedures	1 of 4 loans

Specific examples of these violations follow:

In three loans, First Residential listed compensating factors that were not supported and/or not allowable in accordance with HUD Handbook 4155.1, REV-5, section 2-13G. For instance, income stability, minimum debts and low loan to value ratios were cited as compensating factors, good cash reserves and savings ability were cited without adequate supporting documentation. In three loans, First Residential did not verify the source of funds deposited into borrower's bank accounts. For example, in FHA case # 352-5235982, First Residential did not obtain the source information of the non-payroll deposits of $2,500 on May 27, 2004, $1,778 on April 27, 2004, and seven other non-payroll deposits totaling $2,530 made during the period from April 7, 2004, to May 25, 2004. In two loans, First Residential did not conduct adequate credit analyses for the borrowers. For example, in one case, the borrower's credit report indicated three late payments on a previous conventional real estate loan within 12 months of the borrower's application for an FHA loan. The documentation on file stated that the borrower was a co-signer for this loan. However, the HUD-1 settlement statement listed the borrower as a primary seller, and First Residential did not obtain any explanation of the contradictory information from the borrower. In addition, verifications of paid-out-of-closing costs were not obtained for one loan.

Ineligible Commitment Fees Charged to Borrowers

First Residential charged a borrower an ineligible commitment fee in one of the 11 loans reviewed. Mortgagee Letter 94-7, section IV, provides that a commitment or lock-in fee must be in writing and guarantee the mortgage interest rate and/or discount points for not less than 15 days before the anticipated closing date. First Residential charged an ineligible commitment fee of $495 for one of the 11 loans that we reviewed, even though the supporting documents in the file indicated that borrower did not choose to lock-in the interest rate.

Conclusions

First Residential did not always follow HUD regulations in the approval of loans. As a result, it approved seven loans for which HUD paid a claim on one loan totaling $221,445[2] and remains at risk for $1,463,394[2] in potential claims for the other six loans. The final loss that HUD incurs on the loan for which a claim was

[2] Based upon HUD's current 29 percent default loss experience, the amount of unsupported costs for one loan for which a claim was paid is estimated at $64,219 (29 percent of $221,445). The amount of cost savings or funds to be put to better use on the loan for which indemnification is recommended is estimated at $424,384 (29 percent of $1,463,394).

paid depends upon what HUD realizes when it disposes of the property. HUD's most recent data disclosed that its loss rate is 29 percent. 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 Residential also approved four other loans with technical underwriting deficiencies and charged an ineligible commitment fee to one loan.

Appendix C of the report provides a summary of the underwriting deficiencies noted in the seven cases. Appendix D of this report provides a more detailed description of the deficiencies.

Recommendations

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

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

1B. Indemnify HUD against future losses on six loans with significant underwriting deficiencies.

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

1D. Reimburse the borrower for the $495 ineligible commitment fee.

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

Our review disclosed that First Residential had weaknesses in the implementation of its quality control plan. It did not always comply with both HUD and its own quality control requirements to ensure that (1) all HUD-insured loans that defaulted within the first six payments were reviewed; (2) ten percent or more of the closed and rejected loans were reviewed; (3) quality control reviews were performed in a timely manner; (4) management follow-ups were provided for the quality control findings of the wholesale loans; and (5) HUD was immediately informed of the significant deficiencies that it discovered with one of its loan correspondents. This noncompliance occurred because First Residential did not establish procedures to ensure that its quality control plan was properly implemented. Consequently, the effectiveness of First Residential's quality control plan, which is designed to ensure accuracy, validity, and completeness in its loan underwriting 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 HUD Handbook 4060.1, REV-1, CHG-1, paragraph 6-6 D, and First Residential's quality control plan. We found that quality control reviews were not performed on eight out of the 47 early defaulted loans. First Residential overlooked one loan it originated. The other seven loans were originated by one of its loan correspondents. First Residential officials decided that it was unnecessary to review these seven early defaulted loans since it went into litigation against that loan correspondent regarding its misconduct in loan originations. Quality control reviews of the early defaulted loans can provide valuable information about the causes of default that may indicate inadequate underwriting. First Residential officials acknowledged this weakness and advised that review of these defaulted loans will be enforced.

Insufficient Sampling for Closed and Rejected Loans

HUD Handbook 4060.1 REV-1, CHG-1, paragraph 6-6C states that a mortgagee originating 7,000 or fewer Federal Housing Administration loans per year must review 10 percent of the Federal Housing Administration loans it originates. Paragraph 6-8A(1) states that a minimum of 10 percent or a statistical random sample that provides a 95 percent confidence level with 2 percent precision must be reviewed for the total loans rejected. Our testing disclosed that First Residential did not always follow the requirements. Less than ten percent of the closed and rejected loans received quality control reviews for serveral months during our audit period. First Residential officials acknolwledged this weakness and advised that review of these loans will be reinforced.

Untimely Quality Control Reviews

HUD Handbook 4060.1, REV-1, CHG-1, paragraph 6-3D, states that the review of a specific mortgage should be completed within 90 days of closing. Reviews of different aspects of servicing will vary in frequency; delinquent servicing and loss mitigation activities should be reviewed monthly. First Residential did not always perform the quality control reviews in a timely manner. Quality control reviews for 16 out of the 47 early defaulted loans were significantly delayed. In addition, due to the lack of an audit date on the quality control reports, we cannot determine the timeless of quality control reviews in another nine out of 47 early defaulted loans. Also, the quality control reviews for the loans closed or rejected in June and July 2004 were not performed within 90 days after closing.

Inadequate Management Response to Wholesale Loans

HUD Handbook 4060.1, REV-1, CHG-1, paragraph 6-3I, 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 follow-up activities. We noted that First Residential provided timely management follow-ups for the material deficiencies identified at quality control reviews of the loans originated by itself. However, no management follow-up was provided to the loans from its wholesale division for the quality control reviews conducted in 2003 and 2004. In addition, material deficiences identified in quality control reviews were not addressed by management for several early defaulted loans origianted by its loan correspondents.

Failure to Inform HUD of Significant Deficiencies

HUD Handbook 4060.1, REV-1, paragraph 6-3J states that findings of fraud or other serious violations must be referred, in writing (along with the supporting documentation) to the Director of the Quality Assurance Division in the HUD Homeownership Center having jurisdiction (determined by the State where the property is located) within 60 days after initial discovery. In 2004 First Residential discovered serious violations or deficiencies by one of its loan correspondents, in the origination of FHA-insured loans. These deficiencies included invalid Social Security numbers, corrupted credit documentation, and/or fraudulent document and false information to induce the approval of the loans. First Residential requested the loan correspondent to purchase two loans back, and went into litigaion when the loan correspondent refused to purchase the loans.

However, the issue was not completely resolved by the time this audit started. First Residential officials did not report these serious deficiencies or fraud to the Homeownserhip Center (HOC) because they did not believe that they had sufficient facts to complete a substantiated report against the loan correspondent.

Conclusions

First Residential had weaknesses in the implementation of its quality control plan because it did not: review all HUD-insured loans that went into default within six payments, select sufficient samples for the reviews of closed and rejected loans, always conduct quality control reviews in a timely manner, provide adequate management follow-ups to wholesale loans, and inform HUD of significant deficiencies detected with one of its loan correspondents. As such, its quality control plan was lessened. However, correcting these deficiencies will strengthen the quality control system.

Recommendations

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

2A. Establish procedures to ensure that (1) all HUD-insured loans that default within the first six payments are properly reviewed; (2) ten percent or more of the closed and rejected loans are reviewed; (3) quality control reviews are performed in a timely manner; and (4) adequate management follow-up is provided for any material findings resulting from quality control reviews.

2B. Implement the controls and procedures to ensure that HUD will be informed within 60 days if any significant deficiencies are identified with any loan correspondents.

SCOPE AND METHODOLOGY

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

We reviewed 11 defaulted loan files that were underwritten by First Residential with beginning amortization dates between October 1, 2003, and September 30, 2005. The 11 loans were selected from Neighborhood Watch. Sample selections included loans underwritten for First Residential's wholesale and retail divisions. Loan selection criteria also included factors such as loans that (1) defaulted within 12 payments, (2) were not indemnified by HUD, (3) were not reviewed by the Homeownership Center (HOC) in Philadelphia, and (4) were not a streamline refinance. The results of our detailed testing only apply to the 11 loans tested and cannot be projected.

We performed detailed testing and review of the underwriting procedures for the 11 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 include (1) analysis of borrowers' income, assets, and liabilities; (2) review of the borrowers' savings ability and credit history; (3) verification of selected data on the underwriting worksheet and settlement statements; and (4) confirmation of employment and gifts. We discussed issues with HUD and First Residential officials.

We reviewed First Residential's quality control plan and the quality assurance reports provided by its own quality control personnel as well as its out-sourcing company. We selected a sample of 15 loans to test the implementation of First Residential's quality control plan and to determine compliance with HUD requirements.

We performed the audit fieldwork from February 2006 through May 2006. We conducted our audit in accordance with generally accepted government auditing standards.

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 Residential did not ensure that certain loans were processed in accordance with all applicable HUD requirements (see Finding 1).

- First Residential did not adequately implement its quality control plan to ensure compliance with HUD 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		$64,219	
1B			$424,384
1D	$495		

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 efficient if an Office of Inspector General (OIG) recommendation is implemented. This includes reduction 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 mortgage 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 RESIDENTIAL
MORTGAGE SERVICES CORPORATION
Licensed Mortgage Bankers NJ-NY-FL-MD-VA-PA

July 7, 2006

Edgar Moore
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General
26 Federal Plaza, Room 3430
New York, NY 10278-0068

Dear Mr. Moore:

First Residential Mortgage Services Corp. ("FRMSC") is in receipt of a Draft Audit Report ("Report") dated June 30, 2006 from the U.S. Department of Housing Urban Development, Office of Inspector General. The Report is based on an audit review to determine whether FRMSC approved insured loans in accordance with the U.S. Department of Housing and Urban Development (HUD)/ Federal Housing Administration requirements, and developed and implemented a quality control plan that complied with HUD requirements. The review covers the period between October 1, 2003 and September 30, 2005.

The Report contains two findings: (1) First Residential Mortgage Services Corp. did not always comply with HUD's underwriting requirements; (2) First Residential Mortgage Services Corp. has weaknesses in the implementation of its Quality Control Plan. The report also provides recommendations to the assistant secretary for housing –federal housing commissioner requiring First Residential Mortgage Services Corp. to: (1) reimburse HUD for the amount of claims and associated fees paid on the loan with significant underwriting deficiencies, (2) indemnify HUD against future losses on the six loans with significant underwriting deficiencies, (3) establish procedures to ensure that HUD underwriting requirements are properly implemented and documented, (4) implement procedures to ensure compliance with HUD and its own quality control requirement, (5) reimburse the borrower for $495 in ineligible fees found in one case.

The Office of Inspector General provided First Residential Mortgage Services Corp. with the opportunity to respond to the findings. We sincerely appreciate this opportunity to submit comments which will be included in the final report

First Residential Mortgage Services Corp. became an approved Direct Endorsement Lender of the Department of Housing and Urban Development in June 2, 1994. Since

570 SYLVAN AVENUE, ENGLEWOOD CLIFFS NJ 07632 • TEL: (201) 861 - 0531 • FAX: (201) 758 - 2800

then, FRMSC has taken pride in originating HUD insured loans. FRMSC takes its relationship with the Department of HUD seriously and looks forward to continue originating government loans. Throughout our operations, we strive in complying with all applicable rules and regulations, and never intentionally would violate FHA requirements. FRMSC is always committed to educating its employees in FHA compliance and requirements.

Sincerely,

Sandra Ocasio
Quality Assurance Director

570 SYLVAN AVENUE, ENGLEWOOD CLIFFS NJ 07632 • TEL: (201) 861 - 0531 • FAX: (201) 861 - 0754

Comment 1

Comment 2

Comment 3

I. Finding 1: First Residential Mortgage Services Corp. Did Not Always Comply with HUD's Underwriting Requirements

According to the Report, First Residential Mortgage Services Corp. did not follow prudent lending practices and HUD regulations in the origination and underwriting of 11 loans reviewed. We will address the deficiencies found in each case file in more detail below. The comments along with supporting documentation will clarify that the 11 loans were underwritten in accordance with HUD requirements and the deficiencies found were not necessarily the primary reason for default and consequently caused the risk to the Department.

Significant Underwriting Deficiencies

1. Case Number: 352-5204457

A. Verification of Deposits not Obtained

Indeed there was no explanation provided concerning the non-payroll deposits reflected on the borrower's bank statements of $1,000 and $1,300 on December 26, 2003 and January 12, 2004. According to the HUD Handbook 4155.1, REV-5, section 2-10B, if there is a large increase in an account; the lender must obtain a credible explanation of the source of those funds. Nevertheless, in the account in question there was no large increase shown after these deposits were made. The beginning and ending balances reflected on the bank statement are $405.17 and $1,072.53 respectively, which reveals no significant difference of funds.

B. Inadequate Bank Account Documentation

We agree that the DE Underwriter did not follow FHA requirement regarding alternative documentation in lieu of obtaining a VOD and most recent bank statement as outlined in HUD Handbook 4155.1, REV-5, section 3-1F.

C. Negative Cash Reserve on HUD-1
D. Verification of Paid-Outside-Closing Costs Not Obtained

All the funds to close were verified and documented as required on HUD Handbook 4155.1, REV-5, section 2-10. We firmly believe that the hazard insurance premium of $1,128 paid outside closing was properly documented. The policy declaration page dated April 23, 2004, reflects a policy period from 11-04-2003 to 11-04-2004 and the invoice for same reflects an amount paid of $924.62 and an amount due of $203.38. It was understood that if the policy was effective from 11-04-2003, the amount already paid has been received by the insurance company since the policy became effective. Therefore, the only amount considered to require verification was the amount still due of $203.38. The bank statements dated 3-15-04 reflect a total balance of $4,175. According to the HUD-1, the borrower's total funds to close are

$3,740. If the remainder of the insurance premium was added to the $3,740, the total borrower's investment in the property is $3,944, not $4,868 as stated on the Report.

E. Inadequate Compensating Factors

Comment 2

We agree that the compensating factors listed on the Mortgage Credit Analysis Worksheet (MCAW) by the DE Underwriter do not meet the requirements per HUD Handbook, 4155.1, REV-5, section 2-13A-J.

2. Case Number: 352-5229168

A. Inadequate Credit Analysis

Comment 4

Although the credit report shows a history of derogatory credit, with exception to both car loan accounts, the derogatory items shown are not recent. The underwriter's approval was based on the overall case profile. The qualifying ratios were within the benchmark established by HUD. The borrowers had job and income stability as well as the minimum cash investment required.

B. Inadequate Disclosure of Liabilities

Comment 2

At the time of the initial loan application and underwriting approval, the student loans were considered deferred for more than 12 months of the tentative closing date. Unfortunately, there was a delay in the loan closing; therefore, the actual repayment of the student loans turned out to be scheduled exactly 12 months from the closing date. Due to a technicality, the file appears to violate FHA requirements concerning the projected liabilities rule.

C. Inadequate Support for Income Calculation
D. Inadequate Debt-to-Income Ratios
E. Inadequate Compensating Factors

Comment 5

The overtime earnings used as qualifying income was calculated by the DE Underwriter in accordance to HUD Handbook 4155.1, REV-5, section 2-7A. The overtime pay for the past two years was supported by the W2s and year-to-date pay stubs. The pay stubs show a base income of $2,433.40 ($1123.11 x 26 / 12) in addition to overtime earnings. That is an annual base salary of $29,200.86. Most recent two years W2s show the total earnings of $38,773 and $31,170, respectively. Both years earnings show income beyond the base annual salary which was considered overtime since the pay stubs reflect overtime pay. The amount of $797.68 was calculated as follows: $38,773 / 12 = $3,231.08 - $2,433.40 = $797.68. The total qualifying income used for the borrower was supported by the year-to date earnings shown on the pay stubs. The likelihood of continuance of the overtime pay was based on precedent history documented in the file.

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For this reason, we completely disagree with the inadequate debt-to-income ratios findings. The qualifying ratios still remain below the benchmark stipulated by HUD. As a result, the compensating factors for debt-to-income ratios were not deemed necessary.

3. Case Number: 352-5230020

A. Inadequate Support for Employment

Comment 6

We did adequately verify the co-borrower's two-year employment history in accordance with HUD Handbook 4155.1, REV-5, section 2-6. At the time the loan was underwritten, a verification of employment for Home Depot was obtained verifying employment from March 2000 to August 2002 through the Work Number. Unfortunately, during the copying process, the same was misplaced. We just retrieve from the Work Number another copy for your records (Exhibit A). In addition, the borrower did explain the gap of employment from August 2002 to March 2003. I am attaching copy of the letter along with additional verification of employments that supports the borrower's explanation (Exhibit B).

B. Verification of Deposit not Obtained
C. Inadequate Evaluation of Savings Pattern

Comment 7

We agree that there was no explanation provided concerning the deposits totaling $13,174. According to the HUD Handbook 4155.1, REV-5, section 2-10B, if there is a large increase in an account; the lender must obtain a credible explanation of the source of those funds. Nevertheless, there was no large increase shown in the account after these deposits were made. The beginning and ending balances reflected on the bank statements for the period 12/16/03 to 2/26/04 are $-183.52 and $967.42 respectively, which reveals no significant difference of funds.

Comment 8

The evaluation of the borrower's capacity to make payments was made based on all the factors present in the loan file (e.g. credit history, employment, assets, collateral). The file did contain an explanation for the non-sufficient fund charges reflected on the bank statements during the period of 12/16/03 to 01/16/04. The explanation was considered adequate since it was apparent the borrower had a period of mismanaging his account. In addition, the source of funds to close and significant reserves after closing came from the co-borrower's own funds as reflected in the savings account.

D. Inadequate Credit Analysis

Comment 2

In this case, the underwriter failed to request an explanation for collections accounts appearing on the co-borrower's credit report as required by HUD Handbook 4155.1, REV-5, section 2-3. This was due to the fact the two collection accounts were medical, not recent and totaling $ 475.00. They were considered minor derogatory information occurring in the past not requiring explanation.

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Comment 9

F. Inadequate Compensating Factors

We completely disagree with this finding. The 10% down payment is considered a compensating factor as outlined in HUD Handbook 4155.1, REV-5, section 2-13B. The handbook does not specified that this will not be acceptable if the down payment was derived from gift funds, which in turn are listed as an acceptable source of funds to close. The borrowers had at the time of closing strong cash reserves as documented by the savings account statement showing total assets of $18,501.67. The fact of having substantial documented cash reserves after closing is also a compensating factor per HUD Handbook 4155.1 REV-5, section 2-13G.

4. Case Number: 352-5213442

A. Principal, Interest, Taxes and Insurance (PITI) Cash Requirement not Met

Comment 2

Unfortunately, on this case the requirement for 3 months PITI reserves was not met. In order to avoid similar deficiencies, we have implemented as part of our operations, continued training education for all our active DE Underwriters.

B. Inadequate Credit Analysis

Comment 10

Upon review of the overall borrower's credit history, the explanation for certain derogatory items seemed adequate. First of all, the credit report shows about 12 open and current accounts with no history of late payments rated for a period of 12 to 42 months. The derogatory items reflected on the credit report seem minor incidents in comparison with the entire history of the borrower.

C. Verification of Deposit not obtained
D. Inadequate Evaluation of Savings Pattern

Comment 11

We agree that there was no explanation provided concerning the deposits totaling $1,790 during the period 07/15/04 to 09/3/04. The explanation was not required because the deposits were supported by the borrower's income which was not direct-deposited by the employer. In addition, the Verification of Deposit shows an average balance in the last two months of $1,517.76. All the assets documentation in the file shows a steady pattern of savings.

Although the borrower did not demonstrate an ability to accumulate savings, other factors in the case file compensated the lack of savings. The borrower made 9% down payment and the credit and rental payment history demonstrated the borrower's willingness to repay debt. In addition, the housing and debt to income ratios were below the benchmark per HUD Handbook 4155.1 REV-5.

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Comment 12

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Comment 13

Comment 14

5. Case Number: 352-5167847

A. Inadequate Credit Analysis

In further analyzing the derogatory credit explanation from the borrower, the explanation from the borrower that she was unaware of the 48 late payments with one creditor was supported. The creditor can make errors in reporting account performance. The account was opened in 11/98 with a balance of $300. It was reported late since the beginning and believed to be a roll-over late. For this reason, the explanation from the borrower was deemed acceptable by the underwriter.

Regarding the other delinquent account where the borrower explained that the reason for late payments is because the employer did not pay her on time. This explanation was acceptable to the underwriter since loss of income can create a burden and consequently, unable the customer to make payments on time.

We agree that the explanation for one judgment of 4,213 was not provided. Nevertheless, I would like to clarify that only one judgment was filed against the borrower on 06/03, the other two judgments appearing on the credit report are duplicates since they have the same docket number.

Indeed the five additional inquiries appearing on the most recent credit report from 08/28/03 to 11/17/03 were not explained. We believe that this was not provided because when the updated credit report was pulled, the underwriter reviewed the report to determine if new accounts or new information was reported concerning the accounts, public records, etc. but the inquiries were missed due to the minor impact in the evaluation of the entire case profile.

B. Inadequate Earnest Deposit Documentation
C. Negative Cash Reserve on HUD-1

The verification of the source of funds for the earnest deposit of $3,500 was not deemed necessary because it did not exceed 2% of the sales price. Although, the history of accumulated savings of the borrower was low, the monthly payroll net pay of approximately $4,500 from both jobs was considered sufficient to support the down payment given.

Since we disagree with the findings about the inadequacy of the documentation of the earnest deposit of $3,500, we considered the Negative Cash Reserve on the HUD-1 invalid as well.

D. Verification of Deposit Not Obtained

The explanation for the $2,414.96 deposit on 11/05/03 was deemed sufficient. The borrower explained that it was accumulated earnings from the prior three payroll checks. The $50 deposits every two weeks from the employer are shown as a "credit

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union" deduction on the pay stubs and it is not the entire payroll earnings of the borrower. The net pay of the borrower's both jobs is not directly deposited into the borrower's account. Therefore, it is reasonable that the borrower may deposit the payroll income in her only savings account.

6. Case Number: 352-5246588

A. Verification of Deposit Not Obtained

Comment 15

We did not obtain an explanation for the non-payroll deposits to the borrower's checking account because in accordance to the HUD Handbook 4155.1, REV-5, section 2-10B, if there is a large increase in an account, the lender must obtain an explanation and evidence of the source of funds. In this case, the checking account did not show any increase during the period from 03/18/04 to 05/07/04 which reflects a beginning and ending balance of $1,505.68 and $829.79, respectively.

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On the other hand, the explanation and source of funds from the borrower concerning the non-payroll deposits to the savings account of $2,798 on 02/19/04 and $1,000 on 04/15/04 were not deemed necessary because the bank statements show a steady history of accumulated savings. Also, the borrower's position held as a police officer gives room for additional income earned from side jobs in the borrower's field. Additionally, the beginning balance as of 2/19/04 is $11,757.51 and the ending balance as of 5/13/04 is $16,871.66 which further supports the stable savings pattern of the borrower.

B. Inadequate Credit Analysis

Comment 16

Although the HUD Handbook 4155.1, REV-5 section 2-3 requires written explanation for major indication of derogatory credit, on this case, the explanation was not considered necessary because the credit report shows four collection accounts but three of them were opened several years prior to the loan application including the one for the US Department of Education of $6,611. All of them were paid preceding the loan application. In addition, the late payments for several creditors were incurred sporadically.

C. Inadequate Evaluation of Savings Pattern

Comment 17

Although seven overdraft charges were shown in the bank statements of the borrower's checking account, an explanation was not deemed necessary since we considered this a result of mismanaging the account for a brief period of time. In addition, we concluded that the borrower did demonstrate the ability to save as reflected in the savings pattern in her savings account. The borrower was capable of maintaining an average balance of approximately $15,000 for a three-month period. Therefore, the borrower did not lack the capacity to make the mortgage payments.

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The fact that some overdraft charges are present in her checking account is not a major indication that the borrower does not have the ability to repay the debt because funds to avoid these charges were readily available in her savings account. The evaluation of the borrower's capacity to repay was based on the entire case profile such as cash investment comes from the borrower's own funds and qualifying ratios well below benchmark.

7. Case Number: 352-5217394

A. Inadequate Verification of Assets at Private Savings Club
B. Verification of Deposit not obtained

Comment 18

As stated on your Report, the borrower in fact opened the bank account on 02/09/2004. The reason why the two most recent, consecutive months of bank statements were not provided is that the underwriter released the loan to close on 03/05/04 and the account was recently opened; therefore, no two months activity was available. In regards of the source of funds explanation for the $9,000 deposit on 2/9/04, we concluded that it was not necessary since the documentation supporting the funds was provided by the borrower. In this case, the explanation was considered redundant.

We firmly believe that the require documentation per HUD Handbook 4155.1, REV-5, section 2-10R was provided in this file. We have an Affidavit from the Private Savings Club summarizing how the funds were received and disbursed with a list of all the participants and the dates when each participant will receive their share. In addition, the Club Treasurer provided information where he can be contacted in order for FRMSC to verify the information. Further, the file contains a verification performed by one of our staff members re-verifying the information provided by the Club Treasurer. We also like to clarify that the Savings Club Affidavit from the Club Treasurer indicates that the savings plan is in both borrowers' names, not only the co-borrower.

Finally, the underwriter determined that it was reasonable for the borrowers to accumulate the savings when considering both borrowers' gross monthly income of $5,686 and the fact that throughout the years the borrowers did not believe in having a bank account to save their money.

C. Inadequate Earnest Money Deposit Documentation

Comment 19

We completely disagree with this finding based on our explanations in section A and B, concerning the $9,000 funds from the savings private club. We considered the $9,000 deposit an acceptable source of funds; consequently, the earnest money deposit of $5,450 withdrawn from the recently opened bank account was considered

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acceptable and well documented with an escrow deposit letter, bank statement showing withdrawal and copy of the certified bank check. The initial deposit of $1,000 given to the realtor on 01/11/04 was not sourced due to the minimal amount.

D. Negative Cash Reserve on HUD-1

Comment 20

We believe that all the funds for the borrower's investment in the property were verified and documented properly in accordance with HUD Handbook 4155.1, REV-5 section 2-10. The paid-outside-of-closing costs $475 was paid to FRMSC to cover the appraisal report and credit report fees at the time of the initial loan application on 2/18/04. The source of funds for these POC costs was not verified because it was considered a minimal amount in relation to the combined borrowers' monthly income of $5,686. In reference to the earnest deposit of $6,450, the funds were verified in accordance to the HUD Handbook 4155.1 REV-5. The file contains an escrow letter for the realtor acknowledging receipt of funds. Although the initial deposit of $1,000 was not sourced because it did not exceed the 2% of the sales price, the additional deposit in the amount of $5,450 was given by an official bank check drawn from the borrower's savings account. Further, the source of funds for the $9,000 from the private savings club (SUSU) was properly verified. The file contained all the required documentation as required by HUD Handbook 4155.1 REV-5 and the accumulation of these funds seemed reasonable when considering both borrowers' gross monthly income of $5,686. In conclusion, the borrower met the cash requirement at closing.

E. Inadequate Credit Analysis

Comment 21

We agree that one of the derogatory credit account explanations was not provided by the co-borrower. This seems to be an oversight by the underwriter since there are explanations for the rest of derogatory accounts. In regard to the rental history for the co-borrower, it was verified by our credit reporting vendor for accuracy. The reason why it appears that we did not provide alternate credit documents for the borrower is that the alternate credit letters were in the name of both borrowers who are husband and wife. We asked our credit reporting vendor to verify and add these references to only the co-borrower's credit report because it was unnecessary to verify the same references on both credit reports.

F. Verification of costs Paid-Outside of-Closing not Obtained

Comment 22

As stated before the $475 for appraisal and credit report fees were received by FRMSC at the time of initial loan application were not verified because of the minimal amount. Unfortunately, evidence of receipt of funds was not kept in the file. However, FRMSC, in fact, received these funds and credited the borrowers for same.

Regrettably, the fact that the commitment fee of $395 was paid by a third party was unnoticed by the underwriter. This situation will be addressed to our Underwriting Dept. to prevent recurrences in the future.

Technical Underwriting Violations

First Residential Mortgage Services Corp. had previously addressed its position on the findings cited as technical underwriting violations in your Report in our letter dated May 16, 2006. Even though we disagreed with the majority of the findings we will take this in consideration to strengthen our current policies and use the samples as a training tool for our new and current DE Underwriters.

Ineligible Commitment Fees Charged to Borrowers

Comment 23

First Residential Mortgage Services Corp. was not aware of any ineligible commitment fees charged to a borrower. Your report indicates that in one loan ineligible fees were charged but there is no mention of the pertinent case number file. Please provide us with this information in order to review the file and determine if your findings are accurate.

Comment 24

II. Finding 2: First Residential Mortgage Services Corp. Had Weaknesses in the Implementation of Its Quality Control Plan

First Residential Mortgage Services Corp. has already established procedures to ensure that our quality control plan is properly implemented. About more than one year ago, we restructured our Quality Control Department because we became aware through our internal review process that some deficiencies existed. The restructuring of the department included but not limited to the following: (1) Assign a senior underwriter with vast experience in the field as the new director of our quality assurance division, (2) use a widely recognized outsource quality control firm to perform our post closing and early payment default audit reviews, (3) revise our written quality control plan to make certain that all HUD requirements are met as well as other investors, guarantors, and/or agencies. Nevertheless, First Residential Mortgage Services Corp. acknowledges that there are still some slight deficiencies and is working efficiently in preventing similar recurrences.

Loans Defaulting within Six Payments Not Reviewed

On our letter dated May 16, 2006, we agreed that during the period from October 1, 2003 through September 30, 2005, eight loans that defaulted within the first six months were not selected for quality control review as required by HUD Handbook 4060.1, REV-1, CHG-1. We stated that the failure to select the loans for quality control review was due to the fact that on or around April 2004, the volume of government loans produced by our Wholesale Division decreased drastically. The decrease in production somehow resulted in minimizing the control of monitoring the performance of these loans through the Neighborhood Watch. Regretfully, it must have been during this period that these loans defaulted and consequently they were not selected for review. However, upon realizing the error of not selecting these loans for quality control review, we decided to send it to our outsource firm and the review was already completed. Please see attached copy of the final individual case reports (Exhibit C). As previously mentioned since then, we have reinforced our Quality Assurance Control Program to prevent same errors in the future. Therefore, I am confident that our improved program is effectively assuring compliance with HUD requirements throughout our Operations.

Insufficient Sampling for Closed and Rejected Loans

We here at First Residential Mortgage Services Corp. are continuously striving for excellence throughout our operations and are making better changes to assure compliance with HUD, investors, agencies and/or guarantors. Regrettably, less than 10% of closed and rejected loans were selected for review as required by HUD Handbook 4060.1 REV-1, CHG-1. This error was caused by inaccurate data from our

LOS System. The reason for this was that in order to select the 10% sampling, pipeline reports were generated to make the required random selection. The selection was based on the total production shown on the reports obtained during that time. Due to our continuous monitoring we became aware of the existing problem with the system. To remedy the problem, we assigned members of our staff to regularly correct data inaccuracies, if any. I know that when the recent reports were generated for submission to the Office of Inspector General as requested, the total production volume differed from past reports resulting in the apparent shortage of the 10% requirement. It is necessary to mention that we have taken additional measures to prevent similar recurrences. Last year we switched to a new, sophisticated and reliable LOS System as well as having full time staff members ensuring that our reporting contains 100% accurate data.

Untimely Quality Control Reviews

While timeliness of the quality control review and reporting is a standard policy under our quality control plan, in some months we were faced with delays in performing accordingly with our plan. This was due to circumstances beyond our control such as change in personnel in our quality control division. Nonetheless, this is an issue of the past. In reference to some of the quality control reviews not containing dates, we have addressed the issue with our outsource quality control firm to assure that all reports contain the audit date. Additionally, we have taking measures to assure that as long as we are operating, the quality control functions will perform in accordance to our quality control plan. I am proud to say that I believe we have in place an effective, new and improved quality assurance program.

Inadequate Management Response to Wholesale Loans

We believe that the quality control findings of the loans from our wholesale division received the proper management follow up. All the serious findings were immediately addressed to the appropriate loan correspondent. The correspondence between our parties was either by mail, email, telephone, or in person. However, our loan correspondent(s) completely disagreed with the findings and promised to provide documentation to prove the findings were in error. Some time elapsed and when no resolution was obtained, management immediately suspended the relationship with the loan correspondent(s). In addition, the Wholesale Division was completely restructured. We implemented new procedures that enable us to better manage our third party origination relationships.

Failure to Inform HUD of Significant Deficiencies

First Residential Mortgage Services Corp. did not inform HUD of the significant deficiencies discovered for one of our loan correspondent(s) in the timeframe required because there was too much disagreement between all parties. Even though, the individual quality control review reports for each case file revealed serious discrepancies and/or evidence of potential misrepresentation, FRMSC gave the loan correspondent the opportunity to provide explanations to these findings. The loan correspondent's officers completely disagree with our discovery and that is when the litigation began. Several months passed with correspondence back and forth between our legal counsels but nothing was finalized. Therefore, FRMSC felt that since no solution was obtained, the reporting was delayed. It is necessary to mention that due to the lack of cooperation of the loan correspondent(s) to respond to our quality control review findings, we terminated the relationship.

First Residential Mortgage Services Corp. recognizes our failure to report in a timely manner. As a result, we decided to amend our error by reporting the findings of the loan correspondent to the HUD Home Ownership Center (HOC).

First Residential Mortgage Services Corp. learned from this difficult situation. Going forward we will ensure compliance with HUD Handbook 4060.1 REV-1, paragraph 6-3(J).

OIG Evaluation of Auditee Comments

Comment 1 First Residential concurs that there was no explanation provided concerning the non-payroll deposits of $1,000 and $1,300 on December 26, 2003 and January 12, 2004, respectively into a bank account. However, First Residential implies that since there was no large increase in the account after these deposits were made, the lender did not have to obtain credible explanation of the source of these funds. HUD Handbook 4155.1, REV-5, section 2-10B, states that if there is a large increase in a bank account, the lender must obtain a credible explanation of the source of the funds. HUD regulations do not specifically state that it is not necessary to obtain a credible explanation of the source of the funds, when there is no significant difference between beginning balance and ending balance.

Comment 2 First Residential concurs with our determinations.

Comment 3 The hazard insurance policy declaration page dated April 23, 2004, reflects a billing period from November 04, 2003 to November 04, 2004. However, we were not provided with an explanation on why the borrower was billed for hazard insurance from November 04, 2003, when the closing of the FHA loan did not take place until April 28, 2004. Further, although the invoice provided by First Residential indicated that the borrower had paid $924.62 towards the $1,128 hazard insurance premium, and the remaining $203.38 was not due until May 24, 2004; no copies of cancelled checks were on file. In addition, the bank statements for two bank accounts did not provide any evidence that the $924.62 was paid from the borrower's bank account. Therefore as explained for this case, the borrower did not have adequate funds to close.

Comment 4 First Residential officials concur that there is a history of derogatory credit. However, with the exception of the car loans they maintain that it was not necessary to verify the other derogatory items because they were not recent. We noted that some collections occurred in March 2004, which was during the time the borrowers applied for the loan. In addition, several credit delinquencies that lead to a court judgment happened within a year of the closing date. As such, the borrower must explain in writing all collections and judgments and the lender must consider this per HUD Handbook 4155.1, section 2-3C.

Comment 5 There was no specific support for the past two-year history of the overtime income and its continuance. From the documentation provided there was no verification that the amount of compensation (as shown on Form W2s) that was in excess of the base pay was all overtime pay or that it is likely to continue. In addition, overtime income is required to be averaged for the past two years. If it varies significantly from year to year, a period of more than two years must be used in calculating the average income.

Comment 6 First Residential subsequently provided a copy of a verification of employment for the co-borrower's previous job held with Home Depot from March 2000 to August 2002. Based on this supporting document, we agreed to modify this deficiency. We still consider the co-borrower's explanation about the employment gap to be inadequate. The co-borrower stated that she started collecting unemployment benefits and was baby sitting for two individuals from September 2002 to April 2003; each individual paid her $100 a week. These two jobs were not listed on the FHA loan application. The verbal verification provided by First Residential for these two jobs did not disclose income information.

Comment 7 First Residential concurs that no explanation was obtained for seven deposits totaling $13,174. However, First Residential implied that the lender did not have to obtain a credible source of the funds since the beginning balance and ending balance did not reflect significant difference on the bank statements for the period of December 16, 2003 to February 26, 2004. However, the difference between the beginning and ending balance was significant since the ending balance was positive whereas the beginning balance was negative. Accordingly, a credible explanation of the source of the funds should have been obtained per HUD Handbook 4155.1, REV-5, section 2-10B. HUD regulations do not state that it is not necessary to obtain credible explanation of the source of the funds, when there is no significant difference between beginning balance and ending balance.

Comment 8 The borrower had eight non-sufficient fund charges in one month, during the period of December 16, 2003, to January 16, 2004. As such, First Residential's explanation that the borrower had a period of mismanaging his account is not adequate. Chapter 3 of the HUD Handbook, 4155.1, REV-5, provides that the lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation, source of funds for the transaction, and the intended use of the property. All information must be verified and documented. First Residential also stated that the source of funds to close and significant reserves after closing came from the co-borrower's own funds as reflected in the savings account. However, funds from gifts from any source are not to be included as cash reserves as defined in HUD Handbook 4155.1, REV-5, section 2-13. If we exclude the gift of equity in calculating cash reserves, then the borrower would have had negative cash reserves of $10,926.

Comment 9 First Residential explained that a 10% down payment is considered as a compensating factor. However, the Mortgage Credit Analysis Worksheet (MCAW) did not list the 10% down payment as a compensating factor; it only listed (1) low loan-to-value (LTV) ratio and (2) strong reserves after closing, as compensating factors. Low LTV ratio is not an allowable compensating factor, and funds from gifts from any source are not to be included as cash reserves as defined in HUD Handbook 4155.1, REV-5, section 2-13. If we exclude the gift of equity in calculating cash reserves, then the borrower would have had negative cash reserves of $10,926. Further, First Residential stated that at the time of closing, the borrower had strong cash reserves as documented by the savings account statement showing total assets of $18,501.67. Our review of a copy of the savings account passbook disclosed that the co-borrower had $18,501.67 as of February 20, 2004, which was approximately three months prior to the closing date of May 13, 2004. In addition, there is no evidence of what the savings balance was after the closing.

Comment 10 HUD Handbook, 4155.1, REV-5, Section 2-3, states that major indications of derogatory credit require sufficient written explanation from the borrower. The borrower's explanation that these late payments were due to the creditor's computer errors or that the bills were sent to the neighbor's house is inadequate.

Comment 11 HUD Handbook, 4155.1, REV-5, Section 2-10B states that if there is a large increase in a bank account, the lender must obtain credible explanation of the source of those funds. First Residential officials state the verification of deposit shows an average balance of $1,517.76 in the last two months. However, the bank statement for the period of August 10, 2004, to September 03, 2004, shows that the ending bank balance was $353.63.

Our review of the Mortgage Credit Analysis Worksheet disclosed that the assets available totaling $39,035 included a relocation benefit received by the borrower amounting to $38,672; therefore, the borrower only had $363 in a bank account. There was no other asset documentation in the file, thus the borrower did not demonstrate savings ability.

Comment 12 A total of 48 consecutive late payments and numerous other delinquencies are significant. First Residential should have conducted further credit analysis regarding the borrower's credit and inadequate explanations. However, First Residential did concur with our determinations on the judgement and additional credit inquiries.

Comment 13 HUD Handbook 4155.1 requires the lender to verify the source of the earnest deposit when it appears excessive based on the borrower's history of accumulating savings. Monthly income is not a qualified source document for the earnest deposit. Without the $3,500 earnest deposit, the borrowers would have had a negative cash reserve at closing.

Comment 14 First Residential did not address the missing supporting documents for the $848.23 deposit on 12/12/03 in its comments. First Residential maintains that the borrower's explanation for the $2,414.96 deposit on 11/05/03 was reasonable based on the assumption that the borrower may deposit the payroll income via means other than direct deposit. However, we noted one of the three payroll checks the borrower quoted in her explanation was not supported by documents such as payroll statements or canceled checks. The borrower did not even mention from which employer that paycheck was from. As a result, the borrower's explanation was inadequate.

Comment 15 First Residential considers that it is not necessary to verify the source of funds because the beginning and ending balance in the account did not change greatly and bank statements show a steady history of accumulated savings. However, this is not a valid justification for a lender to avoid underwriting procedures that are required by the regulations. The large increases or deposits to the acccont of $2,798, $1,000 and $4,107 should have been explained per HUD Handbook 4155.1, section 2-10. In addition, the assumption of additional income based on the borrower's position as a police officer is not a qualified explanation for the the significant deposits.

Comment 16 HUD Handbook 4155.1, section 2-3C states that collections indicate a borrower's disregard for credit obligations and must be considered in the analysis of creditworthiness with the lender documenting its reasons for approving a mortgage where the borrower has record of accounts in collection. In addition, First Residential should have obtained explanations for the late payments with the other creditors because several of these late payments were recently incurred.

Comment 17 An explanation is required because seven overdrafts within a month of the closing date brought a significant drawback to the borrower's credit worthiness. First Residential should have asked sufficient questions regarding the large deposits, overdrafts, collections and late payments to elicit a complete picture of the borrower's financial situation and source of funds for the transaction as required by HUD Handbook 4155.1, section 3.

Comment 18 HUD Handbook 4155.1, REV-5, section 2-10B states that if there is large increase in an account, or the account was opened recently, the lender must obtain a credible explanation of the source of the funds. Contrary to HUD regulation, First Residential did not obtain an explanation of the source of the funds. The file only contained a verbal verification of the account and an affidavit from the club treasurer. HUD Handbook 4155.1, REV-5, section 2-10R requires that at a minimum, the clubs must have account ledgers, receipts from the club, verification from the club treasurer, and identification of the club so that the lender can re-verify the information provided.

Further, since our review disclosed that the treasurer of the private savings club paid a commitment fee for this FHA loan and was the co-borrowers landlord, it should have been evident that there is an appearance of a possible conflict of interest. Thus, First Residential should have asked sufficient questions to elicit a complete picture of the borrower's financial situation, the source of funds for the transaction, and the intended use of the property as stated in the Chapter 3 of the HUD Handbook, 4155.1, REV-5.

Comment 19 HUD Handbook, 4155.1, REV-5, section 2-10A provides that if the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of the funds. The file contained a copy of an escrow letter from realtor acknowledging the receipt of $6,450, which exceeded 2 percent of the sales price of $215,000. According to the bank statement on file, the source of the earnest money deposit was the inadequately verified $9,000 from the private savings club as explained previously, thus the borrower did not have sufficient funds to cover the earnest money deposit and the documentation in the file for the earnest money deposit was inadequate. First Residential should have verified the source of the $6,450 earnest money deposit, and the $1,000 initial deposit.

Comment 20 HUD Handbook 4155.1, REV-5, section 2-10 requires that all funds for the borrower's investment in the property be verified and documented. First Residential should have verified the source of the $6,450 earnest money deposit, and the $1,000 initial deposit. Therefore, we conclude that due to unsupported paid outside of closing costs of $475, and the unverified earnest money deposit of $6,450, the borrower could not meet the cash requirement at closing. The HUD-1 settlement statement indicates the cash due from the borrower was $2,756 and if we add back $475 and $6,450, then the borrower would have been required to pay $9,681.

Comment 21 First Residential agreed that no satisfactory explanation was obtained for the co-borrower's derogatory account, due to an oversight by the underwriter. First Residential also did not provide satisfactory explanations for the other matters/deficiencies noted in this section.

Comment 22 HUD Handbook 4155.1, REV-5, section 2-10 requires that all funds for the borrower's investment in the property be verified and documented.

Comment 23 We provided the FHA case number of that loan to First Residential at the exit conference.

Comment 24 First Residential concurs with our finding on its quality controls and is willing to improve the current system.

Appendix C

Summary of Underwriting Deficiencies

Apendix	D-1	D-2	D-3	D-4	D-5	D-6	D-7	
FHA Case #	352-5204457	352-5229168	352-5230020	352-5213442	352-5167847	352-5246588	352-5217394	Total Loans
Mortgage Amount ($)	254,013	249,091	274,050	267,858	236,241	182,141	211,678	$1,675,072
Areas of Deficiencies:								
Inadequate Credit Analysis								
Inadequate Credit Analysis		X	X	X	X	X	X	
Inadequate Evaluation of Savings Pattern			X	X		X		6 loans
Inadequate Verification of Funds To Close								
Verification Of Deposit Not Obtained	X		X	X	X	X	X	
Verification of Assets at Private Savings Club							X	
Verification Of POC Cost Not Obtained	X						X	
Inadequate Bank Account Documentation	X							
Inadequate Earnest Money Deposit Documentation					X		X	6 loans
Minimum Cash Investment Not Met								
Negative Cash Reserve On HUD-1	X				X		X	
PITI Cash Requirement Not Met				X				4 loans
Inadequate Verification of Income/Employment								
Inadequate Support For Income Calculation		X						
Inadequate Support For Employment			X					2 loans
Qualifying Ratios and Compensating Factors								
Inaccurate Debt To Income Ratios		X						
Inadequate Compensating Factors	X	X	X					
Inadequate Disclosure Of Liabilities		X						3 loans
Indemnification Recommended	Yes	Yes	Yes	Yes	Yes	Yes	Yes *	$1,463,394 **

Note: * A claim of $221,445 (mortgage amount of $211,678 plus associated fees) was paid. Based upon HUD's current 29 percent defaulted loss experience, the amount of unsupported costs is estimated at $64,219 (29 percent of $221,445). A reimbursement of $64,219 is recommended.

** Total mortgage amount of the remaining six loans is $1,463,394. Based upon HUD's current 29 percent defaulted loss experience, the amount of funds put to better use on the loan for which indemnification is recommended is estimated at $424,384 (29 percent of $1,463,394).

Appendix D

CASE SUMMARY NARRATIVES

Case number: 352-5204457
Loan Amount: $254,013
Settlement date: April 28, 2004
Status: Delinquent

Pertinent details:

A. Verification of Deposits not Obtained

The lender did not adequately verify the excessive deposits in the borrower's bank account. The HUD Handbook, 4155.1, REV-5, section 2-10B states that if there is a large increase in a bank account, the lender must obtain a credible explanation of the source of those funds. The borrower made non-payroll deposits of $1,000 and $1,300 on December 26, 2003, and January 12, 2004, respectively into a bank account. No explanation was provided in the file.

B. Inadequate Bank Account Documentation

The lender did not properly verify the bank assets by obtaining adequate bank account documents. HUD Handbook 4155.1, REV-5, Section 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. The bank statements in the file were not consecutive. The statements covered the period from December 16, 2003 through January 15, 2004, and February 14, 2004 through March 15, 2004, therefore the period from January 16, 2004 through February 13, 2004, was missing.

C. Negative Cash Reserve on HUD-1

The lender did not verify or document that the borrower had adequate funds to close. HUD Handbook 4155.1, REV-5, Section 2-10 requires that all funds for the borrower's investment in the property be verified and documented. Cash due from the borrower on the HUD-1 settlement statement was $3,740. If the unsupported paid-outside-closing costs for hazard insurance premium of $1,128 (see section D) were added to the $3,740, the borrower was required to pay $4,868. The borrower only had an asset of $4,175 as per the Mortgage Credit Analysis Worksheet (MCAW). Therefore, the borrower would have had a deficit of $693 at closing.

D. Verification of Paid-Outside-Closing Costs Not Obtained

The lender did not verify the payment for the paid-outside-closing costs. HUD Handbook 4155.1, REV-5, Section 2-10 requires that all funds for the borrower's investment in the property be verified and documented. The HUD-1 settlement statement in the file reported that the borrower paid $1,128 outside of closing for hazard insurance premium. However, there was no documentation to show that this had been paid before closing.

E. Inadequate Compensating Factors

The lender did not provide adequate compensating factors to justify the excessive debt to income ratios. Mortgagee Letter 2005-16, states that the lender must describe the compensating factors used to justify mortgage approval when the borrower's mortgage payment to effective income ratio (front) and total fixed payment to income ratio (back) exceeded 31 and 43 percent respectively. The borrower's ratios were 39.05 and 42.19 percent respectively as per the lender's calculation. Compensating factors listed on Mortgage Credit Analysis Worksheet were (1) employment stability, (2) excellent rental payment history, and (3) potential for increased earnings (has been receiving raises consistently). Employment stability and excellent rental payment history are not allowable compensating factors as defined in HUD Handbook 4155.1, REV-5, section 2-13. The Verification of Employment stated that the borrower received a raise in January 2004 of 6 percent. The date on the Verification of Employment was April 14, 2004. Therefore, we determined that current annual gross pay of $64,254 incorporated the raise received in January 2004.

Even though we took into consideration the 6 percent raise to $64,254, the front ratio would be 36.84 percent, which is still higher than 31 percent threshold.

Case number:	352-5229168
Loan amount:	$249,091
Settlement date:	May 14, 2004
Status:	Foreclosure Started

Pertinent details:

A. Inadequate Credit Analysis

The lender did not conduct an adequate analysis of the borrowers' credit history. HUD Handbook 4155.1, REV-5, section 2-3, provides that major indications of derogatory credit require a sufficient written explanation from the borrower. The credit report in the file indicated that the co-borrower incurred 19 late payments for a car loan from June 2002 to April 2004, including four delinquencies from January 2004 to April 2004 (during the time the borrowers applied the loan). The co-borrower explained that the account was for a car she purchased for her mother. Her mother was the person using the car and paying the car loan, even though the loan was under the co-borrower's name. HUD Handbook section 2-11B states that a contingent liability exists when an individual will be held responsible for payment of a debt, should another party, jointly or severally obligated, default on that payment. If the individual applying for a Federal Housing Administration insured mortgage is a co-signer on a car loan, a contingent liability applies unless the lender obtains documented proof that the primary obligor has been making payments during the previous 12 months on a regular basis and does not have a history of delinquent payments on the loan. As a result, the co-borrower's explanation for this derogatory account was inadequate.

The borrowers also incurred several late payments for another car loan. The borrower explained that this was due to the dispute regarding the car's warranty. A recent late payment happened two months before closing. The borrower said that they missed the payment because of the packing and moving commotion for the new home. In addition, the borrowers showed a consistent derogatory credit history, even though they indicated that they are trying to keep their credit clean, however, because of numerous recent late payments, we conclude that the explanations are not satisfactory.

B. Inadequate Disclosure of Liabilities

The lender did not disclose the projected liabilities for the underwriting analysis. HUD Handbook 4155.1, REV-1, section 2-11 C, provides that if a debt payment, such as a student loan, is scheduled to begin within 12 months of the mortgage loan closing, the lender must include the anticipated monthly obligation in the underwriting analysis, unless the borrower provides evidence that the debt will be deferred to a period outside this timeframe. The credit report in the file disclosed that the co-borrower had $13,250 in Sallie Mae student loans. First Residential did not provide any explanation that repayment of the Sallie Mae student loans would not start within 12 months of closing.

C. Inaccurate Support for Income Calculation
D. Inaccurate Debt To Income Ratios

The ratios calculated by First Residential were incorrect because the monthly income was overstated by $797.68 in overtime income. HUD Handbook 4155.1, REV-5, section 2-7A, provides that overtime may be used as qualifying income if the borrower has received such income for approximately the past two years and there are reasonable prospects of its continuance. The file did not contain documentation indicating that the borrower had received overtime income for the past two years. No indication of its continuance was provided either. After deducting $797.68 from the borrower's monthly income, the debt to income ratios would increase to 32.12 and 47.87 percent, respectively.

E. Inadequate Compensating Factors

The lender did not provide adequate compensating factors for excessive debt to income ratios. Mortgagee Letter 2005-16 states that the lender must describe the compensating factors used to justify mortgage approval when the borrower's mortgage payment to effective income ratio and total fixed payment to income ratio exceed 31 and 43 percent, respectively. HUD OIG calculated ratios are 32.12 and 47.87 percent. Compensating factors listed were "ratios are within guidelines; employment and income stability." However, these are not allowable compensating factors as defined in HUD Handbook 4155.1, REV-5, Section 2-13.

Case number:	352-5230020
Loan Amount:	$274,050
Settlement date:	May 13, 2004
Status:	First legal action to commence foreclosure

Pertinent Details:

A. Inadequate Support for Employment

The lender did not obtain an adequate explanation for the employment gap from August 2002 to March 2003 from the co-borrower. HUD Handbook, 4155.1, REV-5, section 2-6 requires that the lender must verify the borrower's employment for the most recent two full years. The borrower also must explain any gaps in employment spanning one month or more. The co-borrower stated that she started collecting unemployment benefits and also stated that she was baby sitting for two individuals from September 2002 to April 2003, and that each individual paid her $100 a week. These two employments were not listed on a FHA loan application. The verbal verification provided by First Residential for these two employments did not disclose income information.

B. Verification of Deposit not Obtained
C. Inadequate Evaluation of Savings Pattern

The lender did not verify the excessive deposits in the borrower's bank account. The HUD Handbook, 4155.1, REV-5, Section 2-10B states that if there is a large increase in a bank account, the lender must obtain a credible explanation of the source of those funds. No explanation was provided for seven excessive deposits totaling $13,174 within two months ($1,826 on January 6, 2004, $1,000 on January 23, 2004, $1568.11 on January 26, 2004, $1,333.21 on January 30, 2004, $1,500 on February 4, 2004, $3,348 on February 9, 2004, and $2,599 on February 24, 2004).

In addition, section 2-1 of the handbook also provides that the lender must evaluate the borrower's capacity to make payments. The bank statements in the file showed eight non-sufficient fund charges during the period of December 16, 2003 to January 16, 2004. Explanation in the file was inadequate.

D. Inadequate Credit Analysis

The lender did not apply an adequate analysis to the borrower's credit history. HUD Handbook 4155.1, REV-5, section 2-3 requires that indications of derogatory credit including judgments, collections, and any other recent credit problems require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file. The credit report indicated that the co-borrower had three derogatory accounts. However, no explanation was provided. Two out of these three derogatory accounts were placed for collection. Another account did not show that it was placed for collection, but the file contained a letter, which was dated after the credit report, which indicated that if the amount agreed to settle the account is not paid, then it will be placed for collection. There was no documentation on file to show whether the amount agreed to settle the account was paid or not.

E. Inadequate Compensating Factors

Mortgagee Letter 2005-16, states that the lender must describe the compensating factors used to justify mortgage approval when the borrower's mortgage payment to effective income ratio (front) and total fixed payment to income ratio (back) exceeded 31 percent and 43 percent respectively. The borrower's ratios were 34.92 percent and 37.67percent respectively as per lender's calculations. Compensating factors listed on the MCAW were (1) low loan-to-value (LTV) ratio (2) strong reserves after closing. Low LTV ratio is not an allowable compensating factor, and funds from gifts from any source are not to be included as cash reserves as defined in HUD Handbook 4155.1, REV-5, section 2-13. If we exclude the gift of equity in calculating cash reserves, the borrower would have had negative cash reserves of $10,926.

Case number: 352- 5213442
Loan Amount: $267,858
Settlement date: September 13, 2004
Status: Foreclosure Started

Pertinent Details:

A. Principal, Interest, Taxes and Insurance (PITI) Cash Requirement not Met

HUD handbook, 4155.1, REV-5, Section 1-8 C requires that the borrower must have reserves equivalent to three months' principal, interest, taxes and insurance expenses after closing on purchase transactions for three and four units property. Reserves cannot be derived from a gift. On the Mortgage Credit Analysis Worksheet, the cash reserves was $79.71, which was less than one month's principal, interest, taxes and insurance costs of $2,312.90.

B. Inadequate Credit Analysis

HUD Handbook, 4155.1, REV-5, Section 2-3, states that major indications of derogatory credit–including judgments, collections, and any other recent credit problems require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file. The borrower's credit report showed several derogatory accounts. The borrower explained that these late payments were due to the creditor's computer errors or that the bills were sent to the neighbor's house. We consider this an inadequate explanation.

C. Verification of Deposits not obtained
D. Inadequate Evaluation of Savings Pattern

HUD Handbook, 4155.1, REV-5, Section 2-10B states that if there is a large increase in a bank account, the lender must obtain a credible explanation of the source of those funds. The bank statements indicated that the borrower had five non-payroll deposits totaling $1,790 during the period from July 15, 2004, through September 3, 2004. No explanation of these excessive deposits was contained in the file.

HUD Handbook 4155.1, REV-5, section 2-1 also requires the lender to evaluate the borrower's capacity to make payments. We noted the beginning balance of the bank account was $2,641.49 as of July 15, 2004, and the ending balance was reduced to $353.63 as of September 3, 2004. With five unverified non-payroll deposits of $1,790, the borrower had withdrawn a significant amount of funds from her bank account. The file did not contain an indication that any withdrawals were made towards the purchase of the property. We concluded that the borrower did not demonstrate savings ability, and may lack the capacity to make the mortgage payment.

Case number:	352-5167847
Loan amount:	$236,241
Settlement date:	January 6, 2004
Status:	First Legal Action to Commence Foreclosure

Pertinent details:

A. Inadequate Credit Analysis

HUD Handbook 4155.1, REV-5, section 2-3, provides that major indications of derogatory credit require a sufficient written explanation from the borrower. The credit report indicated that the borrower had 48 instances of late payments for one of her creditors, of which numerous late payments incurred recently. The borrower explained she was unaware of this account. The borrower also incurred numerous delinquencies with another creditor. The borrower explained that the delinquencies happened due to her irresponsible employer who did not pay her on time and the payment was less than promised. We consider these inadequate explanations.

In addition, section 2-3C requires that the borrower must explain in writing all collections and judgments. However, the file did not contain a written explanation for one judgment incurred in June 2003, with an amount of $4,213. The borrower also incurred two other judgments a few years back. The charges of these two judgments were not paid until the closing date. No explanation was obtained from the borrower for the delayed payments.

The borrower stated in her letter that she did not like credit, and always made purchases with cash or money orders. However, the borrower made five inquiries from April 15, 2003, to August 19, 2003, to obtain credit cards. In addition, from August 28, 2003, to November 17, 2003, the borrower made another five inquires. No explanation was obtained for these additional inquiries. The borrower did not demonstrate a conservative attitude toward the use of credit.

B. Inadequate Earnest Money Deposit Documentation

HUD Handbook 4155.1, REV-5, section 2-10A, provides that if the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive, based on the borrower's history of accumulating savings, the lender must verify the amount of deposit and the source of funds. The borrower's bank statement indicated that the regular payroll deposits were about $50 every two weeks. Also, the balance of the borrower's bank account was minimal before her mortgage application. Therefore, $3,500 was excessive compared to the borrower's accumulated savings. The file only contained an attorney's letter indicating that the seller held the borrower's earnest money deposit. However, no verification of the source of funds was obtained.

C. Negative Cash Reserve on HUD-1

HUD Handbook 4155.1, REV-5, section 2-10, provides that all of the funds for the borrower's investment in the property must be verified and documented. The borrower did not appear to have sufficient funds to close. If we do not include the $3,500 earnest money deposit due to its unverified source, as described in section B, the borrower would have a $578.95 shortage at closing.

D. Verification of Deposit Not Obtained

The lender did not adequately verify the excessive deposits into the borrower's bank account. HUD Handbook 4155.1, REV-5, section 2-10B, provides that if there is a large increase in a bank account or the bank account was opened recently, the lender must obtain an explanation and evidence of the source of funds from the borrower. The borrower deposited $2,414.96 to her bank account on November 5, 2003, without adequate explanation and source documents from the borrower. In addition, no explanation was obtained for an $844.23 deposit on December 12, 2003.

Case number: 352-5246588
Loan amount: $182,141
Settlement date: May 14, 2004
Status: Reinstated by Mortgagor or Who Retains Ownership

Pertinent details:

A. Verification of Deposit Not Obtained

HUD Handbook 4155.1, REV-5, section 2-10B provides that if there is a large increase in a bank account or the bank account was opened recently, the lender must obtain an explanation and evidence of the source of funds from the borrower. The bank statement in the file indicated that the borrower made non-payroll deposits of $2,798 on February 19, 2004 and $1,000 on April 15, 2004. Also, the borrower made ten non-payroll deposits to her savings account and four to her checking account, which totaled $4,107 during the period from February 26, 2004, to May 13, 2004. However, no written explanation from borrower was contained in the file.

B. Inadequate Credit Analysis

HUD Handbook 4155.1, REV-5, section 2-3, provides that major indications of derogatory credit require a sufficient written explanation from the borrower. Section 2-3C specifically requires that the borrower must explain in writing all collections and judgments. The credit report in the file indicated that the borrower had numerous late payments for several creditors. One creditor stated on the credit report that the borrower was not responsible for the debt. The file did not contain a written explanation of these delinquencies. In addition, the borrower incurred four collections including the one from US Department of Education for the $6,611 student loan. However, the lender did not obtain any written explanation from the borrower.

C. Inadequate Evaluation of Savings Pattern

HUD Handbook 4155.1, REV-5, section 2-1, requires the lender to evaluate the borrower's capacity to make payments. Section 3-1 also requires that when standard documentation does not provide enough information to support this 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. The file contained a bank statement indicating that the borrower incurred seven overdrafts of her checking account during the period from April 5, 2004 to May 5, 2004, while the closing date was May 14, 2004. However, no explanation was obtained from the borrower for these overdrafts. As a result, we concluded that the borrower did not demonstrate her savings ability, and may lack the capacity to make the mortgage payments. The lender did not evaluate the borrower's ability to repay as required.

Case number: 352-5217394
Loan Amount: $211, 678 (Claim paid amount: $221,445)
Settlement date: April 22, 2004
Status: Claim

Pertinent Details:

A. Inadequate Verification of Assets at Private Savings Club
B. Verification of Deposit not obtained

HUD Handbook 4155.1, REV-5, section 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. Provided the bank statement shows the previous month's balance, this requirement is met by obtaining the two most recent, consecutive statements. Section 2-10B of the handbook also states that if there is a large increase in an account, or the account was opened recently, the lender must obtain a credible explanation of the source of the funds. According to a letter dated March 9, 2004, the file indicated that the borrower did not have a bank account. The bank statement dated February 29, 2004, listed the beginning balance was zero. Therefore, we concluded that the bank account was opened in February 2004. We noted that $9,000 was deposited into that bank account on February 9, 2004. Contrary to HUD regulations, the lender did not obtain an explanation of the source of the funds.

We noted that the co-borrower had $9,000 in assets available at her private savings club. Section 2-10R provides that while private savings clubs are not supervised banking institutions, at a minimum, the clubs must have account ledgers, receipts from the club, verification from the club treasurer, and identification of the club so that the lender can re-verify the information provided. The underwriter must be able to determine that it was reasonable for the borrower to have saved the money claimed and that there is no evidence these funds were borrowed with an expectation of repayment. The file only contained a verification and an affidavit that provided that the borrower started contributing to the club in October 2003. The verification indicated that contributions to the account are made bi-weekly for $900, while the affidavit that was signed by the club treasurer listed the contributions as $900 monthly.

C. Inadequate Earnest Money Deposit Documentation

HUD Handbook, 4155.1, REV-5, Section 2-10A provides that if the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds. The HUD-1 settlement statement and Mortgage Credit Analysis Worksheet listed $6,450 as the earnest money deposit. The file contained a copy of an escrow letter from realtor acknowledging the receipt of $6,450. However, except for an official bank check of $5,450 from an unsupported source, the file did not contain any other evidence that the source of the funds was properly verified. According to the bank statement on file, the source of the earnest money deposit was from the inadequately verified $9,000 from the private savings club as explained in section A and B, therefore, the borrowers did not have sufficient funds to cover the earnest money deposit.

D. Negative Cash Reserve on HUD-1

HUD Handbook 4155.1, REV-5, section 2-10, provides that all of the funds for the borrower's investment in the property must be verified and documented. Cash due from borrower on the HUD-1 statement was $ 2,756.20. Due to unsupported paid-outside of-closing costs of $475, and the unverified earnest money deposit of $6,450, the borrower would have been required to pay $9,681.20 at closing. Since the verification of $9,000 from private savings club was inadequate, we conclude that the borrower could not meet this cash requirement at closing.

E. Inadequate Credit Analysis

No satisfactory explanation was obtained for the late payments of the co-borrower's derogatory accounts. The co-borrower had incurred numerous late payments with one creditor recently (within 6 months) without any explanations. The co-borrower's credit report indicated that the rental payment was made to the same individual who was also the co-borrower's private savings club treasurer. Also the borrower's credit report indicates that the credit history was insufficient; no credit score appeared on the credit report. HUD Handbook 4155.1, REV-5, provides that some prospective borrowers may not have an established credit history. For those borrowers, and for those who do not use 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. However, no alternative credit documents such as utility payment records or verification of rental payments were contained in the file.

F. Verification of costs Paid-Outside of-Closing not Obtained

HUD Handbook 4155.1, REV-5, section 2-10 requires that all funds for the borrower's investment in the property be verified and documented. The HUD-1 settlement statement in the file reported that the borrower paid $450 for appraisal fees, $25 credit reports fees and $395 for commitment fees. A copy of a cancelled check for a commitment fee indicates that it was paid by the co-borrower's private savings club treasurer who was also the co-borrower's landlord. In addition, there were only invoices on file for appraisal fees and credit report fees and there were no copies of cancelled checks on file.