Issue Date	March 15, 2006
Audit Report Number	2006-KC-1007

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

//signed//

FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: American Lending Group Did Not Properly Originate 9 Loans and Did Not Have Adequate Quality Control Procedures

HIGHLIGHTS

What We Audited and Why

We audited American Lending Group (American Lending) because it had a high default rate among active nonsupervised lenders in the St. Louis, Missouri, area. American Lending's St. Louis area branch had a default rate of 9.22 percent. Our audit objectives were to determine whether American Lending properly originated Federal Housing Administration loans, properly submitted late requests for endorsement, and implemented adequate quality control procedures.

What We Found

American Lending did not follow U.S. Department of Housing and Urban Development (HUD) requirements when underwriting 8 of the 17 loans reviewed. These loans contain material deficiencies that affect the insurability of the loans. Material deficiencies include unsupported income, excessive ratios, unsupported gift funds and assets, and questionable credit histories. As a result, HUD insured 8 loans that placed the Federal Housing Administration insurance fund at risk for $935,318.

American Lending did not follow HUD requirements for late insurance endorsement when submitting 1 of the 48 loans reviewed. It submitted a Federal Housing Administration loan for insurance endorsement when the borrowers had delinquent payments before loan submission. As a result, HUD is insuring a loan that places the Federal Housing Administration insurance fund at risk for $144,296.

American Lending's quality control procedures did not comply with HUD requirements. American Lending did not review all loans that defaulted within the first six months, perform the required 10 percent review of all Federal Housing Administration loans during 20 of the 23 months in which it originated such loans, complete reviews within the required timeframes, or appropriately review its branch offices. American Lending's management was unaware of, or misunderstood, the HUD requirements. These deficiencies prevented American Lending from adequately identifying problems in its loan origination.

What We Recommend

We recommend that HUD take appropriate administrative action against American Lending for not following HUD requirements. At a minimum, HUD should require American Lending to indemnify three loans with material deficiencies with original mortgage amounts totaling $502,611; to indemnify HUD for future losses on four properties not yet sold for which HUD paid claims totaling $364,198; and to reimburse HUD $52,357 for claims paid on one loan that was sold.

We recommend that HUD take appropriate administrative action against American Lending for improperly submitting one loan for late endorsement. At a minimum, HUD should require American Lending to indemnify the loan with an original mortgage amount of $144,296.

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

Auditee's Response

We provided the draft report to American Lending on March 3, 2006, and requested a written response. American Lending provided written comments on March 9, 2006. American Lending generally agreed that it had problems in its origination and quality control activities.

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

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVES

American Lending Group (American Lending) is a direct endorsement lender based in St. Peters, Missouri. It was founded in 1992 and became an approved direct endorsement lender for the Federal Housing Administration that same year. American Lending has three active branch offices. It originates loans and underwrites loans originated by loan correspondents.

On June 29, 2004, the U.S. Department of Housing and Urban Development (HUD) terminated the Federal Housing Administration origination approval agreement for American Lending’s St. Louis, Missouri, office. HUD is permitted by its regulations to terminate the agreement with any lender having a default or claim rate for loans endorsed within the preceding 24 months that exceeds 200 percent of the default rate and claim rate within the geographic area served by a field office and also exceeds the national default and claim rate. A terminated lender may reapply after six months if the underlying causes for termination have been remedied.

For loans closed in June 2003 through May 2005, American Lending’s St. Louis area branch had a default rate of 9.22 percent. The St. Louis area branch originated 206 Federal Housing Administration single-family loans during this period, and 19 of those loans (9.22 percent) defaulted within two years of closing. Including properties in other geographic areas, the St. Louis branch originated 479 loans during this period, 39 of which defaulted within two years of closing.

Our audit objectives were to determine whether American Lending properly originated Federal Housing Administration loans, properly submitted late requests for endorsement, and implemented adequate quality control procedures.

RESULTS OF AUDIT

Finding 1: American Lending Did Not Follow HUD Requirements While Underwriting 8 Federal Housing Administration Loans

American Lending did not comply with HUD requirements while underwriting eight Federal Housing Administration-insured single-family mortgages. Because American Lending closed the branch office that originated seven of these loans, we could not determine the cause of the deficiencies. These deficiencies affected the credit quality of the loans and placed the Federal Housing Administration insurance fund at an increased risk of borrower default on the eight improperly underwritten loans with original mortgage amounts totaling $935,318.

HUD Underwriting Requirements Not Followed

American Lending's St. Louis office underwrote eight loans that contain significant underwriting deficiencies. These deficiencies primarily involve the following:

Unsupported Income/Questionable Employment History (Five Loans)
American Lending did not properly assess income and employment for five borrowers. The income is either overstated or not adequately supported, or the borrowers have unexplained gaps in the two-year employment history required by HUD. HUD requires lenders to evaluate borrowers' employment history to establish stability of income. Lenders must accurately assess borrower income to make informed decisions on income stability and the borrower's ability to repay the mortgage.

Excessive Ratios (Five Loans)
American Lending approved five loans for which the borrowers' front, back, or loan-to-value ratios exceeded HUD limits. It did not identify adequate compensating factors for four borrowers whose housing (front) or total debt (back) ratios exceeded HUD's limits. It also exceeded the loan-to-value ratio for one loan in which the relationship of the borrower and coborrower was not disclosed. HUD limits the maximum mortgage to 75 percent loan-to-value when there are two or more borrowers but one or more will not occupy the property as a principal residence.

Assets/Funds to Close (Six Loans)
American Lending did not properly document gifts from nonprofits or borrower assets for six borrowers. It did not document the transfer of gift funds (funds needed to close the loan) from nonprofit donor to recipient for five borrowers.

There were gift letters in each file, and the gift amount was stated on each borrower's underwriting worksheet and settlement statement. However, there were no documents showing the transfer of funds from the gift donor to the closing agent. We requested the wire transfers to document receipt of these funds. American Lending provided some gift transfer documentation for one borrower, but the documentation only showed the transfer of funds from the seller, not the transfer of funds from the nonprofit to the title company. In addition, American Lending did not obtain adequate bank documentation for two of the six borrowers to provide evidence of funds needed to close the loan.

Questionable Credit History (Three Loans)
American Lending did not adequately assess credit histories for three borrowers. These borrowers' credit histories show significant derogatory credit and collection items within the two years before closing. HUD requires the lender to analyze whether late payments were a disregard for financial obligations or factors beyond the control of the borrower. American Lending did not provide compensating factors for approving these loans. Additionally, it did not obtain a verification of rent to verify two borrowers' payment histories of housing obligations covering the most recent 12-month period and approved the third even though the borrower's landlord submitted a negative verification of rent.

A schedule of the deficiencies is presented in appendix C. A detailed description of the deficiencies for each loan is presented in appendix E.

Cause of Deficiencies

American Lending's home office allowed its South County branch office, from which the seven deficient loans were originated, to use its lender number while not supervising this office according to HUD quality control requirements (see finding 3). American Lending closed its South County branch as result of non-compliance discovered during a branch review. Because American Lending's South County branch was closed in April 2004, we could not determine the cause of the deficiencies.

Effect of Improperly Underwritten Loans

As of December 31, 2005, HUD systems show that HUD has paid claims on five of the eight materially deficient loans.

Status of deficient loans as of December 31, 2005	Number of loans	Original mortgage amount	Claim paid amount	Loss amount
Active insurance – in default	3	$502,611		
Claim paid – not yet sold	4	$355,913	$364,198	
Claim paid - sold	1	$76,794	$81,154	$52,357
Total	**8**	**$935,318**	**$445,352**	**$52,357**

As a result, American Lending originated eight loans containing deficiencies that have placed the Federal Housing Administration insurance fund at risk for $935,318 and caused HUD to incur related losses.

Conclusion

Violations of HUD requirements, caused by fraud or serious negligence on the part of the lender, may require the lender to enter into an indemnification agreement with HUD. Five of the eight deficient loans have resulted in claims, and the other three are in a default status but remain actively insured. HUD should request indemnification for these loans because they contain significant deficiencies that affect their credit quality and place the Federal Housing Administration insurance fund at an increased risk of borrower default.

Recommendations

We recommend that the assistant secretary for housing – federal housing commissioner and chairman, Mortgagee Review Board,

1A. Take appropriate administrative action against American Lending for not complying with HUD underwriting requirements. This action at a minimum should include requiring American Lending to indemnify HUD for three actively insured loans with original mortgage amounts totaling $502,611.

1B. Take appropriate administrative action against American Lending for four loans for which HUD has already paid a claim totaling $364,198, including requiring American Lending to indemnify HUD for future losses on the four properties that have not yet been sold.

1C. Take appropriate administrative action against American Lending for the loan not properly underwritten whose subject property was conveyed to HUD and later sold. This action at a minimum should include requiring American Lending to reimburse HUD $52,357 for actual loss incurred.

Finding 2: American Lending Improperly Submitted a Late Request for Endorsement

American Lending improperly submitted one loan for insurance endorsement when the borrower had prior delinquent payments. Although late endorsement requests were not a significant problem for American Lending, the improperly submitted loan with a mortgage amount of $144,296 represents an increased risk to the Federal Housing Administration insurance fund.

Improperly Submitted Loans

We reviewed 48 loans originated by American Lending between June 1, 2003, and May 31, 2005, which were submitted for late endorsement. American Lending improperly submitted one of these loans for endorsement when the borrowers had delinquent payments before submission. HUD Handbook 4165.1 has specific requirements for lenders to follow when submitting a loan for insurance endorsement more than 60 days after the closing date. Lenders may only submit loans for which the borrowers have made all payments within the month due. If submitted after the 15th of the month, the payment for the month in which the case binder was submitted must also be included. If submitted before the 15th of the month, the current month's payment need not be present. If a borrower has made a late payment, the lender may not submit the loan until the borrower has made six consecutive timely payments. The following table lists the pertinent details for the improperly submitted loan.

Case number	Closing date	Submission date	Endorsement date	Late payment dates
137-2400008	Aug. 25, 2003	Jan 12, 2004	Jan. 14, 2004	Nov. 2003, Dec. 2003, Jan. 2004

Overall, American Lending did not have a significant problem with late requests for endorsement. As of December 31, 2005, case number 137-2400008 is in default.

The mortgage, with an amount of $144,296, represents an increased risk to the Federal Housing Administration insurance fund.

Mortgagee Letter 2005-23 eliminated the requirement that the borrower make six consecutive payments when due before the loan is eligible for insurance. Under the new requirements, lenders need to only certify that the most recent payment that came due was made within that month. The improperly submitted loan violated this most recent requirement.

Recommendation

We recommend that the secretary of housing – federal housing commissioner and chairman, Mortgage Review Board,

2A. Take appropriate administrative action against American Lending. At a minimum, this action should include requiring indemnification of the loans with a mortgage amount of $144,296 that was improperly submitted for late endorsement.

Finding 3: American Lending's Quality Control Procedures Did Not Meet HUD Requirements

American Lending's quality control procedures did not include HUD's requirements for performing reviews. American Lending's management was unaware of the requirements to perform early payment default and site reviews of its branch offices and misunderstood the requirement regarding the number of reviews and the timeframes within which they should completed. As a result, it could not ensure the accuracy, validity, and completeness of its loan originations.

Quality Control Procedures Not Meeting HUD Requirements

Types of Reviews

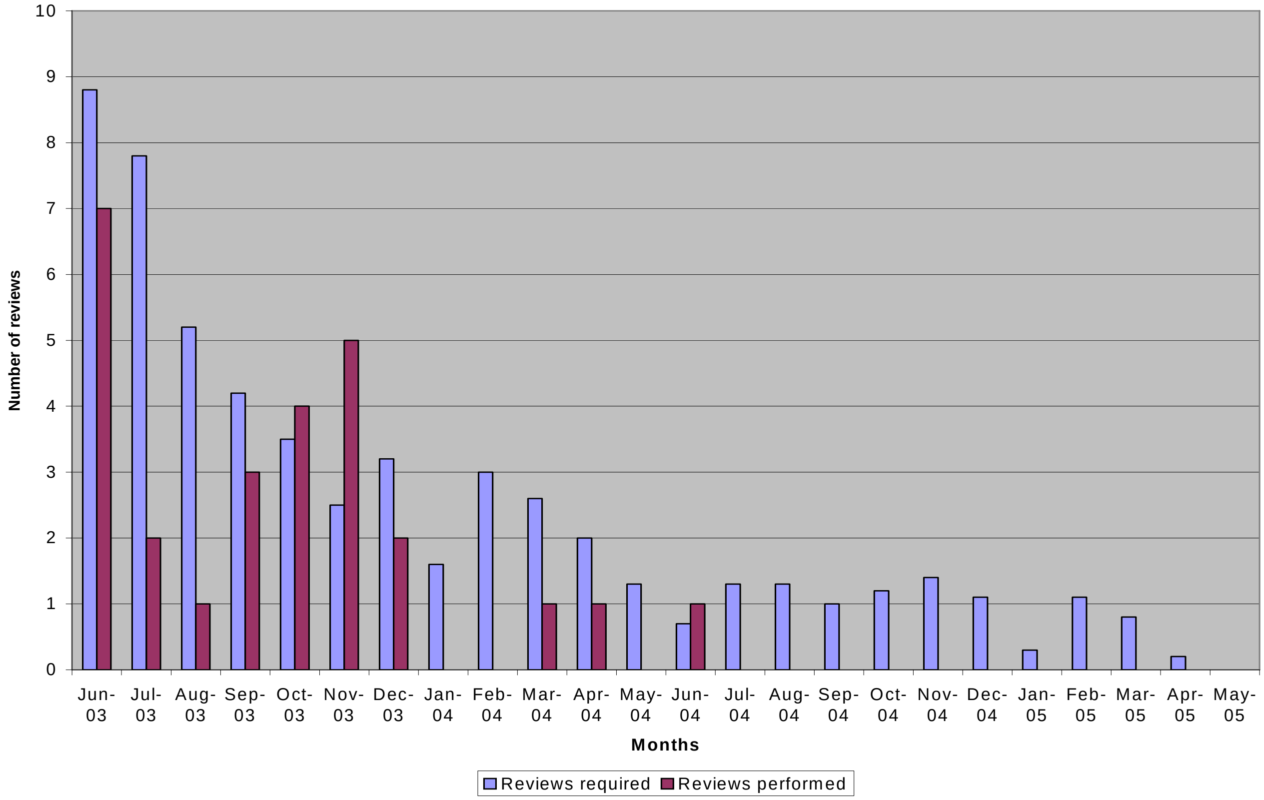
American Lending's written quality control plan did not include all HUD-required elements specified in HUD Handbook 4060.1. Its written quality control plan did not include the requirements to review all loans going into default within the first six months after closing (early payment defaults) and to conduct site reviews of its branch offices.

Consequently, American Lending did not perform any early payment default reviews nor did it conduct reviews of its branch offices in the manner required by HUD. It conducted branch reviews, which prompted the closure of its South County branch office, but the reviews were not documented. Therefore, we could not determine whether the reviews covered all 10 requirements listed in HUD Handbook 4060.1, REV-1, CHG-1 section 6-3 (G).

Number of Reviews and Required Timeframe

Further, American Lending did not conduct all quality control reviews required during the audit period. HUD Handbook 4060.1 requires lenders to conduct quality control reviews of 10 percent of all Federal Housing Administration loans within 90 days of closing and requires reviews either monthly or quarterly, depending on the number of loans closed each month. American Lending's quality control plan instead stated that it would start a review of 10 percent of all loans within 90 days of the closing month.

During the 23 months that American Lending originated Federal Housing Administration-insured loans, it conducted quality control reviews of the required 10 percent sample during only three months. Of the 27 quality control reviews performed during the period, only five were conducted within the 90-day timeframe. On average, the reviews were completed 41 days late. The following chart compares the actual number of reviews performed to the number required.



Management Unaware of Requirements

American Lending's management was unaware of the requirement to conduct quality control reviews of all loans going into default within the first six months after closing. American Lending misunderstood the requirement for conducting quality control reviews of 10 percent of all Federal Housing Administration loans within 90 days of closing. American Lending's quality control plan stated that reviews of 10 percent of all loans would begin within 90 days of closing. American Lending is taking steps to amend its quality control plan accordingly.

Effect of Noncompliance

American Lending's written quality control procedures lacked HUD-required elements necessary to conduct proper quality control reviews, and its staff did not conduct quality control reviews in accordance with HUD requirements. Without a HUD-compliant quality control plan, American Lending cannot ensure that it is protecting itself and HUD from unacceptable risk and that it is guarding against errors, omissions, and fraud.

Recommendation

We recommend that the assistant secretary for housing – federal housing commissioner and chairman, Mortgagee Review Board,

3A. Verify that American Lending follows the new amendments to its quality control plan.

SCOPE AND METHODOLOGY

According to HUD's Neighborhood Watch system, American Lending's St. Louis office processed 479 Federal Housing Administration loans between June 1, 2003, and May 31, 2005. Of the 479 loans, 49 defaulted within the first two years after the loans closed. We reviewed 17 of the 49 defaulted loans. We excluded

- Twenty-seven streamline refinance loans because the underwriter's assessment of these loans is limited,
- Two loans for which HUD's Quality Assurance Division had recommended indemnification,
- Two terminated loans that were no longer a threat to HUD's insurance fund, and
- One loan file that was not available for review.

To accomplish our objectives, we reviewed the Federal Housing Administration underwriting policies and procedures for HUD and American Lending and interviewed the office management and staff. We reviewed the HUD and American Lending loan files for 17 loans to determine whether the loans were properly underwritten. Since we based our findings on the loan files rather than information in HUD's systems, we did not assess the reliability of HUD's systems. We reviewed the results of prior certified public accountant and HUD reviews.

Additionally, in performing our tests to determine whether American Lending complied with HUD's endorsement requirements, we reviewed HUD data and pay histories to identify the presence of payments made outside the month due and delinquent payments before submission. Using HUD's Single Family Data Warehouse system, we identified 48 loans sponsored or originated by American Lending between June 1, 2003, and May 31, 2005, that were submitted for late endorsement.

Finally, we reviewed American Lending's quality control plan to determine whether it contained all HUD requirements. We examined American Lending's quality control reviews from June 2003 through May 2005 to determine whether the required quality control reviews were performed.

We performed audit work from September through December 2005 at American Lending's home office located at 22 Richmond Center Court, St. Peters, Missouri. We conducted our audit in accordance with generally accepted government auditing standards. However, because the South County office was no longer in business, we were unable to assess its internal controls.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Controls over underwriting of Federal Housing Administration loans.

Because the South County office was no longer in business, we were unable to assess its internal controls.

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			$502,611
1B		$364,198	
1C	$52,357		
2A			$144,296

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 quantifiable savings that are anticipated to occur if an Office of Inspector General recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes loans and guarantees not made.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

ALG American Lending Group

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March 8, 2006

Ronald Hosking
Regional Inspector General for Audit
U. S. Department of Housing and Urban Development
Office of Inspector General
Region 7 Office of Audit
Gateway Tower II – 5th Floor
400 State Avenue
Kansas City, KS 66101-2406

Dear Mr. Hosking,

Please accept this written response to the audit reports dated 3/3/06.
American Lending Group has closed its South County branch after the 4/04 HUD audit and an onsite visit by the president of ALG. The audit and visit revealed negligence and non-compliance by certain individuals that were terminated. These individuals were responsible for 95% of all FHA loans which have deficiencies and are now under review. We have tried to recover the majority of the loan files from this office but have not been successful in locating all loan files originated. Due to the lack of documentation, we weren't able to complete an entire investigation on the files in question. We are still continuing our efforts to investigate all deficiencies that were discovered. ALG started originating FHA loans in1992. From 1992-2003 we had not experienced any issues and remained compliant during this time period. Our default rate was affected and increased after the opening of our South County branch in 2003.

Quality Control:

Comment 1

American Lending Group was unaware of the HUD requirement of reviewing 10% of all FHA loans. In our QC Manual it indicated that ALG review 10% of all loans originated and not just FHA loans. We were reviewed by HUD auditor [redacted] during the week of 4/12/04 and at this time it was not mentioned that we do a separate review of our FHA loans. Our QC Manual was submitted to HUD at the time of our application for approval as a non-supervised lender in 8/96. It was reviewed and approved and there was no mention of any deficiencies in our manual. Since this was brought to our attention during this audit, we have amended our QC Manual and added this requirement. (See attached).

HUD Reimbursement:

Comment 2

HUD is asking for reimbursement regarding case number 2924446965 in the amount of $52,357 for actual loss incurred from the property being conveyed to HUD and later sold. American Lending Group disagrees with this amount because we did not receive any

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notification from the servicer or HUD regarding the loan details of this HUD insured loan. Nor were we informed that the loan had been conveyed to HUD and ALG was not offered the choice to intervene in the property disposition. We want to reiterate that ALG had no control over the ultimate outcome of this case since it was sold to an investor which did not communicate the delinquency pertaining to this loan. We ask for reconsideration for the requested amount of reimbursement.

Comment 3

Late Endorsement:

Case Number: 137-2400008

This loan was sold to Washington Mutual and they did the servicing. Washington Mutual was experiencing servicing difficulties during the last quarter of 2003 and first quarter of 2004 because of high volume due to the refinance boom. The President, Warin Kumar, was told of these posting discrepancies on many of the loans sold to WAMU at that time. This finding was a result of this situation during this time period which was out of our control as we sold this loan and servicing to investor Washington Mutual. Washington Mutual failed to notify us of any late payment defaults due to their system problems at that time.

This case was also a streamline refinance. The FHA loan that was paid off at closing was a 30 year fixed with an interest rate at 6.375% which was originally closed in 11/02. This loan in question was a 1 year arm at 4.75% that closed in 8/03 which means that the borrowers would have had at least 24 payments at a interest rate lower than their previous rate. This actually represented a decreased in risk to the Federal Housing Administration.

Underwriting:

After our quality control audits in 2004, it was revealed that the bulk of the loans with deficiencies were underwritten by one individual that was terminated. American Lending Group has suffered losses as a result of this particular underwriter's negligence. We now have an experienced and qualified underwriter that is aware of all HUD guidelines and procedures. She has been instrumental in assisting us in our continuous review of all files originated from our former branch location.

Comment 4

Case Number: 1372985860

ALG recently contacted the borrower to obtain bank statements to satisfy the auditor's findings regarding deposit verification. It was discovered that the property is listed and the borrower explained to ALG that he did not have the old records and is relocating and the house will be sold soon.

Case Number: 2924417975

American Lending Group does not have all documentation and has been unsuccessful contacting the borrowers to try and rectify the underwriting deficiencies. This is largely due to the language barrier as these borrowers are Bosnian and do not speak English. At

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the time of loan origination, we had a loan officer who was Bosnian and could communicate with the borrowers.

Case Numbers: 2924371418, 2924425828

The auditor went through the files and did not find proper documentation on gift transfers. We contacted the particular title company trying to get proof of the gift transfers that were listed on the HUDs but we were unsuccessful. We contacted Better Family Life, the gift donors and Old Republic Title regarding both of these files to try and obtain supporting documentation. We discovered that the title company did not disburse the files according to their HUD settlement statement which is unusual since it is a reputable title company that is experienced in funding transactions of this nature. There appears there may have been an influential relationship between former employees of this former branch, the title company, and/or Better Family Life due to the insufficient supporting documentation. It also is possible that these documents may have been old files that we have not been able to locate or we have only obtained partial copy files after the closing of this branch.

Case Numbers: 2924446965, 2924419136

On these cases, the borrowers received gift funds from Better Family Life. American Lending Group has tried to document the transfer of these funds and was unsuccessful.

Case Number: 2924419136

Please find the attached verification of employment for the borrower's primary job. American Lending Group obtained this verification from the Employer A by calling 900-263- .

Case Number: 2924425828

The auditor noted there was a lack of employment history. We contacted her prior employer, Employer A, and received additional employment verification that is attached that covers 4 of the 8 months missing employment verification as noted by the auditor. We tried to contact the employer, Employer B, prior to her working for Employer A but were unsuccessful due to the closing of this company 10/01. We searched on the IL Secretary of State website to confirm this business and its dates of operation. We assume that since we have a partial file that the written verification of employment from Employer B is part of the missing documents.

Case Number: 2924371418

The auditor has referred to late pays in the last two years but should not be listed as a deficiency because the file was run through DU and received an automated approval. The DU findings did not require a verification of rent. It has been brought to ALG's attention there was an error on the DU findings which reflected the borrower receiving cash back from the transaction in the amount of $1841.00. The auditor mentioned this would invalidate the findings in which ALG disagrees with because DU does not include cash back as reserves so the cash back would not have any impact on the DU approval on this transaction. Also the auditor mentioned that the underwriter signed the DE approval as a

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manual underwritten FHA loan. The underwriter made an error. Our internal notice of loan approval reflected the final being approved as a DU approved loan. Also, the auditor mentioned a medical account that was 90 days late on 10 occasions. This account was actually a medical collection which was over 2 years old.

Case Number: 2924439118

The $25 courier fee which the borrower was charged was charged by the title company. It is standard procedure for American Lending Group to review the final HUD settlement statement on each transaction prior to the borrower signing. FHA borrowers are not charged courier fees. This must have been an oversight.

As previously mentioned, we want to stress that the bulk of the loans reviewed were originated out of our previous South County branch office. We sold the majority of these loans to Washington Mutual during this time period and unfortunately did not receive any correspondence from their QC or servicing departments regarding early payment defaults. Had we been informed, we would have taken immediate action and conducted a full investigation. During an on-site visit by the president, Warin Kumar, in mid 2004 discovered non-compliance within this branch. After much investigating and reviewing of operations of this branch location it was decided that this office be immediately shut down and terminated all employees. We at that time quit originating FHA loans to reorganize and assess our FHA procedures. We as a company have made significant changes in our policies and procedures and have put controls in place throughout to ensure American Lending Group and HUD will not be subject to any negligence and non compliance. We have a strong underwriting department with each underwriter averaging 10 years of experience. We have also implemented a fraud detection program Appinteligence's Dissco product, which is mandatory on all loans originated. At the time of the 4/04 audit, we employed approximately 35 individuals. We now have over 120 employees that include 69 experienced and well qualified loan officers and 6 underwriters. We are confident in our knowledge of HUD requirements and ask that our FHA origination approval be reinstated for the St. Louis branch.

Sincerely,

Warin Kumar	Tricia Migliazzo	Rhonda Goeglein
President	Director of Operations	Senior Underwriter, S397

attachments

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3/1/06
Ammendement to American Lending Group's Quality Control Procedure for FHA loans

BASIC ELEMENTS OF QUALITY CONTROL

There are several basic elements that are required in all Quality Control Programs that apply to both origination and servicing.

1. ***System of Loan File Review.*** ALG's Quality Control Program provides the review of a representative sample of mortgage loans. This review evaluates the accuracy and adequacy of the information and documentation used in reaching decisions in the origination processes.
2. ***Adequate Scope and Sampling.*** If there are any deficiencies relating to the origination of mortgages, the Quality Control reviews thoroughly evaluate ALG's origination functions to determine the root cause of such deficiencies. ALG expands the scope of the Quality Control review when fraud or patterns of deficiencies are uncovered; scope means both an increased number of files as well as more in-depth review. All aspects of ALG's operation, including but not limited to all branch offices or sites, FHA approved Loan Correspondents, Authorized Agents, loan officers or originators, processors, underwriters, appraisers, closing personnel, all FHA loan programs, servicing personnel, loss mitigation procedures, escrow analysis, and assumptions, must be subject to ALG's Quality Control reviews.
3. ***Site Review.*** All ALG's offices, including traditional and nontraditional branch offices engaged in origination or servicing of FHA-insured loans, must be reviewed to determine that they are in compliance with HUD's requirements.

   A. ***Review Items.*** The review must include, but not necessarily be limited to, confirmation of the following items:

   - The office is properly registered with HUD and the address is current.
   - Operations are conducted in a professional, businesslike environment.
   - If located in commercial space, the office is properly and clearly identified for any walk-in customers; has adequate office space and equipment; is in a location conducive to mortgage lending; and is separated from any other entity by walls or partitions (entrances and reception areas may be shared).
   - If located in noncommercial space, the office has adequate office space and equipment; displays a fair housing poster if the public is received; if it is open to receive the public, it must be accessible to persons with disabilities, including those with mobility impairments; if it is not open to the public, but used occasionally to meet with members of the public, alternate means of accommodation may be used to serve persons with disabilities.
   - The servicing office provides toll-free lines or accepts collect calls from mortgagors.
   - The office is sufficiently staffed with trained personnel.
   - Office personnel have access to relevant statutes, regulations, HUD issuances and Handbooks, either in hard copy or electronically.
   - Procedures are revised to reflect changes in HUD requirements and personnel are informed of the changes.
   - Personnel at the office are all employees of the mortgagee or contract employees performing functions that HUD allows to be outsourced.
   - The office does not employ or have a contract with anyone currently under debarment or suspension, or a Limited Denial of Participation.

   B. ***Frequency.*** Technology enables ALG to conduct effective Quality Control remotely. Annual visits are mandatory for offices meeting certain higher risk criteria such as high early default rates, new branches or new key personnel, sudden increases in volume, and past problems. Other sites are reviewed to assure compliance with HUD's requirements at a frequency and in a manner determined appropriate by the mortgagee. The criteria used by ALG to determine the frequency of on-site reviews is in writing and available for review by HUD at the corporate office and any branch office that is not being reviewed annually.

   C. ***Staffing.*** When it is not feasible for Quality Control staff to visit each branch, qualified personnel from another office of ALG, not involved in the day-to-day processes they are reviewing, or an outside firm may perform the review.
4. ***Affiliate Review.*** ALG ensures that their contractors, agents, and Loan Correspondents are acceptable to FHA and operate in compliance with FHA requirements.

A. *Sponsors.* ALG's Quality Control Program provides for a review of loans originated and sold to it by each of its Loan Correspondents. ALG determines the appropriate percentage review based on volume, past experience and other factors. ALG documents the methodologies and results.

5. ***Reporting and Corrective Action.*** Review findings are reported to ALG's senior management within one month of completion of the initial report. Management must take prompt action to deal appropriately with any material findings. The final report or an addendum must identify actions being taken, the timetable for their completion, and any planned follow-up activities.
6. ***Notification to HUD.*** 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 propert is located). If HUD staff is suspected of involvement, refer to the Office of Inspector General at 451 7th Street, SW, Room 8256, Washington, DC 20410. ALG requires that findings discovered by employees during the normal course of business and by quality control staff during reviews/audits of FHA loans are reported to HUD within 60 days of the initial discovery.
7. ***File Retention.*** ALG's Quality Control review report and follow-up, including review findings and actions taken, plus procedural information (such as the percentage of loans reviewed, basis for selecting loans, and who performed the review) must be retained by ALG for a period of two years from the date of insurance endorsement. These records must be made available to HUD on request.

BASIC REQUIREMENTS FOR QUALITY CONTROL OF SINGLE-FAMILY PRODUCTIO

1. ***Timeliness.*** Loans must be reviewed within 90 days of the closing of the loan. This requirement is intended to ensure that problems left undetected prior to closing are identified as early after closing as possible.
2. ***Frequency.*** When ALG is closing more than 15 loans monthly, quality control reviews must be conducted at least monthly and must address one month's activity. When ALG is closing 15 or fewer loans monthly the company performs quality control reviews on a quarterly basis.
3. ***Sample Size and Loan Selection.*** ALG originates 7,000 or fewer FHA loans per year therefore requires a review of 10% of the FHA loans it originates. If ALG originates more than 7,000 FHA loans per year than requires a review 10% of its loans or a statistical random sampling that provides a 95% confidence level with 2% precision. Each review must document how the sample size and selections were determined.

Regardless of the percentage of loans being reviewed, ALG complies with the following:

A. *Targeting Loans for Review.* ALG selects loans meeting the conditions stated below. It may not be feasible to select loans from each category every month, but an effort must be made to select loans from each category as often as possible. An emphasis should be placed on any participants that have large volumes of loans, show sudden increases in loan volumes or loan default rates, have recently begun a relationship with ALG, or concentrate in soft market areas.

a) Loans must be reviewed from all branch offices and all sources including authorized agents and Loan Correspondents.
b) ALG must review the work of each of the loan processors, loan officers, and underwriters based on the sample selected. In addition, ALG must review the work of roster appraisers, real estate companies, and builders with whom ALG does a significant amount of business.
c) The sample must include all FHA programs in which ALG participates including, but not limited to, 203 (b), 203(k), 234, and Home Equity Conversion mortgages.

B. ***Criteria for Selecting Individual Loans are as follows:***

- 2-4 unit properties
- New construction or rehab loans
- Properties transferred within the past year
- Substantial seller concessions

- Nonoccupying comortgagors or multiple mortgagors
- Housing expenses increasing by 1.5 times or more
- Large or multiple earnest money deposits (money orders)
- Large increase in bank account balance
- Sale of personal property for funds to close
- Gifts or loans of funds to close
- Self-employed
- Loans risk assessed as "refers" by automated underwriting systems

4. ***Early Payment Defaults.*** In addition to the loans selected for routine quality control reviews, ALG must review all loans going into default within the first six payments. As defined here, early payment defaults are loans that become 60 days past due.
5. ***Documentation Review and Verification.*** ALGs reviews and confirms the following information of all loans selected for review.

    1. ***Credit Report.*** A new credit report must be obtained for each borrower whose loan is included in a Quality Control review, unless the loan was a streamline refinance or was processed using a FHA approved automated underwriting system exempted from this requirement. A credit report obtained for a Quality Control review may be a Residential Mortgage Credit Report, a three repository merged in-file report or, when appropriate, a business credit report. The report must comply with the credit report standards described in HUD Handbook 4155.1 (as revised). A full Residential Mortgage Credit Report must be obtained from a different credit source on cases in which the in-file report reveals discrepancies with the original credit report.
    2. ***Credit Document Reverification.*** Documents contained in the loan file should be checked for sufficiency and subjected to written reverification. Examples of items that must be reverified include, but are not limited to, the mortgagor's employment or other income, deposits, gift letters, alternate credit sources, and other sources of funds. Sources of funds must be acceptable as well as verified. Other items that may be reverified include mortgage or rent payments. If the written reverification is not returned to ALG, a documented attempt must be made to conduct a telephone reverification. If the original information was obtained electronically or involved alternative documents, a written reverification must still be attempted. Any discrepancies must be explored to ensure that the original documents (except blanket verification releases) were completed before being signed, were as represented, were not handled by interested third parties and that all corrections were proper and initialed. All conflicting information in the original documentation should have been resolved before the complete file was submitted to the underwriter.
    3. ***Appraisals.*** A desk review of the property appraisal must be performed on all loans chosen for a Quality Control review except streamline refinances and HUD Real Estate Owned (REO) sales. The desk review must include a review of the appraisal data, the validity of the comparables, the value conclusion ["as repaired" to meet safety and soundness requirements in HUD Handbook 4905.1 (as revised)], any changes made by the underwriter and the overall quality of the appraisal.

    ALG performs field reviews on 10% of the loans selected during the sampling process outlined previously in number 3 ***Sample Size and Loan Selection*** above. Field reviews must be performed by licensed appraisers listed on FHA's Roster of Appraisers. ALG selects loans for field reviews based on factors such as those listed in ***Criteria for selecting individual loans are as follows*** and the following:

    - Property complaints received from mortgagors
    - Discrepancies found during desk reviews
    - Large adjustments to value
    - Comparable sales more than six months old
    - Excessive distances from comparables to the subject property
    - Repetitive sales activity for the subject property

- Investor-sold properties
- Identity of interest between buyer and seller
- Seller identity differs from owner of record
- Vacant properties
- Value increased 20% or more within 12 months of a previous sale

In addition, a field review should be completed on loans selected in accordance with paragraphs above ***Sample Size and Loan Selection and Early Payment Defaults***. If serious deficiencies or patterns are uncovered, ALG must report these items, in writing, to the Quality Assurance Division in the HUD Homeownership Center having jurisdiction.

4. ***Occupancy Reverification.*** In cases where the occupancy of the subject property is suspect, ALG must attempt to determine whether the mortgagor is occupying the property. The failure of the mortgagor to occupy the property may be an indication that the loan contains other problems. If it is found that the mortgagor is not occupying a property mortgaged as owner-occupied, ALG must report this, in writing, to the Quality Assurance Division in the HUD Homeownership Center having jurisdiction. It also would be advisable to review other similar loans for occupancy.

6. ***Underwriting Decisions.*** Each Direct Endorsement loan selected for a quality control review must be reviewed for compliance with HUD underwriting requirements, sufficiency of documentation and the soundness of underwriting judgments.

7. ***Condition Clearance and Closing.*** Each loan selected for a quality control review must be reviewed to determine whether:

   - Conditions which were required to be satisfied prior to closing were in fact met prior to closing;
   - The seller was the owner of record, or was exempt from the owner of record requirement in accordance with HUD regulations;
   - The loan was closed and funds disbursed in accordance with the mortgagee's underwriting and subsequent closing instructions; and
   - The closing and legal documents are accurate and complete.

OIG Evaluation of Auditee Comments

Comment 1 Quality Control

We commend American Lending Group for taking prompt action and closing its South County branch upon discovering issues of non-compliance when underwriting Federal Housing Administration loans. We also commend American Lending for promptly amending their quality control plan to meet HUD requirements and to improve their Federal Housing Administration loan origination process.

Comment 2 HUD Reimbursement

The reimbursement amount of case number 292-4446965 is a matter that must be addressed by HUD. HUD has a method for determining the loss amount of the properties on which it has paid a claim. American Lending Group should contact HUD's Real Estate Owned division to resolve any disagreements they may have with the loss amount.

Comment 3 Late Endorsement

American Lending Group could not provide evidence that the loan payments for November and December 2003, and January 2004, for case number 137-2400008 were timely. The documentation provided showed that the payments for these months were delinquent. Therefore, this loan was not eligible for endorsement.

Comment 4 Underwriting

Case Number 137-2985860 – Without any evidence of proper asset verification, we are unable to determine that the borrower had the funds necessary to close the loan, and whether this loan should have been approved.

Case Number 292-4417975 – Without any evidence showing the relationship between the borrower and co-borrower, we are unable to determine whether the loan-to-value ratio should have been allowed to exceed 75 percent. Therefore, HUD will have over-insured the loan.

Case Number 292-4371418 - Without any evidence of the transfer of gift funds, we cannot determine that the gift funds were properly provided to the borrower and not provided by a party to the transaction. American Lending's response indicates that they discovered the title company did not correctly disburse the funds.

This loan was originally underwritten using an automated underwriting software and stating that borrower would receive cash back. The HUD form 92900-A says that the loan was rated as "refer" by an automated underwriting system, and/or was manually underwritten by a direct endorsement underwriter. The underwriter signed the Mortgage Credit Analysis Worksheet indicating that the loan was manually underwritten, and the settlement statement showed no cash back to the borrower. Therefore, this loan should have met the requirements of a manually underwritten loan, including verification of rent and acceptable credit.

Case Number 292-4425828 - Without any evidence of the transfer of gift funds, we cannot determine that the gift funds were properly provided to the borrower and not provided by a party to the transaction. American Lending's response indicates that they discovered the title company did not correctly disburse the funds. In response to our audit, American Lending Group obtained an employment verification for four of the eight months that were missing. The loan was approved without the required 24 months of verified employment.

Case Number 292-4446965 - Without any evidence of the transfer of gift funds, we cannot determine that the gift funds were properly provided to the borrower and not provided by a party to the transaction.

Case Number 292-4419136 - Without any evidence of the transfer of gift funds, we cannot determine that the gift funds were properly provided to the borrower and not provided by a party to the transaction. In response to our audit, American Lending Group did obtain a verification of employment.

Case Number 292-4439118 – We did not request repayment of the courier fee because the amount was not material. In the future, American Lending Group should ensure that borrowers are not charged unallowable fees.

Appendix C

SCHEDULE OF UNDERWRITING DEFICIENCIES

Federal Housing Administration case number	Original insured mortgage amount	(1) Claim paid by HUD	Income and employment	Excessive ratios	Assets/funds to close	Questionable credit history
292-4417975	$ 76,794	$ 82,143		X		
292-4439118	$ 70,887	$ 72,905	X	136/182		
292-4371418	$ 163,927				X	X
292-4425828	$ 91,563	$ 91,607	X		X	
292-4358891	$ 176,234		X	24.88/87.07	X	
292-4446965	$ 76,794	$ 81,154	X	35.76/39.06	X	X
137-2985860	$ 162,450				X	
292-4419136	$ 116,669	$ 117,543	X	42.04/53.48	X	X
Totals	**$ 935,318**	**$ 445,352**				

We have included the narrative case studies for each of the 8 questioned loans represented in the chart above in appendix D.

(1) Loans that have defaulted and for which HUD has paid a claim and acquired the property. As of December 31, 2005, five properties have gone to claim. One of these properties (292-4446965) has been sold for a loss of $52,357.

Appendix D

CASE SUMMARIES OF LOAN DEFICIENCIES

Case number: 292-4417975

Loan purpose: Purchase

Underwriter type: Manual

Date of loan closing: September 19, 2003

Insured amount: $76,794

Housing/debt ratio: 19.33/19.33 percent

Status: Claim paid – not sold

HUD costs incurred: $82,143

Liabilities

The borrower's negative monthly rental income of $112 was not factored into his liabilities on the underwriting worksheet when computing his ratios ($787 mortgage payment on his current house, minus the rental income of $900 reduced by the 25 percent, which equals $675). This deficiency is not indemnifiable. The borrower's ratios were 19.33/19.33 percent; after including the $112 monthly liabilities, his ratios increase to 19.33/22.59 percent, which remains below the HUD limits of 29/41 percent. The file does contain the proper documentation for the rental income.

HUD Requirements

HUD Handbook 4155.1, REV-4, CHG-1, section 2-7 (M)(2).
HUD Handbook 4155.1, REV-4, CHG-1, section 2-11(A).

Ratios and Compensating Factors

The borrower and coborrower filled out the application, stating that they were single, but both are married to other people; their relationship was not disclosed in the case binder, and there could be a nonoccupying borrower, affecting the maximum allowable loan-to-value ratio. The loan-to-value on this loan was 97.75, whereas it should have been limited to 75 percent unless the borrowers had a qualifying relationship.

HUD Requirements

HUD Handbook 4155.1, REV-4, CHG-1, section 1-8 (B).

Case number: 292-4439118

Loan purpose: Purchase

Underwriter type: Manual

Date of loan closing: October 22, 2003

Insured amount: $70,887

Housing/debt ratio: 29.04/38.80 percent

Status: Claim paid – not sold

HUD costs incurred: $72,905

Income and Employment History

American Lending failed to properly document income and employment history. The lender documented only one month of the borrower's amount of income, and 10 months of employment. The borrower had held his then current position for one month before closing. The borrower did not provide an explanation for the period before December 1, 2002.

American Lending later provided pay stubs and tax returns for the borrower that we previously obtained from the HUD file. The borrower's application stated that he earned $1,200 per month ($14,400 annually) during 2001 and 2002, but his tax returns showed that he earned considerably less. In addition, the borrower's pay stubs did not show the employer's name or a breakdown of the pay amount, and the year-to-date amount did not carry forward correctly from pay stub to pay stub. American Lending provided no explanation for these discrepancies. The borrower's average income for the prior two years is a better indicator of the borrower's income stream than one month of the borrower's new employment for which the pay stubs are questionable. The new documentation provided does not satisfy HUD's requirements.

HUD Requirements

HUD Handbook 4155.1, REV-4, CHG-1, section 2-6.

Ratios

The front and back ratios of 29.04 and 38.80 percent were derived from unsupported/unstable monthly income of $2,100. When calculated using the average income amount, the front and back ratios rise to 136 and 183 percent.

Office of Inspector General (OIG) Calculations:
25 months income = $5,971 (2001 tax return) + $1,920 (2002 tax return) + $3,325 (year-to-date on current pay stub, even though year-to-date does not carry forward correctly from pay stub to pay stub - manually computed, it would be $2,242) = $11,216.
Average monthly income = $11,216/25 = $449.
Front ratio = 610/449 = 136%.
Back ratio = 819/449 = 182%.

HUD Requirements

HUD Handbook 4155.1, REV-4, CHG-1, section 2-12 (B).
HUD Handbook 4155.1, REV-4, CHG-1, section 2-13.

Borrower Charges

The borrower was charged a $25 courier fee, which is not allowed for purchase loans.

HUD Requirements

The Homeownership Reference Guide, chapter 2, section 15, "Closing Cost Guidance."

Case number: 292-4371418 | Loan purpose: Purchase

Underwriter type: Manual | Date of loan closing: June 12, 2003

Insured amount: $163,927 | Housing/debt ratio: 23.29/41.93 percent

Status: Active – In Default | HUD costs incurred: 0

Assets/Funds to Close

According to the documentation in the file, the borrower was approved to receive a sum of $4,995 in gift funds through Better Family Life. The file did not contain evidence of the transfer of the gift funds. American Lending provided gift transfer documentation, but during our review of the documentation, it appeared that the nonprofit did not wire the gift funds, but instead the borrowers gift and the sellers donation were netted, and then the difference (the administration fee) was provided to the nonprofit by the title company. The nonprofit should provide the funds to the borrower, and the seller then donates funds to the nonprofit to benefit future borrowers. The process used to pass the funds to the borrower is questionable.

HUD Requirements

HUD Handbook 4155.1, REV-4, CHG-1, section 2-10 (C).

Credit History

The coborrower had an outstanding judgment of $365 on the credit report, and the lender provided no evidence of settlement. In addition, the borrowers had four accounts that were past due in the last two years before closing. One of the accounts was more than 90 days delinquent on two occasions. The remaining three accounts were delinquent 30 days or more on four occasions and 60 days or more on one occasion. The coborrower had a medical account that was 90 days late on 10 occasions. Also, the underwriter did not obtain a verification of rent form for the coborrower. The coborrower's driver's license, which was to expire the year following closing, had the address of the home being purchased, but this address did not appear on any of the coborrower's other documents; the underwriter should have followed up on this discrepancy.

HUD Requirements

HUD Handbook 4155.1, REV-4, CHG-1, section 2-3.
HUD Handbook 4155.1, REV-4, CHG-1, section 2-3 (A).

Case number: 292-4425828 | Loan purpose: Purchase

Underwriter type: Manual | Date of loan closing: September 10, 2003

Insured amount: $91,563 | Housing/debt ratio: 21.17/33.49 percent

Status: Claim paid – not sold | HUD costs incurred: $91,607

Income and Employment History

The lender did not document two-years of employment history for the borrower. The documentation provided by the lender documents only 16 months of the borrower's employment history and does not provide an explanation for the remaining eight months that were not documented. In response to our audit, the lender verified 4 additional months of employment by telephone, but was unsuccessful in further verification because the second employer listed on the application was out of business

HUD Requirements
HUD Handbook 4155.1, REV-5, CHG-1, section 2-6.

Assets/Funds to Close
According to the documentation in the file, the borrower was approved to receive a sum of $2,790 in gift funds through a nonprofit organization (Better Family Life). The file contained no evidence of the transfer of the gift funds.

HUD Requirements
HUD Handbook 4155.1, REV-5, CHG-1, section 2-10 (C).

Case number: 292-4358891

Loan purpose: Purchase

Underwriter type: Automated

Date of loan closing: June 20, 2003

Insured amount: $176,234

Housing/debt ratio: 16.33/49.99 percent

Status: Active – In Default

HUD costs incurred: 0

Income and Employment History
The loan prospector certificate and underwriting worksheet stated joint monthly income of $7,545. The total amount of income cannot be used because the income was not calculated according to HUD regulations. The borrower and coborrower earned a combined income of $54,292 and $49,676 in 2001 and 2002, respectively. The self-employed borrower and coborrower provided profit and loss statements from 2003 as documentation of their current income. HUD does not allow income verified by tax returns from previous years when an income stream increases considerably from the previous year to the current one. The borrowers estimated a joint income of $90,540 on an annual basis, which is far above the $49,676 they earned in 2002. Using the income verified by two years' tax returns, the monthly income is computed as follows:

$$\frac{54{,}292+49{,}676}{24 \text{ months}} = \frac{103{,}968}{24} = \$4{,}332 \text{ per month}$$

The income computed is $3,213 short of the claimed monthly income of $7,545. The borrower would not have obtained the loan if the computed income had been used.

Additionally, the underwriter failed to obtain a verification of employment; therefore, the application employment information could not be verified.

HUD Requirements
HUD Handbook 4155.1, REV-4, CHG-1, section 2-9 (A).
HUD Handbook 4155.1, REV-4, CHG-1, section 2-9 (C).
HUD Handbook 4155.1, REV-4, CHG-1, section 3-1 (E).

Ratios and Compensating Factors
The front and back ratios of 16.33 and 49.99 percent, respectively, were derived from incorrect monthly income of $7,545. When calculated using the corrected income amount, the front and back ratio are 28.44 and 87.07 percent, respectively. The back ratio of 87.07 percent violates HUD's limit of 41 percent. The underwriter did not present any compensating factors for this loan.

HUD Requirements
HUD Handbook 4155.1, REV-4, CHG-1, section 2-12 (B).
HUD Handbook 4155.1, REV-4, CHG-1, section 2-13.

Assets/Funds to Close
The underwriter failed to include a verification of deposit form and the borrower's most recent bank statements. According to the loan prospector document checklist, a bank statement showing the previous month's balance or two months' statements for each account was provided by the borrower, but these documents were not found in the file. American Lending later provided the borrower's bank statements for the two months before closing.

The loan prospector documentation stated the loan was submitted with $1,000 of depository accounts. The lender should have verified that the borrower had at least a balance of $1,000 at the time closing. The borrower's bank statement two months before closing has an ending balance of $1,436; the borrower's bank statement one month before closing has an ending balance of $635. Although American Lending provided the borrower's bank statements, the borrower did not have the amount upon which loan prospector based its approval.

According to the gift funds letter, underwriting worksheet, and the settlement statement, the borrower was approved to receive a sum of $5,370 in gift funds through a nonprofit organization (Better Family Life). The file contained no evidence of the transfer of the gift funds.

HUD Requirements
HUD Handbook 4155.1, REV-4, CHG-1, section 2-10 (B).
HUD Handbook 4155.1, REV-4, CHG-1, section 2-10 (C).
HUD Handbook 4155.1, REV-4, CHG-1, section 3-1 (F).

Case number: 292-4446965 | Loan purpose: Purchase

Underwriter type: Manual | Date of loan closing: November 13, 2003

Insured amount: $76,794 | Housing/debt ratio: 29.69/32.43 percent

Status: Claim paid - sold | HUD costs incurred: $81,154

Assets/Funds To Close
According to the gift funds letter, the settlement statement, and the underwriting worksheet, the borrower was approved to receive a sum of $2,340 in gift funds through a nonprofit organization (Better Family Life). The loan file contained no evidence of the transfer of the gift funds from the donor to the borrower.

HUD Requirements
HUD Handbook 4155.1, REV-4, CHG-1, section 2-10 (C).

Income and Employment History
The borrower's income was overstated. According to the documentation submitted, the borrower claimed a monthly income of $2,080. Based on the pay stubs submitted for 2003, the borrower earned $1,857 monthly as of October 31, 2003 ($18,570 year-to-date/10 months). Based upon the Internal Revenue Service W-2 form submitted for 2002, the borrower earned $1,402 monthly ($5,607/four months). The monthly income for the period was $1,727 when the income is averaged over a 14-month period ($18,570 + $5,607/14 = $1,727; September 2002-October 2003).

Also, the borrower provided documentation of 14 months of employment. HUD requires the documentation of two full years of employment with an explanation for any gaps during the two-year period. No explanation was provided for the remaining 10 months.

HUD Requirements
HUD Handbook 4155.1, REV-4, CHG-1, section 2-6.
HUD Handbook 4155.1, REV-4, CHG-1, section 2-7.

Credit History
The borrower displayed a negative payment history in regard to housing obligations. According to the verification of rent form in the file, the landlord did not know whether rent was paid for October 2003, and the borrower was $115 in arrears for her November 2003 rent. Additionally, the borrower had limited credit and was delinquent two months after opening a new account. The lender did not offer any compensating factors for approving the mortgage.

HUD Requirements
HUD Handbook 4155.1, REV-4, CHG-1, section 2-3.
HUD Handbook 4155.1, REV-4, CHG-1, section 2-3 (A).

Ratios and Compensating Factors
The front and back ratios in the file were calculated based upon the overstated income of $2,080 per month. When the front and back ratios are calculated using the actual monthly income of

$1,727, the front and back ratios rise from 29.69 and 32.43 percent, respectively, to 35.76 and 39.06 percent, thereby exceeding the HUD limit for the front ratio of 29 percent. The lender did not offer any compensating factors for approving the mortgage.

OIG Calculations:
$617.54 total mortgage payment/$1,727 = 35.76 percent; $674.54 total fixed payment/$1,727 = 39.06 percent.

HUD Requirements
HUD Handbook 4155.1, REV-4, CHG-1, section 2-12.
HUD Handbook 4155.1, REV-4, CHG-1, section 2-13.

Case number: 137-2985860

Loan purpose: Purchase

Underwriter type: Manual

Date of loan closing: July 19, 2004

Insured amount: $162,450

Housing/debt ratio: 36.20/36.20 percent

Status: Active – In Default

HUD costs incurred: 0

Assets/Funds to Close
The loan file did not contain documentation required for proper verification of deposit. The file contained bank statements for periods covering February 14, 2004, through March 18, 2004, and October 21, 2003, through November 14, 2003, and October 16, 2003, through November 10, 2003, for a second account. The file also contained verifications of deposit for May 2004 and June 2004. The borrower closed on the loan on July 19, 2004. The most recent bank statement provided by the borrower was more than 120 days before the closing date. Although the verification of deposit showed that the ending balance was just enough to close, the average balance was $3,000 lower. Without current statements, the underwriter could not check for large unexplained deposits.

HUD Requirements
HUD Handbook 4155.1, REV-5, CHG-1, section 2-10 (B).
HUD Handbook 4155.1, REV-5, CHG-1, section 3-1.
HUD Handbook 4155.1, REV-5, CHG-1, section 3-1(F).

Case number: 292-4419136

Loan purpose: Purchase

Underwriter type: Manual

Date of loan closing: September 15, 2003

Insured amount: $116,669

Housing/debt ratio: 34.37/43.72 percent

Status: Claim paid – not sold

HUD costs incurred: $117,543

Income/Employment History
The loan file did not contain a verification of employment form, indicating that the borrower's employment history was verified. The file did contain the borrower's check stubs for a 30-day period, as well as Internal Revenue Service W-2 forms for the two previous years, but no telephone verification of employment was found in file. In response to our audit, American Lending obtained a telephone verification of employment. The file also did not contain documentation to support the $500 in monthly alimony/child support income claimed on the borrower's application.

HUD Requirements
HUD Handbook 4155.1, REV-4, CHG-1, section 2-7(F).
HUD Handbook 4155.1, REV-4, CHG-1, section 3-1(E).

Ratios and Compensating Factors
The front and back ratios are 34.37 and 43.72 percent, respectively, which exceed the limits set by HUD. The lender did not offer any compensating factors for approving the mortgage with ratios exceeding HUD's limits. When we subtract the unsupported alimony/child support income, the borrower's front and back ratios rise to 42.04 and 53.48 percent, respectively.

OIG Calculations:
Front ratio = $941 total mortgage payment/$2,238 = 42.04 percent; back ratio = $1196.96 total fixed payments/$2,238 = 53.48 percent.

Criteria
HUD Handbook 4155.1, REV-4, CHG-1, section 2-12.
HUD Handbook 4155.1, REV-4, CHG-1, section 2-13.

Assets/Funds to Close
According to the gift funds letter, the settlement statement, and the underwriting worksheet, the borrower was approved to receive a sum of $3,555 in gift funds through a nonprofit organization (Better Family Life). The loan file contained no evidence of the transfer of the gift funds from the donor to the borrower.

HUD Requirements
HUD Handbook 4155.1, REV-4, CHG-1, Section 2-10 (C).

Credit History
The file did not contain a verification of rent form to verify the borrower's payment history of housing obligations covering the most recent 12-month period. Also, the borrower had a poor credit history, evidenced by a 36-month delinquency on a Famous Barr account. This delinquency increased the credit risk posed by the borrower.

HUD Requirements
HUD Handbook 4155.1, REV-4, CHG-1, section 2-3.
HUD Handbook 4155.1, REV-4, CHG-1, section 2-3 (A).
HUD Handbook 4155.1, REV-4, CHG-1, section 2-3 (C).

Appendix E

CRITERIA

HUD Handbook 4000.2, REV-2, Section 2-19
Repair requirements outstanding on the conditional commitment must be satisfied before the mortgage is submitted for endorsement. If adverse weather conditions prevent completion of the repairs, the loan may be submitted for insurance if a repair escrow is established and the lender provides a mortgagee's assurance of completion.

HUD Handbook 4004.4, REV-1, CHG-2, Section 2-4 (C)
Underwriters determine the overall acceptability of the loan for HUD insurance and are required to perform underwriting decisions with due diligence in a prudent manner. Underwriters must review all credit analyses performed by fee and staff personnel to ensure reasonable conclusions, sound reports, and compliance with HUD requirements. Underwriters must have an awareness of warning signs that may indicate irregularities and the ability to detect fraud.

HUD Handbook 4004.4, REV-1, CHG-2, Section 2-13
Loan correspondents may take the initial application, assign an appraiser, obtain credit reports, order verifications, and close the loan after it has been underwritten. A direct endorsement-approved sponsor must perform the underwriting function. Loan correspondents cannot perform any underwriting function including mortgage credit examination.

HUD Handbook 4155.1, REV-4, CHG-1, Section 1-8 (B)
Certain types of loan transactions affect the amount of financing available and the calculation of the maximum mortgage. These include identity-of-interest transactions, properties with nonoccupying coborrowers, three- and four-unit properties, properties for which the house is being constructed by the borrower on his or her own land or as a general contractor and land contract transactions. Unless otherwise stated, the mortgage calculation procedures described previously also apply, including the limits applied to the appraised value excluding closing costs.

(B) Nonoccupying Coborrowers.
When there are two or more borrowers, but one or more will not occupy the property as a principal residence, the maximum mortgage is limited to 75 percent loan-to-value. However, maximum financing is available for borrowers related by blood (parent-child, siblings, aunts-uncles/nieces-nephews, etc.) or for unrelated individuals that can document evidence of a family type, longstanding and substantial relationship not arising out of the loan transaction. The occupying borrower must sign the security instrument and mortgage note.

HUD Handbook 4155.1, REV-4, CHG-1, Section 2-3
Past credit performance serves as the most useful guide in determining the attitude toward credit obligations that will govern the borrower's future actions. A period of financial difficulty in the past does not necessarily make the risk unacceptable if a good payment record has been maintained since. When delinquent accounts are revealed, the lender must determine whether the late payments were due to a disregard for or an inability to manage financial obligations or to

factors beyond the control of the borrower. Major indications of derogatory credit, including judgments and collections, and any other recent credit problems require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

For borrowers who do not use traditional credit or have not yet established a credit history, lenders must develop a credit history using alternate documentation. Alternate credit documentation includes utility payment records, rental payments, automobile insurance payments, and other means of direct access from the credit provider.

The basic hierarchy of credit evaluation is the manner of payments made on previous housing expense, including utilities, followed by the payment of installment debts, then revolving accounts. Generally, an individual with no late housing or installment debt payments should be considered as having an acceptable credit history.

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-3 (A)</u>
Lenders must determine the borrower's payment history of housing obligations either directly from the landlord, through the credit report, or using canceled checks covering the most recent 12-month period.

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-3 (B)</u>
Lenders must obtain an explanation from the borrower for all recent inquiries shown on the credit report.

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-6</u>
Lenders must verify the borrower's employment for the most recent two full years. To analyze the probability of continued employment, lenders must examine the borrower's past employment record, qualifications for the position, previous training and education, and the employer's confirmation of continued employment. A borrower who changes jobs frequently within the same line of work but continues to advance in income or benefits should be considered favorably. Income stability takes precedence over job stability.

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-7</u>
Lenders must analyze the income of each borrower to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage loan.

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-7 (A)</u>
Overtime income may be included in the qualifying ratios if the borrower has received such income for approximately two years and there are reasonable prospects of its continuance. Lenders are required to develop an earnings trend and must provide a sound rationalization when including overtime income that has continually declined.

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-7(F)</u>
Alimony, child support, or maintenance income: Income in this category may be considered as effective if such payments are likely to be consistently received for the first three years of the mortgage. The borrower must provide a copy of the final divorce decree, legal separation

agreement, or voluntary payment agreement, as well as evidence that payments have been received during the last 12 months. Acceptable evidence of payment regularity includes canceled checks, deposit slips, tax returns, and court records. Periods less than 12 months may be acceptable, provided the buyer's ability and willingness to make timely payments is adequately documented by the lender.

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-7 (M)(2)</u>
Rent received for properties owned by the borrower may be acceptable, subject to proper documentation. A separate schedule of real estate is not required provided all properties are shown on the application. The rental income may be considered as effective income if shown on the borrower's tax returns. Otherwise, the income may only be considered as a compensating factor and must be adequately documented by the lender. The following is required to verify rental income:

Current leases: If a property was acquired since the last income tax filing and is not shown on Schedule E, a current, signed lease or other rental agreement must be provided. The gross rental amount must be reduced for vacancies and maintenance by 25 percent (or the percentage developed by the Federal Housing Administration office having jurisdiction where the property is located) before subtracting principal, interest, taxes, insurance, and any homeowners' association dues, etc., and applying the remainder to income (or recurring debts, if negative).

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-9 (A)(2)</u>
Income from borrowers self-employed for less than one year may not be considered as effective income.

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-9 (B)</u>
Self-employment income must be documented using the year-to-date balance sheet and profit-and-loss statement. The borrower must provide signed and dated individual tax returns for the most recent two years, including all applicable schedules.

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-9 (C)</u>
The lender must establish the borrower's earnings trend over the previous two years but may average the income over three years if all three years' tax returns are provided. If the borrower provides quarterly tax returns, the analysis can include income through the period covered by the tax filings. If the borrower is not subject to quarterly tax filings or does not file quarterly returns (Internal Revenue Service form IRS 1040 ES), the income shown on the profit and loss statement may be included in the analysis, provided the income stream based on the profit and loss statement is consistent with the previous years' earnings. If the profit and loss statements submitted for the current year show an income stream considerably greater than what is supported by the previous years' tax returns, the analysis of income must be predicated solely on the income verified through the tax returns.

<u>HUD Handbook 4155.1, REV-4, CHG-1, Section 2-10</u>
Lenders must verify all funds for the borrower's investment in the property. The borrower's investment in the property is the difference between the amount of the insured mortgage,

excluding any up-front mortgage insurance premium, and the total cost to acquire the property, including prepaid expenses.

HUD Handbook 4155.1, REV-4, CHG-1, Section 2-10 (A)
Lenders must verify the amount and source of funds for earnest money deposits which appear excessive based on the borrower's history of accumulated savings or exceed 2 percent of the sales price. To document the amount of funds, lenders may use a copy of the borrower's canceled check or a certification from the deposit holder acknowledging receipt of funds. To document the source of funds, lenders may use a verification of deposit or bank statement showing that the average balance was sufficient to have included the earnest money deposit.

HUD Handbook 4155.1, REV-4, CHG-1, Section 2-10 (B)
Lenders must document depository accounts (savings and checking) using a verification of deposit along with the most recent bank statement. If there is a large increase in an account, the lender must obtain an explanation and evidence the source of funds for the deposits.

HUD Handbook 4155.1, REV-4, CHG-1, Section 2-10 (C)
Lenders must document the transfer of gift funds from the donor to the borrower. Acceptable documentation includes a donor's withdrawal slip or cancelled check, along with the borrower's deposit slip or bank statement showing the deposit. If the funds are not deposited to the borrower's account before closing, the lender must obtain verification that the settlement agent received the gift from the donor.

HUD Handbook 4155.1, REV-4, CHG-1, Section 2-11 (A)
The borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other additional recurring charges including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc., extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing.

HUD Handbook 4155.1, REV-4, CHG-1, Section 2-12
Ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. HUD requires underwriters to compute ratios of the borrower's mortgage payment expense to effective income and total fixed payment to effective income. The borrower's total mortgage payment includes principal and interest and escrow deposits for real estate taxes, hazard insurance premiums, homeowners' association dues, and mortgage insurance premiums. The borrower's total fixed payment is comprised of the borrower's total mortgage payment and all recurring charges. The borrower's ratios are considered acceptable if the total mortgage payment and total fixed payment do not exceed 29 and 41 percent of gross monthly income, respectively. Ratios exceeding these benchmarks may be considered acceptable if significant compensating factors are presented.

HUD Handbook 4155.1, REV-4, CHG-1, Section 2-13

The following compensating factors may be used in justifying approval of mortgage loans with ratios exceeding the 29 and 41 percent benchmarks. Underwriters must state the compensating factors used to support loan approval on the "remarks" section of the underwriting worksheet.

- The borrower has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage.
- The borrower makes a large downpayment toward the purchase of the property.
- The borrower has demonstrated a conservative attitude toward the use of credit and an ability to accumulate savings.
- Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses.
- The borrower receives compensation or income not reflected in effective income but directly affecting the ability to pay the mortgage, including food stamps and similar public benefits.
- There is only a minimal increase in the borrower's housing expense.
- The borrower has substantial cash reserves after closing.
- The borrower has substantial nontaxable income (if no adjustment was made previously in the ratio computations).
- The borrower has potential for increased earnings, as indicated by job training or education in the borrower's profession.
- The home is being purchased as the result of relocation of the primary wage earner, and the secondary wage earner has an established history of employment and is expected to return to work.

HUD Handbook 4155.1, REV-4, CHG-1, Section 3-1

The loan package submitted for insurance endorsement is expected to contain sufficient documentation to support the lender's decision to approve the mortgage loan. When standard documentation does not provide enough information to support the approval decision, the lender must provide additional explanatory statements, consistent with other information in the application, to clarify or supplement the documentation submitted by the borrower. Verification forms must pass directly between lender and provider without being handled by any third party.

HUD Handbook 4155.1, REV-4, CHG-1, Section 3-1(E)

Lenders are required to obtain a verification of employment and the most recent pay stub to document borrower income. If the lender does not obtain a verification, it must obtain pay stubs covering the most recent 30-day period along with original copies of the previous two years' Internal Revenue Service W-2 forms. The pay stub(s) must show the borrower's name, Social Security number, and year-to-date earnings. Any copies of the W-2 form not submitted with the borrower's income tax returns are considered "original" W-2s. (These original documents may be photocopied and returned to the borrower.) The lender also must verify by telephone all current employers. The loan file must include a certification from the lender that original documents were examined and the name, title, and telephone number of the person with whom employment was verified.

HUD Handbook 4155.1, REV-4, CHG-1, Section 3-1 (F)

As an alternative to obtaining a verification of deposit, the lender may choose to obtain from the borrower original bank statement(s) covering the most recent three-month period. Provided the bank statement shows the previous month's balance, this requirement is met by obtaining the two most recent consecutive statements. Verification of deposit and the most recent bank statements are to be provided. "Most recent" means at the time the initial loan application is made. Provided the document is not more than 120 days old when the loan closes (180 days old on new construction), it does not have to be updated.

HUD Handbook 4155.1, REV-5, CHG-1, Section 2-10 (C)
An outright gift of the cash investment is acceptable if the donor is the borrower's relative, the borrower's employer or labor union, a charitable organization, a governmental agency or public entity that has a program to provide homeownership assistance to low- and moderate-income families or first-time homebuyers, or a close friend with a clearly defined and documented interest in the borrower. The gift donor may not be a person or entity with an interest in the sale of the property, such as the seller, real estate agent or broker, builder, or any entity associated with them. Gifts from these sources are considered inducements to purchase and must be subtracted from the sales price. No repayment of the gift may be expected or implied.

The lender must document the gift funds by obtaining a gift letter, signed by the donor and borrower, that specifies the dollar amount of the gift; states that no repayment is required; shows the donor's name, address, and telephone number; and states the nature of the donor's relationship to the borrower. In addition, the lender must document the transfer of funds from the donor to the borrower.

Mortgage lenders are responsible for assuring that the gift to the homebuyer from the charitable organization meets the appropriate Federal Housing Administration requirements and the transfer of funds is properly documented.

Homeownership Reference Guide, Chapter 2, Section 15, "Closing Cost Guidance"
Any lock-in or commitment agreement for which a fee is charged must be in writing and must guarantee the rate and/or discount points for a period of not less than 15 days before the anticipated closing date. Lock-in fees may be paid by the borrower but not financed in the mortgage or part of the 3 percent minimum cash investment.

A courier fee may be charged only on refinances and only for delivery of the mortgage payoff to the lien holder and for closing documents to the settlement agent. The borrower must agree in writing to pay for the courier service, and the request must be made before loan closing.

HUD Mortgagee Letter 00-28
Assets such as 401(k)s, IRAs (individual retirement account), and thrift savings plans may be included in the underwriting analysis up to 60 percent of value unless the borrower provides credible evidence that a higher percentage may be withdrawn after subtracting taxes and penalties.

Fannie Mae's Desktop Underwriter User's Guide for FHA Loans, Chapter 2
The lender is accountable for compliance with all Federal Housing Administration guidelines, as well as for any eligibility requirements, credit capacity, and documentation requirements not

covered in the user's guide. The data entered into the automated system must be true, accurate, and complete.

Fannie Mae's Desktop Underwriter User's Guide for FHA Loans, Chapter 4
The lender must comply with all messages and conditions listed on the automated underwriting findings report. Additionally, the lender must review the credit report to confirm that the data evaluated by the system were accurate.