



Issue Date August 20, 2008

Audit Report Number 2008-KC-1004

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

//signed//

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

SUBJECT: Peoples Bank Did Not Follow HUD’s Requirements When Underwriting Nine
FHA Loans and Implementing Its Quality Control Program

HIGHLIGHTS

What We Audited and Why

We reviewed 23 Federal Housing Administration (FHA) loans underwritten by Peoples Bank of Overland Park, Kansas. Our audit objectives were to determine whether Peoples Bank followed U.S. Department of Housing and Urban Development (HUD) requirements for (1) borrower eligibility and creditworthiness and property eligibility when underwriting loans and (2) implementing a quality control program.

We audited Peoples Bank because of its high 30-day delinquency rate. From January 2006 through December 2007, Peoples Bank originated 571 FHA loans, valued at \$65.5 million. During this same period, 112 of the loans (19.6 percent) had been at least 30 days delinquent (past due) during our audit period.

What We Found

Peoples Bank did not follow HUD’s requirements when underwriting nine FHA loans. These loans had material underwriting deficiencies that affected the insurability of the loans. In addition, Peoples Bank’s quality control plan did not

contain all of HUD's required elements, and Peoples Bank did not fully implement the elements in its quality control program.

What We Recommend

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner require Peoples Bank to indemnify HUD for eight actively insured loans with unpaid principal balances totaling \$905,908 and reimburse HUD for one loan for which HUD incurred losses totaling \$41,938 when it sold the property. We also recommend that HUD verify that Peoples Bank has implemented an adequate supervisory structure and adequately trained its underwriters regarding HUD requirements for FHA loans. Further, we recommend that HUD ensure that Peoples Bank implements a revised quality control plan that meets HUD requirements and develops and implements procedures to monitor its quality control contractor.

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

Peoples Bank generally agreed that deficiencies existed in its underwriting, loan documentation, and quality control program but considered the deficiencies minor. Therefore, it disagreed with the recommendations related to the underwriting deficiencies and stated that it had begun to make changes to its quality control program. We provided the draft report to Peoples Bank on June 10, 2008, and requested a response by July 15, 2008. It provided written comments on July 15, 2008.

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

Peoples Bank is a Federal Housing Administration (FHA)-approved direct endorsement lender based in Overland Park, Kansas. It became an authorized FHA loan originator in March 1994. Peoples Bank has branch offices in Lawrence, Louisburg, Ottawa, and Paola, Kansas, and in Albuquerque and Taos, New Mexico.

Peoples Bank participates in HUD's Lender Insurance program. The Lender Insurance program enables high-performing FHA-approved direct endorsement lenders with acceptable default and claim rates to endorse FHA loans without a preendorsement review being conducted by FHA. The program also eliminates the lender's submission of case binders to FHA.

From January 2006 through December 2007, Peoples Bank originated 571 FHA loans, valued at \$65.5 million. During this same period, 112 of the loans (19.6 percent) were at least 30 days delinquent. There were also two claims against the FHA insurance fund during this period.

Our audit objectives were to determine whether Peoples Bank followed HUD requirements for (1) borrower eligibility and creditworthiness and property eligibility when underwriting loans and (2) implementing a quality control program.

RESULTS OF AUDIT

Finding 1: Peoples Bank Did Not Follow HUD Requirements When Underwriting Nine FHA Loans

Peoples Bank did not follow HUD's requirements when underwriting nine FHA loans. This occurred because Peoples Bank senior management did not adequately supervise underwriters approving FHA loans or ensure that underwriters were adequately trained regarding HUD requirements. As a result HUD insured nine loans that unnecessarily placed the FHA insurance fund at risk.

Underwriting Did Not Meet HUD Standards

Peoples Bank did not follow HUD's requirements when underwriting nine FHA loans. FHA-approved lenders must follow HUD Handbook 4155.1, REV-5, Mortgage Credit Analysis for Mortgage Insurance, One- to Four-Family Properties, and HUD mortgagee letters when underwriting FHA loans. Appendix C provides details of HUD underwriting requirements.

The underwriting deficiencies primarily involved the following:

Overstated/Unsupported Income

Peoples Bank did not always properly assess income for borrowers. Borrower income was either overstated or not adequately supported in five loans. Lenders must accurately assess borrower income to make informed decisions on income stability and the borrower's ability to repay the mortgage.

For example, in case number 183-0055148, Peoples Bank overstated the borrower's income by \$638 per month when it used income of \$4,818 to evaluate the borrower's ability to repay the mortgage. The borrower supported income of only \$4,180 per month. The supported monthly income resulted in the borrower's total debt ratio increasing to 48.3 percent, well above HUD's limit of 43 percent, and increased the risk that the borrower would be unable to repay the mortgage.

Unpaid Judgments

Peoples Bank did not always adequately assess borrower credit histories. Borrower credit histories reflected unpaid judgments in two loans. HUD requires judgments to be paid in full for a loan to be eligible for FHA insurance. HUD makes an exception if the borrower has agreed with the creditor to make regular and timely payments on the judgment and the borrower provides evidence that he or she has made required payments in accordance with the agreement.

For example, in case number 181-2179272, Peoples Bank did not adequately assess the documentation for a borrower who had an unpaid judgment of \$2,556 on his credit report. About three years before the FHA loan closing, the borrower's nonpurchasing spouse agreed to make monthly payments to the creditor to repay the judgment. However, the spouse had missed about 20 payments during those three years, with six of the missed payments being in the year before the FHA loan closing. Therefore, the homeowners had not met their commitment to repay the judgment as agreed.

Missing Verification of Mortgage Payments

Peoples Bank did not obtain a verification of prior mortgage payments for two loans in which the borrowers refinanced from conventional loans to FHA loans. HUD generally requires lenders to obtain a verification of previous rental or mortgage payment history for all FHA loan packages, except certain streamline refinances. In addition, HUD does not allow refinanced loans to include delinquent interest, late charges, or escrow shortages.

For example, in case number 183-0053891, Peoples Bank did not obtain a verification of payments for the borrower's prior mortgage although there was evidence in the loan file that the borrower was past due on the mortgage being refinanced. The borrower's bank statement reflected that the borrower had made three monthly mortgage payments in the month before the FHA loan closing. Also, the prior mortgage was listed as a derogatory account on the borrower's credit report. Further, the borrower's credit report reflected a principal balance of \$26,576 for the prior mortgage. However, the payoff statement from the prior lender showed a payoff amount of \$34,737, indicating that there may have been delinquent interest, late charges, or escrow shortages included in the payoff of the prior mortgage.

Underwriters Were Not Adequately Supervised or Trained

Peoples Bank senior management staff did not adequately supervise their underwriters. During our audit period, the senior underwriter was also the operations manager for the entire mortgage department, overseeing the processing of all mortgage loans (conventional and government). She also directly supervised a junior underwriter and four loan processors. Because of this management structure, no one reviewed the senior underwriter's work, and she had no other person to consult when evaluating compliance with HUD underwriting requirements.

Senior management staff told us that they began planning operational changes in July 2007. They also told us that they planned to have a contractor perform an underwriting review on the bank's FHA loans in addition to the conventional

loans that the contractor was already reviewing. Peoples Bank began making the planned operational changes affecting its underwriting processes in February 2008, about the same time as we began our audit work.

Senior management staff also told us that FHA loan volume had recently increased and the managers had identified a need for the senior underwriter to concentrate her efforts solely on underwriting. As a result, Peoples Bank hired a new operations manager with underwriting experience to supervise the senior underwriter.

Peoples Bank also did not adequately train its underwriters regarding HUD requirements. HUD requires lenders to ensure that underwriters are adequately trained and have completed a direct endorsement training program. The senior underwriter told us that she had participated in various FHA training classes. However, she did not know that she was required to manually underwrite loans with full documentation when the automated underwriting systems rejected or referred loans. She also told us that she was not aware of the HUD requirement to verify rental or mortgage payment history as part of a borrower's credit history.

Although senior management staff had identified and changed the inadequate supervisory structure, they were unaware that the senior underwriter was underwriting FHA loans that did not meet HUD's standards. However, the mortgage operations manager told us that Peoples Bank had scheduled the senior underwriter for upcoming FHA training.

Loans Containing Material Deficiencies Were Submitted for FHA Insurance

HUD cannot be assured that borrowers are eligible for FHA insurance on their loans when lenders do not properly monitor their underwriting efforts.

Peoples Bank had submitted for FHA insurance nine loans with material deficiencies that had unpaid principal balances of about \$1 million as of May 2008. Therefore, HUD insured nine loans that should not have been insured. The loans unnecessarily placed the FHA insurance fund at risk for more than \$350,000 in potential losses and nearly \$42,000 in losses already incurred.

Recommendations

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

- 1A. Require Peoples Bank to indemnify HUD for eight actively insured loans with unpaid principal balances totaling \$905,908. The projected loss is \$353,304 based on the FHA insurance fund average loss rate of 39 percent for fiscal year 2007 (see appendix D).
- 1B. Require Peoples Bank to reimburse HUD for one loan for which HUD incurred losses totaling \$41,938 when it sold the property (see appendix D).
- 1C. Verify that Peoples Bank has implemented an adequate supervisory structure that allows managers to identify and mitigate underwriting problems and prevents Peoples Bank from submitting loans for insurance endorsement that do not meet HUD requirements.
- 1D. Verify that Peoples Bank has adequately trained its underwriters regarding HUD requirements for FHA loans, including requiring it to provide HUD with evidence that its underwriters have received recent, acceptable training.

Finding 2: Peoples Bank's Quality Control Program Did Not Meet HUD Requirements

Peoples Bank's quality control program did not meet HUD requirements. This occurred because its managers were not aware of all HUD requirements and did not monitor their quality control contractor. As a result, Peoples Bank could not ensure the accuracy, validity, and completeness of its loan originations.

Quality Control Process Did Not Meet HUD Standards

Peoples Bank's quality control program did not meet HUD requirements. HUD Handbook 4060.1, REV-2, states that all FHA-approved lenders must implement and continuously have in place a quality control plan for the origination of insured mortgages as a condition of receiving and maintaining FHA approval. Further, the handbook establishes several basic elements that are required in all quality control programs (appendix C, items 3-15, provide the detailed HUD quality control requirements).

Peoples Bank's quality control plan lacked six required elements. The plan did not require the scope of quality control reviews to include all loan originators, appraisers, or FHA loan programs. The plan also did not require the lender to

- Use the reporting feature in HUD's Neighborhood Watch database when notifying HUD of material deficiencies or fraud;
- Retain quality control review reports, including actions taken, for a period of two years and have the reports available to HUD upon request;
- Verify the identity of the loan applicant;
- Review all early payment defaults (loans that defaulted within the first six payments due); and
- Conduct an occupancy reverification for cases in which the occupancy of the subject property was suspect.

Further, Peoples Bank did not fully implement the elements in its quality control plan. The lender did not provide FHA loan files to its quality control contractor in a timely manner. As a result, the contractor was not able to review loans within 90 days of the month of closing, and not all of the quality control reports that should have been available for our review were available. Peoples Bank also did not ensure that its quality control contractor performed reviews of its branch offices or that the contractor reviewed 10 percent of its FHA-insured loans.

Managers Were Unaware of All HUD Requirements and Did Not Monitor Their Contractor

Peoples Bank managers were not aware of all HUD requirements and did not monitor their quality control contractor. The operations manager for the period of our audit told us that she was unaware that the quality control plan did not contain all of HUD's required elements and that she relied on the contractor to follow HUD requirements.

Without a properly implemented quality control program, the lender could not ensure that it

- Complied with HUD requirements when originating loans;
- Protected itself and HUD from unacceptable risk; and
- Guarded against errors, omissions, and fraud.

As a result, HUD lacked assurance that Peoples Bank identified and corrected potential deficiencies in its loan origination process before submitting loans for FHA insurance.

Recommendations

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

- 2A. Ensure that Peoples Bank implements a revised quality control plan that contains all of the elements that HUD requires.
- 2B. Ensure that Peoples Bank develops and implements procedures to monitor its quality control contractor.

SCOPE AND METHODOLOGY

To accomplish our objectives, we reviewed HUD and Peoples Bank's underwriting policies and procedures. We interviewed Peoples Bank management and staff and HUD staff. We also reviewed Peoples Bank's quality control plan and quality control reports.

Our audit period was January 1, 2006, through December 31, 2007. During this timeframe, Peoples Bank originated 571 FHA loans. Of the 571 loans, 112 became at least 30 days delinquent during our audit period, and 25 of the 112 reached a 90-day defaulted status. We reviewed Peoples Bank's loan files for 23 of the 25 defaulted loans. We did not review two loans for which the FHA insurance was terminated and the loans no longer posed a risk to the FHA insurance fund.

When identifying underwriting deficiencies, we assessed whether the deficiencies were material and should have caused the lender to disapprove the loan. We considered any deficiencies that affected the approval and insurability of the loans as significant and recommend that HUD take appropriate action on these loans. When identifying underwriting deficiencies that we considered minor, we informed Peoples Bank of the deficiencies but have not recommended that HUD take action on these loans.

We relied on computer-processed data contained in HUD's Single Family Data Warehouse system. During the audit, we assessed the reliability of the data and found the data to be adequate. We also performed sufficient tests of the data, and based on the assessments and testing, we concluded that the data were sufficiently reliable to be used in meeting our objectives.

We assigned a value to the potential savings to HUD if it implements our recommendations to require Peoples Bank to indemnify loans with material deficiencies. For those loans for which HUD had not yet incurred a loss, we applied FHA's average loss experience for fiscal year 2007 provided by HUD. We calculated the savings value at \$353,304 for those properties currently actively insured, which is 39 percent of the unpaid principal balance of \$905,908.

We performed audit work from February through May 2008 at the Peoples Bank mortgage operations branch office in Stanley, Kansas. We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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 to ensure that direct endorsement underwriters are adequately trained.
- Controls to ensure adequate supervision of direct endorsement underwriters.
- Controls to ensure that the quality control program has been implemented and the quality control contractor is adequately monitored for compliance with HUD requirements.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

Based on our review, we believe the following items are significant weaknesses:

- Peoples Bank did not adequately supervise and train its direct endorsement underwriters (finding 1).
- Peoples Bank did not have adequate controls in place to ensure that it followed HUD requirements when implementing its quality control program (finding 2).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A		\$ 353,304
1B	\$ 41,938	

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/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs 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 recommendations to require Peoples Bank to indemnify HUD for materially deficient loans will reduce the risk of loss to the FHA insurance fund. The amount above reflects that, upon sale of the mortgaged property, FHA's average loss experience is about 39 percent of the unpaid principal balance based upon statistics provided by HUD.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Peoples
Banking Unusual

BANKING • MORTGAGE • WEALTH MANAGEMENT

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July 15, 2008

**U.S. Department of Housing
and Urban Development
Office of Inspector General
Region 7 Office of Audit
Gateway Tower II – 5th Floor
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Kansas City, Kansas 66101-2406**

Attn: Kim Randall
Assistant Regional Inspector General

Dr. Kim

Thanks for the opportunity to respond to the issues raised by the OIG office in your Audit dated June 10, 2008. Attached you will find our formal response as well as supporting documentation we feel is pertinent to our response.

If you have any questions regarding this response please call me at 913-239-1708.

Thanks again,



Douglas N. Starkweather
Senior Vice-President
Loan Operations Manger

Peoples Bank

** We provided HUD officials with the attachments that Peoples Bank included with its written response. Due to the sensitive nature and volume of the attachments, we have not included them in the report but can provide them upon request. In addition, we redacted borrower's names from the auditee comments to protect their privacy.

**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, Kansas 66101-2406

Attn: Kim Randall
Assistant Regional Inspector General

Dear Kim,

Peoples Bank appreciates the opportunity to respond to the issues raised by the OIG office in this audit report. While Peoples Bank agrees that there may be some minor deficiencies in the underwriting or documentation of the files, and in our quality control plan, we believe that the recommendation that Peoples indemnify HUD with respect to the nine loans is unwarranted, and that its underwriters made reasonable underwriting judgments in approving the loans, taking into account all the facts and circumstances of each loan.

I. Introduction.

Peoples Bank is a state chartered, federally regulated bank that has originated FHA loans since 1994. As a federally regulated bank, we are subject to a much higher level of scrutiny than most FHA lenders. Peoples Bank has embraced FHA lending as a means to provide homeownership opportunities for all segments of our society-as long as the risk is mitigated by sound underwriting principles. I believe this is one of the underlying tenets of the FHA program. Peoples Bank has been proactive in providing ample training for its entire mortgage operations staff to ensure that potential losses to the FHA insurance program are minimized as we will demonstrate in this letter.

While the 30 day delinquency rate is higher than desirable, the implication that the delinquency rate is attributable to the issues documented in the audit report is unsupported. The fact is (unlike previous business cycles) delinquency rates are not being driven by credit issues or any other issue addressed in the audit report. It has been irrefutably documented that the decline in housing prices has impacted delinquency rates more than any other factor.

Peoples Bank can not be held responsible for the impact of the housing market and its affect on the delinquency rates throughout its lending area. We can not anticipate the economic or familial issues that lead to these delinquencies, and nor should we.

While their may be some technical deficiencies in the underwriting/documentation of certain loans in the audit report, many of these issues are

Comment 1

disagreements over underwriting judgments, aided by 20/20 hindsight. Peoples will demonstrate that its underwriters approved the loans within the range of reasonable underwriter judgment.

II. The quality control Plan was adequate and is being improved.

The quality control plan may not have met all of the HUD's requirements, but in our opinion these discrepancies are minor. Nonetheless, as a result of the audit, Peoples Bank will analyze the quality control program to ensure that all elements comply with HUD guidelines.

Peoples Bank is in the process of revising its quality control plan to meet all of HUD's requirements. Peoples Bank has implemented a procedure to monitor its quality control contractor by routing all correspondences and findings from the contractor through the Bank's independent internal audit department (rather than through the mortgage department). In addition Peoples Bank is in the process of replacing the quality control contractor with a vendor that we expect will improve compliance with HUD requirements.

We disagree with HUD's assertion that the scope of the existing quality control plan did not include all loan originators, appraisers, or FHA loan programs. However, as a result of this audit, we are reviewing the HUD handbook to ensure that at a minimum, all elements required for FHA-approved lenders are in place (including the six required elements reported by the OIG). Peoples Bank will craft a new quality control plan which incorporates all elements required by HUD; and Peoples Bank will monitor the performance of the underwriters and the mortgage department as a whole to ensure the quality control plan is being followed.

III. The Supervisory structure of Peoples with respect to Underwriting was adequate and is being improved.

It should be noted that in the modern business environment most companies strive for a flatter corporate structure for many reasons. Layers of management are eliminated to enhance profitability and to eliminate unnecessary impediments to address the concerns of the customer. Peoples Bank strives to provide the best service for our customers in our market by empowering employees. However, Peoples Bank has for the last year contemplated and planned to modify its supervisory structure. In March an operation manager position was created and filled. This allowed the underwriting manager to focus solely on underwriting and freed her of the responsibility of managing the department. The operations manager (a DE underwriter) also reviews the files to ensure that they are being underwritten per FHA guidelines. In addition, Peoples Bank has recently recruited and hired an additional experienced underwriter with outstanding qualifications.

Peoples Bank senior underwriter has been underwriting FHA insured loans for 12 years. She is a highly respected member of the mortgage lending community in Kansas

City; and is in fact, a past president of the Kansas City Mortgage Bankers Association. She has been personally active in providing FHA training to other companies in the Kansas City area and has routinely participated in local and national level training. She has participated in many past conferences and her attendance at the Government Lending Council in Washington D.C. in June had been scheduled well in advance of this audit.

The senior underwriter is a member of the following Professional associations in Kansas City:

- Mortgage Bankers association of Kansas City (a 5 year board member and past 2005 president);
- Mortgage Bankers association of Missouri(a 4 year board member);
- National association of Professional Mortgage Women;
- Kansas City Regional Association of Realtors (first time homebuyer trainer);
- Kansas State Bank Commissioner Committee on Continuing Education-2006;
- Kansas State Bank Commissioner Mortgage Assessment Task Force-2007.

The senior underwriter has participated in numerous training opportunities as follows:

- MBA Government Finance Conference Attendee 2005, 2006, 2007, 2008;
- MBA Underwriting Conference 2005, 2006;
- MBA-KC trainer for Kansas Broker Licensing-FHA and VA Trainer 2004, 2005, 2006.

Peoples Bank has gone well beyond its peers to ensure that adequate training has been provided for the underwriting staff and will continue to be committed to ongoing training and supervision of the underwriting function.

Peoples Bank takes great pride in our reputation as a premier FHA lender in the mortgage community in Kansas City. Both the underwriting manager and the newly hired underwriter will be attending a three-day HUD sponsored FHA underwriting training seminar in August 2008. We will continue to invest in the training and development of the loan operations staff, especially the underwriting department.

IV. Peoples properly underwrote all nine of the loans in which OIG recommends indemnification

There are many factors that determine the credit worthiness of a borrower. Underwriting (AUS and Manual) is based on a number of factors including LTV, credit history, employment history, debt load, liquid assets, etc.. The totality of the circumstances must be considered. HUD Handbook 4155.1 REV-5, Chapter 2, section 2-1 ("The purpose of underwriting is to determine a borrower's ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties, and to examine the property offered as security for the loan to determine if it is sufficient collateral. The "Four C's of credit" (Credit History, Capacity to repay, Cash to close, and the collateral) are evaluated during the underwriting process"). HUD

Handbook 4155.1 REV-5, Chapter 2, section 5 (“Underwriting requires careful analysis of the many aspects of the mortgage. Each loan is a separate and unique transaction, and there may be other factors that demonstrate the borrower’s ability and willingness to make timely mortgage payments”).

In addition, FHA does allow financial qualifying ratios in excess of guidelines. HUD Handbook 4155.1 REV-5, Chapter 2, Section 5 (“As evidenced by the description of compensating factors, ratios can be exceeded when significant compensating factors exist. We also do not set an arbitrary percentage that ratios may never exceed; however, the underwriter should judge the overall merits of the loan application and determine what compensating factors apply and the extent to which ratios may be exceeded”) Peoples Bank believes that the nine loans fell within the range of a reasonable underwriting judgment. Each loan will be addressed separately below.

1. Case number 181-2156090, [REDACTED]

The OIG asserts:

Peoples Bank overstated the borrower's overtime and Social Security income by \$1,153 per month, resulting in excessive qualifying financial ratios of 51 percent and 74 percent (\$751 / \$1,473 and \$1,092 / \$1,473). The borrower provided one pay stub that showed \$242 in overtime compensation in January and February 2006. HUD requires a two-year history of overtime earnings, and the lender did not obtain a two-year history. Therefore, the lender should not have included overtime pay in the income calculation. Further, the borrower's base pay was \$8.50 per hour and equated to \$1,473 per month (\$8.50 x 40 hours x 52 weeks / 12 months), not the \$1,579 in year-to-date earnings on the pay stub (\$3,159 / 2).

Peoples Bank also overstated the borrower's Social Security survivor benefit income by \$926 per month. This income was for the borrower's 17-year-old son, and the monthly income was not expected to continue during the first three years of the mortgage, which HUD requires. The borrower's son could only qualify for the income until he was 19, if it took him that long to graduate from high school, but would discontinue at 18 if he had finished high school.

RESPONSE: We dispute the assertion that the social security income for the borrower’s son was not likely to continue. The underwriter’s notes indicate that the borrower’s son was disabled and the social security income was likely to continue as a disability payment after the survivors benefits expired. See Exhibit A-1 to A-7. In addition the social security income was not grossed up by 125% which is allowable.

Also, FHA guidelines allow ratios that exceed the limits if there are compensating facts. HUD Handbook 4155.1 REV-5, Chapter 2, Section 5 (“As evidenced by the description of compensating factors, ratios can be exceeded when significant compensating factors exist. We also do not set an arbitrary percentage that ratios may never exceed; however, the underwriter should judge the overall merits of the loan

Comment 2

Comment 3

application and determine what compensating factors apply and the extent to which ratios may be exceeded"). In this case, there were compensating factors involved in the decision to approve this loan (although they may not have been noted on the MCAW). They include:

- The non borrowing spouse had documented income which was not included in the underwriting ratios. His income was in excess of \$15,000 per year. See Exhibit B-1 to B-3. In addition, the non-borrowing spouse had NO additional debt.
- The borrower was attending Brown Mackey College to further her career and increase potential earnings. (Her field of study coincides with her career, which was documented in the file). See Exhibit C-1 to C-2.

It should also be noted that per the FHA connection website, the reason for default was that the principle borrower had become ill. Obviously, the underwriter can not anticipate such circumstances, nor was the delinquency related to the issues found in the audit report. Under these circumstances, Peoples believes that the underwriter made a reasonable underwriting judgment in approving this loan.

2. Case number 181-2179272, [REDACTED]

HUD asserts:

Peoples Bank did not obtain a satisfactory pay history for an open judgment on the borrower's credit report. The borrower's credit report showed an unpaid judgment of \$2,556 that was filed in May of 2002. Although court-ordered judgments are supposed to be paid before a mortgage loan is eligible for FHA insurance, HUD makes an exception if the borrower has agreed with the creditor to make regular and timely payments on the judgment and documentation is provided that payments have been made in accordance with that agreement.

The borrower's nonpurchasing spouse agreed to repay the debt at \$10 to \$20 per month beginning September 8, 2003. The payment ledger indicated that the borrower missed about 20 payments during the three years between the agreement and the FHA loan closing. Further, the non-purchasing spouse missed 6 of the 20 monthly payments in the year before the FHA loan closing.

Comment 4

RESPONSE: Although the payment history obtained from the attorney's office of Blackwell and Blackwell indicated that the payment history had been sporadic, it was also clear the payment history was acceptable, that is, there were no garnishments or court orders resulting from the judgment indicated on the title commitment. See Exhibit D-1 to D-4.

It should also be noted that Peoples carefully analyzed the payment history before approving this loan. It was obvious the borrower did not agree to repay the judgment with the sole purpose of obtaining a mortgage loan. In fact, the borrower/nonpurchasing

spouse had been paying the judgment since 1996; 10 years before the mortgage was originated. See Exhibit E-1 to E-5.

This borrower applied for a mortgage under the Sedgwick County Mortgage Revenue Bond issue. This program is specifically intended to help low to median income borrowers, who sometimes have outstanding judgments. This borrower had made regular and timely payments and the creditor was not dissatisfied with the performance of the borrower. Under these circumstances, Peoples believes that the underwriter made a reasonable underwriting judgment in approving this loan.

3. Case number 182-0814658 [REDACTED]

HUD asserts:

Peoples Bank overstated the total household income by \$598 per month. The borrower's income was overstated by \$518 per month, as the lender calculated the monthly income at \$2,722. The borrower's pay stubs reflected a salary of \$1,361 bimonthly for all of the pay stubs provided (November 2005-February 2006). This bimonthly salary equated to \$32,668 per year (\$1,361 x 24 pay periods). However, the December 2005 year-to-date salary and 2005 Internal Revenue Service (IRS) Form W-2 reflected a salary of \$26,447, which equaled \$2,204 per month (\$26,447 / 12 months). The loan closed in March of 2006, and the IRS Form W-2 for 2005 was a reasonable calculation for her income because her pay stubs indicated that she was still making the same bimonthly salary in February 2006.

The borrower was a teacher and stated on the loan application that she had worked at the same school for seven years. The difference in annual income could reflect that the borrower received her salary during the nine-month school year only and not in June, July, and August. If this were the case, the borrower's annual income would have been \$24,501 (\$1,361 x 18 pay periods), which was more in line with her IRS Form W-2 from 2005. On the pay stubs provided, the borrower received pay in the "other" pay category, which could account for the difference between the 2005 IRS Form W-2 (\$26,447) and the calculation for nine months (\$24,501). The lender should have obtained an explanation of the income discrepancies from the borrower.

Additionally, Peoples Bank overstated the co-borrower's income by \$80 per month. The lender qualified the co-borrower using a monthly income of \$2,178; however, it was unclear how the lender calculated the income. Peoples Bank obtained an earnings record for the co-borrower that did not reflect full-time employment. The earnings record covered 10 weeks during November 2005, December 2005, and January 2006. Only 1 of the 10 weeks reflected a 40-hour work week. Using the 2005 IRS Form W-2, the lender supported only \$2,098 per month (\$25,181 / 12 months). The 2005 IRS Form W-2 was recent income information when the loan was underwritten (the mortgage credit analysis worksheet was dated March 9, 2006).

The decreased monthly income resulted in excessive qualifying financial ratios of 37.8 percent and 47.4 percent. The mortgage credit analysis worksheet included a note by

the underwriter that the borrowers had reserves as a compensating factor for the excessive ratios. To be considered a compensating factor, HUD requires reserves of at least three months of housing payments. The mortgage credit analysis worksheet showed \$1,181 in cash reserves. The borrower's bank statement showed a balance of \$2,063; however, the \$1,000 earnest money check had not cleared the account, so actual reserves totaled \$1,063. In addition, the borrowers needed \$664 at closing, leaving \$399 in reserves (less than one monthly payment). The borrowers' principal and interest payment was \$1,185. The lender did not support that the borrowers had at least three months of housing payments in reserves, and, therefore, this compensating factor was not valid.

Comment 5

RESPONSE: Peoples Bank agrees that the Borrower's income was calculated over a 12 month period instead of a 9 month period, and that the discrepancy noted "might reflect" that the borrower received her salary over the 9 month school year rather than the full year. However, this is speculation and Peoples believes that it is not fair for an indemnification request to be based on speculation. There could be many other reasons why there was a discrepancy between the W-2 income of the previous year and the current year. Also, the auditor did not include income for extra duties as reflected in the pay stub and this is a compensating factor.

The auditor states it was unclear how the co-borrower's income was established. The co-borrower's income was calculated by adding the year-to-date income of \$5,317.48 and the 2005 W-2 income \$25,180.56 and dividing that by 14 months. The result is \$2,178 as stated on the MCAW. The lender deemed it reasonable to use the 14 month average since there was no significant difference between the 2004 and 2005 income as reported on the co-borrower's W-2 form. See Exhibit F-1 to F-2.

HUD Handbook 4155.1 REV-5, chapter 2, section 2-7 ("Both Overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of bonus or overtime income for the last two years, and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes").

Comment 6

In addition the auditor did not consider additional seasonal employment reflected on a 2005 W-2 of \$1,844.40. That equals an additional \$153.70 in monthly income. See Exhibit G. HUD Handbook 4155.1 REV-5, chapter 2, section 2, paragraph 2-7A ("We recognize that many low –and moderate families rely on part time and seasonal income for day- to-day needs. Lenders must not restrict the consideration of such income in qualifying these borrowers"). When you consider the audit's income calculation for the borrower of \$2,204 per month and the borrower's income of \$2,178 per month plus the part-time seasonal income of \$153.70 per month; the total financial qualifying ratio is 44.96%. This is reasonable considering the borrower had been employed on her job for 7 years and 5 months; that co-borrower had been employed for 6 years and 7 months.

Comment 7

HUD asserts:

Peoples Bank did not require the borrower to pay a \$100 unpaid judgment before the loan closed. The borrower's credit report listed the judgment as unpaid. Court-ordered judgments are supposed to be paid before a mortgage loan is eligible for FHA insurance.

RESPONSE: Peoples Bank agrees that it did not require the judgment be paid before closing, but the amount (\$100) is so small as to be immaterial.

Hud asserts:

Peoples Bank did not resolve a Social Security number discrepancy. The borrower's credit report and a Social Security number report obtained by the lender showed that at least two other people were associated with the same Social Security number. HUD requires the lender to resolve any Social Security number discrepancies. The lender should have obtained a Social Security number verification from another source document or an acceptable explanation from the borrower.

RESPONSE: Peoples Bank agrees that a discrepancy in the borrower's social security number. Peoples Bank routinely checks any discrepancies of this nature; however, in this case, the discrepancy was not resolved. Since there is no indication that the borrower was in the country illegally, and it is not claimed that the error caused the delinquency, Peoples believes that this oversight was immaterial. Under these circumstances, Peoples believes that the underwriter made a reasonable underwriting judgment in approving this loan.

Comment 8

4. Case number 182-0821834; [REDACTED]

HUD asserts:

Peoples Bank overstated the borrower's income by \$816 (\$604 + \$212) per month when it included income that was not supported as likely to continue and included unsupported overtime income. The only pay stub provided by the borrower (pay period ending June 15, 2006) did not indicate the number of hours worked or number of days in the pay period or specify a pay rate. The lender used year-to-date earnings for a \$2,417 monthly average (\$13,293 / 5.5 months). The 2005 IRS Form W-2 yielded a \$2,283 (\$27,390 / 12) monthly average. Both earnings records included overtime income that was not addressed in the verification of employment. Therefore, the lender did not develop a two-year earnings trend for overtime. The year-to-date amount for base pay was \$9,972 or \$1,813 per month (\$9,972 / 5.5 months). Employment income was overstated by \$604 per month (\$2,417 - \$1,813).

In addition, the borrower provided documentation of receiving Social Security Administration benefits for her children of \$212 per month, which the lender included in

Comment 9

income. However, the lender did not obtain documentation to support the length of time that the Social Security payments would continue.

The loss of the overtime income and Social Security income increased the qualifying financial ratios well above HUD's limit, to 54.8 percent and 59.7 percent.

RESPONSE: Peoples Bank disagrees with the auditor's statement that the overtime is unsupported or overstated. Using the YTD income (5-1/2months) from the paystub submitted to us and averaging her income for the 12 months in 2005 and 6 months in 2004, the borrower's income is \$2,160.00 per month. See Exhibit H-1 to H-3.

YTD \$13,293
05 W2 \$27,389
04 W2 \$10,079
TOT \$50,761
AVG \$2,160.04 income averaged over 23.5 months.

The borrower also receives social security income for two dependants. The borrower listed the age of the dependants as 15, 13 and 10 on the loan application. See Exhibit I. Even if the social security income was for the oldest child, it would continue for 3 years. In addition neither the auditor, nor the underwriter grossed up the social security income 125%, which is allowed. The amount of the grossed-up social security income would have been \$265.00 per month.

Based on information from the Social Security Administration, it is entirely possible that the borrower was receiving Social Security survival benefits that were not considered in the underwriting decision. See Exhibit J-1 to J-10.

Comment 10

In addition, the auditor included a payment of \$49.00 in the liabilities which was a debt that had been charged off 4 years prior to the mortgage. The total debt to income ratio would be 42.56% using the income calculated above (total liabilities of \$1,032 divided by income of \$2,425 = 42.56%).

This loan was for a no cash back refinance with a total loan to value ratio of 95.45%, and the borrower lowered their house payment by \$154.00 per month (\$1,235-\$1,081).

As stated earlier, mortgage loans should not be underwritten using a single criterion. In this case; the fact that the overtime income is reasonable; and the loan to value ratio is 95.45%; and the borrower lowered their monthly housing expense supports the underwriting decision. Under these circumstances, Peoples believes that the underwriter made a reasonable underwriting judgment in approving this loan.

5. Case number 182-08223672; [REDACTED]

HUD asserts:

Peoples Bank overstated the borrowers' income by \$1,084 per month. The lender qualified the borrowers using \$4,160 in monthly income (\$2,080 each). Pay stubs for each of the borrowers supported a pay rate of \$12 per hour (\$12 x 40 hrs x 52 weeks / 12 months = \$2,080). The year-to-date amounts on the pay stubs did not support earnings of \$2,080 per month for either borrower.

The year-to-date amount on the borrowers' most recent pay stub, dated August 15, 2006, was \$11,897. Average monthly income based on this amount was only \$1,586 (\$11,897 / 7.5 months). The 2004 and 2005 income documentation, if used, would have made the monthly income even lower. The year-to-date amount on the co borrower's most recent pay stub, dated August 1, 2006, was \$11,000. Average monthly income based on this amount was only \$1,490 (\$11,000 / 32 weeks x 52 / 12 months). The 2004 and 2005 income documentation, if used, would have made the monthly income even lower.

The total monthly income supported by the pay stubs was \$3,076. The lender obtained verbal verifications of employment for both borrowers; however, neither included information on pay rate, work hours, or overtime and bonuses. In addition, the co borrower's verification did not include a start date for employment. The lender did not establish and document earnings trends for overtime or bonus income. Heretofore, the lender overstated income by \$1,084 per month, which, when eliminated, increased the qualifying financial ratios to 37.4 percent and 5 1.5 percent

Comment 11

RESPONSE: Peoples Bank agrees that the income was not supported by the pay stubs and W2s that were in the file. The income was calculated using \$12.00 per hour which was reported by both employers. In this case, the co-borrower was an employee of Peoples Bank and it was known at the time the loan was originated, the borrower was a full time employee and this was confirmed by Peoples Bank records.

HUD asserts:

Peoples Bank submitted an ineligible property for FHA insurance. The appraisal listed a married couple as the owners of record. The sales contract named an investment company as the owner. Loan file documentation indicated that the married couple sold the property to the investment company on August 15, 2006, which was less than one month before the sale of the property to the FHA borrowers. This property was not eligible for FHA insurance.

Comment 12

RESPONSE: Peoples Bank is well aware of the anti-flipping ruling by FHA and we are extremely mindful of ensuring that no ineligible properties are submitted for insurance. However, in this case the anti-flipping mortgagee letter came out just over 90 days before this loan was originated. Peoples Bank simply did not notice that the property had been sold within 90 days after the date of acquisition. However, there is no indication that the transaction between the couple and the investment company inflated the price. The attached appraisal indicates that recent improvements had been made to the property, and the value is well supported by the comparable properties listed. Clearly

the appraiser was not influenced by the conveyance of the property between the investment company and the borrower. See Exhibit K-1 to K-6. The purpose of the anti-flipping rule is to prevent real estate scams where prices are artificially inflated. There is no evidence of that here. Therefore, Peoples believes that this issue is immaterial.

6. Case number 182-0824524 [REDACTED]

HUD asserts:

Peoples Bank under reported the borrower's liabilities by \$324.00 per month. The lender did not adequately consider a car payment that affected the borrower's ability to repay the mortgage in the months immediately after closing. The lender did not include the payment in the financial ratios.

The loan documentation was contradictory, as described below.

- *The credit report, dated August 7, 2006, showed a monthly payment of \$324 and a balance of \$4,817, which yielded more than 14 months left to repay the loan;*
- *The creditor verification letter, dated August 4, 2006, listed the monthly payments at \$300.00 and the balance of the loan at \$4,724, which yielded more than 15 months to pay off the loan;*
- *A payment printout, dated August 15, 2006, showed bi-monthly payments of 4150 and a balance of \$4,701.*

Based on the information provided by the creditor, it appeared that the most current balance was \$3,000 and that the borrower was paying \$150 bi-monthly, an average of (\$324/mo.). The borrower had 9.3 months of payments left to make, and therefore, the liability should have been included in the ratio calculation because the monthly payment was large enough to adversely affect the borrower's ability to make the mortgage payment immediately after closing. The liability increased the total debt ratio from 38.7 to 54.7 percent, which was well above the HUD limit. The transactions on this loan before loan closing could be an indication that the borrower's intention was to pay down the loan so that the liability would not affect already high ratios.

Additionally the lender should have questioned the source of funds used to pay down the car loan. To pay down the car loan, the borrower may have secured an additional loan that might not have appeared on the credit report and not have been included in the financial ratio calculation. The borrower used only about \$300 of their own assets in closing the loan. Their bank balance was only \$557 as of August 23, 2006 (three weeks before closing the loan). The balance of the month before was only \$306. Both months showed a number of insufficient funds charges. The mortgage credit analysis worksheet showed that the borrower had reserves of only \$299, less than one month of the \$549 monthly principal and interest payment. The lender did not list compensating factors on the mortgage credit analysis worksheet.

Comment 13

RESPONSE: This borrower is Hispanic, an underserved minority that traditionally saves money outside of the normal banking establishment so it is entirely possible that the borrower used cash, not held in a bank, to pay the car loan down. The statement from the (car payment) lender was deemed to be the most accurate reflection of the terms. See Exhibit L. The car loan had a balance of \$3,027 with monthly payments of \$324; which equals 9.5 remaining monthly payments. The auditor assumes there may have been a loan obtained by the borrower to pay the car loan down, but that is speculation.

The underwriter did not consider the car payment since there were 9.5 monthly payments remaining. HUD Handbook 4155.1 REV-5, chapter 2, section 4 paragraph 2-11A. ("In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other additional recurring charges extending 10 months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc. Debt lasting less than ten 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").

In addition, this borrower had over \$3500 in overtime and bonus on a fully completed verification of employment stating overtime and bonus were likely to continue. See Exhibit M. That income (\$500 per month) was not used in qualifying the borrower. The borrower became delinquent due to curtailment of income almost 1 year after the loan was originated, which was beyond the due date of the final car payment. Therefore, the alleged error is completely unrelated to the default. Under these circumstances, Peoples believes that the underwriter made a reasonable underwriting judgment in approving this loan.

7. Case number 183-0053891; [REDACTED]

HUD asserts:

Peoples Bank did not obtain a verification of mortgage for the borrower although, there was evidence that the borrower was past due on refinancing the mortgage. The borrower's bank statements showed that she had made a payment on February 2, 2007, for more than three times the monthly payment ($\$1,316 / 423 = 3.11$). The prior lender verified that the borrower's monthly payment was \$423. The mortgage credit analysis worksheet showed that the borrower's current housing expense was \$468 per month.

Further, there was a significant difference between what the credit report showed as the principal balance (\$26,576) on the prior mortgage and the loan payoff amount paid at closing (\$34,860). This difference indicated that the borrower may have missed payments, accrued additional interest, had escrow shortages, and been charged fees for late payments. Peoples Bank should have questioned the large payment and obtained a verification of mortgage payment history from the prior lender. HUD does not allow refinanced mortgages to include late interest, late fees, or escrow shortages. Without the

payment history, Peoples Bank was unable to verify that the unallowable fees were not included in the FHA mortgage.

Comment 14

RESPONSE: This was not a manually underwritten loan as reported by the auditor. The loan-to-value ratio of this loan was 66%. Peoples Bank relied on information in the credit report to determine the loan balance and payment history; which is allowed by FHA. HUD Handbook 4155.1 REV-5, Section 1, paragraph 2-3A ("The lender must determine the borrower's payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity-of-interest with the borrower) or verification of mortgage directly from the mortgage servicer, or through cancelled checks covering the most recent 12-month period").

Comment 15

The report cites a discrepancy in the subsequent payoff obtained from the previous lender. The auditor contends that the discrepancy may have been due to missed payments or late payments, but this is speculation. Peoples Bank feels that in the environment that existed at the time, the discrepancy could more likely be due to negative amortization, a pre-payment penalty or some other explanation. In addition, this loan was a cash-back refinance. Cash out refinances can pay off any debt, including mortgage delinquencies according to HUD guidelines. The section of the HUD handbook is silent regarding the use of funds on a cash out refinance. HUD Handbook 4155.1 REV-5, Section 4, paragraph 1-11B.

Under these circumstances, Peoples believes that the automated underwriting system made a reasonable underwriting judgment in approving this loan.

8. Case number 183-0055148; [REDACTED]

HUD asserts:

Peoples Bank overstated the borrower's income by \$638 per month, resulting in excessive qualifying financial ratios of 34 percent and 48 percent. The borrower's statement of earnings and leave showed the borrower's annual salary as \$50,155, which equaled \$4,180 per month (\$50,155 / 12 months). However, the lender listed the borrower's monthly income on the mortgage credit analysis worksheet as \$4,818, which would be an annual salary of \$57,818. Therefore, the lender overstated the borrower's monthly income by \$638 (\$4,818 - \$4,180).

RESPONSE: The auditor considered base salary only when calculating the income. It is the underwriter's discretion to use additional income. HUD Handbook 4155.1 REV-5, chapter 2, section 2-7 ("Both Overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of bonus or overtime income for the last two years, and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes").

This borrower had been on her job for almost 12 years. The total year to date

Comment 16

income included salary, annual leave, compensatory leave and other leave was considered. The total of \$22,886 / 4.75 months equals \$4,818 per month.

The bad credit on the borrower's credit report was old, minimal, and/or medically related. This was a not a cash-back refinance that was initiated to remove the ex-husband from the loan. In addition, there was a major compensating factor in the long duration of the job.

This borrower became delinquent, cashed in her 401K and brought the loan current. She obviously has demonstrated that she intended to comply with the terms of her loan and she continues to do so.

Under these circumstances, Peoples believes that the underwriter made a reasonable underwriting judgment in approving this loan.

9. Case number 183-3457668; [REDACTED]

HUD asserts:

Peoples Bank did not obtain a verification of mortgage payments for a refinanced mortgage and a home equity loan. The borrower's credit report indicated that the borrower had two loans with the prior lender; however, the credit report showed the first mortgage was paid off in 2001 and the home equity loan was paid off in 2000. The credit report showed no outstanding mortgage balance. The loan file included no documentation regarding the borrower's payment history on these prior mortgage loans or an explanation of why the credit report showed no outstanding mortgage.

In addition, the payoff statements from the prior lender did not provide a payment history of the loans to indicate whether the loans had a negative payment history (i.e., late payments, significant defaults, etc.). Further, HUD does not allow refinanced mortgages to include late interest, late fees, or escrow shortages. Without the payment history, Peoples Bank was unable to adequately evaluate the borrower's creditworthiness and to verify that the unallowable fees were not included in the FHA mortgage.

RESPONSE: The first issue to consider on this loan is the loan-to-value ratio of 82.68% which is far below the maximum LTV required by FHA. In addition, the borrower's qualifying ratio stood at 13% - 14%, again, well below the maximum preferred DTI of 43%. The borrower had two liens on the property with Beneficial/HFC. There were two loans reflected on the credit report that coincided with the balance and payments of the loans stated on the application (and in the title work). The credit report did report one of the loans as having been paid in full, and the other as closed due to transfer or refinance; however, both loans were disclosed on the borrower's application and considered in the underwriting decision.

In addition, this borrower lived in the property for 35 years, the loan was no cash back refinance and as stated above, the loan to value ratio was 82.68%. All are major compensating factors which mitigate the risk. Under these circumstances, Peoples

Comment 17

believes that the underwriter made a reasonable underwriting judgment in approving this loan.

V. Conclusion.

Thank you for the opportunity to present Peoples' response to the OIG findings. As indicated at the beginning of this letter, Peoples takes its FHA origination responsibilities seriously. We have learned valuable lessons from this auditing report, and will tighten our procedures with the goal of full compliance with every HUD rule, regulation and guideline. However, we respectfully disagree that our quality control plan and underwriting supervision were seriously deficient. In addition, we believe that we have demonstrated that each of the nine loans recommended for indemnification were approved within the range of a reasonable underwriting judgment, when all the facts and circumstances have been considered.

Please contact me if you wish to discuss any aspect of this matter.

Sincerely,

Peoples Bank

BY: 

OIG Evaluation of Auditee Comments

- Comment 1** We used Peoples Bank's delinquency rate only to select a lender to review that indicated potential for deficiencies in its FHA loan underwriting and quality control processes that could cause unnecessary risk to the FHA insurance fund.
- Comment 2** Peoples Bank did not adequately verify and document whether the Social Security income was expected to continue during the first three years of the mortgage, as HUD requires. The dependent was 17 years old and his survivor benefit would have ended at age 18. The loan file contained only an underwriter and borrower note indicating that the dependent was going to receive Social Security disability when the survivor benefit ended. However, these notes were not sufficient documentation to include the unconfirmed disability income when underwriting the loan.
- Comment 3** The compensating factors provided in Peoples Bank's response (i.e. nonpurchasing spouse income and the borrower's efforts to increase potential earnings) were not sufficient to offset a 74 percent total debt ratio. Further, the nonpurchasing spouse had a \$5,000 judgment listed on his credit report. According to a loan officer's note in the loan file, Peoples Bank did not include the spouse on the loan because of the spouse's credit problems and the borrower(s) would have had to pay off the judgment or be participating in an acceptable repayment plan before being considered for an FHA loan.
- Comment 4** HUD Handbook 4155.1, REV-5, points out that past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions. Further, HUD requires borrowers to pay court-ordered judgments before a loan is eligible for FHA insurance. An exception is made when the borrower has agreed to make regular and timely payments. The borrower and nonpurchasing spouse agreed to make monthly payments but in the three years before the FHA loan closed the borrower and spouse made less than half of the agreed-upon monthly payments. Further, the absence of garnishments or court orders to force repayment does not confirm that the payment history was acceptable to the creditor, but serves only to show that the creditor had not pursued further actions to collect the debt.
- Comment 5** The recommendation for indemnification was based on our conclusion that Peoples Bank substantially overstated the borrowers' income and should not have approved the loan. The borrower's income discrepancy was material and the lender should have resolved the discrepancy before approving the loan. The borrower's supported income was \$2,204 per month, or \$518 per month less than calculated by the underwriter. Also, the extra duty income was minimal and not sufficient to offset the excessive financial ratios.

The coborrower's earnings record demonstrated that he did not consistently work full time. In the ten weeks just before the FHA loan closed, the coborrower worked only one 40-hour week. A better measurement of his income would have been an entire year, which would have taken into consideration fluctuations in hours worked. His 2004 average monthly income was \$2,086 and 2005 average monthly income was \$2,098. The loan closed March 15, 2006, and the coborrower was still at the same employer. Because his monthly income changed only \$12 per month over two year period of 2004 and 2005, the monthly average of \$2,098 from 2005 was the most prudent estimate of his income.

Comment 6 We did not include, nor should the lender include, the seasonal employment in income or consider it a compensating factor because it was not reflected on the uniform residential loan application as additional employment for the coborrower. While the income may have been available for the borrowers in 2005, the borrowers did not indicate that they would have this income in future periods. Further, the underwriter did not include the income when underwriting the loan in 2006. Therefore, we maintain that the coborrower's supported income was only \$2,098 per month.

Comment 7 HUD requires borrowers to pay court-ordered judgments before the loan is eligible for FHA insurance, regardless of the amount. Also, as explained in comment 4, past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions. Failure to pay a court-ordered judgment does not show that the borrower was committed to paying financial obligations.

Comment 8 HUD requires lenders to validate Social Security numbers and resolve discrepancies revealed during processing and underwriting. HUD also requires the underwriter to be aware of the warning signs that may indicate irregularities, to have the ability to detect fraud, and to take the responsibility that their underwriting decisions are performed with due diligence and in a prudent manner. We maintain that validating Social Security numbers is a critical part of underwriting that is intended to ensure that the borrowers have not provided a fraudulent identity to obtain the FHA loan and the underwriter should have positively verified the Social Security number.

Comment 9 HUD requires a lender to establish a two year earnings trend before including overtime in effective income. The only overtime income that the lender verified was 5.5 months shown on the borrower's pay stub. Using only the Internal Revenue Service Form W-2 did not establish a history of overtime income because the W-2 did not distinguish between base pay and overtime pay. Further, the employer did not confirm that the borrower was likely to incur overtime in the future.

Based on the Social Security Administration information provided with Peoples Bank's response, we agree that the lender provided sufficient evidence that the

Social Security income was going to continue through at least the first three years of the mortgage. Therefore, we removed the related information from the case study in appendix E and recalculated the ratios. Total supported income for the borrower was \$2,025 (\$1,813 + \$212), resulting in financial ratios of 49 percent ($\$993 / \$2,025$) and 53.4 percent ($\$1,082 / \$2,025$), well above HUD's limits.

- Comment 10** We used the same liability amount that the underwriter used to calculate the qualifying ratios on the mortgage credit analysis worksheet. As explained in comment 9, the financial ratios greatly exceeded HUD's limits.
- Comment 11** Peoples Bank agreed that its loan documentation did not support the income claimed when underwriting the loan and stated that it had additional information that supported the income used to underwrite the loan. However, Peoples Bank did not provide the support and therefore, we continue to consider the income overstated.
- Comment 12** The mortgagee letter that Peoples Bank referred to in its response is Mortgagee Letter 2006-14, which states that if the seller has not owned the property for at least 90 days the property is not eligible for insurance. However, Mortgagee Letter 2006-14 rescinded Mortgagee Letter 2003-07, which also included the same requirement. Therefore, the "anti-flipping" rule had been in effect well before Mortgagee Letter 2006-14. We maintain that this property was not eligible for FHA insurance and is a material deficiency.
- Comment 13** HUD requires lenders to include debts in the qualifying financial ratios if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after closing. In this case, the car payment debt raised the total debt ratio from 38.7 percent to 54.7 percent, which was well above HUD's limit, and the car payment was to continue for at least nine months. The total debt ratio greatly exceeded HUD's limit and the borrowers did not demonstrate the ability to accumulate cash assets, as demonstrated by minimal balances on the two months of bank statements provided. The bank statements also showed 25 insufficient funds charges, demonstrating that the borrowers were not adequately handling their financial obligations.
- Comment 14** Peoples Bank agreed during the audit that the loan was manually underwritten by the junior underwriter, just as it was reflected in HUD's systems. In addition, the automated underwriting system approved the loan with a 30 year term. However, Peoples Bank closed the loan with a 20 year term. The lender invalidated the automated underwriting system approval when it closed the loan with a significantly shorter term and significantly higher mortgage payments.
- Comment 15** Although HUD allows lenders to evaluate borrowers' housing payment history through credit reports or verifications of rent or mortgages, Peoples Bank should have performed more due diligence on the borrowers' payment history when it received a payoff amount that was significantly higher than shown on the credit

history. As explained in the report, HUD does not allow refinanced mortgages to include late interest, late fees, or escrow shortages. Without a payment history (verification of mortgage) from the prior lender, Peoples Bank could not be assured that the higher payoff had not resulted from missed payments or other costs not allowed by HUD.

Further, the prior lender confirmed to us that the loan was not structured in a way that would allow accrual of interest outside of the monthly payments. The prior lender indicated that the mortgage balance included more than principal and interest. The underwriter should have also questioned the borrower about the large payment made two months before closing to determine whether the payment was to bring the loan current in order to obtain the FHA loan, as this should have been considered by the underwriter when evaluating the potential FHA loan.

Comment 16 We maintain that the borrower's income was overstated, as the lender should have used a more prudent calculation of monthly income. The earnings and leave (payroll) statement supported annual salary of only \$50,155 (\$4,180 per month) and the borrower had earned only one hour of overtime through May 2007 of the current year. The lender based the calculated income on \$22,886 earnings to date, which equated to \$4,818 per month. The payroll statement gave no indication of what the extra pay was for, or if it would continue in the future.

Comment 17 As explained in comment 15, Peoples Bank should have performed more due diligence and obtained the borrowers' payment history when it received a payoff amount on a refinance loan for which the credit report showed no outstanding mortgage. The underwriter should have required a payment history from the prior lender to evaluate the borrower's willingness and ability to pay previous housing expenses and also questioned why the mortgage balances were not reflected on the borrower's credit report.

Appendix C

CRITERIA

Criterion 1

HUD Handbook 4000.2, REV-3, paragraph 1-7C, states that a property acquired by the seller is not eligible for a mortgage to be insured by FHA for the buyer unless the seller has owned that property for at least 90 days. If a property is resold 90 days or fewer following the date of acquisition by the seller, the property is not eligible for a mortgage insured by FHA. FHA defines the seller's date of acquisition as the date of settlement on the seller's purchase of that property. The resale date is the date of execution of the sales contract by a buyer intending to finance the property with an FHA-insured loan.

Criterion 2

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C, states that HUD looks to the underwriter as the focal point of the direct endorsement program. The underwriter must assume the following responsibilities:

- Compliance with HUD instructions, the coordination of all phases of underwriting, and the quality of decisions made under the program.
- The review of appraisal reports, compliance inspections and credit analyses performed by fee and staff personnel to ensure reasonable conclusions, sound reports, and compliance with HUD requirements.
- The decisions relating to the acceptability of the appraisal, the inspections, the buyers capacity to repay the mortgage, and the overall acceptability of the mortgage loan for HUD insurance.
- The monitoring and evaluation of the performance of fee and staff personnel used for the direct endorsement program.
- Awareness of the warning signs that may indicate irregularities and an ability to detect fraud, as well as the responsibility that underwriting decisions are performed with due diligence in a prudent manner.

Criterion 3

HUD Handbook 4060.1, REV-2, section 7-3, states that there are several basic elements that are required in all quality control programs that apply to both origination and servicing. Paragraph 7-3F states that all aspects of the mortgage 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, and all FHA loan programs, must be subject to the lender's quality control reviews.

Criterion 4

HUD Handbook 4060.1, REV-2, paragraph 7-3G, states that lender offices, including traditional, nontraditional branch, and direct lending offices engaged in origination or servicing of FHA-

insured loans, must be reviewed to determine that they are in compliance with HUD's requirements.

Criterion 5

HUD Handbook 4060.1, REV-2, paragraph 7-3J, states that findings of fraud or other serious violations must be immediately referred to HUD using the lender reporting feature in the Neighborhood Watch early warning system.

Criterion 6

HUD Handbook 4060.1, REV-2, paragraph 7-3K, states that the quality control review report and followup, including review findings and actions taken, plus procedural information must be retained by the lender for a period of two years and these records must be made available to HUD on request.

Criterion 7

HUD Handbook 4060.1, REV-2, paragraph 7-5A, states that lenders should monitor the application process and must verify the identity of the loan applicant.

Criterion 8

HUD Handbook 4060.1, REV-2, paragraph 7-6A, states that loans must be reviewed within 90 days from the end of the month in which the loan closed. This requirement is intended to ensure that problems left undetected before closing are identified as early after closing as possible.

Criterion 9

HUD Handbook 4060.1, REV-2, paragraph 7-6B, states that for lenders closing more than 15 loans monthly, quality control reviews must be conducted at least monthly and must address one month's activity.

Criterion 10

HUD Handbook 4060.1, REV-2, paragraph 7-6C, states that a lender who originates and/or underwrites 3,500 or fewer FHA loans per year must review 10 percent of the FHA loans it originates.

Criterion 11

HUD Handbook 4060.1, REV-2, paragraph 7-6C(1)a, states that loans must be reviewed from all branch office and all sources including authorized agents and loan correspondents.

Criterion 12

HUD Handbook 4060.1, REV-2, paragraph 7-6C(1)b, states that lenders must review the work of each of the loan processors, loan officers, and underwriters based on the sample selected. In addition, lenders must review the work of roster appraisers, real estate companies, and builders with whom they do a significant amount of business.

Criterion 13

HUD Handbook 4060.1, REV-2, paragraph 7-6C(1)c, states that the sample must include all FHA programs in which the lender participates, including but not limited to 203(b), 203(k), 234(C), and home equity conversion mortgages.

Criterion 14

HUD Handbook 4060.1, REV-2, paragraph 7-6D, states that in addition to loans selected for routine quality control reviews, lenders must review all loans going into default within the first six payments. Early payment defaults are loans that become 60 days past due.

Criterion 15

HUD Handbook 4060.1, REV-2, paragraph 7-6E(4), states that in cases in which the subject property is suspect, lenders must attempt to determine whether the borrower is occupying the property.

Criterion 16

HUD Handbook 4155.1, REV-5, paragraph 1-11A(2), states that in refinances, the amount of the existing first mortgage may not include delinquent interest, late charges, or escrow shortages.

Criterion 17

HUD Handbook 4155.1, REV-5, paragraph 1-11B, states that “cash out” refinances for debt consolidation represent considerable risk, especially if the borrowers have not had an attendant increase in income. Such transactions must be carefully evaluated.

Criterion 18

HUD Handbook 4155.1, REV-5, section 2-2, states that the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower’s capacity to repay mortgage debt. Income may not be used in calculating the borrower’s income ratios if it comes from any source that cannot be verified, is not stable, or will not continue.

Criterion 19

HUD Handbook 4155.1, REV-5, paragraph 2-3A, states that the lender must pay particular attention to the borrower’s previous rental or mortgage payment history. The payment history of the borrower’s housing obligations holds significant importance in evaluating credit. The lender must determine the borrower’s payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity of interest with the borrower), verification of mortgage directly from the mortgage servicer, or canceled checks covering the most recent 12-month period.

Criterion 20

HUD Handbook 4155.1, REV-5, paragraph 2-3C, states that court-ordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement. An exception may be made if the borrower has agreed with the creditor to make regular and timely payments on the judgment and documentation is provided that the payments have been made in accordance with the agreement.

Criterion 21

HUD Handbook 4155.1, REV-5, section 2-7, states that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage loan. If the borrower intends to retire during this period, the effective income must be the amount of documented retirement benefits, Social Security payments, or other payments expected to be received in retirement.

In most cases, the borrower's income will be limited to salaries or wages. Income from other sources can be included as effective income with proper verification by the lender. Procedures for analyzing other acceptable income sources besides salaries and wages are described below.

- A. Overtime and bonus income. Both overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of bonus or overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes.

An earnings trend also must be established and documented for overtime and bonus income. If either type shows a continual decline, the lender must provide a sound rationalization in writing for including the income for borrower qualifying. If bonus income varies significantly from year to year, a period of more than two years must be used in calculating the average income.

- E. Retirement and Social Security income. Retirement and Social Security income require verification from the source (i.e., former employer, Social Security Administration) or federal tax returns. If any benefits expire within the first full three years, the income source may be considered only as a compensating factor.

Criterion 22

HUD Handbook 4155.1, REV-5, paragraph 2-11A, states that 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 recurring charges extending 10 months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts, alimony, etc. 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.

Criterion 23

HUD Handbook 4155.1, REV-5, section 2-13, states that compensating factors that may be used in justifying approval of mortgage loans with ratios exceeding the guidelines include those listed below. Underwriters must state on the "remarks" section of the Form HUD-92900WS the compensating factors used to support loan approval.

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

Criterion 24

HUD Handbook 4155.1, REV-5, section 3-1, states that a payment history of present mortgages must be in the form of a direct verification from the landlord or mortgage servicer or through information shown on the credit report.

Criterion 25

HUD Handbook 4155.1, REV-5, paragraph 3-1C, states that the lender is required to document a valid Social Security number for each borrower, coborrower, and cosigner on the mortgage. All individuals eligible for legal employment in the United States must have a Social Security number. Each borrower must provide the lender with evidence of his or her own valid Social Security number as issued by the Social Security Administration. This requirement applies to purchase money loans and all refinances, including streamline refinances. While the actual Social Security card is not required, the lender is required to validate the Social Security number. Lenders may use various means for validating the Social Security numbers, including examining the borrower's pay stubs, passport, and valid tax returns and may use service providers including those with direct access to the Social Security Administration. The lender is also required to

resolve any inconsistencies or multiple Social Security numbers for individual borrowers that are revealed during loan processing and underwriting.

Criterion 26

Mortgagee Letter 2005-16 states that FHA's benchmark payment-to-income and debt-to-income ratios of 29 percent and 41 percent, respectively, were promulgated before Congress enacted recent federal tax cuts. Consequently, most borrowers seeking FHA mortgage insurance have enjoyed a reduction to their federal income tax during the last several years, thus increasing their buying power and disposable income.

Therefore, for manually underwritten mortgages in which the direct endorsement underwriter must make the credit decision, the qualifying ratios are raised to 31 percent and 43 percent. This change will allow a larger number of deserving families to purchase their first home while not increasing the risk of default. As always, if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval.

Criterion 27

Mortgagee Letter 2005-27 states that although FHA provides validation checks on Social Security numbers, lenders are reminded that it is their responsibility, not FHA's, to verify each borrower's Social Security number as well as each borrower's identity. FHA provides this validation process to protect the insurance funds it manages.

Criterion 28

Mortgagee Letter 2006-14 states that if the owner sells a property within 90 days after the date of acquisition, that property is not eligible security for a mortgage insured by FHA unless it falls within one of the exceptions to the time restrictions on resales set forth in paragraph 203.37a(c) of the regulations. FHA defines the seller's date of acquisition as the date of settlement on the seller's purchase of that property. The resale date is the date of execution of the sales contract by the buyer that will result in a mortgage to be insured by FHA.

Appendix D

SCHEDULE OF SIGNIFICANT UNDERWRITING DEFICIENCIES

FHA case number	Unpaid principal balance	Actual loss on sale of property	Deficiency area					
			Overstated income	Underreported liabilities	Ineligible property	Unpaid judgment	Missing mortgage payment history	Social Security number discrepancy
181-2156090		\$ 41,938	x					
181-2179272	\$ 94,762					x		
182-0814658	\$ 187,616		x			x		x
182-0821834	\$ 111,285		x					
182-0823672	\$ 142,036		x		x			
182-0824524	\$ 85,247			x				
183-0053891	\$ 64,582						x	
183-0055148	\$ 167,641		x					
291-3457668	\$ 52,739						x	
Totals	\$ 905,908	\$ 41,938						

Appendix E

CASE STUDIES FOR NINE QUESTIONED LOANS

Case number: 181-2156090

Insured amount: \$93,345

Section of Housing Act: 203(b)

Status upon selection: Claim - defaulted on 1st payment

Date of loan closing: March 31, 2006

HUD costs incurred: Loss on sale of property as a result of foreclosure \$41,938

Underwriter type: Manual

Overstated Income/Excessive Ratios

Peoples Bank overstated the borrower's overtime and Social Security income by \$1,153 per month, resulting in excessive qualifying financial ratios of 51 percent and 74 percent (\$751 / \$1,473 and \$1,092 / \$1,473). The borrower provided one pay stub that showed \$242 in overtime compensation in January and February 2006. HUD requires a two-year history of overtime earnings, and the lender did not obtain a two-year history. Therefore, the lender should not have included overtime pay in the income calculation. Further, the borrower's base pay was \$8.50 per hour and equated to \$1,473 per month ($\$8.50 \times 40 \text{ hours} \times 52 \text{ weeks} / 12 \text{ months}$), not the \$1,579 in year-to-date earnings on the pay stub ($\$3,159 / 2$).

Peoples Bank also overstated the borrower's Social Security survivor benefit income by \$926 per month. This income was for the borrower's 17-year-old son, and the monthly income was not expected to continue during the first three years of the mortgage, which HUD requires. The borrower's son could only qualify for the income until he was 19, if it took him that long to graduate from high school, but would discontinue at 18 if he had finished high school.

HUD Requirements – Appendix C

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, section 2-2 (criterion 18)

HUD Handbook 4155.1, REV-5, section 2-7 (criterion 21)

HUD Handbook 4155.1, REV-5, paragraphs 2-7A and E (criterion 21)

Mortgagee letter 2005-16 (criterion 26)

Case number: 181-2179272

Insured amount: \$96,536

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 4th payment

Date of loan closing: September 20, 2006

Current status: Foreclosure sale held in April 2008 – loss not yet determined

Underwriter type: Manual

Unpaid Judgment

Peoples Bank did not obtain a satisfactory pay history for an open judgment on the borrower's credit report. The borrower's credit report showed an unpaid judgment of \$2,556 that was filed in May of 2002. Although court-ordered judgments are supposed to be paid before a mortgage loan is eligible for FHA insurance, HUD makes an exception if the borrower has agreed with the creditor to make regular and timely payments on the judgment and documentation is provided that payments have been made in accordance with that agreement.

The borrower's nonpurchasing spouse agreed to repay the debt at \$10 to \$20 per month beginning September 8, 2003. The payment ledger indicated that the borrower missed about 20 payments during the three years between the agreement and the FHA loan closing. Further, the nonpurchasing spouse missed 6 of the 20 monthly payments in the year before the FHA loan closing.

HUD Requirements – Appendix C

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, paragraph 2-3C (criterion 20)

Case number: 182-0814658

Insured amount: \$192,479

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 4th payment

Date of loan closing: March 15, 2006

Current status: Foreclosure sale held in April 2008 – loss not yet determined

Underwriter type: Manual

Unsupported Income/Excessive Ratios

Peoples Bank overstated the total household income by \$598 per month. The borrower's income was overstated by \$518 per month, as the lender calculated the monthly income at \$2,722. The borrower's pay stubs reflected a salary of \$1,361 bimonthly for all of the pay stubs provided (November 2005-February 2006). This bimonthly salary equated to \$32,668 per year (\$1,361 x 24 pay periods). However, the December 2005 year-to-date salary and 2005 Internal Revenue Service (IRS) Form W-2 reflected a salary of \$26,447, which equaled \$2,204 per month (\$26,447 / 12 months). The loan closed in March of 2006, and the IRS Form W-2 for 2005 was a reasonable calculation for her income because her pay stubs indicated that she was still making the same bimonthly salary in February 2006.

The borrower was a teacher and stated on the loan application that she had worked at the same school for seven years. The difference in annual income could reflect that the borrower received her salary during the nine-month school year only and not in June, July, and August. If this were the case, the borrower's annual income would have been \$24,501 (\$1,361 x 18 pay periods), which was more in line with her IRS Form W-2 from 2005. On the pay stubs provided, the borrower received pay in the "other" pay category, which could account for the difference between the 2005 IRS Form W-2 (\$26,447) and the calculation for nine months (\$24,501). The lender should have obtained an explanation of the income discrepancies from the borrower.

Additionally, Peoples Bank overstated the coborrower's income by \$80 per month. The lender qualified the coborrower using a monthly income of \$2,178; however, it was unclear how the lender calculated the income. Peoples Bank obtained an earnings record for the coborrower that did not reflect full-time employment. The earnings record covered 10 weeks during November 2005, December 2005, and January 2006. Only 1 of the 10 weeks reflected a 40-hour work week. Using the 2005 IRS Form W-2, the lender supported only \$2,098 per month (\$25,181 / 12 months). The 2005 IRS Form W-2 was recent income information when the loan was underwritten (the mortgage credit analysis worksheet was dated March 9, 2006).

The decreased monthly income resulted in excessive qualifying financial ratios of 37.8 percent and 47.4 percent. The mortgage credit analysis worksheet included a note by the underwriter that the borrowers had reserves as a compensating factor for the excessive ratios. To be considered a compensating factor, HUD requires reserves of at least three months of housing payments. The mortgage credit analysis worksheet showed \$1,181 in cash reserves. The borrower's bank statement showed a balance of \$2,063; however, the \$1,000 earnest money check had not cleared the account, so actual reserves totaled \$1,063. In addition, the borrowers

needed \$664 at closing, leaving \$399 in reserves (less than one monthly payment). The borrowers' principal and interest payment was \$1,185. The lender did not support that the borrowers had at least three months of housing payments in reserves, and, therefore, this compensating factor was not valid.

HUD Requirements – Appendix C

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, section 2-2 (criterion 18)

HUD Handbook 4155.1, REV-5, section 2-13 (criterion 23)

Mortgagee Letter 2005-16 (criterion 26)

Unpaid Judgment

Peoples Bank did not require the borrower to pay a \$100 unpaid judgment before the loan closed. The borrower's credit report listed the judgment as unpaid. Court-ordered judgments are supposed to be paid before a mortgage loan is eligible for FHA insurance.

HUD Requirements – Appendix C

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, paragraph 2-3C (criterion 20)

Social Security Number Discrepancy

Peoples Bank did not resolve a Social Security number discrepancy. The borrower's credit report and a Social Security number report obtained by the lender showed that at least two other people were associated with the same Social Security number. HUD requires the lender to resolve any Social Security number discrepancies. The lender should have obtained a Social Security number verification from another source document or an acceptable explanation from the borrower.

HUD Requirements – Appendix C

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, paragraph 3-1C (criterion 25)

Mortgagee Letter 2005-27 (criterion 27)

Case number: 182-0821834

Insured amount: \$113,354

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 14th payment

Date of loan closing: July 25, 2006

Current status: First legal action to commence foreclosure in April 2008

Underwriter type: Manual

Overstated Income/Excessive Ratios

Peoples Bank overstated the borrower's employment income by \$604 per month when it included unsupported overtime income. The only pay stub provided by the borrower (pay period ending June 15, 2006) did not indicate the number of hours worked or number of days in the pay period or specify a pay rate. The lender used year-to-date earnings for a \$2,417 monthly average (\$13,293 / 5.5 months). However, the 2005 Internal Revenue Service Form W-2 yielded a \$2,283 (\$27,390 / 12 months) monthly average. In addition, the lender did not develop a two-year earnings trend for overtime. Further, the employer did not address the likelihood of future overtime in the verification of employment, which is especially important when the claimed monthly income includes a significant amount of overtime. The year-to-date amount for base pay was \$9,972 or \$1,813 per month (\$9,972 / 5.5 months). Employment income was overstated by \$604 per month (\$2,417 - \$1,813).

Without the overtime income, the qualifying financial ratios increased to well above HUD's limit, to 49 percent and 53.4 percent.

HUD Requirements – Appendix C

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, section 2-2 (criterion 18)

HUD Handbook 4155.1, REV-5, section 2-7 (criterion 21)

HUD Handbook 4155.1, REV-5, paragraphs 2-7A and E (criterion 21)

Mortgagee Letter 2005-16 (criterion 26)

Case number: 182-0823672

Insured amount: \$144,645

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 8th payment

Date of loan closing: September 8, 2006

Current status: Active – 10 months delinquent

Underwriter type: Manual

Overstated Income/Excessive Ratios

Peoples Bank overstated the borrowers' income by \$1,084 per month. The lender qualified the borrowers using \$4,160 in monthly income (\$2,080 each). Pay stubs for each of the borrowers supported a pay rate of \$12 per hour ($\$12 \times 40 \text{ hrs} \times 52 \text{ weeks} / 12 = \$2,080$). The year-to-date amounts on the pay stubs did not support earnings of \$2,080 per month for either borrower.

The year-to-date amount on the borrowers' most recent pay stub, dated August 15, 2006, was \$11,897. Average monthly income based on this amount was only \$1,586 ($\$11,897 / 7.5 \text{ months}$). The year-to-date amount on the coborrower's most recent pay stub, dated August 11, 2006, was \$11,000. Average monthly income based on this amount was only \$1,490 ($\$11,000 / 32 \text{ weeks} \times 52 / 12 \text{ months}$). The 2004 and 2005 income documentation, if used for either the borrower or coborrower, would have made their monthly incomes even lower.

The total monthly income supported by the pay stubs was \$3,076. The lender obtained verbal verifications of employment for both borrowers; however, neither included information on pay rate, work hours, or overtime and bonuses. In addition, the coborrower's verification did not include a start date for employment. The lender did not establish and document earnings trends for overtime or bonus income. Therefore, the lender overstated monthly income by \$1,084. Using only supported income, the financial ratios were to 37.4 percent and 51.5 percent.

HUD Requirements – Appendix C

HUD Handbook 4000.4 REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, section 2-2 (criterion 18)

HUD Handbook 4155.1, REV-5, section 2-7 (criterion 21)

Mortgagee Letter 2005-16 (criterion 26)

Ineligible Property

Peoples Bank submitted an ineligible property for FHA insurance. The appraisal listed a married couple as the owners of record. The sales contract named an investment company as the owner. Loan file documentation indicated that the married couple sold the property to the investment company on August 15, 2006, which was less than one month before the sale of the property to the FHA borrowers. This property was not eligible for FHA insurance.

HUD Requirements – Appendix C

HUD Handbook 4000.2, REV-3, paragraph 1-7C (criterion 1)

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

Mortgagee Letter 2006-14 (criterion 28)

Case number: 182-0824524

Insured amount: \$86,813

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 12th payment

Date of loan closing: September 18, 2006

Current status: First legal action to commence foreclosure in April 2008

Underwriter type: Manual

Underreported Liabilities/Excessive Ratios

Peoples Bank underreported the borrower's liabilities by \$324 per month. The lender did not adequately consider a car payment that affected the borrower's ability to repay the mortgage in the months immediately after closing. The lender did not include the payment in the financial ratios.

The loan file documentation was contradictory, as described below.

- The credit report, dated August 7, 2006, showed a monthly payment of \$324 and a balance of \$4,817, which yielded more than 14 months left to repay the loan.
- The creditor verification letter, dated August 14, 2006, listed the monthly payments at \$300 and the balance of the loan at \$4,724, which yielded more than 15 months to pay off the loan.
- A payment printout, dated August 15, 2006, showed bimonthly payments of \$150 and a balance of \$4,701.

On September 5, 2006 (two weeks before closing the FHA loan), the borrower made a \$1,474 payment (in two installments) to reduce the loan balance to \$3,000. The final loan application listed the payment as \$324 with a balance of \$3,074, which yielded a 9.5-month payoff period.

Based on the information provided by the creditor, it appeared that the most current balance was \$3,000 and that the borrower was paying \$150 bimonthly (an average of \$324/mo.). The borrower had 9.3 months of payments left to make, and, therefore, the liability should have been included in the ratio calculation because this monthly payment was large enough to adversely affect the borrower's ability to make the mortgage payment immediately after closing. The liability increased the total debt ratio from 38.7 percent to 54.7 percent, which was well above HUD's limit. The transactions on this loan before loan closing could be an indication that the borrower's intention was to pay down the loan so that the liability would not affect already high ratios.

Additionally, the lender should have questioned the source of funds used to pay down the car loan. To pay down the car loan, the borrower may have secured an additional loan that might not have appeared on the credit report and not have been included in the financial ratio calculation. The borrowers used only about \$300 of their own assets in closing the loan. Their bank balance was only \$557 as of August 23, 2006 (three weeks before closing the loan). The balance for the

month before was only \$306. Both months showed a number of insufficient funds charges. The mortgage credit analysis worksheet showed that the borrower had reserves of only \$299, less than one month of the \$549 monthly principal and interest payment. The lender did not list compensating factors on the mortgage credit analysis worksheet.

HUD Requirements – Appendix C

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, paragraph 2-11A (criterion 22)

Mortgagee Letter 2005-16 (criterion 26)

Case number: 183-0053891

Insured amount: \$65,975

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 2nd payment

Date of loan closing: May 11, 2007

Current status: Active – six months delinquent

Underwriter type: Manual

Missing Verification of Mortgage Payments

Peoples Bank did not obtain a verification of mortgage for the borrower although there was evidence that the borrower was past due on refinancing the mortgage. The borrower's bank statements showed that she had made a payment on February 2, 2007, for more than three times the monthly payment ($\$1,316 / 423 = 3.11$). The prior lender verified that the borrower's monthly payment was \$423. The mortgage credit analysis worksheet showed that the borrower's current housing expense was \$468 per month.

Further, there was a significant difference between what the credit report showed as the principal balance (\$26,576) on the prior mortgage and the loan payoff amount paid at closing (\$34,860). This difference indicated that the borrower may have missed payments, accrued additional interest, had escrow shortages, and been charged fees for late payments. Peoples Bank should have questioned the large payment and obtained a verification of mortgage payment history from the prior lender. HUD does not allow refinanced mortgages to include late interest, late fees, or escrow shortages. Without the payment history, Peoples Bank was unable to verify that the unallowable fees were not included in the FHA mortgage.

HUD Requirements – Appendix C

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, paragraph 1-11A(2) (criterion 16)

HUD Handbook 4155.1, REV-5, paragraph 1-11B (criterion 17)

HUD Handbook 4155.1, REV-5, paragraph 2-3A (criterion 19)

HUD Handbook 4155.1, REV-5, section 3-1 (criterion 24)

Case number: 183-0055148

Insured amount: \$169,099

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 3rd
payment

Date of loan closing: June 23, 2007

Current status: Active – two months delinquent

Underwriter type: Manual

Unsupported Income/Excessive Ratios

Peoples Bank overstated the borrower's income by \$638 per month, resulting in excessive qualifying financial ratios of 34 percent and 48 percent. The borrower's statement of earnings and leave showed the borrower's annual salary as \$50,155, which equaled \$4,180 per month (\$50,155 / 12 months). However, the lender listed the borrower's monthly income on the mortgage credit analysis worksheet as \$4,818, which would be an annual salary of \$57,818. Therefore, the lender overstated the borrower's monthly income by \$638 (\$4,818 - \$4,180).

HUD Requirements – Appendix C

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, section 2-2 (criterion 18)

HUD Handbook 4155.1, REV-5, paragraph 2-7A (criterion 21)

Mortgagee Letter 2005-16 (criterion 26)

Case number: 291-3457668

Insured amount: \$53,744

Section of Housing Act: 203(b)

Status upon selection: Defaulted on 14th
payment

Date of loan closing: July 6, 2006

Current status: Active – current

Underwriter type: Manual

Missing Verification of Mortgage Payments

Peoples Bank did not obtain a verification of mortgage payments for a refinanced mortgage and a home equity loan. The borrower's credit report indicated that the borrower had two loans with the prior lender; however, the credit report showed the first mortgage was paid off in 2001 and the home equity loan was paid off in 2000. The credit report showed no outstanding mortgage balance. The loan file included no documentation regarding the borrower's payment history on these prior mortgage loans or an explanation of why the credit report showed no outstanding mortgage.

In addition, the payoff statements from the prior lender did not provide a payment history of the loans to indicate whether the loans had a negative payment history (i.e., late payments, significant defaults, etc.). Further, HUD does not allow refinanced mortgages to include late interest, late fees, or escrow shortages. Without the payment history, Peoples Bank was unable to adequately evaluate the borrower's creditworthiness and to verify that the unallowable fees were not included in the FHA mortgage.

HUD Requirements – Appendix C

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 2-4C (criterion 2)

HUD Handbook 4155.1, REV-5, paragraph 1-11A(2) (criterion 16)

HUD Handbook 4155.1, REV-5, paragraph 2-3A (criterion 19)

HUD Handbook 4155.1, REV-5, section 3-1 (criterion 24)