



Issue Date	August 3, 2010
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Audit Report Number	2010-BO-1007
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TO: Vicki Bott, Deputy Assistant Secretary for Single Family Housing, HU

FROM:   
John Dvorak, Regional Inspector General for Audit, Boston Region, IAGA

SUBJECT: New England Regional Mortgage Corporation, Salem, NH, Generally Complied With HUD Requirements for Loan Origination but Did Not Properly Underwrite One Loan

## **HIGHLIGHTS**

### **What We Audited and Why**

We audited New England Regional Mortgage Corporation (Corporation), a Federal Housing Administration (FHA) lender approved to underwrite and close mortgage loans without prior FHA review or approval. We selected the Corporation because its early payment default rate for insured single-family loans originated between January 1, 2008, and December 31, 2009, was significantly higher than the default rate in the local area in which it does business. Our audit objectives were to determine whether (1) the Corporation acted in a prudent manner and complied with U.S. Department of Housing and Urban Development (HUD) regulations, procedures, and instructions for the origination, underwriting, and closing of the FHA-insured single-family loans selected for a detailed review and (2) its quality control plan, as implemented, fulfilled HUD's requirements.

### **What We Found**

The Corporation generally complied with HUD requirements in the origination of FHA-insured single-family loans. In addition, the Corporation's quality control plan, as implemented, fulfilled HUD's requirements. However, one loan had

significant underwriting deficiencies that negatively affected the insurability of the loan. The underwriting deficiencies included improperly documented borrower income, an omitted liability, undervalued debt-to-income ratios, and failure to notify HUD of an employee loan transaction. These deficiencies occurred because the lender did not act in a prudent manner when it approved this loan. The loan was not eligible for FHA mortgage insurance and placed the FHA insurance fund at risk for a potential loss of more than \$221,000.

The Corporation was also incorrectly listed as the holding lender for 43 active loans and the servicing lender for 8 active loans. These errors occurred because the Corporation was not aware of HUD requirements regarding mortgage record changes after it sold loans to investing lenders. Inaccurate or untimely reporting of mortgage record changes directly affects the payment of claims for insurance benefits. HUD will not pay a claim for insurance benefits for which the information on the claim and HUD's FHA insurance system do not agree.

### **What We Recommend**

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require the Corporation to indemnify HUD for a loss that may be incurred related to the loan that did not meet FHA insurance requirements. The projected loss to HUD of \$221,590 is based on an actuarial review of FHA's insurance fund prepared for HUD; a loss rate of 60 percent of the unpaid principal balance of the loan (see appendix C). We also recommend that the Corporation update its remaining mortgage records in HUD's system to reflect the appropriate mortgage holder and implement procedures to ensure the timely submission of mortgage record changes for future loans sold to investing lenders.

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

### **Auditee's Response**

We provided Corporation officials draft finding details throughout the course of the audit. We also provided the officials with a draft audit report on June 29, 2010, and requested a response by July 14, 2010. We discussed the draft report at an exit conference on July 7, 2010, and received the Corporation's written comments on July 14, 2010. The Corporation generally disagreed with finding 1 and agreed with finding 2.

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

The National Housing Act, as amended, established the Federal Housing Administration (FHA), an organizational unit within the U.S. Department of Housing and Urban Development (HUD). FHA provides insurance to protect lenders against losses on mortgages financing homes. The basic single-family mortgage insurance program is authorized under Title II, Section 203(b), of the National Housing Act and is governed by regulations in 24 CFR (Code of Federal Regulations) Part 203. The single-family programs are generally limited to dwellings with one-to four-family units. HUD handbooks and mortgagee letters provide detailed processing instructions and advise the mortgage industry of major changes to FHA programs and procedures.

We identified New England Regional Mortgage Corporation (Corporation) as a lender for review based on a risk assessment of mortgage lenders in the New England region. We identified the Corporation as having a higher than average FHA-insured mortgage default rate when compared to other FHA lenders. The lender originated and underwrote 526 loans during our review period with a total original mortgage amount of more than \$126 million. The lender originated at least one FHA loan in eight different States during this period, with primary originations occurring in New Hampshire, Rhode Island, Massachusetts, and Connecticut. Forty of the loans (or 7.6 percent) defaulted within the first 2 years of origination, and three of the default loans (or 7.5 percent) were claim terminated. When comparing loans underwritten by the lender to the rest of the lenders in each State, the lender had a total early payment default percentage that was much higher than average (compare ratio<sup>1</sup>), especially for those loans originated in New Hampshire and Rhode Island (see table below).

State	Compare ratio	Total orig.	Total defaults by 2 yr	% def by 2 yr	# of def by 2 yr to claim	% of def by 2 yr to claim	State total orig.	State total defaults by 2 yr	State % def by 2 yr	State # of def by 2 yr to claim	State % of def by 2 yr to claim
New Hampshire	403%	122	20	16.39	2	10.00	11,823	481	4.07	30	6.24
Rhode Island	172%	80	7	8.75	1	14.29	10,552	538	5.10	28	5.20
Massachusetts	106%	253	12	4.74	0	0.00	46,024	2,051	4.46	39	1.90
Connecticut	33%	52	1	1.92	0	0.00	35,641	2,065	5.79	45	2.18
Maine	0%	3	0	0.00	0	--	9,603	503	5.24	7	1.39
Florida	0%	3	0	0.00	0	--	146,205	15,188	10.39	187	1.23
Vermont	0%	11	0	0.00	0	--	2,778	122	4.39	0	0.00
Maryland	0%	2	0	0.00	0	--	93,141	6,956	7.47	138	1.98
Totals		526	40	7.6	3	7.5					

\*Source: HUD's Neighborhood Watch/Early Warning System

<sup>1</sup> The percentage of originations that are seriously delinquent or were claim terminated divided by the percent of originations that are seriously delinquent or were claim terminated for the selected geographic area. Compare ratio is the value that reveals the largest discrepancies between the subjects' seriously delinquent and claim percentage and the seriously delinquent and claim percentage to which it is being compared.

In addition, the lender had a high compare ratio for several fiscal quarters (see table below).

Quarter end dates	Compare ratio	Corp. total orig.	Corp. total seriously delinquent	Corp. total claims	Corp. total seriously delinquent and claims	Corp. % seriously delinquent and claims	United States total orig.	United States total seriously delinquent	United States total claims	United States total seriously delinquent and claims	United States % seriously delinquent and claims
03/31/2010	141%	509	30	2	32	6.29	3,399,995	142,832	8,978	151,810	4.47
12/31/2009	139%	526	34	3	37	7.03	3,212,363	154,190	7,959	162,149	5.05
09/30/2009	152%	494	34	3	37	7.49	2,878,599	134,910	7,219	142,129	4.94
06/30/2009	167%	449	32	2	34	7.57	2,483,073	105,969	6,144	112,113	4.52
03/31/2009	207%	381	35	0	35	9.19	2,105,924	88,002	5,244	93,246	4.43
12/31/2008	201%	311	27	0	27	8.68	1,788,355	72,809	4,210	77,019	4.31
09/30/2008	193%	257	18	0	18	7.00	1,477,687	50,088	3,508	53,596	3.63
06/30/2008	129%	223	10	0	10	4.48	1,179,175	37,667	3,332	40,999	3.48
03/31/2008	109%	170	7	0	7	4.12	977,809	33,712	3,344	37,056	3.79
12/31/2007	132%	130	7	0	7	5.38	864,323	32,495	2,878	35,373	4.09
09/30/2007	131%	85	4	0	4	4.71	817,871	26,823	2,652	29,475	3.60
06/30/2007	173%	54	3	0	3	5.56	817,555	23,591	2,775	26,366	3.22
03/31/2007	77%	45	1	0	1	2.22	837,100	21,134	2,944	24,078	2.88

\*Source: HUD's Neighborhood Watch/Early Warning System

The Corporation is a nonsupervised<sup>2</sup> mortgage company. HUD authorized the lender to originate FHA loans in February 1992. The home office for the lender is located in Salem, NH, and it currently has three active branch offices in Connecticut, Massachusetts, and Rhode Island, all of which have opened within the last 3 years.

The audit objectives were to determine whether (1) the Corporation acted in a prudent manner and complied with HUD regulations, procedures, and instructions for the origination, underwriting, and closing of the FHA-insured single-family loans selected for a detailed review and (2) its quality control plan, as implemented, fulfilled HUD's requirements.

<sup>2</sup> This designation applies to non-depository financial entities that have as their principal activity the lending or investment of funds in real estate mortgages.

## RESULTS OF AUDIT

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### Finding 1: The Corporation Did Not Underwrite One Loan in Accordance With HUD Requirements

The Corporation did not underwrite one loan in accordance with HUD requirements. Specifically, our review of the loan exhibited underwriting deficiencies significant enough to warrant indemnification. The deficiencies included inadequate disclosure to HUD of a loan involving an employee, inadequate support for job/income stability of the borrower, inadequate credit history of the borrower and incorrect calculation of debt-to-income ratios. These deficiencies occurred because the lender did not act in a prudent manner when it approved the loan and may have been due to the financial interest in the transaction of both the president of the Corporation and the president's spouse, a loan officer. Although the Corporation did not follow proper HUD underwriting guidelines for this loan, there was no indication of a pattern of noncompliance. However, the loan placed the FHA insurance fund at risk for loss of \$221,590.

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#### **Two Loans Had Significant Underwriting Deficiencies**

The Corporation did not underwrite one loan in accordance with HUD requirements. Specifically, the loan reviewed had significant underwriting deficiencies that warrant indemnification.

#### **FHA Case No. 341-0867550**

We found significant underwriting deficiencies for this loan,<sup>3</sup> including inadequate disclosure to HUD of a loan involving an employee, inadequate support for job/income stability of the borrower, inadequate credit history of the borrower and incorrect calculation of debt-to-income ratios.

#### Inadequate Disclosure to HUD of a Loan Involving an Employee

This loan involved an employee of the Corporation. The employee was the seller and had a financial interest in the transaction. The seller, a Corporation loan officer, was also married to the president of the Corporation and owned the property jointly with the president until the closing date of this loan. On the closing date, the president transferred ownership to the spouse, who then transferred ownership to the

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<sup>3</sup> This was the original case number for the purchase mortgage. The borrower had two later streamline refinances. The FHA case number on the last streamline refinance was 341-895000.

buyer.<sup>4</sup> The Corporation did not adequately disclose to HUD that the loan involved an employee. The case was not clearly identified in the remarks section of the Mortgage Credit Worksheet and beneath Box F, "Employment," on the front of the case binder, as required.<sup>5</sup>

In addition, the employee was involved in the processing of the application. Supporting documentation for the loan application was sent to the attention of the loan officer, indicating that the employee was also involved in the origination process, which HUD regulations prohibit.<sup>6</sup> Additionally, the president and spouse were the loan officers on two later FHA streamline refinance transactions.

Finally, the underwriter certified on Form HUD-92900A, HUD/VA [U.S. Department of Veterans Affairs] Addendum to Uniform Residential Loan Application, that the lender, owners, officers, employees, or directors did not have a financial interest in or a relationship, by affiliation or ownership, with the seller involved in this transaction, which was not true.

#### Inadequate Support for Job/Income Stability

The Corporation accepted inadequate support for the job/income stability of the borrower.<sup>7</sup> The Corporation did not adequately evaluate the documentation provided by the borrower and employer when it approved this loan. Specifically, income documentation did not adequately support that the borrower was an employee of, rather than a subcontractor for, the company that provided the verification of employment.

The file contained a letter from the employer dated May 5, 2006, which indicated the borrower's previous work history as a 1099 employee and current and future employment history with the employer. The underwriter requested and obtained a completed VOE form dated May 18, 2006 from the employer, which did not agree with information included in the letter previously provided by the employer. The verification of employment form and a letter provided by this company included discrepancies regarding income, overtime hours and dates of employment. Additionally, the prior-year earnings shown on the verification of employment form did not agree with the Internal Revenue Service (IRS) Form 1099 provided to the borrower. According to the letter, the borrower accepted a position as a foreman with the company as of May 1, 2006, the same month of the closing. The Corporation obtained one uncashed paycheck, dated May 26, 2006, to support current income. The deductions information on the pay stub were handwritten, did not include year-to-date information, and had inaccurate Medicare and Social Security deductions. The VOE form showed year-to-date

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<sup>4</sup> The president was not shown as the seller on the sales contract, although the president had ownership in the property until the closing date of this loan.

<sup>5</sup> HUD Handbook 4000.4, REV-1, CHG-2, paragraph 1-14

<sup>6</sup> HUD Handbook 4000.4, REV-1, CHG-2, paragraph 1-14.

<sup>7</sup> HUD Handbook 4155.1, REV-5, paragraphs 2-6 and 2-7.

income of \$22,000, which according to the Corporation, was year-to-date income up until the borrower's promotion. The Corporation stated the uncashed paycheck was probably the borrower's first pay check. The underwriter notated on the letter from the employer that the employer verbally verified that the letter was a true and accurate statement.

The borrower was paid as a subcontractor, not an employee. As a subcontractor, the borrower would have been liable for federal income and self-employment taxes on earnings that would have reduced net income, and the borrower would have been required to provide tax returns to the Corporation. A verification of employment obtained by the Corporation during a later FHA refinance transaction also showed that the borrower was in fact a subcontractor during this period.

Additionally, the Corporation did not obtain adequate income documentation for the previous 2-year period. The borrower was self-employed and the Corporation did not obtain the borrower's tax returns for the previous two years and did not obtain IRS Forms 1099 for two companies, as required.<sup>8</sup> Instead, the underwriter accepted a letter and a payment printout for one company and an invoice from another company stating the amounts paid to the borrower for one tax year.

#### Inadequate Credit History

The Corporation did not adequately establish the borrower's credit history or rental history.<sup>9</sup> The credit report showed that the borrower had a limited credit history; therefore, the Corporation should have documented a nontraditional credit history for the borrower to include documenting timely payments for monthly bills such as rent, utilities, and insurance premiums. According to the borrower's written statement, the borrower paid cash for bills but did not support that bills were paid on time. The Corporation obtained a Rent-A-Center printout showing that the borrower made cash payments; however, this payment history was more than 15 months before the loan transaction. In addition, the Corporation could not have verified an adequate rental payment history for the borrower, since the borrower's spouse received housing rental assistance from the State housing finance agency for the unit they occupied. The borrower's spouse was not a coborrower on the loan.

#### Debt-to-Income Ratios Incorrectly Calculated

The Corporation incorrectly calculated the housing payment-to-income ratio and the total monthly payments-to-income ratio at 36.25 and 40.54 percent, respectively, because it erroneously excluded a cosigned loan for the borrower's spouse, and used an incorrect overtime rate and overtime hours. The Corporation should have included this contingent liability in the calculation because since it was a new loan, there was an insufficient payment history by the spouse. In

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<sup>8</sup> HUD Handbook 4155.1, REV-5, paragraph 2-9.B.

<sup>9</sup> HUD Handbook 4155.1, REV-5, paragraph 2-3 and 2-4.



addition, the bank did not provide a statement indicating that the borrower would not be liable should the spouse default on the loan. The Corporation also incorrectly used a higher overtime rate than the borrower was paid and used anticipated overtime hours instead of overtime hours for the previous two years.<sup>10</sup> If the total mortgage payment<sup>11</sup> does not exceed 31 percent of the gross effective income, the relationship of the mortgage payment to income is considered acceptable. A ratio exceeding 31 percent may be acceptable only if significant compensating factors are documented and are recorded on the mortgage credit analysis worksheet. In addition, if the total of the mortgage payment and all recurring charges does not exceed 43 percent of the gross effective income, the relationship of total obligations to income is considered acceptable. A ratio exceeding 43 percent may be acceptable only if significant compensating factors are documented and are recorded on the mortgage credit analysis worksheet.<sup>12</sup> The correct ratios should have been 45.78 and 57.02 percent, respectively, and the minimal compensating factors listed were not supported.

### **The Corporation Did Not Act in a Prudent Manner**

The Corporation did not act in a prudent manner when it approved the loan. It should have been more prudent when evaluating the documentation provided by the borrowers and employers and should have required additional supporting documentation to verify the borrower's employment status.

In addition, the Corporation's president and underwriter agreed that they did not follow HUD requirements for loans involving an employee. The president and underwriter stated that they were not aware of the additional requirements when the employee was a seller in an FHA loan transaction.

### **Conclusion**

The Corporation did not underwrite one loan reviewed in accordance with HUD requirements. This deficiency occurred because the lender did not act in a prudent manner when it underwrote the loan. In addition, the underwriting deficiencies may have been due to the financial interest of both the president of the Corporation and the president's spouse, a loan officer, in the transaction. The two loans unnecessarily placed the FHA insurance fund at risk for more than \$221,000 in potential losses should the property be foreclosed upon and resold for less than the unpaid principal balance.

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<sup>10</sup> HUD Handbook 4155.1, REV-5, paragraph 2-7.A.

<sup>11</sup> Total housing payment includes principal and interest; escrow deposits for real estate taxes, hazard insurance, the mortgage insurance premium, homeowners' association dues, ground rent, special assessments, and payments for any acceptable secondary financing

<sup>12</sup> HUD Handbook 4155.1, REV-5, paragraph 2-12.A. and 2-12.B and Mortgagee Letter 2005-16, Revised Qualifying Ratios and Treatment of Child Support.

## Recommendations

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require the Corporation to

- 1A. Indemnify HUD for losses that have been or may be incurred related to FHA case number 341-0895000 (the original purchase FHA case number was 341-0867550). The projected loss to HUD of \$221,590 is based on an actuarial review of FHA's insurance fund prepared for HUD; a loss rate of 60 percent of the unpaid principal balance.

## Finding 2: Mortgage Records Were Not Accurate in HUD Systems

The Corporation was incorrectly listed as the holding lender for 43 active loans and the servicing lender for 8 active loans. This condition occurred because the Corporation was not aware of HUD requirements regarding mortgage record changes and considered it solely a responsibility of the new servicers of the loans to update the mortgage records after it sold the loans to investing lenders. Inaccurate or untimely reporting of mortgage record changes directly affects the payment of claims for insurance benefits. HUD will not pay a claim for insurance benefits for which the information on the claim and HUD's FHA insurance system do not agree.

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### **Mortgage Records for the Corporation Were Not Accurate**

As of March 31, 2010, the Corporation was still listed as the holding lender for 43 active loans and the servicing lender for 8 active loans, most of which were more than 90 days past endorsement. The Corporation sells all loans that it originates, including the servicing rights, at closing to investing lenders. Originating lenders initially process the loan application. Holding lenders hold title to the mortgage note. Servicing lenders maintain the servicing rights to the loan as they relate to FHA-insured mortgages, including the collection of loan payments, servicing delinquent accounts, foreclosure processing, mortgage insurance premium billing, escrow administration, and general maintenance of records.

In November 2003, recognizing the new technology under which the mortgage industry and HUD operate the single-family insurance programs, HUD eliminated the paper mortgage insurance certificate in favor of electronic records maintained by HUD for the purpose of verification of both the ownership and the insured status of a mortgage. As a result, HUD made several procedural changes that affected the originating lender, the holding lender, and the servicing lender.<sup>13</sup>

HUD determined that it was imperative that the data contained in HUD's Single Family Insurance System regarding a lender's FHA-insured portfolio be accurate.<sup>14</sup> Of key concern is the submission of mortgage record changes and mortgage insurance terminations that update HUD's insurance system. Lenders must notify HUD of a sale of an FHA-insured loan within 15 calendar days.<sup>15</sup> HUD identified that the most common problem was that lenders often did not update the holder of record for each loan as required. As of December 1, 2005, only the existing holder of record is able to provide HUD with mortgage record

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<sup>13</sup> Mortgagee Letter 2003-17.

<sup>14</sup> Mortgagee Letters 2003-17, 2004-34, 2005-11, and 2005-42.

<sup>15</sup> 24 CFR 203.431, Sale of insured mortgage to approved mortgagee.

changes to update a new holder of record if 90 days have passed after endorsement.<sup>16</sup>

### **The Corporation Took Immediate Corrective Action**

Corporation officials acknowledged that they had not notified HUD or updated mortgage records upon the sale of FHA-insured loans because they were not aware of the requirements. However, they took immediate action on this finding. They stated that they had updated all mortgage records. HUD will have to verify the updated mortgage records after the next refresh of data in HUD's single-family systems.

### **Conclusion**

Corporation officials did not properly notify HUD upon the sale and/or transfer of FHA-insured loans. This condition occurred because the officials were not aware of the HUD requirements regarding mortgage record changes. Inaccurate or untimely reporting of mortgage record changes directly affects the payment of claims for insurance benefits. HUD will not pay a claim for insurance benefits for which the information on the claim and HUD's FHA insurance system do not agree. Therefore, it is incumbent upon the lender to ensure that HUD's records accurately reflect both the correct holder and servicer of record.

### **Recommendations**

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require the Corporation to

- 2A. Update its remaining mortgage records in HUD's system to reflect the appropriate mortgage holder.
- 2B. Implement procedures to ensure the timely submission of mortgage record changes for future loans sold to investing lenders.

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<sup>16</sup> Mortgagee Letter 2005-42.

## SCOPE AND METHODOLOGY

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We identified the Corporation as a lender for review based on a risk assessment of mortgage lenders in the New England region. We researched lenders using HUD's Single Family Neighborhood Watch system (SFNW) and Single Family Housing Enterprise Data Warehouse system (SFHEDW). SFNW is a web-based comprehensive data processing, automated querying, reporting and analysis system designed to highlight exceptions to lending practices to high-risk lenders and mortgages, so that potential problems that may arise are readily identifiable. SFHEDW is data warehouse that is the key source of single-family data. SFHEDW allows queries and provides reporting tools to support oversight activities, market, and economic assessment, public and stakeholder communication, planning and performance evaluation, policies and guidelines promulgation, monitoring and enforcement. Our audit period was January 1, 2008, through December 31, 2009. We identified lenders that

- Were active direct endorsement lenders,
- Had a home or branch office in Region 1,
- Had originated at least 100 loans in the past 2 years,
- Had a higher percentage of loans that defaulted within the first 2 years after endorsement compared to the rest of the area selected for comparison, and
- Had not been reviewed by HUD OIG or HUD's Quality Assurance Division in the past 5 years.

To accomplish the survey objectives, we

- Identified, obtained, and reviewed relevant regulations pertaining to the origination of single-family mortgages, including the Code of Federal Regulations, HUD handbooks, mortgagee letters, and the United States Code.
- Obtained and reviewed pertinent performance information relating to the lender.
- Obtained and reviewed copies of policies and procedures that the lender uses for its loan origination processes.
- Reviewed HUD postendorsement technical review data.
- Reviewed HUD case binders.
- Reviewed the lender's loan files to determine whether additional information was available that would support loan approval for FHA insurance that was not available in the HUD case binder.
- Reviewed the lender's file for information (e.g., missing liabilities, missing credit history, borrower lost his/her job before closing and the lender was aware) that was not considered during the loan origination process, which would have precluded approval of the loan for FHA insurance.
- Performed reverifications of borrower asset and income information to confirm dates, amounts, and other information reported.
- Interviewed the borrower(s) and/or employer(s) to determine their roles in the transaction.
- Interviewed lender staff involved in the origination of loans for which we identified

deficiencies/irregularities.

- Performed tests to verify that the lender had implemented an adequate quality control plan and initiated immediate corrective action when discrepancies were found.
- Assessed other general aspects of the lender's operations to ensure their continued lender approval status.

We identified and conducted a detailed review of 19 FHA-insured loans originated by the Corporation. We selected the loans based on several risk factors from the 40 loans that went into early payment within the first 2 years of origination during our audit period:

- Loans that were claim terminated,
- Purchase loan transactions,
- Loans that went to claim with six or fewer payments before the first default being reported,
- Loans with excessive debt ratios, and
- Loans with gift letter amounts.

The 19 loans represent the best loans for selection out of the 40 loans that were early payment defaults based on the analysis of available loan-level data and online records searches. This methodology allowed us to focus on loans that had a greater inherent risk to the FHA insurance fund and/or of noncompliance or abuse.

We relied on information from systems used by HUD (including SFNW and SFHEDW) to target loans for review and verified that the information submitted to HUD was consistent with the information in the lender's own files. We also used LexisNexis Investigative Portal to verify borrower and property information. LexisNexis is a web-based search tool that provides access to billions of public records, news, businesses, legal records, and other types of information, which helps locate individuals, businesses, and assets. Other evidence supported the information obtained; therefore, we determined that the data were sufficiently reliable for our purposes. The corroborating evidence independently supports our conclusions.

We conducted the 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

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Internal control is a process adopted by those charged with governance and management designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to:

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

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

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## Relevant Internal Controls

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

- Loan origination process - Policies and procedures established by management to ensure that FHA-insured loans are originated in accordance with HUD requirements.
- Quality control process - Policies and procedures established by management to ensure that the quality control plan has been implemented and related reviews are performed in accordance with HUD requirements.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

### **Significant Deficiency**

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

- The Corporation did not follow HUD requirements when originating and underwriting an FHA loan (see finding 1).
- The Corporation did not ensure that its mortgage records were accurate in HUD systems (see finding 2).
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### **Separate Communication of Minor Deficiencies**

Minor internal control and compliance issues were reported to the auditee in a separate memorandum, dated July 7, 2010.



## APPENDIXES

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### Appendix A

#### SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

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Recommendation number	Funds to be put to better use <sup>1/</sup>
1A	\$221,590

- <sup>1/</sup> Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. Implementation of our recommendation to require the Corporation to indemnify HUD for the loan will reduce the risk of loss to the FHA insurance fund. The amount above reflects HUD's estimated loss of 60 percent of the unpaid principal balance of the loan (see appendix C).

# Appendix B

## AUDITEE COMMENTS AND OIG'S EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments

#### **Audit Recommendation Referral Summary: Referral of Recommendation Because of Disagreement**

#### **AUDIT REPORT**

Office of Inspector General for Audit's discussion draft  
For New England Regional Mortgage Corporation (NERMC)

Issued June 29, 2010

#### **HUD ADDRESSEE**

US Department of Housing and Urban Development  
Office of Inspector General for Audit, Region 1  
10 Causeway Street, Room 370  
Boston, MA 02222

#### **FINDING AT ISSUE**

Finding 1: The Corporation did not always underwrite loans in accordance with HUD requirements

Finding 2: Mortgage Records were not accurate in HUD Systems

#### **SUMMARY OF FINDING**

NERMC strongly disagrees that we did not act in a prudent manner while underwriting two FHA-Insured single family loans. The statement that the underwriting deficiencies including improperly documented borrower income, an omitted liability, undervalued debt-to-income ratios, inadequate documentation to show source of funds are unwarranted and, respectfully, some HUD's statement of the facts have material inaccuracies in its Draft response.

#### **SUMMARY OF DISAGREEMENT**

FHA Case # 341-0867550 was previously sited in a post technical review for the items we are discussing today. The post technical review was done in June 2006, just one month after the loan closed. [REDACTED], the acting director at the time was, the HUD official who issued the site and [REDACTED] is the Underwriter from HUD who received our response and satisfactorily accepted our explanation of all the above issues. (Exhibit C) If HUD were unsatisfied at the time, we would of immediately responded by removing the loan from HUD Insurance Fund and Re-underwrote the file for conventional loan or otherwise, as this underwriter has sign off up to 650K including PMI. The Collateral Value at the time was stable and we had programs in place at the time, other than FHA that we had access to and could have alternatively place the [REDACTED] loan into. This issue then would not be an issue at all, should of HUD at that time, disagreed with our conclusions and withdrew its insurance. Instead, HUD accepted our explanation and closed the matter. The Auditors, at this late date and once the loan had become delinquent, is now disagreeing with our and HUD's conclusions. The borrower completed two loans after the loan that is in question. The Auditors are stating

**Comment 1**

the same reasons as were previously stated by HUD and explained by NERMC and our explanation was accepted in writing as satisfactory, then later it is reopened and we should indemnify.

**Comment 2**

Lastly, [REDACTED] has lost many months of work because of the onset of his illness, his current condition and his treatments. This cancer was not predictable in the loan underwriting. However, during the times he has been temporarily past due, he has struggled and successfully brought his loan current. In addition, [REDACTED] just recently worked out a loan modification with his servicer, lowering his rate, and is now due for July 2010. (see attached Exhibit A).

**Comment 3**

In regards FHA Case #341-0896983 this underwriter met the guidelines she sites and she exceeded the documentation level on income that was required. There is strong disagreement by NERMC with the conclusion of the auditors, respectfully, of the underwriting and its guidelines. The underwriter carefully analyzed the loan documentation. HUD's stated guidelines that both OIG and this underwriter site were satisfactorily met. We interpreted the guidelines differently but both sited the some of the same guidelines as reasons to do or not do the loan. During our discussion with the auditors the issue on this was narrowed to the lack of documentation of the 2 year work history. This underwriter requested and the borrower did provide us with a written history of all the work he did during the past two years and more. He gave us all he had in terms of income documentation including all available tax returns. The issue is not that we did not ask for or receive the documentation that was available, the issue, for the auditors, is that we accepted what we received. We concluded that the borrower had a very good mortgage payment history for many years, that during the time that the borrower was self-employed, he continued to make his payments and the new salaried position that the borrower had taken was used to qualify the borrower, not his previous self employment income. FHA requires verification of two years employment. The borrower had been at his new job for 2 months prior to loan closing. Those 2 months were part of his 2 year history and we requested and received income documentation on his new position. In addition, the borrower was employed part time at [REDACTED] during the previous two years and this is also verified by the Written VOE and by tax returns that match the VOE. The self-employment period during the previous two years was supported through the executed letter from the borrower in the file at closing. The lack of income from the self employment was also documented through most recent Two Years of Tax Returns. Recent Earnings from Self-employment were evidenced on Bank Statements. Each loan issue was addressed to meet guidelines. OIG is dissatisfied with the documentation this underwriter accepted. This underwriter demonstrated why she was satisfied with all the documentation she asked for and received and why the loan should have been made at the time. The loan subsequently became delinquent, but the nonperformance was not a predictable weakness in the loan.

The disagreement began during the OIG audit and is on-going with the Draft Discussion. Both auditors were extremely respectful and relayed to us more than once that we were most cooperative in all ways during this audit. Significantly, the auditors stated as #2) of the "Why We Audit" section that we were audited to confirm that "it's Quality Control

**Comment 4**

Plan, as implemented, fulfilled HUD's requirement". This report is absent of this answer but we were told, many times, how exacting and satisfactory our QC plan and findings were and how we demonstrated more than once that the QC plan actually works. It is taken seriously, acted upon, up to date and vigorously maintained.

RECOMMENDATION

In our review and research of HUD's 4000.4 and 2000.06 we found that HUD's Quality Assurance Division units in the four Homeownership centers were generally consistent in resolving material underwriting deficiencies but sometimes had different approaches for resolving the deficiencies. According to the research, some homeownership centers closed the reviews without requiring indemnifications based on the lender's commitments and efforts to provide additional FHA underwriting guidance to Underwriting Staff. However, Philadelphia and Denver homeownership centers showed that these units more aggressively required lenders to indemnify materially deficient loans even when the lenders promised to improve their underwriting on future loans.

**Comment 5**

In this case, NERMC has already demonstrated that we have taken very aggressive steps to add its own overlays, far stricter than FHA requires, to protect the FHA fund and to protect itself. These overlays, which are not required by FHA but are and have been voluntarily in place, have significantly increased our satisfactory Neighborhood Watch numbers. The OIG did show our numbers at one time but not recently. We have 33 loans on the NW and out of those 22 are Streamline Refinances. This is a significant factor in reviewing NW numbers. In addition, we underwrite in Underserved Areas, that HUD tracks both in RI and NH, that fact alone is important. Importantly, today we rank at 735 out of 1000 lenders on NW with a total range of 139 and the lowest (best) number being 117. This is relevant.

**Comment 6**

In essence, we have committed a long time ago, once the NW numbers were released and we could use them as a tool, to institute measures that would reduce risk. Those measures would not have affected the two loans in question and this underwriter would have made the same decision on those loans, with the measures in place, at that time. The measures became gradually more risk intolerant as guidelines changed. These overlays are analyzed carefully so as not to lose sight of what the FHA program is designed to do and how we implement the stated mission statement for FHA loans in our community. We continually strive to meet the needs of the community with FHA financing and ensure that the Insurance Risk Pool for FHA is protected.

Here is the statement taken directly from HUD 4000.4

1-5 MARGINAL CASES. The Department's mortgage insurance programs are designed to serve the credit needs of those homebuyers not adequately served by the private sector. Processing cases under the Direct Endorsement program should not result in lesser consideration of applications involving marginal locations, properties

or credit risks. The program provides mortgagees the necessary assurance of endorsement since subjective underwriting determinations are reviewed only after the mortgage has been endorsed.

And..

ASSURANCES OF ENDORSEMENT. The Direct Endorsement program has been designed to give the mortgagee sufficient certainty of HUD endorsement requirements to justify the assumption of the responsibilities involved in originating and closing mortgage loans without prior HUD review. Mortgagees are responsible for complying with all applicable HUD regulations and handbook instructions. If the mortgage loan meets the pre-endorsement review criteria, HUD will endorse the mortgage for insurance. The resulting insurance contract is incontestable except in cases of fraud or misrepresentation by the mortgagee. If, at the time the case is submitted for endorsement, HUD has evidence that there is fraud or misrepresentation on the part of the originating mortgagee, HUD will consider the certifications as fraudulent and will not endorse the mortgage for insurance.

With all the information we have provided to date and with our NW as sited and with not only a promise of improvement in performing loans but a measureable track history and with an excellent QC plan and with the verification that there is NO pattern of imprudent underwriting, NERMC respectfully requests that the Department utilize other corrective measures that would help us continue to service the needs of our community and our employees.

An important mitigating circumstance is that these loans, and almost all the 1000's of loans that company has done over the last 20 years have been underwritten mostly by this one underwriter who underwrote these two FHA loans in question. It is not a matter of widespread disregard for guidelines as it in large companies but the underwriting analysis of one underwriter on two specific loans out of the thousands she has done. This circumstance should give HUD the green light for corrective action with Training of our underwriters as opposed to indemnification and putting the company and all its employees out of business and out of work.

We recommend what HUD Handbook 4000.4 Chapter 5 Program Management recommends for deficiencies stated above which fall into Level 1 or at most Level 2. They are as follows in their entirety:

5-3 TYPES OF DEFICIENCIES. This paragraph offers parameters to consider the seriousness of noncompliance actions.

A. Level One Deficiencies.

**Comment 7**

1) Definition. A level one deficiency is generally any minor underwriting deficiency which does not change the eligibility determination of the property, the mortgagor, the mortgage amount or the term.

2) Examples of level one deficiencies are the following: improperly completed builder certification; missing construction exhibits that do not preclude inspection; appraisal reports without a conventional sale; use of a comparable sale more than six months old; insufficient documentation of compensating factors; and use of an outdated credit report.

Level one deficiencies also include more serious deficiencies which the mortgagee is able and willing to correct, such as obtaining flood insurance coverage for a dwelling located in a flood hazard area and increasing the amount of escrow when the mortgagee's assurance of completion of escrow is insufficient as submitted with the endoresemtn request.

3) Response. Isolated incidents are brought to the attention of the underwriter via the Underwriting Report. Patterns or continual problems should result in probation or withdrawal of Direct Endorsement approval.

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5-3

4000.4 Rev-1  
CHG-2

(5-3)

B. Level Two Deficiencies.

1) Definition. A level two underwriting deficiency is one which, when corrected, results in a significant increase in mortgage risk, through either, greater credit risk or a decrease in property security. It is also one with involves acceptance of a mortgagor or property not permitted by HUD policy, such as a condominium in an ineligible project.

2) Examples of level two deficiencies include: gross miscalculation of income; acceptance of a property seriously deficient of the required standards; missing builder certifications; construction changes that affect value without proper change orders; and utilization of the mortgagee's assurance of completion when the dwelling involved is not habitable, safe and essentially complete.

3)Response. Appropriate Field Office response to level two underwriting deficiencies requires careful consideration of the deficiency in terms of the previous Direct Endorsement performance of the mortgagee. A deficiency of this nature should result in probation or withdrawal.

C. Level Three Deficiencies

1)Definition. A level three deficiency is one which involves an action by the mortgagee to misrepresent either the financial capacity of the applicant-mortgagor or the condition of the property offered as security for the mortgage.

2)Examples of level three deficiencies include: fraudulent information or documentation, such as falsified verifications of employment; false certifications, such as reporting a delinquent loan as being current; omitting conditions relating to the health and safety of the property; and construction exhibits that do not represent the property resulting in a significant change in the security of the mortgage.

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5-4

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4000.4 Rev-1  
CHG-2

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(5-3c.)

3)Response. Due to the severity of this type of deficiency, the appropriate response could include: (a) imposing a limited denial of participation, (b) withdrawal of Direct Endorsement approval, (c) referral to the Mortgagee Review Board to consider withdrawing the mortgagee's HUD approval, (d) referral to the participation and Compliance Division in the Director of the Office of Lender Activities and Land penalties by the housing Civil Penalties Panel or the Mortgagee Review Board, or (f) referral to the Regional Office of the Inspector General.

It is our opinion that the issues that the OIG have described fall into Level one and Level Two. There are no Patterns found in the entire Audit.

With these deficiencies which NERMC strongly disagrees with OIG conclusions. The Field office is allowed to take any number of corrective actions. The actions we are asking for come directly from 4000.4 and are for lenders that show no patterns of underwriting deficiencies and are isolated incidents of deficiency which the OIG has verified.

Office of the Inspector General.

5-4 APPLICATION OF SANCTIONS. The sanctions described in this Chapter

**Comment 7**

have been designed to give Field Office staff the flexibility to respond appropriately to any noncompliance action of a mortgagee or an individual. Noncompliance actions vary significantly in their scope and effect. The more serious the scope and effect of the actions, the more serious would be the sanction applied by the Field Office.

In deciding what sanction is appropriate, consider the seriousness and extent of the violations, the degree of fault on the part of the individual or the mortgagee, and any mitigating factors.

We therefore respectfully recommend an alternative corrective measure in Lieu of indemnification, it is Probation that provides Training (retraining):

5-5 PROBATION. When a mortgagee fails to comply with the Direct Endorsement program requirements, the Field Office may place the noncomplying office on probation.

A. Probation Elements. Probation consists of one or more of the following elements:

1) Training. The mortgagee's underwriter, or other technical staff, may be required to attend appropriate training sessions.

We value training and continually attend training given by HUD themselves in different parts of the country, or given in conjunction with partners such as K&L Gates. We understand the seriousness of the claims made here and hope that HUD will consider all the factors as presented and agree to Probation and Training as the corrective measure.

INDEX OF DOCUMENTS

- Exhibit A-Response to Finding 1 of Deficiencies
- Exhibit B-Policy and Procedure for Finding 2



**NEW ENGLAND REGIONAL MORTGAGE CORPORATION  
90 STILES ROAD  
SALEM NH 03079**

**Finding 1: The Corporation did not always underwrite loans in accordance with HUD requirements**

**Comment 8**

NERMC strongly disagrees that we did not act in a prudent manner while underwriting two FHA-Insured single family loans. The statement that the underwriting deficiencies including improperly documented borrower income, an omitted liability, undervalued debt-to-income ratios, inadequate documentation to show the source of funds to close and failure to notify HUD of an employee loan transaction is unwarranted. The underwriter did act in a prudent, analytical and diligent manner and would never act otherwise to put the Company or FHA mortgage insurance at risk for any potential losses.

**FHA Case No: 341-0867550**

Inadequate Disclosure to HUD of a Loan Involving an Employee

**Comment 9**

This loan did involve an employee of NERMC. The subject property was owned jointly by the employee and his spouse, who is the President of NERMC. Transfer of ownership was made solely to employee before closing. The transfer specifically did not take place until that time as the loan was not approved to close as an FHA or a Conventional until the end of May. The Seller (s) then needed to wait for loan approval to close before they transferred the property. If the loan was not going to close as an FHA loan, there was no reason to transfer the property as Fannie Mae has no such conflict of interest guideline. Therefore the Purchase and Sale was done in employee's name only, in anticipation, if the loan was to ultimately be cleared as an FHA. This underwriter was very upfront with the owner of the company that the loan may or may not be approved and that it depended on whether or not the borrower could satisfactorily meet the conditions and they would have to wait. This should satisfactorily explain why the P&S was in employee's name only and also why the transfer was completed right before closing. The loan was cleared to close on the same day it closed.

This underwriter looked up the guidelines while underwriting in the 4155.1, Rev-5 and did not find a guidelines that if the seller was an employee then we needed to disclose this. That is because that guideline was not in the 4155.1, Rev-5 at the time. The seller guideline was added to 4155.1 Rev -5 at a later date after the loan was closed. It was only in the 4000.4 and this is not an underwriting handbook or one that is normally used to underwrite credit.<sup>1</sup> The Mortgage Credit Worksheet was not noted and the HUD binder was not marked beneath Box F, "Employment" due to the same reason. This underwriter

<sup>1</sup> HUD Handbook 4000.4, Rev-1, Chg-2 paragraphs 1-14

will always remember, when the seller is an employee, to disclose to HUD this condition now. This is an isolated incident of Seller disclosure and has absolutely no bearing on whether the loan was prudently underwritten. The borrower's capacity and willingness to make the mortgage payments was never at risk based on if the "employment" disclosure box was checked and on MCAW. This was inadvertently not checked on MCAW or Binder. This underwriter explained to the auditors that she believed she was certifying the MCAW correctly as the property was transferred prior to execution of the MCAW. Therefore this underwriter understood then that as the owner owned 100% of the company and was not the seller than this certification was done correctly. This oversight would never happen again and is a one- time occurrence that has no effect on the creditworthiness of the borrower.

### Comment 10

The seller/employee was not involved in any manner with the processing or underwriting of this file or any other file. Documentation is always faxed, or emailed or received from US Mail to NERMC. The address is the same for sales and processing and the fax numbers are the same for sales and processing. HUD allows processing of "employment" loans to be done in the same office. The fact that some of the paperwork say "Attn: [REDACTED]" is in no way a verification that he "was involved" in the processing of the loan. The seller, the borrower, the originator and this underwriter have all stated that the seller had nothing to do with the processing of this loan at any time. The loan officer explains he pulled the credit report under [REDACTED] sign on but that he pulled it and took the loan application, face to face. The borrower told us directly, that he gave the seller's business card to the vendors, even his housemate [REDACTED], who is also now his wife, who addressed her information to [REDACTED] as she had his card. There was no involvement by the seller in the processing of this loan, period. This underwriter was fully aware of this area of requirement and was steadfast in guaranteeing the integrity of the file. The fax cover sheets (which is what the Auditors are referring to) document nothing. HUD Handbook 4000.4 allows for processing to happen in same office and have no guideline that states if the cover letter says Attn to the seller than the loan is not endorsable.<sup>2</sup> If that were the case, this underwriter would have required that all cover letters be resent with a name on it and just the loan number. This procedure was explained to the auditors while in the exit interview.

### Comment 11

The borrower did complete two FHA streamline refinances which the seller and his spouse, the owner of the company originated at a later date. This should have no bearing on the underwriting of the original file. If anything, it should strengthen the borrower's ability to make his mortgage payments in a timely manner. At the time of the two future streamlines, [REDACTED] loan was underwritten, and [REDACTED] was continuing to make his payments in a perfect timely manner for two future loans. The Streamlines were analyzed for credit and [REDACTED] had perfect mortgage credit history and qualified for the streamlines. These later loans had no relationship though to the original full documentation loan except to further illustrate that [REDACTED] was analyzed 3 times for a loan here and qualified all 3 times. The streamlines were limited documentation and HUD always goes back to the original loan not the streamlines. I cannot think of a reason why [REDACTED] or [REDACTED] should be impeded from originating this streamline refinance.

<sup>2</sup> HUD Handbook 4000.4, Rev-1, Chg 2, paragraphs 1-14

## Comment 12

### Inadequate Support for Job/Income Stability

This underwriter strongly disagrees the job/income stability was not properly documented. Per FHA guidelines, FHA does not impose a minimum length of time a borrower must have held a position to be eligible. However, the lender must verify the borrower's employment for the most recent two years. If a borrower is about to start a new job and has a guaranteed, non-revocable contract for employment that will begin within 60 days of loan, the income is acceptable for qualifying.<sup>3</sup>

Borrower had recently accepted the position of Foreman as a W2 employee which is normally considered more stable than a 1099 employee. To support current income as a Foreman, and to document the last 2 years employment we received:

1. Written Verification of Employment Form executed by the employer
2. Written Verification in the form of a letter from the employer
3. Most recent Paystub
4. Verbal VOE
5. 2 Years of 1099 income
6. Letters from Employers in Lieu of a 1099 print out

The Letter was received First, then the VOE and then the paystub. After the first three forms of income documentation were received, this underwriter carefully analyzed all 3 forms. This underwriter found a discrepancy in between the letter and the Written employment info and the 1099. The underwriter found the 1099 income provided by [REDACTED] did not add up to the Total as provided on the VOE. To satisfy the discrepancy, she called the employer and conducted a Verbal VOE and asked for additional explanation on the income, the 1099 and the handwritten paystub. The employer stated the discrepancy between the verification of employment of employment was his error and the 1099 was indeed correct. To verify this paystub and handwritten the pay info. The Verbal VOE was documented in the file on the same form as the letter from the employer. This underwriter verified past and present income, both. The YTD info on the paystub as a W2 was accurate. The 1099 YTD income was also satisfactorily documented on the Written VOE. The employer would NOT place the YTD 1099 info on the W2 paystub as he would be expected to eventually issue a 1099 and a W2 at year end accurately reflecting YTD info for both schedules of income paid during the year. The auditors are factually wrong stating then we did not get, or accepted insufficient info for YTD.

In addition, he stated that it was handwritten because [REDACTED] position was new but he indeed had his first paycheck. The verbal verification of employment, further verifying the actual paystub and the letter and the VOE and all his 1099's were more than satisfactory and was all in the case binder at closing. The taxes taken out may have not have been to the penny, but in considering this, at NERMC, when the Controller issues a

<sup>3</sup> HUD Handbook 4155.1, Rev-5, paragraphs 2-6 and 2-7

manual check from time to time, he takes out the estimated taxes and when the manual check is accounted back into the payroll the taxes are reconciled .

**Comment 13**

In addition, keep in mind that although we did verify all the work history, as required, we did not use his previous work history income to qualify. We qualified him on his new job income which HUD clearly allows, even to the extent that the new job is not even started yet. In this case, [REDACTED] had started and we verified all of this, in writing, from his employer.

**Comment 14**

The HUD auditors have factual inaccuracies in regards to the VOE and dates and YTD info. We did discuss this with them in our interview. The VOE, with YTD info, was for the work done as a subcontractor up to the date of the execution. The auditors wrote that the VOE form dated May 18, 2006 showed the borrowers start date as of May 1, 2006. This is inaccurate and the VOE does not give that start date. The start date on the VOE should not have been January 05 as we have documentation showing a longer work history. A future Verbal VOE for the streamline refinance documents the computer systems at [REDACTED] don't go back far enough for the earliest start date. The underwriter questioned [REDACTED] directly on this as part of her Verbal VOE to rectify the inconsistencies at that time.

**Comment 15**

The written VOE documents what the borrower was making during the 05 and 06 and YTD time frame. The income for 2006 was YTD and the 2005 income was more than the 1099 presented by the borrower. The inconsistency of the 05 number for the VOE and the 1099 was not relevant for verification of qualifying income as the borrower was NOT qualified on any former 1099 income. However, the underwriter , when completing her VOE, asked [REDACTED] about this inconsistency and he confirmed that the VOE income was correct and could not explain the singular 1099 we have in the file except that there was probably an additional 1099 issued that [REDACTED] did not provide to us. My Verbal Voe did document the correct info. This is allowed by the DO Findings. The main purpose of the Verification of employment was to verify, per the findings, the actual employment, the overtime history and any trends and the likelihood of continued employment and continued overtime. The income for 2004 1099 and income documentation by letter from the employers for 2004 are fully documented in the file.

**Comment 16**

The 40-50 hours worked per week verify that [REDACTED] had a history of overtime and overtime was used to qualify [REDACTED]. The lender must do two things, average the past documented two years overtime and also must develop an overtime and bonus earnings trend. The letter from [REDACTED] employer, [REDACTED], verifies that [REDACTED] was now a full time employee with overtime from 50-60 hours per week. [REDACTED] position would be as a Foreman. [REDACTED] background and longevity in the business clearly demonstrate the likelihood of this position. The letter from [REDACTED] identifies and explains [REDACTED] new compensation agreement. The owner confirmed [REDACTED] has worked there as a 1099 for over 2.5 years. When the VOE arrived, the underwriter questioned [REDACTED] via a documented Verbal VOE to discuss the discrepancy (s). [REDACTED] confirmed the date should be 2004 and he RE-ASSERTED that the letter was a true and accurate statement, thereby, using the verbal VOE vehicle and certifying it, overriding the inaccurate date and inconsistent income info for 2005 on the VOE. This was all done PTC. [REDACTED] also

confirmed that [REDACTED] accepted his position as of May 1, 2006. [REDACTED] confirmed [REDACTED] base pay was \$27.00 and this was used to qualify [REDACTED] as a full time regular employee which is 100% allowed by FHA and by the Manual underwrite DO findings in the file at time of closing. [REDACTED] also reconfirmed that [REDACTED] would be working 50-60 hours per week. This underwriter then took the conservative middle ground of 15 hours per week overtime based on his overtime trend going forward and accounting for his history of overtime.

To comply with the findings the Paystub, which was most certainly cashed but not required by FHA to verify it being cashed, satisfied the conditions that [REDACTED] has just started his new job. FHA absolutely allows this as documented in 4155.1 4.E.5.d. The income on the faxed paystub coming directly from [REDACTED] indicated to this underwriter that this was his first paycheck and this is the correct YTD info for him a W2 employee in his new position. The Verification of employment clearly showed his YTD info just before the start of the new job. The two added together was his official YTD.

The \$1566.00 was exactly right on his paystub and that was his new base pay for week one. The Voe shows YTD up to May 18, 2006.

The borrower and employer both represented that they paid and were paid as a regular employee with taxes withheld at the time of the loan. Underwriting verified this, in writing, by a letter from the employer and a copy of most recent paystub. The next paystub would have been paid after the loan had closed. Up to the time of the loan, NERMC confirmed that the borrower was paid as a 1099 and for future loans show that [REDACTED] position continued as Foreman/Carpenter at Robie until October 2006 and then [REDACTED] began working fulltime as a Foreman/Carpenter for [REDACTED]. [REDACTED] had worked there part time from 2003- August 2007 as confirmed in Telephone Verifications.

At no time during this loan transaction did the borrower or the originator or the employer say that the borrower had not become a regular employee. All documentation we requested and received supported and verified that [REDACTED] had been offered a Foreman position as a regular employee, accepted a foreman position as a regular employee and worked as foreman for [REDACTED] as a regular employee. At a later date, when the employment situation with [REDACTED] changed, that change is out of scope of this underwriter's responsibility for this loan. [REDACTED] did confirm with this office, in a recent post closing review, that he and [REDACTED] had a falling out and he changed jobs in late 2006. This may be the reason the auditors were unable to verify the information from the employer

Verification from refinances reflecting borrower as a sub-contractor have no bearing on the original file. After this audit, the borrower was questioned and according to the borrower he had a falling out with the employer and returned to working as a subcontractor for a different employer. In addition, contractor, sub-contractor, Foreman and other terms or nomenclature are commonly used interchangeably in the Construction business.

### Comment 17

### Comment 18

**Comment 19**

The underwriter did not obtain prior tax returns due to the fact that the borrower was a 1099 employee and copies of the 1099's and alternative documentation were in the file and the tax returns write offs have no consequence as the borrower was qualified as a W2 employee. There would be no question of deductions as the borrower had become a W2 and those deductions he could avail himself of in the past would no longer be eligible to receive, thereby not an underwriting issue.

Inadequate Credit History

**Comment 20**

This underwriter strongly disagrees that an acceptable credit history or rental history was not documented. Per Hud 4155, Neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejecting the loan application. FHA also recognizes that some borrowers may not have an established credit history.<sup>4</sup> In this case, we documented a complete credit history. We documented vendors paid in cash within last two years, plus regular credit, plus rental payments.. This underwriter was diligent in making sure his credit file was properly documented. In fact, [REDACTED] credit score then was higher than what FHA currently requires (HUD now requires 580 and [REDACTED] was 602) for maximum financing.

The rental history was reflected on credit report with on time payments. The borrower's spouse (not married at the time of closing) did receive housing rental assistance from the State House finance agency for the unit occupied. It covered a portion of the payment. The payment was approximately \$431.00 monthly going a bit down and a bit up. The balance of the payment was usually paid in cash here at the office. A spreadsheet was kept for the rental payments received. The rental payments, of course, were not used to qualify and had nothing to do with income, it was used as a credit source. Therefore, since cancelled checks were not available, the credit agency verified the rental history.

In many cases, rental payments are based on a lease agreement. Many times, household members may contribute to the monthly rental payment. In this case, even though [REDACTED] girlfriend was receiving NH Housing Assistance at the time, this should have no bearing on his rental payment history. If she had moved out, he was still responsible for the entire payment.

The borrower also paid for furniture on a monthly basis that he purchased from the seller which is notated on the spreadsheet. The spreadsheet was provided to the Auditors.

The [REDACTED] payment history did reflect that the borrower paid that account in cash also. The payment history was roughly 1.5 years old and well within acceptable FHA and investor guidelines.

Debt to Income Ratios Incorrectly Calculated

<sup>4</sup> HUD Handbook 4155.1, REV-5, paragraphs 2-3 and 2-4

**Comment 21**

This underwriter did originally calculate the hourly rate of overtime incorrectly. It was noticed on a technical review by the Department of HUD. The underwriter's response to the technical review was accepted by the Department of HUD.

Income should be calculated as follows:

Base	\$27.00/hr x 40 x 52 / 12 = \$ 4680/mo
Overtime (based on guaranteed overtime)	\$33.51/hr x 15 (average) x 52 / 12 = \$2178/mo
Rental income x 85%	\$1275/mo
Total income	<u>\$8133/mo</u>

Ratios without contingent liability 37.61 / 42.06  
Ratios with contingent liability 37.61 / 46.85

The HUD auditors are factually wrong in regards to income and ratios. The income HUD used did not give full credit for the rental unit of 85% which is what is allowed. If you use the overtime correctly and the correct allowable rental income, the ratios are exactly as stated above. This underwriter and HUD would approve and endorse this loan with those worst case ratios, considering all compensating factors. The contingent liability was documented for 8 months and from the inception of the loan, as coming directly from the sole account of the main obligor not co-obligor. The guidelines state that during the past 12 months the payments need to have been made by the main obligor. We verified this during the past 12 months. The guidelines do not state for all 12 months just during the previous 12 months. The loan was on time for the full 8 months at time of closing. The loan, as shown to the auditors, was a 6 year loan and is continued to be paid by [REDACTED], out of her sole account exactly as we said then it is now. However, adding back the liability, the ratios are approvable with all the compensating factors and this underwriter would have issued an approval and HUD would have endorsed it. We know this based on the letter we got from HUD years ago, accepting our explanations.

The two important guidelines for income are:

FHA 4155.1 4.D.1.c which states ... "Favorably consider a borrower for a mortgage if he./she changes jobs frequently within the same line of work, but continues to advance in income or benefits. In this analysis, income stability takes precedence over job stability."

FHA 4155.14.D.2.c which states .... "The lender *must* establish and document an earnings trend for overtime and bonus income. If either type of income shows a continual decline, the lender must document in writing a sound rationalization for including the income when qualifying the borrower.

A period of more than two years *must* be used in calculating the average overtime and bonus income if the income varies significantly from year to year."

**Comment 22**

In this case, we documented past overtime and we also documented an overtime trend and allowed for usage of more than two years as the overtime did vary and change to a higher amount. We developed an earning trend, upward, on overtime and we got documented proof that it was happening at time of loan and was to likely to continue.

Compensating factors: Potential for increased earnings, ability to pay housing expense, and conservative use of credit and large down payment and low LTV<sup>5</sup>. The compensating factors were stated in the loan at the time. The bank statements to show that [REDACTED] social security income was in the file at closing. She was not a coborrower but HUD allows for income coming into the home to be used as compensating factors and the housing assistance was likely to continue with [REDACTED] as the Landlord. We know of no other debt that [REDACTED] had at the time besides the car payment. In addition, [REDACTED] worked then and continues to work now at the same job, [REDACTED], and we verified her income through the bank statement in the file at time of closing. All of the above negates the liability of the auto payment. [REDACTED] credit history showed a respect for usage of credit and his unwillingness to overextend himself. This is important and why HUD uses it as legitimate compensating factor. In addition, the loan, which ultimately became FHA had a significant downpayment and thereby a low LTV.

Inadequate Support for Funds to Close

**Comment 23**

This underwriter strongly disagrees that we did not obtain adequate documentation to show the source of funds to close from the borrower.<sup>6</sup> The borrower was requested to open a bank account PTC. In accordance with the commitment letter [REDACTED] did open a bank account five days prior to closing with an initial deposit of \$30.00. On May 30th, an additional deposit of \$2400 was made. In the file at closing was a print out of the bank account and an explanation that the SOF was the return of security deposit. Additional documentation was provided to the Auditors evidencing this. We requested the borrower to open the bank statement to be able to accept the security deposit back and use it for any cash needed for closing. The explanation of the deposit was in the file at the time of closing. The auditors were additionally provided with seller statements evidencing the separate renter's account and a faxed letter to [REDACTED] to close the accounts and transfer the money to the seller's account. The seller then withdrew the \$2210 and gave it to the borrower which he deposited. Actually, we could have showed the security refund as a credit on the HUD-1 just as we did sewer and water, both with the same results. There was no gift involved as the borrower's wife spoke erroneously and wishes to clarify any misunderstanding about this with HUD anytime.

This underwriter extended a great deal of analytical capacity in reviewing this loan and researching guideline to make sure this loan would work. There is no indication in anything presented in the file or at any other time that this underwriter did not act prudently in asking for documentation, receiving it, analyzing it and then making a decision.

<sup>5</sup> HUD Handbook 4155.1, REV-5, paragraphs 2-11, 2-12 and 2-13

<sup>6</sup> HUD Handbook 4155.1, REV-5, paragraph 2-10



**Comment 24**

FHA Case No. 341-0896983

Inadequate Support for Income/Job Stability

This underwriter strongly disagrees that we accepted inadequate support to show the borrower's job/income stability for the previous two years. Borrowers employed at businesses owned by family member are required to provide additional documentation. These borrowers must provide the normal verification of employment, paystub, and evidence that they are not an owner of the business. For self-employed borrowers, there is a high probability of failure during the first few years.<sup>7</sup>

To satisfy these conditions **and** qualify for and comply with additional FHA standard guidelines NERMC received and reviewed:

1. VOE from [REDACTED], Sole owner of [REDACTED] verifying 2007 new job information (paystub), 2006 and 2005 income info
2. 2006 and 2005 Tax returns of borrower and wife living in house and contributing to household income and expenses (files jointly)
3. 2006 and 2005 W2 information.
4. Bank statements to verify income from wife and other income (from (b) business)
5. Detailed letter of explanation of job history including any gaps
6. On Line verification of non ownership of company from Sec of States office.

This underwriter requested and reviewed a Written Verification of Employment, confirming that the borrower had no ownership in the company. In addition, the personal tax returns for the two most recent years filed was a secondary source that the borrower had no ownership and for another totally unrelated Third Party Verification, it was then and is now a matter of public record on line that the borrower had no ownership in the company. This was over and above what FHA requires. The verification of employment evidenced that the borrower was hired by his father's company as a Foreman and had year to date earnings on it which corresponded with his paystub. This underwriter required and received a most recent YTD paystub after [REDACTED] began his new position as Foreman with [REDACTED].

The paystub was verified by the Written VOE.

This underwriter requested the two most recent years tax returns and these were provided. The borrower had not as yet filed his 2007 tax returns. The borrower was asked to write a detailed explanation of his work history for our documentation and review. We received the executed letter detailing his income and lack of income during the previous two years. His tax returns reflected no income from the self-employment. [REDACTED] stated that his expenses outweighed his income and reporting a negative loss on his taxes would not affect his return. In carefully reviewing his tax returns, this underwriter found that to be a true statement that there would be no benefit to reporting a loss, as they received the

<sup>7</sup> HUD Handbook, 4155.1, REV-5, paragraphs 2-8 and 2-9

maximum refund due them. In addition, during the same 2 year period that [REDACTED] was working his own start up business, he was also working for [REDACTED]. This history was documented on the VOE and his W2 and his tax return. The borrower, working part time for [REDACTED], was always paid W2 from [REDACTED] as evidenced in the file.

The borrower who had taken a new full time position with his father's business of 25 years, was considered a stable new position. FHA absolutely allows the underwriter to use the income from the new job, especially W2 income as a Foreman. See same guideline 4155.1Rev 5 4.E.5.d...."Projected income is acceptable for qualifying purposes for a borrower scheduled to start a new job within 60 days of loan closing if there is a guaranteed, non-revocable contract for employment. The lender must verify that the borrower will have sufficient income or cash reserves....."

The two year history was requested and all information that was available was documented, and the auditors did visit [REDACTED] and this was confirmed. The issue then is not that we did not document it, but that the auditors believe that the documented history of income or stability was not adequate for an FHA loan. This is factually incorrect. We are required to attain the history of the income and analyze the stability of that income as it relates to the borrowers current employment and his capacity and willingness to pay.

This underwriter prudently requested and received all tax returns that were filed, we received and reviewed the most recent paystub, we got a Written VOE for part time employment with [REDACTED] which matched up exactly as the Paystub reflected. [REDACTED] was not qualified using 1099 income or his self employment income as he never received that. He was always a W2 at [REDACTED] and claimed no income from his self employment history on his tax returns. [REDACTED] had continual employment with [REDACTED] and went from Part time to Full time in a new position. [REDACTED] had already started his new job and had been working, full time, for 2 full months (of the 24) before we closed the loan. The income and position of his new job, of which he had for 2 months, was used to qualify.

While analyzing the borrower's income per the Written VOE, the underwriter took into consideration that the borrower worked as a W2 employee in 2005 earning \$16170 for 4-6 months). Depending on the exact number of months worked, his income ranged from \$2667 - \$4000 monthly. Therefore, working as a foreman at \$1000/wk or \$4333/mo, did not seem unreasonable.

Borrower also had very good Compensating Factors: Low LTV, Continuous multi- year on time mortgage history and was currently in an ARM that was to adjust the next payment and this was documented in the file. The borrower had a significant net tangible benefit and was drastically reducing his housing expense. During the time of self employment, where borrower did not claim his income or deductions on his tax returns,

he still maintained his perfect mortgage payment history. The borrower had savings and also other income coming into the home.

As evidenced by the bank statements in the file, the borrower's spouse had additional income of approximately \$1200/mo which was a compensating factor. This income was in the file, but not used in the debt ratio.

This underwriter was very prudent in determining approval of this loan. The commitment letter was clear and if the borrower could not meet the conditions that were provided for in the file, she would not have cleared the loan. This loan was fully documented, the income that was relied upon was fully allowed by FHA. The borrowers 2 year work history was received and was analyzed. The loan would not have been approved if the borrower was not at a new position in management as a successful company of 25 years that he had no ownership in and the fact that the borrower was employed there for 2 months before the loan closed. The borrower was a homeowner with a good mortgage credit history and was significantly improving and stabilizing his financial mortgage position by decreasing his payment and going from ARM to fixed. This loan was a prudently underwritten loan, it was thoroughly analyzed and this underwriter made a loan decision based on allowable guidelines and compensating factors all within the file at the time of closing.

It is a shame, looking backwards that this loan went delinquent, however, with all the documentation we have in the file, including his very good mortgage credit history for years, there was no reason to believe this would discontinue. The economy has ravaged these hard hit areas of NH and the building trade in general.

**Finding 2: Mortgage Record were not accurate in HUD Systems**

Corporate officials did acknowledge that they had not notified HUD or updated mortgage record changes upon the sale of FHA-insured loans because we were not aware of the requirements. Upon further research, we reviewed our closing policy and we found that this task is in the Closing Policy book and that the closer has been doing it all along. With recent staffing changes, the new hires were not consistent in completing the MRC Task. This explains why we had only 43 changes not made out of the Thousands that we did do.

However, we immediately took action on this finding and updated the records brought to our attention.

A written policy and procedure have been reissued put so this does not occur again (Exhibit B)



## OIG Evaluation of Auditee Comments

- Comment 1** We were aware of the HUD postendorsement technical review. However, our review found additional underwriting deficiencies that warrant indemnification. We also disagree that the lender could have financed the borrower through other conventional loan programs. The fact is that the seller provided the down payment assistance to the borrower through a nonprofit organization in order for the borrower to meet the FHA minimum down payment requirements. In addition, based on the underwriting deficiencies found and the president of the Corporation's conflict of interest (See comment 9), we believe that had conventional financing been an option, it would have been the proper choice for the lender.
- Comment 2** Our review focused on the borrower's past credit worthiness and ability to pay at the time of the loan; not the borrower's after-the-fact recent medical circumstances you indicate contributed to the loan default.
- Comment 3** Based on additional document received and discussions held with the Corporation, FHA case number 341-0896983 was removed from the report and as was the recommendation that the Corporation indemnify HUD for any future losses regarding this loan.
- Comment 4** We disagree. We answered the second objective relating to the Corporation's quality control program in the "What We Found" section. However, in response to the auditee's concerns we added, "In addition, the Corporation's quality control plan, as implemented, fulfilled HUD's requirements."
- Comment 5** Our results only relate to the loans reviewed and to our audit review period. As of June 30, 2010, the Corporation has a higher serious delinquency rate as compared to the average of all other lenders, per the latest Neighborhood Watch report. See also Comment 6. The remaining loan with significant underwriting deficiencies in this report was a purchase loan transaction, which required a full manual underwriting analysis.
- Comment 6** The Corporation continues to have a higher default percentage when compared to other lenders, as shown in the background section of this report.
- Comment 7** We considered all evidence regarding the loans in question. After the additional documentation received and discussions held, we have removed all but the one loan from this report. The audit results as shown support a recommendation for indemnification of the loan. Additionally, we only selected 19 loans for review with the highest risk and the results only relate to the one loan. The method of selection of the loans reviewed did not result in a representational sample of the thousands of loans originated by the Corporation.

**Comment 8** OIG disagrees that the Corporation acted in a prudent manner when approving FHA Loan #341-0867550. However, the discussion on inadequate documentation for funds to close was removed based on additional documentation provided at the exit conference, which had not been included in the loan file. The remaining significant underwriting deficiencies support the recommendation for indemnification for this loan, FHA Loan #341-0867550. OIG considered the Corporation's written response and further explanation provided at the exit conference for FHA Loan #341-0896983 and removed this loan from finding 1 of this report.

**Comment 9** The underwriter stated during the exit conference that there was a conflict of interest, as the president of the Corporation had a financial interest in the property, and that is why they transferred the president's ownership in the property to the president's spouse. By doing this, the Corporation attempted to circumvent the regulation. The underwriter was also aware that the employee/spouse was the seller in this transaction, and certified that the seller was not an owner or employee of the company, which was not true.

The Corporation agreed it did not follow the requirements required in HUD Handbook 4000.4. Although OIG agrees that the regulation was not in HUD Handbook 4155.1, Rev-5, the Corporation is required to follow all required guidance and regulations, and not knowing the regulations is not an acceptable argument.

For loans where the owner, employees, officers, etc, are also sellers, HUD's post endorsement reviews would be more stringent given the nature of the loan. In this case, not only did the Corporation not disclose this was an employee loan, there were other deficiencies identified during our review. Because we were aware this was an employee loan, we reviewed this loan in more detail.

The underwriter was put in a situation of approving or denying a loan in which the underwriter's employer and employer's spouse were the seller's of the property. Remaining completely objective in this conflict of interest situation would be difficult for anyone.

**Comment 10** The file contained many faxed documents from the borrower and third parties that were to the attention of the employee/seller. The initial credit report was also pulled under the seller's name. The Corporation's statement that the loan officer on this loan signed on using the employee's/seller's account information to pull the credit report is not a plausible explanation.

**Comment 11** The Corporation's comment about the borrower's perfect payment history is incorrect. The borrower went in and out of delinquency several times after the loan refinance transactions. The loan was only eligible for an FHA refinance after the borrower had cured the loan just before the refinance. HUD will need to

determine whether the involvement of the president and employee/spouse in the streamline refinances was allowable, given the history of the first loan.

**Comment 12** The Corporation did not adequately document what was clarified and discussed with the employer. The underwriter only notated on the employer's letter that the employer verified this was a true and accurate statement; and it is factually correct that there was no year-to-date information on the uncashed paycheck dated May 26, 2006. However, the Corporation believes this was the borrower's first paycheck, but it is unclear from the letter when the actual start date was for the new position. The letter states the borrower accepted the position of foreman on May 1, 2006. The VOE form includes all of 2006 income for the year-to-date.

**Comment 13** The Corporation stated it did not qualify the borrower based on the prior work history, although it obtained the documentation, but qualified the borrower based on the new job income. However, the new job income obtained did not adequately support that the borrower was an employee rather than a subcontractor. Verbal verification with this employer was not adequate to support that the borrower was an employee, and no longer just a subcontractor. We followed up with the borrower and confirmed the borrower was paid as a subcontractor, not an employee.

The underwriter accepted an uncashed check with hand written deductions on the copy that did not have the correct Medicare and Social Security deductions to support the borrower's current income as an employee for the company. We were unable to verify information with the employer during the audit, as the employer would not return our numerous phone calls.

**Comment 14** The VOE form dated May 18, 2006 showed \$55,800 as the prior year earnings, which is a discrepancy of over \$15,400 from the 1099 issued in 2005. The Corporation advised us that they talked to the employer and was told that there may have been another 1099 issued; yet the Corporation did not obtain a copy of the 1099 or explain the discrepancy in the file.

The Corporation stated in its response that OIG had factual inaccuracies in regards to the VOE, employment dates, and YTD info. OIG stands by the statements in our report and that they are factual, and believes the OIG and the Corporation have different interpretations of the information and level of reliance on the supporting documentation provided. See Comment 12 above regarding year-to-date information.

Our report states that the letter showed the borrower was hired on May 1, 2006. OIG reworded it to show the borrower accepted the position as of May 1, 2006. The VOE form dated May 18, 2006, showed that the borrower was hired on January 2005 but the letter stated the borrower worked at the company over 2.5 years as a 1099 employee. OIG agrees with the Corporation that future verbal

VOEs showed that the computer system did not go back far enough for the earliest start date.

- Comment 15** See comment 12 above regarding year-to-date. Considering this was a loan in which the president of the Corporation and spouse/employee owned the property, the inconsistencies in documentation should have been relevant to the underwriter when considering whether the information provided by the borrower and employer were accurate, and could be relied on for qualifying the borrower for the loan. The underwriter must use due diligence when reviewing supporting documentation provided, especially when there are so many inconsistencies.
- Comment 16** The letter stated the employer anticipated the borrower working 50-60 hours per week. The VOE form, which the Corporation contends was for prior work history, showed 40-50 hours. The Corporation stated that it used the conservative 15 hours of overtime, however, the Corporation should have used average overtime hours for the past two years; not the anticipated hours as shown in the letter. Overtime hours shown on the uncashed check would only be one week's worth of documented overtime in support of 15 hours of overtime for the borrower in this new position as a W-2 employee. The Corporation should have used the conservative 5 hours of overtime shown on the VOE form, or not included overtime hours at all. To be conservative in our calculations, we gave the borrower the 5 hours overtime. Further, there was no documentation in the file to support that the borrower cashed this check, as the Corporation stated.
- Comment 17** The Corporation should have used due diligence when reviewing the documentation provided and required additional support to show the borrower was no longer a subcontractor, but an employee. Although it obtained a letter, VOE form, and an uncashed check, there were enough discrepancies that the underwriter should have required additional documentation from this employer showing the borrower was an employee. The Corporation's argument that the verbal VOE supports that the borrower was an employee is not adequate support. The notation on the letter that the letter was a true and accurate statement does not indicate anything regarding the discrepancies with the VOE form or uncashed check. The letter had no fax information on it and was not creased, indicating it was hand delivered. Per the borrower, the employer was present when the borrower completed the loan application, and the employer may have provided the letter at that time.
- Comment 18** The Corporation contends that the verbal verification from the streamline refinance has no bearing on this loan; however, it supports our statement that the borrower was never a W-2 employee, but was a subcontractor for the employer.
- Comment 19** Given that the documentation showed the borrower accepted the position of foreman for the company as of May 1, 2006, the same month of the closing, the Corporation should have obtained the tax returns. The file did not contain all of the 1099's for the companies that the borrower stated worked as a subcontractor,

but instead were on an invoice and provided in a letter with a payment history. Additionally, for another loan that we reviewed, the tax returns were required when the borrower went from a subcontractor to an employee the month before the closing; but the Corporation was not consistent for this borrower.

**Comment 20** The borrower had an inadequate credit history. As such, the Corporation was required to document a nontraditional credit history, which would include residential rental payments, utility payments, insurance payments, etc. What the Corporation documented in the file was that the borrower paid cash to a furniture rental company, for which the last payment was almost 15 months prior to the closing of the loan. The credit report showed a credit card opened less than a year before which only had a \$500 available credit limit. The credit report also showed new credit for two car loans, one of which the borrower was a cosigner. The Corporation documented that the spouse paid for the car loan exclusively, as evidenced by the bank statements that were in the spouse's name alone showing the payments. The credit report for the borrower showed no late rental payments for a 24-month period. The borrower lived at the property owned by the president and employee/spouse that he was buying. The Corporation's response stated that the borrower made payments for rent at the Corporation's address. At the exit meeting, it was stated that the borrower made cash payments to the underwriter and the underwriter maintained a spreadsheet to track the payments.

However, we noted that the original credit report pulled in April 2006 for the borrower did not include information on the rental history. There was a credit report showing it was revised in May 2006, showing 24 months of rental history, which appears to have been added by the landlord, who was also the president of the Corporation and the employee/spouse. Based on the lease date, there would have only been 21 months of rental payment history at the time that the report was revised. The underwriter stated the credit report was used to support the credit history. OIG finds the credit history to be questionable since the information appears to have been added by the president or spouse after the initial report was pulled and there would have only been 21 months worth of history, not 24 months.

The underwriter and president stated during the exit conference that the underwriter collected rental payments in cash from the borrower and recorded them in a spreadsheet, and the cash was put in a safe, not in a bank account. However, based on our review of the spouse's bank statements provided at the time of the loan, the difference between the housing assistance payment and rent amount came out of the spouse's bank account in the form of a check. The spouse was not on the loan and the borrower was not on the bank account. Therefore, the rental history could not have been verified for the borrower. Further, the actual rent to the president and spouse by the tenants was not the full amount as on stated the credit report, since the state housing finance agency paid a subsidy on this unit. There was no indication in the file that the underwriter supported the rental history/credit history with a spreadsheet of rental and



furniture payments maintained at the Corporation's office, nor was this mentioned until the Corporation received our finding outlines and draft report. Therefore, it should not have been used to support the underwriting decision.

**Comment 21** OIG disagrees that the liability should have been excluded as there were only eight months of documented payments by the borrower's spouse. The Corporation and OIG have different interpretations of the regulations regarding the payments made within the previous 12 months.

OIG used 85% of the rental income, used the correct overtime rate and used the overtime hours based on the historical average of 5 hours of overtime shown on the VOE form, and included the liability for the cosigned loan in its calculation, which results in a significantly higher debt to income ratio than the underwriter calculated. Based on our calculation, the ratios were not acceptable. See also comment 16 above regarding determination of overtime hours.

**Comment 22** The documented compensating factors on the MCAW were minimal debt (can use more income towards housing) and potential for increased earnings (recently promoted). In the auditee's response, the Corporation stated there were additional compensating factors in the file; however, these were not documented on the MCAW. The Corporation's response stated that a compensating factor was a large down payment and low loan to value. However, the president and spouse/employee provided the \$28,500 in downpayment assistance through a nonprofit that gifted the funds to the borrower, resulting in a lower loan to value ratio. Further, the response stated that the spouse's income would be a factor also; however, the Corporation should also have considered the spouse's liabilities, which were unknown since the spouse was not on the loan. Finally, the response states that "the housing assistance was likely to continue with the buyer as the landlord." We question how the assistance could continue, since the buyer resided in the unit that received housing assistance, in violation of HUD's rules.<sup>17</sup>

**Comment 23** The Corporation provided additional documentation after we presented the findings, in order to support the notation on the bank transaction screen stating the deposit was a security deposit. Based on the additional documentation, we removed this section from the finding of the report. However, we note that the original notation in the file was not adequate, but we accepted the additional support.

**Comment 24** OIG removed this loan from the finding of the report. We removed this loan based on the consideration of additional information/explanation provided by the auditee at the exit conference and in its written response. We did not base our decision on factual inaccuracies, as the Corporation contends.

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<sup>17</sup> 24 CFR 982.352(a)(6) A unit occupied by its owner or by a person with any interest in the unit may not be assisted in the Section 8 tenant-based program.

## Appendix C

### LOAN DETAILS

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FHA case number	Original mortgage amount	Unpaid principal balance	Default status as of April 30, 2010	Estimated potential loss to HUD <sup>18</sup>
341-0895000 <sup>19</sup>	\$377,195	\$369,317	Special forbearance	\$221,590

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<sup>18</sup> The amount above reflects HUD's estimated loss of 60 percent of the unpaid principal balance of the loans.

<sup>19</sup> The original case number was 341-0867550. The borrower had two later streamline refinances. The FHA case number on the last streamline refinance was 341-895000.