



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

MEMORANDUM NO: 2010-NY-1807

September 27, 2010

MEMORANDUM FOR: Vicki Bott, Deputy Assistant Secretary for Single Family, HU

Dane M. Narode, Associate General Counsel for Program
Enforcement, CACC

Edgar Moore

FROM: Edgar Moore, Regional Inspector General for Audit, New York/New Jersey, 2AGA

SUBJECT: First Tennessee Bank, N.A., Memphis, TN, Did Not Properly Underwrite a
Selection of FHA Loans

INTRODUCTION

We conducted a review of Federal Housing Administration (FHA) loans underwritten by First Tennessee Bank, N.A. (First Tennessee), an FHA direct endorsement lender. This review was conducted as part of our Operation Watchdog initiative to review the underwriting of 15 direct endorsement lenders at the suggestion of the FHA Commissioner. The Commissioner expressed concern regarding the increasing claim rates against the FHA insurance fund for failed loans. The objective of the review was to determine whether First Tennessee underwrote 18¹ loans in accordance with U.S. Department of Housing and Urban Development (HUD)/FHA requirements.

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

We sent the draft memorandum report to First Tennessee officials on August 20, 2010 and their written comments were received on September 3, 2010. First Tennessee officials generally disagreed with our findings and recommendations and maintained that in all cases, First Tennessee complied with HUD/FHA underwriting requirements and made loans to qualified borrowers.

¹ We selected 20 loans for review; however, we later learned that 2 loans had fully executed indemnification agreements. Therefore, we did not review those 2 loans; thus, we only reviewed 18 loans.

The complete text of First Tennessee officials' response, along with our evaluation of that response, can be found in appendix C of this memorandum. However, the exhibits, which accompanied the response, have not been included in the report due to their volume. In addition, as a result of First Tennessee officials' written response and accompanying exhibits, several sections of the report have been adjusted.

METHODOLOGY AND SCOPE

First Tennessee is 1 of 15 direct endorsement lenders we selected from HUD's publicly available Neighborhood Watch² system (system) for a review of underwriting quality. These direct endorsement lenders all had a compare ratio³ in excess of 200 percent of the national average as listed in the system for loans endorsed between November 1, 2007, and October 31, 2009. We selected 20 loans underwritten by First Tennessee officials that had gone into claim status within 30 months of the loans' endorsement. The sample of 20⁴ loans for detailed review was based on a prioritization matrix that would ensure, to the maximum extent possible, the selected loans were: (1) not streamlined refinanced; (2) not electronically underwritten by Fannie Mae or Freddie Mac; and (3) associated with an underwriter lender identified as having a high number of loans going to claim. We later learned that 2 loans had fully executed indemnification agreements; therefore, we only tested 18⁵ loans. To accomplish our objectives, we reviewed applicable HUD handbooks, mortgagee letters, and reports from HUD's Quality Assurance Division.

We performed our work from March through July 2010. We conducted our work in accordance with generally accepted government auditing standards, except that we did not consider the internal controls or information systems controls of First Tennessee, consider the results of previous audits, or communicate with First Tennessee's management in advance. We did not follow standards in these areas because our goal was to aid HUD in identifying material underwriting deficiencies and/or potential wrongdoing on the part of poorly performing lenders that contributed to a high rate of default and claims against the FHA insurance fund. To meet our objectives, it was not necessary to fully comply with standards, nor did our approach negatively affect our review results.

BACKGROUND

²Neighborhood Watch is a Web-based data processing, automated query, reporting, and analysis system designed to highlight exceptions to lending practices regarding high-risk mortgages so that potential problems are readily identifiable.

³HUD defines "compare ratio" as a value that reveals the largest discrepancies between the direct endorser's default and claim percentage and the default and claim percentage to which it is being compared. FHA policy establishes a compare ratio of more than 200 percent as a warning sign of a lender's performance.

⁴In this case, the sample of 20 loans consisted of 18 purchases, of which 1 was electronically underwritten by Fannie Mae, and 2 streamlined refinances. The 20 loans were originated by First Horizon Home Loans, a division of First Tennessee Bank, N.A.

⁵The 18 loans consisted of 16 purchases, of which 1 was electronically underwritten by Fannie Mae, and 2 streamline refinances.

First Tennessee is a HUD-approved Title II supervised lender located in Memphis, TN. A supervised lender is a HUD/FHA-approved financial institution that is a member of the Federal Reserve System or an institution, the accounts of which are insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration, which is not required to have mortgage lending as its principal source of revenue. In addition, a supervised lender may be approved to originate, sell, purchase, hold, and/or service HUD/FHA-insured mortgages, depending on its wishes and qualifications. FHA approved First Tennessee as a supervised lender on March 12, 1980. First Tennessee was approved to participate in the Lender's Insurance (LI) program, effective August 24, 2006. The LI program enables high-performing lenders, pursuant to section 256 of the National Housing Act, to endorse FHA mortgage loans without a pre-endorsement review⁶ being conducted by FHA. Under the LI program, the approved lender performs its own pre-endorsement review and enters mortgage loan-level data to FHA via FHA Connection.⁷ FHA Connection will perform an automated verification process to check the data for accuracy and completeness, and the lender then will be able to endorse the mortgage loan automatically. First Tennessee was removed from the LI program on December 1, 2009.

The goal of Operation Watchdog is to determine why the selected lenders had such a high rate of defaults and claims as compared to the national average. We selected 20 loans in claim status from each of the 15 lenders. The 15 lenders selected for Operation Watchdog endorsed 183,278 loans valued at \$31.3 billion during the period January 2005 to December 2009. These same lenders also submitted 6,560 FHA insurance claims with an estimated value of \$794.3 million from November 2007 through December 2009. During this period, First Tennessee endorsed 58,350 loans valued at more than \$9 billion and submitted 2,691 claims worth more than \$340.3 million.

The objective of this review was to determine whether First Tennessee underwrote the 18 selected loans in accordance with HUD/FHA requirements and if not, whether the underwriting reflected systemic problems.

RESULTS OF REVIEW

First Tennessee officials did not underwrite five of the 18 loans reviewed in accordance with HUD/FHA regulations. As a result, the FHA insurance fund suffered actual losses of \$435,574 on the five loans as shown in the table below.

⁶ A preendorsement review is conducted by HUD's Homeownership Center staff on the FHA case binder to ensure that FHA documentation requirements have been met, forms and certifications are properly executed, and FHA Connection and Automated Underwriting System data have integrity.

⁷ FHA Connection is an interactive system available through the Internet that gives approved FHA lenders real-time access to FHA systems for the purpose of conducting official FHA business in an electronic fashion.

FHA/loan number	Closing Date	Number of payments before first default	Acquisition cost	Unpaid balance	Original mortgage amount	Actual loss to HUD ⁸
151-8161023	08/23/06	5	137,446	124,652	128,898	66,300
241-7877788	07/25/07	6	333,513	286,943	293,680	141,906
291-3491113	12/11/06	5	47,215	153,469	156,543	47,215 [@]
332-4542658	03/11/08	0	230,771	210,591	214,368	121,347
441-7773869	03/31/06	10	101,862	84,544	87,310	58,806
			<u>\$850,807</u>	<u>\$860,199</u>	<u>\$880,799</u>	<u>\$435,574</u>

[@] This amount was obtained from HUD’s Single Family Insurance System (SFIS) and not HUD’s Single Family Acquired Asset Management System (SAMS) and represents HUD’s acquisition costs for a preforeclosure sale. SFIS is used to maintain the insurance-in-force database, which contains accurate and detailed case information on FHA-insured single-family properties.

The table below summarizes the material deficiencies that we identified in the five loans.

Area of noncompliance	Number of loans ⁹
Excessive ratios	1
Gift funds	4
Borrower’s investment	5

Appendix A of this report shows a summary schedule of material deficiencies in each of the five loans, and appendix B provides a detailed description of all loans with material underwriting deficiencies noted in this report.

Specific examples of these underwriting deficiencies follow.

Excessive Ratio(s) Without Adequate Compensating Factors

First Tennessee officials approved one loan that had a debt-to-income ratio (back ratio) that exceeded HUD’s benchmark of 43 percent, as set forth in Mortgagee Letter 2005-16, without valid compensating factors. For loan number 291-3491113, First Tennessee officials approved the loan, which had a back ratio of 47.16 percent, and recorded the following compensating factors on the mortgage credit analysis worksheet: “Credit: VOR (verification of rent) – 60 months on CR (credit report), 2 trades on CR Rpt + 12 mos.” However, these are not valid compensating factors as defined by HUD Handbook 4155.1, REV-5, paragraph 2-13. In this case, although the credit report showed that the borrower successfully demonstrated the ability to pay housing expenses over the past 60 months, the proposed monthly mortgage payment of \$1,246.09 was more than 300 percent greater than the monthly rental payment of \$375. Therefore, First Tennessee officials did not provide adequate support for the compensating factors used to justify the loan approval.

⁸The loss amount was obtained from HUD’s Single Family Acquired Asset Management System (SAMS). SAMS tracks properties from acquisition to final sales closing and maintains all accounting data associated with the case records.

⁹The deficiencies noted are not independent of one another, as one loan may have contained more than one deficiency.

Inadequate Gift Fund Documentation

First Tennessee officials did not properly document the transfer of gift funds for four loans. For example, for loan number 151-8161023, First Tennessee officials did not adequately verify the transfer of a \$3,921 gift; therefore, the borrower's investment in the property was not verified. The mortgage credit analysis worksheet showed that the borrower's minimum cash investment requirement was \$3,921, and First Tennessee's file contained a gift letter, dated August 22, 2006, from a nonprofit corporation for a \$3,921 gift to the borrower to assist with the property purchase. The gift approval letter stated that \$3,921 in gift funds would be wired from the nonprofit to the closing attorney. However, neither the FHA case binder nor First Tennessee's file contained documentation verifying that the closing agent received the gift funds. The HUD-1 settlement statement showed that the loan closed on August 23, 2006; however, there was no documentation to verify that these gift funds were provided to the closing agent. Without documentation verifying that the closing agent received the funds from the nonprofit, First Tennessee officials did not verify and document that the gift funds ultimately did not come from an unacceptable source. Consequently, the borrower's investment in the property was not properly verified and documented.

Borrower Investment in Property Not Verified and/or Documented

First Tennessee officials did not verify the borrower's investment in the property for five loans. This deficiency involved not adequately verifying and documenting the transfer of gift funds as previously mentioned, and not ensuring that the borrowers met the minimum cash investment requirement. In one example related to loan number 441-7773869, First Tennessee officials did not ensure that the borrower met the 3 percent minimum cash investment requirement of \$2,640. First Tennessee's file contained a sales contract, which reported that the borrower made a \$1,000 earnest money deposit; a copy of a check, dated February 20, 2006, in the amount of \$1,000 made payable to the selling broker for the earnest money deposit; and a copy of the borrower's bank statement for the period January 12 through February 12, 2006, which reported \$2,107 in personal funds. Furthermore, the HUD-1 settlement statement reflected that the borrower's total cash investment in the property was \$2,485, which consisted of a \$1,000 earnest money deposit, \$1,091 paid at closing, and \$394 paid outside of closing. Since the minimum cash investment requirement was \$2,640, the borrower invested \$155 less than was required.

Incorrect Underwriter's Certifications Submitted to HUD

We reviewed the certification for the five loans with material underwriting deficiencies for accuracy. First Tennessee's direct endorsement underwriters incorrectly certified that due diligence was used in underwriting these five loans. When underwriting a loan manually, HUD requires a direct endorsement lender to certify that it used due diligence and reviewed all associated documents during the underwriting of the loan.

Applicable Statutes

The Program Fraud Civil Remedies Act of 1986 (31 U.S.C. (United States Code) 3801-3812) and (24 CFR (Code of Federal Regulations) Part 28) provides Federal agencies, which are the

victims of false, fictitious, and fraudulent claims and statements, with an administrative remedy to (1) recompense such agencies for losses resulting from such claims and statements; (2) permit administrative proceedings to be brought against persons who make, present, or submit such claims and statements; and (3) deter the making, presenting, and submitting of such claims and statements in the future, up to \$7,500 for each violation and double the amount of paid claims (recovery limited to claims of \$150,000 or less).

Regulations at 24 CFR 30.35 provide that the Mortgagee Review Board may initiate a civil money penalty action against any lender that knowingly violates any of the listed 14 different violations, up to \$7,500 for each violation but not to exceed \$1.375 million.

RECOMMENDATIONS

We recommend that HUD’s Associate General Counsel for Program Enforcement

- 1A. Determine legal sufficiency and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act and/or civil money penalties against First Tennessee and/or its principals for incorrectly certifying to the integrity of the data or that due diligence was exercised during the underwriting of five loans that resulted in actual losses of \$435,574, which could result in affirmative civil enforcement action of approximately \$908,648.¹⁰

We also recommend that HUD’s Deputy Assistant Secretary for Single Family

- 1B. Take appropriate administrative action against First Tennessee and/or its principals for the material underwriting deficiencies cited in this report once the affirmative civil enforcement action cited in recommendation 1A is completed.

SCHEDULE OF INELIGIBLE COSTS

Recommendation number	Ineligible 1/
1A	\$435,574
Totals	\$435,574

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations. The amount shown represents the actual loss HUD incurred when it sold the affected properties.

¹⁰ Double damages for actual loss amounts related to five loans ($\$435,574 \times 2 = \$871,178$) plus \$37,500, which is a \$7,500 fine for each of the 5 loans with material underwriting deficiencies.

Appendix A

SUMMARY OF MATERIAL UNDERWRITING DEFICIENCIES

FHA loan number	Excessive ratio(s) without adequate compensating factors	Inadequate gift documentation	Borrower investment in property not verified and/or documented
151-8161023*		X	X
241-7877788*		X	X
291-3491113*	X	X	X
332-4542658*		X	X
441-7773869			X
TOTALS	1	4	5

*Loan was originated under the LI program. Therefore, the lender self-insures the FHA loan and only submits those case binders (paper or electronic) when requested for review by HUD. (Note the loan without the asterisk was originated before First Tennessee was approved to participate in the LI program on August 24, 2006)

Appendix B

LOANS WITH MATERIAL UNDERWRITING DEFICIENCIES

Loan number: 151-8161023

Mortgage amount: \$128,898

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: August 23, 2006

Status as of June 30, 2010: Claim

Payments before first default reported: Five

Loss to HUD: \$66,300

Summary:

We found a material underwriting deficiency relating to the borrower's gift funds and investment in the property.

Inadequate Verification of Transfer of Gift Funds **Borrower Investment in Property Not Verified**

First Tennessee officials did not adequately verify the transfer of a \$3,921 gift; therefore, the borrower's investment in the property was not verified. The mortgage credit analysis worksheet showed that the borrower's minimum cash investment requirement was \$3,921, and First Tennessee's file contained a gift letter, dated August 22, 2006, from a nonprofit corporation for a \$3,921 gift to the borrower to assist with the property purchase. The gift approval letter stated that \$3,921 in gift funds would be wired from the nonprofit to the closing attorney. However, neither the FHA case binder nor First Tennessee's file contained documentation verifying that the closing agent received the gift funds. The HUD-1 settlement statement showed that the loan closed on August 23, 2006; however, there was no documentation to verify that these gift funds were provided to the closing agent. Without documentation verifying that the closing agent received the funds from the nonprofit, First Tennessee officials did not verify and document that the gift funds ultimately did not come from an unacceptable source. Consequently, the borrower's investment in the property was not properly verified and documented.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10, states that all funds for the borrower's investment in the property must be verified and documented and the lender must be able to determine that the gift funds ultimately were not provided from an unacceptable source and were indeed the donor's own funds. When the transfer occurs at closing, the lender remains responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source.

Mortgagee Letter 2004-28 provides that the lender must obtain and keep the documentation of the wire transfer of downpayment funds from charities in its mortgage loan application binder.

Loan number: 241-7877788

Mortgage amount: \$293,680

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: July 25, 2007

Status as of June 30, 2010: Claim

Payments before first default reported: Six

Loss to HUD: \$141,906

Summary:

We found a material underwriting deficiency relating to the borrower's gift funds and investment in the property.

Inadequate Verification of Transfer of Gift Funds
Borrower Investment in Property Not Verified

First Tennessee officials did not adequately verify the transfer of a \$10,000 gift; therefore, the borrower's investment in the property was not verified. The mortgage credit analysis worksheet showed that the borrower's minimum cash investment requirement was \$8,800, and First Tennessee's file contained a gift letter, dated June 27, 2007, from a nonprofit charitable organization for a \$10,000 gift to the borrower to assist with the property purchase. The gift approval letter stated that \$10,000 in gift funds would be wired from the nonprofit to the settlement company at closing. The HUD-1 settlement statement showed that the loan closed on July 25, 2007; however, there was no documentation to verify that these gift funds were provided to the closing agent. Without documentation verifying that the closing agent received the funds from the nonprofit, First Tennessee officials did not verify and document that the gift funds ultimately did not come from an unacceptable source. Consequently, the borrower's investment in the property was not properly verified and documented.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10, states that all funds for the borrower's investment in the property must be verified and documented and the lender must be able to determine that the gift funds ultimately were not provided from an unacceptable source and were indeed the donor's own funds. When the transfer occurs at closing, the lender remains responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source.

Mortgagee Letter 2004-28 provides that the lender must obtain and keep the documentation of the wire transfer of downpayment funds from charities in its mortgage loan application binder.

Loan number: 291-3491113

Mortgage amount: \$156,543

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: December 11, 2006

Status as of June 30, 2010: Claim

Payments before first default reported: Five

Loss to HUD: \$47,215

Summary:

We found material underwriting deficiencies relating to the borrower's debt ratios, gift funds, and investment in the property.

Excessive Debt-to-Income Ratio Without Valid Compensating Factors

First Tennessee officials did not document valid compensating factors to justify the approval of a loan with a back ratio of 47.16 percent, which exceeded HUD's benchmark of 43 percent. First Tennessee officials recorded the following compensating factors on the mortgage credit analysis worksheet: "Credit: VOR (verification of rent) – 60 months on CR (credit report), 2 trades on CR Rpt + 12 mos." However, these are not valid compensating factors as defined by HUD Handbook 4155.1, REV-5, paragraph 2-13. In this case, although the credit report showed that the borrower successfully demonstrated the ability to pay housing expenses over the past 60 months, the proposed monthly mortgage payment of \$1,246.09 was more than 300 percent greater than the monthly rental payment of \$375. Therefore, First Tennessee officials did not provide adequate support for the compensating factors used to justify the loan approval.

HUD/FHA Requirements:

Mortgage Letter 2005-16 states that the qualifying ratios are 31 and 43 percent. If either or both ratios are exceeded, the lender must describe the compensating factors used to justify the mortgage approval.

HUD Handbook 4155.1, REV-5, paragraph 2-13, requires ratios exceeding HUD's benchmark guidelines to be accompanied by significant compensating factors documented on the mortgage credit analysis worksheet, which justify the approval of the mortgage loan, and supporting documentation must be provided.

Inadequate Verification of Gift Funds
Borrower Investment in the Property Not Verified

First Tennessee officials did not adequately document the source of an \$8,000 gift. Consequently, the borrower's investment in the property was not properly verified and documented. First Tennessee's file documented a copy of the December 8, 2006, gift letter from the borrower's mother and an official check made payable to the title company, but did not document a copy of the donor's withdrawal slip or cancelled check as required. Therefore, First Tennessee officials did not obtain evidence to ensure that the gift funds came from the donor's personal account and ultimately did not come from an unacceptable source. Moreover, the \$8,000 gift check allegedly issued to the title company was not reflected on the HUD-1 settlement statement. Since the borrower had verifiable assets of only \$1,895, these gift funds were needed to ensure that the borrower had sufficient funds to meet the minimum cash investment requirement of \$4,770 and the funds to close of \$7,820. As a result, First Tennessee officials did not properly verify and document the gift and the borrower's investment in the property.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10C, requires that the transfer of gift funds from the donor to the borrower, by way of an official check, be documented by obtaining a copy of the donor's withdrawal slip or cancelled check for the amount of the gift, showing that the funds came from the donor's personal account. If the donor borrowed the gift funds and cannot provide bank documentation, the donor must provide evidence that those funds were borrowed from an acceptable source.

Loan number: 332-4542658

Mortgage amount: \$214,368

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: March 11, 2008

Status as of June 30, 2010: Claim

Payments before first default reported: Zero

Loss to HUD: \$121,347

Summary:

We found a material underwriting deficiency relating to the borrower's gift funds and investment in the property.

Inadequate Verification of Transfer of Gift Funds
Borrower Investment in Property Not Verified

First Tennessee officials did not adequately verify and document the transfer of an \$8,800 gift; consequently, the borrower's investment in the property was not substantiated. The purchase agreement reported that the seller would contribute 3 percent of the purchase price or the minimum cash investment requirement of \$8,800 to the downpayment assistance program. In addition, First Tennessee's file contained a gift letter from a nonprofit organization, which stated that it would wire \$8,800 in gift funds to the closing office to assist the borrower with the property purchase. The gift letter was signed and dated by the borrower on February 1, 2008. The file also contained wiring instructions for the gift and a "wire in request," dated February 22, 2008, faxed from the settlement company on March 6, 2008. Nevertheless, First Tennessee officials did not document the execution of the wire transfer at closing on March 11, 2008. Since First Tennessee officials did not verify and document that the wire transfer was received by the closing office from the nonprofit, there was no evidence that the gift funds ultimately did not come from an unacceptable source and that the borrower met the minimum cash investment requirement of \$8,800.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10, states that all funds for the borrower's investment in the property must be verified and documented and the lender must be able to determine that the gift funds ultimately were not provided from an unacceptable source and were indeed the donor's own funds. When the transfer occurs at closing, the lender remains

responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source.

Mortgagee Letter 2004-28 provides that the lender must obtain and keep the documentation of the wire transfer of downpayment funds from charities in its mortgage loan application binder.

Loan number: 441-7773869

Mortgage amount: \$87,310

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: March 31, 2006

Status as of June 30, 2010: Claim

Payments before first default reported: 10

Loss to HUD: \$58,806

Summary:

We found a material underwriting deficiency relating to the borrower's investment in the property.

Borrower's Minimum Investment in Property Not Met

First Tennessee officials did not ensure that the borrower met the 3 percent minimum cash investment requirement of \$2,640. First Tennessee's file contained a sales contract, which reported that the borrower made a \$1,000 earnest money deposit; a copy of a check, dated February 20, 2006, in the amount of \$1,000 made payable to the selling broker for the earnest money deposit; and a copy of the borrower's bank statement for the period January 12 through February 12, 2006, which reported \$2,107 in personal funds. Furthermore, the HUD-1 settlement statement reflected that the borrower's total cash investment in the property was \$2,485, which consisted of a \$1,000 earnest money deposit, \$1,091 paid at closing, and \$394 paid outside of closing. Since the minimum cash investment requirement was \$2,640, the borrower invested \$155 less than was required.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 1-7, states that the borrower must make a 3 percent minimum cash investment in the property and borrower-paid closing costs may be used to meet the cash investment requirements.

Appendix C

LENDER COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Lender Comments



Charles W. Rutledge
Senior Vice President & Assistant General Counsel

September 1, 2010

VIA FEDERAL EXPRESS

Mr. Edgar Moore
Regional Inspector General for Audit
U.S. Department of Housing
and Urban Development
Office of the Inspector General
New York/New Jersey, 2AGA
26 Federal Plaza
Room 3430
New York, New York 10278-0068

**RE: First Tennessee Bank National Association
HUD OIG Draft Memorandum Report 2010-NY-180X**

Dear Mr. Moore:

First Tennessee Bank National Association ("First Tennessee" or "Bank") is in receipt of the revised Draft Memorandum Report ("Report"), dated August 20, 2010, from the U.S. Department of Housing and Urban Development's ("HUD" or "Department") Office of Inspector General ("OIG"). The Report is based on a review of eighteen Federal Housing Administration ("FHA") insured loans selected as part of HUD and the OIG's "Operation Watchdog" initiative to examine the underwriting of fifteen lenders at the suggestion of the FHA Commissioner. The eighteen loans were endorsed for FHA insurance and defaulted within the first 30 months, and have since gone into claim status.

The Report states that its objective was to determine whether the Bank underwrote the eighteen selected loans in accordance with FHA requirements and, if not, whether the underwriting reflected systemic problems. The Report's "Results of Review" allege that ten of the eighteen loans contained underwriting deficiencies and, in each of these ten cases, the underwriters incorrectly certified that due diligence was used in underwriting the loans. Based on these assertions, the Report recommends that HUD: (1) take appropriate administrative action with regard to the underwriting deficiencies; and (2) in connection with the underwriting certifications, determine the legal sufficiency and, if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act, 31 U.S.C. §§ 3801 *et seq.* ("PFCRA") and/or civil money penalties under HUD regulations.

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LENDER COMMENTS AND OIG's EVALUATION

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The OIG provided First Tennessee with an opportunity to submit written comments for inclusion in the final report. This response summarizes First Tennessee's history and operations and addresses the individual findings cited in the Report. We believe that this response and accompanying exhibits demonstrate that the Report's recommendations in connection with the cited loans are unwarranted. We appreciate this opportunity to comment on the OIG's findings and recommendations. That said, we understand that final reports routinely include auditors' comments about the lender's written response, but that the lender is not provided an opportunity to respond to these additional comments. Often, these comments include substantive allegations or statements that were not a part of the draft report provided to the lender. To the extent that the OIG makes such additional substantive comments in this instance, we respectfully request an opportunity to respond to these additional statements to ensure that a full picture of the issues is presented in the final report.

I. BACKGROUND

A. FIRST TENNESSEE BANK NATIONAL ASSOCIATION

First Tennessee is a mid-size national bank regulated by the Office of the Comptroller of the Currency and has been an FHA-approved supervised mortgagee since March 1980. Over the past two years, First Tennessee has undergone major strategic and corporate changes, which has had a substantial impact on the FHA-insured loans originated by the Bank. In fact, the Bank currently originating FHA loans is a totally different organization from the Bank that originated the ten FHA loans at issue. During the time period in which these loans were originated, from November 2005 through March 2008, the Bank provided a range of banking products and services to our customers, including residential mortgage loans through First Horizon Home Loans ("First Horizon"), a division of First Tennessee. Until August 31, 2008, First Horizon originated FHA-insured loans on a nationwide basis through both retail and wholesale lending channels.

In July 2008, First Tennessee transferred \$7.7 billion in mortgage loans through a bulk servicing sale to Mid First Bank. In August 2008, First Tennessee sold the majority of its First Horizon mortgage division assets, including nationwide retail and wholesale mortgage lending operations and branch offices to MetLife Bank, along with its mortgage loan origination and servicing platform. However, First Tennessee retained its bank branch and loan origination offices in the States of Tennessee, Mississippi, Georgia, and North Carolina, which are part of the Bank's footprint.¹ In

¹ First Tennessee/First Horizon also retained the servicing rights to approximately \$65 billion in first-lien residential loans and retained certain wind-down operations related to its discontinued One-Time-Close

LENDER COMMENTS AND OIG's EVALUATION

Ref to OIG Evaluation

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November 2008, the Bank again transferred \$34 million in loans through a bulk servicing sale to Chase. Presently, First Tennessee originates new FHA-insured mortgage loans in its name from its main office in the Bank footprint.

Since becoming FHA approved in 1980, First Tennessee has taken its responsibilities under the FHA program seriously. We strive to comply with applicable rules and regulations and are committed to educating and training our employees on issues of FHA compliance. First Tennessee is also dedicated to customer service. We work closely with each individual applicant to ensure that he or she receives the type of financing that best fits his or her needs. Throughout our existence, we have endeavored to provide dependable and professional service and have repeatedly demonstrated our commitment to borrowers and allegiance to the FHA program.

We also note that, as indicated above, the review covered loans originated between November 30, 2005 and March 11, 2008. As you know, during and immediately following this period, the United States experienced a dramatic financial crisis that resulted in record-breaking unemployment, and loan default and foreclosure activity. Many of the borrowers in the cases at issue defaulted after making multiple mortgage payments. This payment activity suggests that these borrowers defaulted as a result of unforeseen economic or personal setbacks as a result of this crisis, rather than because of poor origination or underwriting decisions. In fact, loan servicing data for the loans reviewed demonstrates that at least six of these borrowers reported unemployment/curtailment of income or illness, which often results in income loss, as the reason for the default.

B. THE "OPERATION WATCHDOG" REVIEW

As an initial matter, we would like to take this opportunity to point out that this review was not conducted in the typical manner in which the OIG Audit Division performs audits. As acknowledged in the Report, the OIG did not follow its standard procedures of considering the Bank's internal or information systems controls or the results of previous audits, and did not communicate with First Tennessee's management in advance of issuing the Report. Moreover, instead of reviewing a statistically random sample of loans originated by First Tennessee during the review period, the OIG examined loan files for an adverse sample of 18 loans in which the borrowers had defaulted and the lenders had made a claim to HUD for FHA insurance benefits. Rather than request that the Bank provide information and loan files in the cases reviewed, which First Tennessee would have promptly supplied, the OIG

and Builder Finance operations. Currently, as a result of additional servicing sales and liquidations, First Tennessee retains the servicing rights to approximately \$31 billion in first-lien loans.

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subpoenaed loan file documentation simultaneously from fifteen FHA-approved lenders, including First Tennessee, in connection with the "Operation Watchdog" probe. While HUD and the OIG expressly stated that there was "no evidence of wrongdoing" on the part of First Tennessee or the other lenders subjected to this probe (**Exhibit A-1**), the Department and OIG nevertheless issued a press release announcing the "probe" before reviewing any of the loan files at issue in this matter (**Exhibit A-2**). Typically, HUD and the OIG refuse to disclose the names of entities subject to ongoing reviews by the Department; however, in this instance, the press release included the names of the fifteen lenders, including First Tennessee, subject to this particular review (**Exhibit A-2**).

Although the OIG acknowledged in the press release that it had no evidence of wrongdoing by the Bank at that time, by stating that the Department would "aggressively pursue indicators of fraud," the announcement gave the public the impression that the subject lenders had engaged in misconduct or otherwise posed some risk to the FHA Insurance Fund. The Bank is one of several of the identified lenders whose reputations suffered as a result of the public announcement of the "probe." First Tennessee has always been committed to complying with HUD requirements and originating quality FHA-insured loans. Therefore, upon receiving the draft Report, we conducted a thorough review of the loan file documentation in light of the issues raised, which, significantly, do not include any allegations or findings of fraud. We address the concerns identified in the Report below.

II. RESPONSE TO RESULTS OF REVIEW

As previously noted, the Report alleges noncompliance with HUD requirements in ten loans and recommends action by HUD and the Departmental Enforcement Center regarding these assertions. Upon receipt of the draft Report, First Tennessee performed its own stringent analysis of the loans subject to the OIG's review. Based on First Tennessee's diligent examination, the Bank disagrees with a number of the assertions in the Report and takes strong exception to certain of the recommendations made in the Report, including the suggestion that the Department consider pursuing remedies under PFCRA and/or civil money penalties. Our review indicated that several of the findings in the Report are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability. While we recognize that there is always room for improvement, at no time did the Bank intentionally disregard HUD guidelines or knowingly misrepresent information to the Department. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate First Tennessee's general compliance with HUD/FHA requirements and adherence to prudent lending standards. Below we reply to the individual matters raised in the Report, evidence our adherence to FHA

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requirements in connection with several cited loans, and set forth our opposition to the to the OIG's recommendations regarding action under PFCRA.

A. FIRST TENNESSEE GENERALLY COMPLIED WITH HUD'S UNDERWRITING GUIDELINES

In the "Results of the Review" and Appendix B, the Report alleges that First Tennessee did not underwrite ten of the eighteen FHA loans reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) income verification; (2) excessive qualifying ratios; (3) creditworthiness; (4) documenting borrower assets; (5) documenting the source of gift funds; and (6) verifying the source of funds to close.

We address each of these individual allegations in turn below. Initially, however, we note the Report's discussion of the fact that First Tennessee was approved to participate in the Lender's Insurance ("LI") program as of August 24, 2006, which enabled the Bank to endorse FHA mortgage loans without preendorsement review by HUD. Although First Tennessee was a high-performing lender that qualified for the LI program, please also note that three of the ten loans cited in the Report were not insured under the LI program – [REDACTED] FHA Case No. 121-2299638, (2) [REDACTED] FHA Case No. 321-2422822, and [REDACTED] – FHA Case No. 441-7773869. HUD insured these loans only after First Tennessee had submitted actual case binders to HUD for review and approval. Notably, HUD personnel did not identify any underwriting or other concerns in these files at the time HUD approved the loans for FHA insurance.

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1. Income Verification

In four of the loans reviewed by the OIG, the Report contends that the Bank did not properly calculate the borrower's income and/or did not obtain adequate support for the borrower's employment. First Tennessee respectfully disagrees with the allegations in the cited loans, and our individual responses to these cases are set forth below.

a. [REDACTED] FHA Case No. 291-3491113

In the [REDACTED] case, the Report alleges that First Tennessee did not adequately document the borrower's monthly effective income and that \$198 was deemed unsupported as a result. Specifically, it alleges that, while the file contains the borrower's Internal Revenue Service ("IRS") W-2 forms from the previous two years (i.e., 2004 and 2005), a telephone Verification of Employment ("VOE"), and a pay stub covering a two-week period, the file does not contain the borrower's pay stubs covering the most recent 30-day period. The Report further alleges that, while two letters from the Social Security Administration confirm the borrower's receipt of \$1,310 in monthly

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nontaxable Social Security benefits received on behalf of his dependent children, the loan application and Mortgage Credit Analysis Worksheet ("MCAW") report \$1,508 in monthly benefits, thereby leaving \$198 unsupported. The Report notes that, although HUD permits lenders to "gross-up" nontaxable income and the \$198 appeared to be the grossed-up amount, the file does not document the basis for the 15% adjustment as required.

First Tennessee understands and appreciates the FHA requirement to verify a borrower's two-year employment history and income stability, including the specific documentation requirements. In compliance with both applicable FHA guidelines respecting employment verification and documentation, see HUD Handbook 4155.1 REV-5, ¶ 3-1E,² and Bank policy, it is our practice to obtain a written VOE and the most recent pay stub, or a verbal VOE, pay stubs covering the most recent 30 days, and two years' IRS W-2 forms. Here, as stated in the Report, the [REDACTED] file contains a verbal VOE confirming the borrower's employment as a paramedic with the same employer [REDACTED] for the past 20 years (**Exhibit B-1**), a pay stub from [REDACTED] for the period ending October 28, 2006 (**Exhibit B-2**), and the prior two years' IRS W-2 forms from [REDACTED] (**Exhibit B-3**). Although the file does not contain each and every pay stub received by the borrower for 30 consecutive days, the pay stub in the file does cover the most recent 30 days as required by HUD/FHA. See HUD Handbook 4155.1 REV-5, ¶ 3-1E (requiring retention of the borrower's "pay stub(s) covering the most recent 30-day period"). In fact, it covers nearly 10 months of wages given that it reflects not only the borrower's earnings for the two-week period ending October 28, 2006, but also all earnings and deductions in every category that the borrower had earned year-to-date. Please also note that the borrower's bank statement reflected bi-weekly payroll deposits from [REDACTED] (**Exhibit B-4**).

What's more, we note that the file may have contained additional pay stubs at the time this loan was underwritten and closed. First Tennessee processed the [REDACTED] file over three and a half years ago. Given the FHA requirement to retain loan origination files for only two years, see HUD Handbook 4000.2 REV-3, ¶ 5-8, the file may no longer contain every verification item that was used for underwriting. The file, however, still contains sufficient evidence of the borrower's two-year employment history and income stability as described above. Considering the fact that the borrower worked for the same employer for 20 years and that his employment and income are evidenced by a telephone VOE, a pay stub reflecting earnings for 10 months, two years' W-2 forms, and

² While the Department has issued a new online version of Mortgage Credit Analysis Handbook, 4155.1, the new Handbook became effective for loans originated on or after May 11, 2009, after the loans cited in the Report were originated and closed. We therefore rely on the prior Handbook, 4155.1 REV-5, and accompanying Mortgagee Letters throughout this response.

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bank statements reflecting direct payroll deposits every two weeks, there is no reason to question the borrower's employment or income in this case.

With respect to the borrower's Social Security benefits, First Tennessee properly grossed them up by 15%. FHA guidelines expressly permit a mortgagee to include Social Security income in a borrower's qualifying income and to gross it up. See HUD Handbook 4155.1 REV-5, ¶ 2-7E, Q. As acknowledged in the Report, the file contains verification of \$1,310 in monthly income directly from the Social Security Administration (**Exhibit B-5**). Notably, FHA guidelines provided that the amount of continuing tax savings attributable to such a nontaxable income source could be added to the borrower's gross income for qualifying purposes so long as the percentage added did not exceed the appropriate rate for the borrower's income amount; it clarified that a lender should use the tax rate used to calculate the last year's income tax for the borrower, or 25% if the borrower was not required to file a federal income tax return. See *id.* ¶ 2-7Q. In the [REDACTED] case, the tax rate applied to the borrower in 2005 was 15% based on the 2005 federal IRS tax table, and the Bank therefore appropriately grossed up the borrower's nontaxable Social Security benefits by 15% for qualifying purposes in this case. Contrary to the suggestion in the Report, the Bank adhered strictly to FHA requirements in connection with the [REDACTED] loan.

The above discussion and attached documentation demonstrate that First Tennessee substantially adhered to HUD guidelines in documenting and calculating the borrower's income in this case and the borrower qualified for the FHA-insured loan at issue. For these reasons, administrative action is not warranted and this allegation should be removed from the final report.

b. [REDACTED] FHA Case No. 321-2422822

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In the [REDACTED] case, the Report alleges that First Tennessee incorrectly calculated the borrower's overall effective monthly income by erroneously including overtime income, which thereby purportedly resulted in excessive qualifying ratios. Specifically, the Report alleges that, while the file contains a verbal VOE, two pay stubs, and 2003 and 2004 tax returns, the verbal VOE does not contain information relating to the borrower's overtime income, there is no written VOE or other documentation substantiating an earnings trend for overtime income, only one of the two pay stubs in the file reflected the receipt of overtime income, and special pay varied between the two pay stubs. The Report further alleges that First Tennessee should have obtained pay stubs covering the most recent 30 days and IRS W-2 forms because there was no written VOE. The Report concludes that exclusion of the overtime income increases the borrower's qualifying ratios from 25.7%/39.2% to 36.03%/54.9%, which exceed HUD's

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benchmark guidelines of 31% and 43%, and that there are no compensating factors that would have justified loan approval with the higher ratios.

First Tennessee disagrees with the income analysis in the Report for this borrower and respectfully maintains that it complied with FHA guidelines in this case. As stated in the Report, FHA guidelines provide that overtime income may be used to qualify the borrower if the borrower has received it for the past two years and it is likely to continue; the lender must develop a two-year average for the income and rationalize its use if there has been a continual decline, and the VOE must not state that the income is unlikely to continue. See HUD Handbook 4155.1 REV-5, ¶ 2-7(A). Here, the borrower's pay stubs (**Exhibit C-1**) and tax returns (**Exhibit C-2**) evidence his receipt of overtime income for the past two years and establish the requisite earnings trend, and the verbal VOE does not state the income is unlikely to continue.

Although the two pay stubs indicate that the borrower earned overtime income the week of October 24, 2005, but not the week of October 31, 2005, both pay stubs reflect year-to-date overtime totaling \$4,890.06 as of November 6, 2005 and the total income on the pay stubs is consistent with the total income on the tax returns. As stated in the Report, the borrower's tax returns reflect total wages of \$40,071 in 2004. As reflected on the pay stubs, however, the borrower earned regular pay of \$14 per hour. Assuming the borrower worked an average of 40 hours per week, such earnings would yield \$29,120 per year and the borrower's total wages on the 2004 tax return would have been substantially lower if they did not include overtime income and special pay. Reflection of \$40,071 in total wages on the 2004 tax return suggests overtime income and special pay of \$10,951, and reflection of \$4,890.06 in overtime income and \$4,001.59 in special pay on the pay stubs indicates total overtime income and special pay of \$8,891.65 through November 6, 2005. The tax returns and pay stubs thereby establish an earnings trend of approximately \$10,000 per year in overtime income and special pay. There was no continual decline. What's more, the verbal VOE (**Exhibit C-3**) does not state that overtime income was unlikely to continue. Significantly, FHA guidelines do not require the VOE to confirm the likelihood that overtime will continue. They require only that the VOE does not expressly state it is unlikely to continue. Here, the VOE was silent on the matter and therefore complied with this part of the HUD guidelines. The borrower's overtime income and special pay, including a two-year history and earnings trend, were evidenced by the pay stubs and tax returns. First Tennessee complied with HUD/FHA requirements in this case and the borrower's income was not overstated.

Nevertheless, even using the lower income calculation and higher qualifying ratios suggested in the Report, the borrower still would have qualified for FHA financing. Although the ratios would have exceeded HUD's benchmark guidelines, the Department

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expressly permits financing under such circumstances when significant compensating factors are present. See HUD Handbook 4155.1 REV-5, ¶ 2-12. In the [REDACTED] case, the borrower had \$4,509 in cash reserves, which would cover nearly six months of mortgage payments (**Exhibit C-4**). Notably, HUD has stated that substantial cash reserves amounting to at least three months' worth of mortgage payments constitutes a significant compensating factor that would justify loan approval when the borrower's qualifying ratios exceed the benchmark guidelines. See *id.*, ¶ 2-13(G). Given that the borrower here had nearly double the reserves HUD would have considered sufficient to approve the loan even using the income and ratios suggested in the Report, any deficiency that arguably may have occurred in connection with the income calculation in the [REDACTED] case constituted at worst harmless error.

Lastly, respecting the Report's reference to a lack of additional pay stubs and W-2 forms, First Tennessee understands and appreciates that, to document a borrower's employment, a mortgagee must obtain either a written VOE and the most recent pay stub or a verbal VOE, pay stubs covering the most recent 30 days, and two years' IRS W-2 forms. See HUD Handbook 4155.1 REV-5, ¶ 3-1E. It is First Tennessee's policy and practice to obtain such documentation in each and every case where applicable. In the [REDACTED] case, we note that the loan was processed nearly five years ago and, given the FHA requirement to retain loan origination files for only two years (HUD Handbook 4000.2 REV-3, ¶ 5-8), First Tennessee has been unable to locate the referenced items. While First Tennessee has been unable to locate additional pay stubs covering a full 30-day period and copies of the borrower's IRS W-2 forms, the file does contain not only the most recent two pay stubs (**Exhibit C-1**), but two years of tax returns prepared for the borrower by H&R Block and which presumably were based in part on the borrower's W-2 forms (**Exhibit C-2**), and two verbal VOEs (**Exhibit C-3**). What's more, a recent Quality Control review performed by an independent third-party firm successfully re-verified the borrowers' employment and income, including the validity and accuracy of the borrower's pay stubs (**Exhibit C-5**). There is no reason to question the borrower's employment in this case.

The above discussion and attached documentation demonstrate that First Tennessee substantially adhered to HUD guidelines in documenting and calculating the borrower's income in this case and the borrower qualified for the FHA-insured loan at issue. For these reasons, administrative action is not warranted and this allegation should be removed from the final report.

c. [REDACTED] FHA Case No. 332-4507321

In the [REDACTED] case, the Report alleges that First Tennessee did not adequately document the borrower's monthly effective income and that \$282 was unsupported.

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Specifically, it alleges that while First Tennessee verified the borrower's employment through an automated service and obtained four pay stubs with pay dates ranging from August 3 through September 28, 2007, as well as the previous two years' IRS W-2 forms for 2005 and 2006, the borrower's pay stubs did not cover the most recent consecutive 30 days. The Report further alleges that First Tennessee grossed up the co-borrower's \$1,128 in monthly Social Security retirement benefits to \$1,410, but that the file does not document the basis for this 25% adjustment.

First, with respect to the employment documentation, as stated in the Report, the file contains electronic verification of the borrower's employment (**Exhibit D-1**), pay stubs (**Exhibit D-2**), and two years' IRS W-2 forms (**Exhibit D-3**). The pay stubs are for the borrower's wages from July 22 – 28, August 5 – 11, and September 9 – 22, 2007. Although the file does not contain each and every pay stub received by the borrower for 30 consecutive days, the pay stubs in the file do cover the most recent 30 days as required by HUD/FHA; in fact, they cover eight weeks of wages and the year-to-date amounts reflect appropriate increases to evidence that the borrower in fact was working for this employer and earning wages consistently over all eight weeks. For example, the August 17th pay stub, which was for wages earned between August 5 and 11, 2007, reflected regular pay of \$572.45 for 40 hours during that period and gross year-to-date income of \$22,429.80. The September 21st pay stub, which was for wages earned between September 9 and 15, 2007, reflected the same regular pay of \$572.45 for 40 hours during that period but year-to-date income of \$25,937. The year-to-date amounts on these two pay stubs indicate that the borrower earned \$3,507.20 between August 11th and September 15th, which is consistent with the borrower's regular and overtime earnings reflected in all of her pay stubs. The pay stubs in the file in fact cover the most recent 30 days. What's more, we note that an independent third party recently performed a closed loan review of the file and re-verified the borrower's employment and income. Accordingly, given the file documentation and recent re-verification, there is no reason to question the borrower's employment or income in this case.

With respect to the co-borrower's Social Security benefits, First Tennessee properly grossed them up by 25%. FHA guidelines expressly permit a mortgagee to include Social Security income in a borrower's qualifying income and to gross it up. See HUD Handbook 4155.1 REV-5, ¶ 2-7E, Q. As acknowledged in the Report, the file contains verification of the income directly from the Social Security Administration (**Exhibit D-4**). Notably, FHA guidelines provided that the amount of continuing tax savings attributable to such a nontaxable income source could be added to the borrower's gross income for qualifying purposes so long as the percentage added did not exceed the appropriate rate for the borrower's income amount; it clarified that a lender should use the tax rate used to calculate the last year's income tax for the borrower, or 25% if the borrower was not required to file a federal income tax return.

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See *id.* ¶ 2-7Q. In the [REDACTED] case, the tax rate applied to the borrowers in 2006 was 25% based on the federal IRS tax tables at the time. First Tennessee therefore appropriately grossed up the nontaxable Social Security benefits by 25% for qualifying purposes in this case. Contrary to the suggestion in the Report, the Bank adhered strictly to FHA requirements in this case.

The above discussion and attached documentation evidence that First Tennessee adhered to HUD guidelines in documenting and calculating the borrower's income in the [REDACTED] loan. For these reasons, administrative action is unwarranted and these allegations should be removed from the final report.

d. [REDACTED] FHA Case No. 521-6392924

In the [REDACTED] case, the Report alleges that First Tennessee did not adequately verify the borrowers' employment for the most recent two full years and therefore did not establish income stability. Specifically, it alleges that the telephone number for the borrower's employer, as well as the length of employment for both the borrower and co-borrower, differed on the loan application and verbal VOE, that the co-borrower's pay stubs did not cover the most recent 30-day period, and that there were no 2005 IRS W-2 forms for either borrower. It further alleges that the borrower's 2006 IRS W-2 form suggested that she may have worked only part time in 2006, or worked less than the full year, and a written explanation in the file indicated a period of unemployment, but First Tennessee did not confirm the period of unemployment or document an explanation for the employment gap.

First Tennessee understands and appreciates the FHA requirement to verify a borrower's two-year employment history and income stability, including the specific documentation requirements and the need to explain any gaps in employment of one month or more. In compliance with both applicable FHA guidelines (HUD Handbook 4155.1 REV-5, ¶ 3-1E) and Bank policy, it is our practice to obtain a written VOE and the most recent pay stub, or a verbal VOE, pay stubs covering the most recent 30 days, and two years' IRS W-2 forms, as well as a written explanation of any gaps in employment. In the [REDACTED] case, we note that the loan was processed over three years ago and, given the FHA requirement to retain loan origination files for only two years (HUD Handbook 4000.2 REV-3, ¶ 5-8), First Tennessee has been unable to locate every verification item that may have been used for underwriting. The file, however, still contains substantial evidence of the borrowers' two-year employment history and income stability. What's more, while First Tennessee may be unable to locate all file documentation at this time, any deficiency in connection with this matter constitutes at worst harmless error. A recent Quality Control review performed by an independent third-party firm successfully re-verified the borrowers' employment and income.

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First, the file clearly documents the borrowers' two-year employment histories. To this end, the file contains: a loan application in which the borrowers certified their employment dating back two and a half years (**Exhibit E-1**); a verbal VOE (**Exhibit E-2**) for both borrowers; a letter from the co-borrower's employer (**Exhibit E-3**); a joint credit report reflecting employment (**Exhibit E-4**); pay stubs for the borrower covering the most recent 30 days (**Exhibit E-5**) and pay stubs for the co-borrower covering three two-week periods within the most recent 70 days (**Exhibit E-6**); the prior year's IRS W-2 forms (**Exhibit E-7**); and letters of explanation from the borrowers discussing employment (**Exhibit E-8**). Although First Tennessee is unable to locate the prior year's W-2 forms from 2005, the foregoing items evidence a two-year employment history and income stability for each borrower.

Furthermore, while the telephone number for the borrower's employer [REDACTED] differs on the loan application and verbal VOE, note that the number reflected on the loan application (i.e., [REDACTED]) is in fact the number for [REDACTED] office in Park City, Utah, as reflected on his website at [http://www.\[REDACTED\].com/](http://www.[REDACTED].com/). We believe the telephone number on the verbal VOE (i.e., [REDACTED]) is [REDACTED] mobile telephone number. With respect to the length of employment, we recognize that the time frame differs on the application and verbal VOE, which appears to have resulted from the loan processor's handwritten error on the verbal VOE. All other file documentation referenced above is consistent respecting the length of employment. In addition, while the co-borrower's pay stubs in the file are not consecutive, as previously noted, there are three different pay stubs, each covering a two-week period and covering a 10-week period altogether with the year-to-date amounts reflective of ongoing employment for the entire 10-week period and thus of more than one full month's earnings as required by the Fannie Mae Underwriting Findings (**Exhibit E-9**). Respecting any gap in the borrower's employment, it did not appear that the gap occurred during the prior two years of employment and First Tennessee therefore was not required to document it. As indicated in both the applicable FHA guidelines (HUD Handbook 4155.1 REV-5, ¶ 2-6) and Fannie Mae Underwriting Findings, a lender is required to obtain an explanation of employment gaps that occurred in the last two years. Here, as the borrower certified on the loan application, she had been employed from December 2004 through the date of application in May 2007, and the dates of the derogatory accounts reflected on the credit report suggest that the borrower's reference to a period of unemployment predated the prior two-year work history.

Finally, although the [REDACTED] file verifies the borrowers' employment and income stability, First Tennessee's inability to locate any particular file documentation at this time constitutes at worst harmless error. An independent third party recently performed

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a closed FHA Quality Control review of the [REDACTED] file. During this independent review, the third-party firm successfully re-verified the borrower's employment with [REDACTED] and the co-borrower's prior employment with [REDACTED] thereby re-confirming the borrowers' two-year employment history.

As the loan file documented the borrowers' two-year employment history and as the Bank has reconfirmed the borrowers' employment, administrative action in this instance is unwarranted. Thus, this allegation should be removed from the final report.

2. Qualifying Ratios

a. [REDACTED] FHA Case No. 291-3491113

In the [REDACTED] loan, the Report alleges that First Tennessee did not document valid compensating factors to justify approval of a loan with a back-end ratio of 47.16%, which exceeded HUD's benchmark guideline of 43%. The Report notes that the MCAW references a 60-month rental history and two trades plus 12 months on the credit report, but suggests that these items are not valid compensating factors as defined by HUD because the proposed monthly mortgage payment exceeded 300% of the borrower's monthly rental payment.

First Tennessee understands and appreciates that, when a borrower's qualifying ratios exceed 31% and 43% on a manually underwritten mortgage, the file must document significant compensating factors (as defined by HUD) used to justify loan approval. See HUD Handbook 4155.1 REV-5, ¶2-13; Mortgagee Letter 2005-16. Contrary to the suggestion in the Report, significant compensating factors expressly permitted by HUD and documented in the file justified loan approval in the [REDACTED] case. To this end, as reflected on the MCAW (**Exhibit F-1**), the borrower had \$4,682.27 in cash reserves, which was 3.75 times the mortgage payment of \$1,246.09. The Department provided that substantial cash reserves after closing, defined as at least three months' worth, constitutes a significant compensating factor that would justify loan approval to a borrower with qualifying ratios that exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-13G. As the borrower's reserves satisfied this threshold in the [REDACTED] transaction, First Tennessee complied with HUD/FHA requirements concerning the borrower's qualifying ratios.

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Additionally, as noted in the Remarks section of the MCAW, the borrower had paid his rent timely for 60 months. Although the rental payment was less than the proposed mortgage payment, as the Department itself has emphasized, see HUD Handbook 4155.1 REV-5, ¶ 2-3, a borrower's payment history on housing obligations holds significant importance and is at the top of the hierarchy of credit evaluation. The borrower's long-term dedication to making timely housing payments therefore was of

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paramount importance in evaluating his overall credit profile. Furthermore, the reference to trade accounts on the MCAW was to highlight the fact that derogatory items on the borrower's credit report (**Exhibit F-2**), as the borrower explained by letter (**Exhibit F-3**), generally resulted from a two-year period when the borrower and his wife suffered medical misfortunes that greatly impacted their employment and income and that the borrower in fact had a fairly conservative attitude towards the use of credit, which HUD also has acknowledged is a significant compensating factor that justifies loan approval when the benchmark ratios are exceeded. See HUD Handbook 4155.1 REV-5, ¶ 2-13C.

As the loan file documented significant cash reserves and a conservative attitude towards the use of credit, which are compensating factors according to HUD, as well as a long-term commitment to housing obligations, which HUD has emphasized is the most important factor in evaluating credit performance, First Tennessee was not prohibited from extending financing even though the debt-to-income ratio exceeded HUD's benchmark guideline. The Bank made a permissible loan determination. Accordingly, administrative action in this instance is unwarranted and this allegation should be removed from the final report.

3. Creditworthiness

In one loan – **██████ FHA Case No. 291-3491113** – the Report takes issue with the Bank's evaluation of the borrower's creditworthiness, asserting that the borrower's credit history involved collections, judgments, and/or recent inquiries without adequate explanation in the file. Specifically, in the **██████** loan, the Report alleges that First Tennessee did not justify loan approval in view of the collections and judgments on the borrower's credit report or document satisfaction and release of a court-ordered judgment. Respecting the items on the borrower's credit report, the Report asserts that the borrower provided a written explanation respecting 16 collections and one judgment, but not the nine inquiries within the past 90 days. Respecting the judgment, the Report asserts that the file contained a letter, dated December 20, 2006, indicating that the borrower had documentation showing the judgment had been satisfied and released, but that the file contained only a docket sheet dated the same day reporting that the borrower's attorney had filed for a satisfaction of judgment on March 25, 2005 due to a pending garnishment. The Report states, however, that the file does not contain documentation that that the borrower's earnings had been garnished or the judgment satisfied before the loan closed on December 11, 2006.

These assertions are at variance with the facts. The file documents that the judgment was paid, and no explanation of the credit inquiries was required. Moreover, First Tennessee carefully considered the borrower's entire credit profile in this case and made a permissible and reasonable underwriting determination.

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Initially, regarding the judgment, the file evidences that the judgment was satisfied at closing. To this end, the file contains not only a letter acknowledging the borrower has evidence the judgment was satisfied and released (**Exhibit G-1**), but a docket sheet from the Circuit Court reporting not just that the borrower's attorney had filed for a satisfaction of judgment on March 25, 2005 due to a pending garnishment, but that a release of garnishment was filed and sent to the sheriff on March 29, 2005 (**Exhibit G-2**). The file also contains a copy of the disbursement from the title company to the plaintiff in satisfaction of the judgment (**Exhibit G-3**). Thus, the file clearly evidences that the judgment was paid at closing.

Respecting the borrower's credit, First Tennessee respects the importance of analyzing a borrower's credit performance and examining his or her attitude towards credit obligations. It has been and remains the Bank's policy and practice, with respect to every FHA applicant, to scrutinize the applicant's credit record and reasonably determine the borrower's creditworthiness. Given the potential risks not only to the Department, but to the Bank, of making a poor credit decision, the Bank's management continuously endeavors to monitor underwriting performance and provide ongoing training to employees on the issue of credit analysis.

That being said, we note that HUD delegated to FHA lenders the responsibility for analyzing a borrower's credit and determining an individual's creditworthiness. See HUD Handbook 4155.1 REV-5, ¶ 2-3. While HUD has established specific guidelines, credit analysis remains largely subjective. For example, where derogatory credit items are present, lenders have discretion to consider the borrower's unique circumstances and determine whether financing is appropriate. The Department has recognized that underwriting is more of an art than a science and requires the careful weighing of the circumstances in each individual case. Thus, it is First Tennessee's policy to carefully scrutinize a borrower's credit history and obtain any documentation or explanation necessary to assess a borrower's credit risk. See Mortgagee Letters 00-24 and 95-07; see also HUD Handbook 4155.1 REV-5, ¶ 2-3. While two underwriters may make different decisions about a borrower's credit in the same case, both underwriters may have complied with FHA requirements and made reasonable underwriting decisions. The standard for compliance with FHA requirements is not whether another underwriter or the OIG would have made a different underwriting determination. The standard is whether the Bank's underwriter made a reasonable underwriting decision in light of the facts in each case. First Tennessee takes its underwriting responsibility seriously and never knowingly would approve a loan to an unqualified borrower.

In the [REDACTED] loan, First Tennessee complied with FHA guidelines by examining the borrower's overall pattern of credit behavior and reasonably determined that the borrower qualified for FHA financing. Specifically, the Report acknowledges that the

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borrower provided a letter explaining the derogatory items on his credit report. It suggests, however, that the Bank should have obtained an explanation of recent inquiries. Notably, HUD/FHA does not require a lender to obtain an explanation of credit inquiries from a loan applicant. In this regard, HUD/FHA guidelines provide that major indications of derogatory credit, which include judgments, collections and other recent credit problems, require written explanation from the borrower. See HUD Handbook 4155.1 REV-5, ¶ 2-3. An inquiry, however, is not a major indication of derogatory credit or a recent credit problem. Unlike late payments, collections, judgments, and other derogatory items, an inquiry is merely a query from a creditor for a copy of the consumer's credit report; every time a consumer applies for credit and the sought after creditor checks the consumer's credit report, a credit inquiry is placed on the report. These inquiries do not reflect derogatory history and do not require explanation from the borrower.

That said, please note that First Tennessee's underwriter carefully considered all of the credit information in this case and made a reasonable underwriting decision. The borrower's written explanation detailing physical injuries he had suffered and the untimely death of his wife (**Exhibit F-3**) adequately explained the negative items on his credit report. Based on this explanation, the underwriter reasonably concluded that events outside the borrower's control, and not a lack of responsibility for credit obligations, led to the collection accounts reflected on the credit report. Given the nature of the borrower's circumstances, his acknowledgement of past difficulties and statement that he was "back on top of [his] bills and monthly obligations," as well as his payment of outstanding collections and other accounts at closing (**Exhibits G-3 and G-4**), suggested that the borrower had taken responsibility for his credit obligations and was a reasonable credit risk. The underwriter properly considered the borrower's satisfaction of previous housing obligations, recent and/or undisclosed debts, collections, judgments, and other items on the credit report, and the underwriter reasonably determined that past derogatory items did not reflect a current disregard for financial obligations. The loan file contains required documentation and First Tennessee prudently exercised the discretion granted to it by the FHA. The borrower in this case was a hard-working individual who had suffered financial difficulties during a limited period as a result of medical and personal hardship but took responsibility for his financial obligations. As a result, First Tennessee adhered to FHA requirements by reasonably determining that the borrower was creditworthy and qualified for a FHA loan.

As the loan file contains all required credit documentation and the Bank made a permissible and reasonable underwriting decision, administrative action in this instance is unwarranted. Thus, this allegation should be removed from the final report.

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4. Borrower Asset Documentation

In four loans, the Report asserts that the loan files did not document the source of the borrowers' earned money deposits and/or the funds needed to close the loans. We address each of these loans in turn below.

a. [REDACTED] FHA Case No. 121-2299638

In the [REDACTED] loan, the Report alleges that loan file did not verify the source of a \$12,375 deposit into the borrower's credit union account, which the borrower used to cover the \$9,319 needed to close the loan.

First Tennessee understands and appreciates that, in FHA-insured loans, "[a]ll funds for the borrower's investment in the property must be verified and documented." HUD Handbook 4155.1 REV-5, ¶ 2-10 (emphasis in original). To verify assets held in a borrower's checking or savings account, HUD guidelines require lenders to obtain a verification of deposit ("VOD") or recent bank statements. See id. ¶¶ 2-10(B), 3-1. With regard to the deposits, HUD guidelines require that "[i]f there is a large increase in an account, or the account was opened recently, the lender must obtain a credible explanation of the source of those funds." See HUD Handbook 4155.1 REV-5, ¶ 2-10(B).

First Tennessee maintains that it adhered to these requirements in connection with the [REDACTED] loan. As indicated in the Report, the borrower needed \$9,319 to close the loan on June 9, 2006 (**Exhibit H-1**). The borrower's loan application indicated that the source of these funds would be "checking/savings" (**Exhibit H-2**). Thus, to document the borrower's closing funds, the Bank obtained a copy of his [REDACTED] account statement, which evidenced that the borrower had \$2,325 in that account as of May 3, 2006 (**Exhibit H-3**). The Bank also obtained a copy of the borrower's credit union statement, dated May 18, 2006, which evidenced that the borrower had \$11,486 as of that date (**Exhibit H-4**). This documentation was sufficient to verify the borrower's depository assets in compliance with HUD guidelines. Contrary to the assertion in the Report, the credit union account was not a recently opened account, nor did the referenced \$12,375 deposit constitute a "large increase" in the account. As acknowledged in the Report, the \$12,375 was deposited on January 5, 2006 and it appears was used to open the account on that date, not to increase already available funds (**Exhibit H-4**). As this January 5, 2006 deposit was made five months prior to closing on June 9, 2006 (**Exhibit H-1**), the Bank was not required to verify the source of these funds. We also note that this January deposit occurred almost five months before the sales contract was signed on May 30, 2006 (**Exhibit H-5**), and there is no suggestion that the borrower obtained the savings in his credit union account from an unacceptable source.

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First Tennessee maintains that it complied with HUD guidelines in documenting the borrower's assets used to close the [REDACTED] loan and, therefore, administrative action in this case is unwarranted. We request that this assertion be removed from the final report.

b. [REDACTED] FHA Case No. 321-2422822

In this case, the Report asserts that the loan file did not verify the source of a \$9,180 deposit made to the borrower's checking account more than one month prior to closing. Specifically, although the Report acknowledges that the bank statement clearly states that the funds were derived from a closed certificate of deposit ("CD"), the Report alleges that the loan file did not contain any additional documentation to substantiate the source of these funds.

First Tennessee respectfully disagrees with this assertion. As discussed above, the Bank understands and appreciates that, to verify assets used to close that are held in a borrower's checking or savings account, HUD guidelines require lenders to obtain a VOD or recent bank statement. See HUD Handbook 4155.1 REV-5, ¶ 2-10(B), 3-1. With regard to the deposits, HUD guidelines require that "[i]f there is a large increase in an account, or the account was opened recently, the lender must obtain a credible explanation of the source of those funds." See HUD Handbook 4155.1 REV-5, ¶ 2-10(B). First Tennessee maintains that it adhered to these guidelines in the [REDACTED] loan. As indicated in the Report, the borrowers needed \$2,933 to close the loan on November 30, 2005 (Exhibit I-1). To document the source of these funds, the Bank obtained a copy of the borrower's bank statement, dated October 4, 2005, evidencing that the borrower had \$8,534.36 in available funds (Exhibit I-2). The Bank acknowledges that the bank statement references a large deposit of \$9,180 on October 3, 2005 (Exhibit I-2); however, contrary to the assertion in the report, the bank statement itself evidenced the source of those funds. As stated in the Report, the bank statement clearly evidences that these funds were derived from a closed CD, certificate [REDACTED] (Exhibit I-2). This information was sufficient to evidence the source of these funds, and clearly demonstrated that the funds did not come from an impermissible source.

With regard to large deposits, HUD guidelines require FHA-approved lenders to "obtain a credible explanation of the source of those funds." See HUD Handbook 4155.1 REV-5, ¶ 2-10(B). They do not, as the Report suggests, require lenders to further substantiate the source of such deposits with additional documentation when existing loan file documents, such as the bank statement here, clearly evidence a credible and permissible source of closing funds. First Tennessee verified the source of the borrower's closing funds in the [REDACTED] loan in compliance with HUD guidelines and administrative action is unwarranted. This allegation should be removed from the final report.

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c. [REDACTED] FHA Case No. 332-4542658

Here, the Report asserts that the loan file did not contain verification of the \$1,000 earnest money deposit ("EMD"), as the borrower's account reflected a \$1,000 deposit on the same day the cashier's check for the EMD was purchased.

First Tennessee understands and appreciates that, "[i]f the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds." HUD Handbook 4155.1 REV-5, ¶ 2-10(A) (emphasis in original). The Bank complied with these requirements in the [REDACTED] loan. In this case, the EMD did not exceed 2% of the sales price (**Exhibit J-1**) and, contrary to the Report's allegation, was not excessive based on the borrower's financial situation or deposit history. As indicated in the Report, the borrower's checking account statement reflected a \$1,000 deposit on January 11, 2008 (**Exhibit J-2**); the same day the EMD check was issued (**Exhibit J-3**). The borrower's checking account, however, referenced other deposits in similar amounts during the three months reflected on that account statement, including a \$2,000 deposit on December 20, 2007 (**Exhibit J-2**). Moreover, the borrower's savings account statement also referenced similar deposits, including a \$3,000 deposit on November 14, 2007 (**Exhibit J-4**). Based on these additional deposits, the underwriter reasonably determined that the \$1,000 deposit made on January 11, 2008 was not excessive based on the borrower's history of accumulating savings and, therefore, did not expressly document the source of the funds used for the EMD in this case.

Nevertheless, we note that the loan file evidenced that the borrower earned net pay of \$1,573 and was paid via check, rather than direct deposit, on a semi-monthly basis (**Exhibit J-5**). The loan file also contained a budget letter from the borrower in which he confirmed that he had net earnings of approximately \$3,000 per month and from these earnings was able to save approximately \$1,325 after expenses (**Exhibit J-6**). Based on this documentation, the loan file documented that the source of the borrower's regular cash deposits, including the \$1,000 deposit at issue in the Report, was the borrower's accumulated cash savings from his net monthly earnings. Thus, even if the Bank had been required to document the source of the EMD, the loan file clearly evidenced that the borrower had sufficient cash saved at home to make the \$1,000 deposit used to purchase the EMD check in this case.

The above discussion demonstrates that First Tennessee complied with HUD guidelines in documenting the borrower's EMD in this case. Therefore, administrative action would be inappropriate and this allegation should be removed from the final report.

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d. [REDACTED] FHA Case No. 521-6392924

Finally, in the [REDACTED] loan, the Report alleges that the VOD referenced three attempts to fax the document to the Bank; however, none of these references indicated that the document passed directly between the lender and the financial institution and, without the \$2,370 in deposited funds, the borrower did not have sufficient verified assets to cover the \$600 needed to close the loan.

As discussed above, to verify assets held in a borrower's checking or savings account, HUD guidelines require lenders to obtain a VOD or recent bank statements. See *id.* ¶¶ 2-10(B), 3-1. Moreover, First Tennessee understands and appreciates that "[l]enders may not accept or use documents relating to the credit, employment or income of borrowers that are handled by or transmitted from or through interested third parties (e.g., real estate agents, builders, sellers) or by using their equipment." HUD Handbook 4155.1 REV-5, ¶ 3-1; see also HUD Handbook 4000.2 REV-3, ¶ 3-5. Thus, it is the Bank's policy and practice to obtain credit reports and verifications directly from the providers of these documents and to ensure that faxed documentation is accurate and complete. In this case, the loan processor sent the VOD directly to the borrower's depository institution, [REDACTED] and requested that this entity return the form directly to the processor (**Exhibit K-1**). While the VOD reflects several faxed headers, none of these headers indicate that the VOD passed through the hands of an interested third party, and there is no suggestion that the document was altered or that the borrower did not have the funds reflected on the VOD available at closing. That said, we appreciate that the fax headers create some confusion regarding the provision of this document to First Tennessee, and the underwriter should have included clarification regarding the source of this document in the loan file.

Nevertheless, any confusion regarding the fax headers on the VOD in this case constituted, at worst, harmless error. In a recent Quality Control review of the [REDACTED] loan, an independent third-party Quality Control company re-verified the borrower's assets in this [REDACTED] account (**Exhibit K-2**). According to that re-verification, the borrower had \$2,314.35 in this account as of May 16, 2007 (**Exhibit K-2**). This documentation confirms that the borrower had more than sufficient verified assets to cover the \$600 needed to close the loan on May 31, 2010 (**Exhibit K-3**). For this reason, administrative action in this case would be inappropriate, and we request that this assertion be removed from the final report.

5. Gift Fund Documentation

In six cases, the Report asserts that the loan files did not contain proper verification that gift funds had been provided by the borrowers to the closing agents. Five of the loans at issue involved funds from non-profit downpayment assistance

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organizations, and one loan involved gift funds provided by a relative. We address each of these cases in turn below.

a. Gifts from Downpayment Assistance Organizations

As you know, FHA guidelines require a lender to verify and document the transfer of gift funds used by a borrower. See HUD Handbook 4155.1 REV-5, ¶ 2-10(C). In five of the six cases referenced in this sub-finding, the borrowers obtained "gifts" in the form of downpayment assistance. While the Department no longer permits such assistance in FHA-insured loans, see P. Law 110-289, Section 2113, at the time the loans at issue were originated HUD permitted borrowers to obtain gift funds from non-profit entities providing downpayment assistance. Until 2004, Page 2-11 of HUD's Single Family Reference Guide ("Guide") expressly stated that, with respect to gifts provided by a nonprofit or municipality through a downpayment assistance program, "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." In each of the loans cited in the Report in which downpayment assistance was provided, the HUD-1 Settlement Statement ("HUD-1") documents the transfer of the funds, and the settlement agents certified to the accuracy of the information reflected on the HUD-1. It was not until HUD issued Mortgagee Letter 2004-28 that the Department's guidelines expressly required lenders to obtain and keep the documentation of the wire transfer in its mortgage loan application binder in connection with downpayment assistance gift transfers. After issuance of Mortgagee Letter 2004-28, it was First Tennessee's policy and procedure to obtain evidence of the wire transfer of gift funds provided by downpayment assistance companies in all FHA-insured loans involving such assistance.

At the time the five loans at issue were originated, First Tennessee understands and appreciates that it was required to obtain and retain evidence of the wire transfer of gift funds from the downpayment assistance provider in its loan file. In one of the cases cited, [REDACTED] **FHA Case No. 521-6392924**, contrary to the Report's allegation, the loan file in fact contained evidence of the wire transfer of downpayment assistance funds. The gift letter indicated that the borrower would receive \$5,999.70 in downpayment assistance (**Exhibit L-1**), and the HUD-1 evidenced that the borrower in fact received these funds (**Exhibit K-3**). In addition to these documents, the loan file also contained a "Detail Report" evidencing the settlement agent's receipt of these funds. While the Report takes issue with this document, the Detail Report, which was faxed to the Bank by the settlement agent, clearly evidences that the \$5,999.70 in downpayment assistance funds were deposited into the settlement agent's trust account (**Exhibit L-2**). Although the date of the transfer is not noted in the details of the wire transfer, the document was faxed by the settlement agent on May 31, 2007 (**Exhibit L-2**), the same day the loan closed (**Exhibit K-3**). Contrary to the assertion in the Report,

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the loan file documentation evidenced that the settlement agent had the downpayment assistance funds in this case as of the date of closing. What's more, First Tennessee recently received email confirmation from the settlement agent that the wire transfer was received on May 24, 2007 (**Exhibit K-4**), which was prior to the May 31st closing.

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In the remaining four cases, in preparation of this response, the Bank contacted each settlement agent and, in all but one case, obtained evidence that the funds identified on the HUD-1s were in fact transferred by the non-profit assistance provider to the agent at settlement. In the [REDACTED] loan, **FHA Case No. 241-7877788**, it appears that the settlement agent may no longer be existence and the Bank therefore was unable to locate the wire transfer documentation before this response was due. That said, we are confident that the gift funds were provided, as the file contained a gift letter from the downpayment assistance provider (**Exhibit N-1**), and the HUD-1, which the settlement agent certified was a true and accurate representation of this transaction, evidenced that the funds were in fact received (**Exhibit N-2**). To document the borrowers' receipt of downpayment assistance in the remaining three cases, we have attached: (1) the gift letter from the downpayment assistance organization; (2) the HUD-1 evidencing the gift funds; and (3) the wire transfer documentation confirming that the settlement agent received these funds at or before closing. This documentation is attached as follows:

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<u>Borrower</u>	<u>FHA Case No.</u>	<u>Gift Letter</u>	<u>HUD-1</u>	<u>Wire Transfer Confirmation</u>
[REDACTED]	151-8161023	M-1	M-2	M-3
[REDACTED]	332-4507321	O-1	O-2	O-3
[REDACTED]	332-4542658	P-1	J-1	P-2 ³

The attached documentation demonstrates, in addition to the HUD-1 reference to the gift funds, that each of the five borrowers at issue in the Report in fact received the downpayment assistance gift from the nonprofit provider. While the wire transfer documentation was inadvertently omitted from the loan files in a few isolated cases, any

³ As noted in the Report, the loan file contained a Wire In Request, dated February 22, 2008, providing instructions to wire the \$8,800 gift (**Exhibit P-2**). That document evidenced that the Reference Number for this transaction was 1400 and that the Escrow Number was 02501499 (**Exhibit P-2**). In preparation of this response, the Bank obtained the Posted Receipt for this wire transfer, which reflects the same Reference and Escrow Numbers as the Wire In Request and evidences that, on February 22, 2008, the settlement agent received the \$8,800 in downpayment assistance funds for this borrower (**Exhibit P-2**).

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oversight constituted, at worst, harmless error. The attached documents evidence that the borrowers in all five of the cited cases in fact received the downpayment assistance funds at the time of closing and qualified for FHA financing. For these reasons, these allegations and any requests for administrative action in connection with these cases should be removed from the final report.

b. Gift Funds from Relatives

In one loan, [REDACTED] – **FHA Case No. 291-3491113**, the Report alleges that the loan file did not document an \$8,000 gift the borrower received from his mother, as the file did not contain documentation of the withdrawal of funds from the donor's account and was not reflected on the HUD-1.

With regard to gift funds obtained from a relative, HUD guidelines require a lender to obtain: (1) a gift letter specifying, among other items, the dollar amount given, the donor's name, address, telephone number, and relationship to the borrower, and stating that no repayment is required; (2) a copy of the bank statement showing the withdrawal from the donor's personal account; and (3) evidence that funds have been deposited into a borrower's account before closing or a verification of receipt of the funds from the settlement agent. See HUD Handbook 4155.1, REV-5, ¶12-10(C); Mortgagee Letter 00-28. As stated in the Report, the borrower received an \$8,000 gift to cover the funds needed to close this loan from his mother. To evidence the gift, First Tennessee obtained a gift letter dated December 8, 2006 from the borrower's mother in which she indicated her intent to provide an \$8,000 gift to the borrower (**Exhibit Q-1**). The loan file also contained a copy of the official check, dated December 8, 2006, issued to the donor and evidencing the \$8,000 gift (**Exhibit Q-2**). In addition to official checks, it is First Tennessee's policy and procedure also to obtain a copy of the donor's bank statement to document the funds used to purchase such checks. We note that the loan was processed nearly four years ago and, given the FHA requirement to retain loan origination files for only two years (HUD Handbook 4000.2 REV-3, ¶ 5-8), First Tennessee has been unable to locate this bank statement. Nevertheless, the donor indicated in her gift letter that she would obtain the gift funds from her [REDACTED] account (**Exhibit Q-1**), and the official check was issued by the donor's financial institution (**Exhibit Q-2**). This documentation confirms that the donor utilized her own funds to purchase the check, and there is no evidence to suggest that the funds were obtained from an impermissible source.

With regard to the verification of the deposit of these funds with the settlement agent, we again note that as the loan was processed nearly four years ago, and given the FHA requirement to retain loan origination files for only two years (HUD Handbook 4000.2 REV-3, ¶ 5-8), First Tennessee has been unable to locate any separate verification of receipt from the settlement agent. Nevertheless, the official check was

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made payable to ██████████ Bank, the settlement agent in this case (**Exhibit Q-2**). Moreover, the HUD-1 evidences that the borrower provided \$7,819 to close the loan and the settlement agent certified on that the HUD-1 was a true and accurate representation of this transaction (**Exhibit Q-3**). This certification indicates that the settlement agent received sufficient funds to cover the borrower's cash needed to close, and the official check demonstrates that these funds were provided directly to the settlement agent by the donor (**Exhibit Q-3**). These documents constitute verification of the settlement agent's receipt of these funds. Nevertheless, note that First Tennessee again asked this settlement agent to confirm its receipt of the gift funds, which the settlement agent did by furnishing another copy of the gift check it received from the donor (**Exhibit Q-4**).

In summary, First Tennessee maintains that the loan file contained sufficient documentation to evidence that the borrower received gift funds from his mother, and that these funds were used to close this loan. For these reasons, administrative action would be inappropriate, and we request that this allegation be removed from the final report.

6. Source of Funds to Close

Finally, in ten cases, the Report asserts that the borrowers' source of funds to close the loans was not verified, as: (1) the loan files did not contain gift fund or asset documentation; or (2) the borrowers did not make the required minimum cash investment. We address each of these assertions below.

a. Gift and Asset Documentation

In eight cases, the Report asserts that the borrowers' source of funds to close the loans was not verified, as the loan files did not contain gift fund documentation and/or did not document the source of the borrower's assets used to close the loan.

In all eight of the cases cited in this sub-finding,⁴ rather than cite new allegations regarding the source of the borrowers funds to close, the Report merely repeats the assertions made in the sections regarding gift fund documentation and borrower assets, and concludes that, without proper documentation of the transfer of gift funds or the

⁴ These eight cases are: (1) ██████████ FHA Case No. 121-2299638; (2) ██████████ FHA Case No. 151-8161023; (3) ██████████ FHA Case No. 241-7877788; (4) ██████████ FHA Case No. 291-3491113; (5) ██████████ FHA Case No. 321-2422822; (6) ██████████ FHA Case No. 332-4507321; (7) ██████████ FHA Case No. 332-4542658; and (8) ██████████ FHA Case No. 521-6392924.

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source of assets, First Tennessee did not verify the borrowers' investment in the property.

First Tennessee strongly objects to the inclusion of these allegations in the final report. The assertions made in this section of the Report merely reiterate allegations already made in the Report's sub-findings regarding gift fund and asset source documentation. As you know, HUD guidelines at the time these loans were originated set forth the information the Department requires to document the source of funds used for the borrower's investment in the property in Section 2-10(C) of HUD Handbook 4155.1 REV-5. The Report cites the same section of the same provision in both its allegations regarding gift fund and asset documentation and verification of the borrowers' investment in the properties at issue. These are not separate allegations, but merely a different way of stating the same alleged deficiency in each of these eight cases. Thus, this section of the Report is unnecessarily repetitive and needlessly inflammatory. It appears that inclusion of such repetitive and inflammatory claims in the final report serves only as an attempt to justify the "Operation Watchdog probe."

Moreover, as demonstrated above, the Bank obtained sufficient documentation, either at the time of loan closing or in preparation of this response, to document the borrowers' investments in these properties through the use of either gift funds from relatives or downpayment assistance organizations, or their own documented assets. First Tennessee maintains that it substantially conformed to HUD requirements in these cases and that the attached documentation evidences that the borrowers met their required investment, as evidenced on the HUD-1s. Each of these eight borrowers qualified for the FHA-insured loan. For these reasons, these repetitive and unnecessary allegations are unwarranted and should be removed from the final report.

b. Minimum Cash Investment

In the two remaining cases in this sub-finding, the Report asserts that the loan file did not document that the borrowers met the three percent minimum cash investment in the real property transaction. We address each of these cases below.

i. [REDACTED] FHA Case No. 241-7821658

Here, the Report alleges that the borrowers did not meet the minimum cash investment of \$5,955, as there was no assurance that: (1) the \$1,000 EMD check was cashed; (2) the borrowers brought the \$4,555 in cash to closing; or (3) the borrowers paid \$400 outside of closing.

First Tennessee respectfully disagrees with the assertions in this case. As noted in the Report, HUD guidelines require FHA borrowers to make a minimum cash

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investment of three percent of the property's sales price, see HUD Handbook 4155.1 REV-5, ¶ 1-7, which in this case was \$5,955 (**Exhibit R-1**). As also acknowledged in the Report, the Department requires that "[a]ll funds for the borrower's investment in the property must be verified and documented." Id. ¶ 2-10 (emphasis in original). The Bank adhered to these guidelines in the [REDACTED] loan.

With regard to the EMD, as discussed above, HUD guidelines do not require FHA-approved lenders to document the source of such funds unless the EMD exceeds two percent of the sales price. See HUD Handbook 4155.1 REV-5, ¶ 2-10(A). As the \$1,000 EMD in this case was less than two percent of the \$198,500 sales price (**Exhibit R-1**), First Tennessee was not required to verify its source. Nevertheless, as acknowledged in the Report, the loan file contained a copy of the EMD check in this case (**Exhibit R-2**), and the receipt of the EMD by the settlement agent was recorded on the HUD-1 (**Exhibit R-3**). With regard to the \$4,555 needed to close the loan, as acknowledged in the Report, the loan file contained a copy of the borrower's bank statement, dated February 21, 2007, which indicated that the borrower had \$5,168 in available funds (**Exhibit R-4**). Moreover, the loan file also contained a copy of the co-borrower's retirement account statement, which evidenced that she had \$2,771 in available funds (**Exhibit R-5**). Thus, the borrowers had sufficient assets to cover the \$4,555 needed to close on March 28, 2007 (**Exhibit R-3**). Finally, the loan file contained an invoice from the appraiser evidencing that the \$400 appraisal fee had been satisfied on March 13, 2007 (**Exhibit R-6**), and the HUD-1 clearly indicated that this fee had been paid outside of closing by the borrowers (**Exhibit R-3**).

With regard to the allegation that the loan file did not contain "assurances" that the EMD check was cashed and that the borrower in fact brought the funds to closing and paid the \$400 appraisal fee outside of closing, First Tennessee is not aware of, and the Report does not cite, any provision of HUD guidelines requiring that FHA-approved lenders obtain such "assurances." As acknowledged in the Report, all of these funds were reflected on the HUD-1 as being provided by the borrower (**Exhibit R-3**). On the Addendum to the HUD-1, the settlement agent certified that, to the best of his knowledge, the HUD-1 "is a true and accurate account of the funds which were (i) received, or (ii) paid outside of closing, and the funds received have been or will be disbursed by the undersigned as part of the settlement of this transaction" (**Exhibit R-3**). This certification provided the Bank with evidence that the borrower had in fact made the \$1,000 EMD, paid the \$400 outside of closing, and brought the \$4,555 to closing, and that the settlement agent had or would disburse all of these funds. First Tennessee relied on the HUD-1 and this certification in compliance with HUD guidelines. Nevertheless, please note that the Bank also recently obtained a copy of the Cashier's Check for \$4,555.00 that the borrower brought to closing (**Exhibit R-7**).

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The attached documentation demonstrates that the Bank verified the source of the borrower's investment in the property in this case in accordance with HUD guidelines and properly relied on the settlement agent's certification that the HUD-1 accurately represented the borrower's investment of those funds at or before closing. First Tennessee adhered to HUD guidelines in this case and, as a result, administrative action is not warranted. Thus, we request that this assertion be removed from the final report.

ii. [REDACTED] FHA Case No. 441-7773869

In this case, the Report asserts that the loan file did not document that the borrowers did not meet the minimum cash investment of \$2,640. Specifically, the Report suggests that the file did not document that the borrower had sufficient funds to cover the \$1,000 EMD, the \$394 paid outside of closing to purchase homeowners' insurance, and the \$1,091 needed to close and, even if the borrower provided these funds, they constituted \$155 less than the \$2,640 minimum cash investment.

As noted above, First Tennessee understands and appreciates that FHA borrowers must make a minimum cash investment of three percent of the property's sales price, *see* HUD Handbook 4155.1 REV-5, ¶ 1-7, which in this case was \$2,640 (**Exhibit S-1**). The Department also requires that "[a]ll funds for the borrower's investment in the property must be verified and documented." *Id.* ¶ 2-10 (emphasis in original). With regard to the EMD, as discussed above, HUD guidelines do not require FHA-approved lenders to document the source of such funds unless the EMD exceeds two percent of the sales price. *See* HUD Handbook 4155.1 REV-5, ¶ 2-10(A). As the \$1,000 EMD in this case was less than two percent of the \$88,000 sales price (**Exhibit S-1**), First Tennessee was not required to verify its source. Nevertheless, as acknowledged in the Report, the loan file contained a copy of the borrower's [REDACTED] Bank account statement documenting that, as of February 12, 2006, the borrower had \$2,107 (**Exhibit S-2**). The loan file also contained a copy of a check from the borrower's [REDACTED] Bank account, dated February 20, 2006, covering the \$1,000 EMD (**Exhibit S-3**). The receipt of the EMD by the settlement agent was recorded on the HUD-1 (**Exhibit S-4**).

With regard to the \$1,091 needed to close the loan, as discussed above, the loan file contained a copy of the borrower's bank statement, dated February 12, 2006, which indicated that the borrower had \$2,107 in available funds (**Exhibit S-2**). Thus, even after the \$1,000 EMD check, the loan file documented sufficient assets for the borrower to close. Moreover, the loan file also contained a copy of a deposit slip from the borrower's [REDACTED] Bank Account indicating that, on March 20, 2006, the borrower deposited an additional \$1,620.45 (**Exhibit S-5**). The attached checks demonstrated that these funds predominantly came from the borrower's tax refund and a gift from a

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relative (**Exhibit S-5, S-6**), and provided the borrower with substantially more than needed to close the loan on March 31, 2006 (**Exhibit S-4**). Finally, the loan file contained an invoice from the provider of homeowner's insurance evidencing that the borrower paid the \$394 premium on March 14, 2006 (**Exhibit S-7**), and the HUD-1 clearly indicated that this fee had been paid outside of closing by the borrower (**Exhibit S-4**). On the Addendum to the HUD-1, the settlement agent certified that, to the best of his knowledge, the HUD-1 "is a true and accurate account of the fund which were (i) received, or (ii) paid outside of closing" (**Exhibit S-4**). This certification provided the Bank with evidence that the borrower had in fact made the \$1,000 EMD, paid the \$394 outside of closing, and brought the \$1,091 to closing, and First Tennessee relied on the HUD-1 and this certification in compliance with HUD guidelines.

The attached documentation properly evidenced the sources of the borrower's cash investment in the property in accordance with HUD guidelines. Nevertheless, the Bank acknowledges that the total amount of funds the borrower brought to closing was \$155 short of the three percent minimum investment the borrower was required to make and, as a result, the loan was over-insured by \$155. We note that, when the underwriter signed the MCAW on March 20, 2006, the borrower was scheduled to provide a total of \$3,500, which would have exceeded the minimum cash investment of \$2,640. It appears that, in the ensuing ten days, the transaction amounts changed and the borrower brought \$155 less than needed to meet the minimum investment. That said, as discussed above, the borrower had made an additional \$1,620 deposit on March 20, 2006 (**Exhibit S-5**), and would have easily been able to bring the additional \$155 to closing in this case. For this reason, we believe that any oversight in this case constituted, at worst, harmless error, as the borrower qualified for FHA financing and had sufficient funds to meet the full three percent investment requirement. In addition, the Bank would be willing to buy down the principal balance of this loan by \$155 to remedy the over-insured amount. First Tennessee, however, maintains that further administrative action in this instance would be inappropriate, and requests that this recommendation be removed from the final report.

B. FIRST TENNESSEE STRONGLY OPPOSES THE RECOMMENDATION THAT PFCRA PENALTIES ARE APPROPRIATE IN THIS CASE

1. First Tennessee Exercised Due Diligence in Underwriting the Loans at Issue

In addition to the underwriting deficiencies discussed above, the Report asserts that, in the ten loans at issue, the underwriter's certification on page 3 of the Addendum to the Uniform Residential Loan Application ("URLA"), Form HUD-92900-A ("Addendum") was incorrect, as the underwriter certified to using due diligence in underwriting these cases but did not do so. We understand that this allegation is

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predicated on the OIG's determination that these ten cases contained underwriting deficiencies. The Report alleges that these underlying oversights demonstrate that the underwriter did not exercise due diligence in examining the loan file and, as a result, the certification on the Addendum in these cases was incorrectly signed. The Report recommends in connection with these allegations that HUD's Associate General Counsel for Program Enforcement determine the legal sufficiency of and, if sufficient, pursue civil money penalties and/or remedies under the PFCRA for the inaccurate certifications in these cases. As discussed in detail above, First Tennessee takes exception to the allegations that these loans contained underlying origination deficiencies, as well as the inflammatory recommendation to impose PFCRA penalties made in connection with this finding.

HUD is authorized to impose civil penalties under PFCRA against persons who "make, submit, or present, or cause to be made, submitted, or presented, false, fictitious, or fraudulent claims or written statements to Federal authorities or to their agents." 24 C.F.R. § 28.1. The Report suggests that, because the OIG identified underwriting deficiencies in these ten cases, the underwriters' certifications that due diligence was used in underwriting these loans are inaccurate. As demonstrated in the above discussion, however, in the ten cases cited, First Tennessee substantially complied with HUD requirements and the underwriter made a reasonable decision to approve the loans after exercising due diligence in examining each of the files at issue. For these reasons, First Tennessee disagrees with the recommendation of any penalty in connection with these loans, let alone the harsh sanctions of civil money or PFCRA penalties recommended in the Report.

Additionally, the Report does not allege, and there is no evidence to suggest, that First Tennessee or its employees intended to circumvent HUD underwriting guidelines in these cases. Rather, the certifications in these ten cases were executed by the underwriters after diligent review of the loan files in which these individuals made every effort to comply with FHA requirements. The certifications in these cases were executed in the belief that the borrowers qualified for FHA financing, which in fact they did in each case, rather than in an attempt to mislead the Department. The Report does not allege that First Tennessee or its underwriters knowingly misrepresented facts to the Department or intentionally provided false information in the cases at issue. Before imposing penalties on FHA-approved lenders, HUD weighs a number of factors. While intentional violations or a disregard for HUD requirements can lead to severe sanction, such as PFCRA penalties, HUD traditionally imposes less severe consequences for deficiencies caused by unintentional error. Additionally, First Tennessee maintains that the borrowers in the cited cases qualified for FHA financing. At worst, certain of these loans contained minor errors that did not affect the insurability of the loans. As indicated above, First Tennessee believes that the final report should omit

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recommendations of administrative action in connection with many of these cases, making the recommendation of PFCRA penalties all the more severe under these circumstances.

We also note that, rather than cite new allegations, the PFCRA recommendation appears to be an attempt to pile on the allegations made against First Tennessee's underwriting practices in this Report. Typically, OIG audit reports allege certain deficiencies in a company's FHA operations, and the company is given an opportunity to address the materiality and accuracy of the allegations. By also adding an incorrect certification allegation to these underwriting assertions, the OIG has created a situation where every misunderstanding of FHA requirements or oversight of a detail or document in a FHA loan could give rise to allegations of a false certification claim. Considering the sensationalizing of the "Operation Watchdog" probe, and the devastating effects this matter has and will continue to have on the targeted lenders, such actions will create a chilling effect on lenders who want to participate in the FHA Program. Enforcement actions are meant to reinforce HUD's rules and regulations, rather than discourage broad participation in FHA lending. For the sake of the Program, therefore, we believe the OIG should reconsider its approach to alleging false certifications and focus on the compliance with FHA rules and regulations.

2. The PFCRA Allegations Constitute a Recommendation to HUD, Rather than a Final Action by the Department

As noted above, the Report merely recommends that the Department determine the legal sufficiency of pursuing PFCRA remedies and/or civil money penalties in the cited cases. Upon receiving the final report, the Department will have an opportunity to independently examine the review findings and make an independent determination of whether such penalties are appropriate in these ten cases. As discussed at length earlier in this response, First Tennessee disagrees that the Report's assertions warrant administrative action, civil money penalties, or PFCRA remedies. HUD may also disagree with the Report's assertions and decide not to pursue PFCRA or civil money penalties in this instance.

In addition, while the review process is still ongoing at the time the OIG issues its "final" report, the Report and the OIG's recommendations typically are made public on the OIG website. As a result, a lender's investors and peers are able to access the preliminary recommendations of the OIG before a final assessment as to their merit can be made by the Department. These entities often misinterpret the OIG's recommendations to be final actions by the Department. Under these circumstances, making these preliminary recommendations public and including inflammatory allegation that HUD pursue PFCRA remedies with the suggestion that the loans identified involve misrepresentations will have a material, adverse effect on the Bank's business. This

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would be especially detrimental in this circumstance, as the public nature of the "Operation Watchdog" probe has already resulted in reputational damage to First Tennessee.

If the OIG's goal is to present the reader with a full and accurate disclosure of this review and its implications to the Bank, the Report should include the following disclosure on the first page in bold, capitalized lettering:

THE REPORT FINDINGS REFLECT THE VIEWS OF THE OFFICE OF INSPECTOR GENERAL AND DO NOT CONSTITUTE A FINAL DETERMINATION OF THE MATTERS RAISED HEREIN BY THE U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT. THE FINAL DETERMINATION IN THIS MATTER WILL BE MADE BY THE REPORT'S ADDRESSEE, THE HUD ASSISTANT SECRETARY FOR HOUSING – FEDERAL HOUSING COMMISSIONER, WHO WILL ULTIMATELY DECIDE WHETHER TO ACCEPT THE REPORT'S RECOMMENDATIONS IN WHOLE OR IN PART OR REJECT THEM.

Such a disclosure would more accurately convey the status of the OIG's "final" report to the Bank's investors, customers, and the public.

III. CONCLUSION

First Tennessee takes the matters raised in the draft Report seriously. Because FHA lending comprises a significant portion of First Tennessee's overall business operations, the Bank is committed to educating and training its employees on issues regarding FHA compliance and to assuring their adherence to HUD's rules and regulations. As discussed above, First Tennessee's review of the loan files at issue indicated that the Report's findings are, for the most part, at variance with the facts, do not constitute violations of HUD/FHA requirements on the part of First Tennessee, or do not affect the underlying loans' insurability. The Bank substantially complied with FHA underwriting requirements in several of the loans identified in the Report and made loans to qualified FHA borrowers. Accordingly, we respectfully request that the OIG revise the allegations cited in the Report based on the information and documentation provided in this response and remove allegations for which First Tennessee has demonstrated its compliance with HUD requirements.

Finally, First Tennessee believes that the recommendations involving PFCRA penalties are unwarranted, as they suggest an intent to circumvent HUD requirements when the OIG knows full well that no such intention existed in these cases. First Tennessee values its relationship with the Department and did not, in any manner, seek to misrepresent any information to HUD. First Tennessee believes that the various remedies available to HUD, short of the severe sanctions under PFCRA, are

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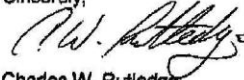
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commensurate to resolve any deficiency identified in the Report. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate that including these recommendations in the Report is unnecessary, inappropriate, and will further damage First Tennessee's reputation, which has already suffered as a result of the public nature of the "Operation Watchdog" probe. We respectfully request that the OIG revise its recommendations to fit the facts of this case.

If you have any additional questions, or if you need additional information, please do not hesitate to contact our Washington counsel, Phillip Schulman, at (202) 778-9027.

Thank you for your kind consideration.

Sincerely,



Charles W. Rutledge
Senior Vice President and
Assistant General Counsel

Attachments

cc: Phillip L. Schulman, Esq., K&L Gates LLP

OIG's Evaluation of Lender Comments

- Comment 1** First Tennessee officials questioned the methodology used to select the 18 loan files reviewed. However, we want to point out that the loan sample was not intended to be statistical or random. The sample was the result of a targeted analysis to specifically identify loans that had gone into claim status. Further, we did not project the results of the review to First Tennessee's universe of FHA loans. Consequently, the conclusions made only pertain to the five loans that remain in the report, which were identified as having material underwriting deficiencies.
- Comment 2** First Tennessee officials took issue with the press release announcing OIG's Operation Watchdog initiative. However, the January 12, 2010, HUD press release did not make any accusations or presumptions of fraud. The goal of the initiative was to determine why there was such a high rate of defaults and claims with respect to the 15 companies and whether wrongdoing may have been involved. Since the detection and investigation of fraud is the responsibility of the Office of Inspector General, the reviews were proactive attempts to identify systemic underwriting problems that HUD should address.
- Comment 3** First Tennessee officials stated that three of the ten loans cited in the report were not insured under the Lender's Insurance program (FHA Case Numbers: 121-2299638, 321-2422822, and 441-7773869) and based on the actual case binders submitted, HUD approved these loans for FHA insurance without identifying any underwriting concerns. HUD approved these loans based on a pre-endorsement review, which merely ensured that all necessary forms were present and executed, and that the case binder was acceptable. HUD's pre-endorsement review did not involve an underwriting analysis of the loan. Nevertheless, FHA Case Numbers: 121-2299638 and 321-2422822 have been removed from the report as a result of First Tennessee officials' written response and the accompanying documentation, which supported the removal of the reported deficiencies.
- Comment 4** For FHA Case Number 291-3491113, First Tennessee officials stated that although the loan file did not contain each and every borrower paystub for 30 consecutive days, the paystub included in the loan file did cover the most recent 30-day period as required since it reflected the borrower's year-to-date earnings over a 10-month period. Further, First Tennessee officials stated that the borrower's nontaxable social security benefits were grossed-up 15 percent based on the borrower's 2005 tax rate as defined by the federal IRS tax table.

Regardless of the 10 months of earnings reflected on the paystub, the fact remains that the loan file only contained one paystub covering a two-week period. HUD Handbook 4155.1, REV-5, paragraph 3-1 E requires lenders to obtain the borrower's original paystubs covering the most recent 30-day period along with original IRS W-2 Forms from the previous two years when as an alternative, the lender obtains a verbal rather than a written verification of employment, which

was the case with this loan. Additionally, the loan file did not contain documentation to support the borrower's 2005 tax rate as required by HUD Handbook 4155.1, REV-5, paragraph 2-7Q. However, with the exception of one paystub, the loan file did contain the alternative documentation required to verify the borrower's two-year employment history and income stability. Further, we were able to confirm First Tennessee officials' argument that the borrower's bank statements reflected biweekly payroll deposits. In addition, since HUD allows lenders to "gross-up" nontaxable income and we were able to verify the percentage used by First Tennessee officials, we accepted the gross-up amount. Therefore, based on the additional information provided and verified, we have removed the related unsupported income deficiency from the report.

Comment 5 With respect to FHA Case Number 321-2422822, while the tax returns for 2003 and 2004 evidenced the borrower's income for the past two years, they did not evidence the borrower's receipt of overtime income. Further, the verbal verification of employment reported that the borrower was hired by the current employer on February 27, 2004. Therefore, the borrower's pay stub, referenced in First Tennessee officials' response, which includes overtime income through November 6, 2005, is only relevant to the discussion of overtime income earned by the borrower after February 27, 2004 through November 6, 2005 or 20.33 months. Furthermore, First Tennessee officials maintained that even using the lower income calculation and higher qualifying ratios suggested in the report, the borrower still would have qualified for FHA financing because of the presence of a significant compensating factor. Namely, the borrower had \$4,509 in cash reserves, which would cover six months of mortgage payments. Moreover, First Tennessee officials acknowledged that the loan file lacked additional paystubs and W-2 forms as required by HUD Handbook 4155.1, REV-5, paragraph 3-1E. Nevertheless, given First Tennessee official's justification concerning the borrower's ample cash reserves, we have removed the deficiency and the loan from the report.

Comment 6 For FHA Case Number 332-4507321, First Tennessee officials agreed that although the loan file did not contain each and every borrower paystub for 30 consecutive days, the paystub included in the loan file did cover the most recent 30-day period as required. In fact, the paystubs covered eight weeks of wages, which were consistent over all eight weeks. In addition, First Tennessee officials referenced a closed loan review, which re-verified the borrower's employment and income. However, evidence of this review was not provided.

The borrower was paid on a weekly basis. Thus, the four non-consecutive paystubs covered four, not eight weeks of wages and the loan file did not document the coborrower's original paystubs covering the most recent 30-day period as required by HUD Handbook 4155.1, REV-5, paragraph 3-1 E. First Tennessee officials also stated that the coborrower's nontaxable social security benefits were grossed-up 25 percent based on the borrower's 2006 tax rate as defined by the federal IRS tax table. Nevertheless, the loan file did not contain documentation to support the borrower's 2006 tax rate as required by HUD

Handbook 4155.1, REV-5, paragraph 2-7Q. Since HUD allows lenders to “gross-up” nontaxable income, we have removed the unsupported income deficiency from the report because it was the only issue remaining after First Tennessee officials provided documentation to support the removal of the deficiencies related to the inadequate verification of the transfer of gift funds and the borrower’s investment in the property. Further, the unsupported income deficiency by itself is not material to warrant punitive actions against the lender.

Comment 7 For FHA Case Number 521-6392924, First Tennessee officials acknowledged that it had been unable to locate every verification item used to underwrite the loan, but maintained that the loan file still contained substantial evidence of the borrowers’ two-year employment history and income stability. Further, First Tennessee officials stated that a recent quality control review performed by an independent third-party firm successfully re-verified the borrowers’ employment and income; however, this review was not provided.

First Tennessee officials agreed that the 2005 IRS W-2 forms were not documented in the loan file and the length of employment reported on the loan application differed from the verbal verification of employment. Officials attributed the difference to the loan processor’s handwritten error on the verification. However, although the loan application reported that the borrower and coborrower had been employed for one year and one year and four months, respectively; the credit report showed that the borrower and coborrower had been employed by their current employers for approximately nine months. Yet, no explanation was provided for this discrepancy. Moreover, only one of the coborrower’s two current employers listed on the loan application was reflected on the credit report and none of the borrowers’ former employers listed on the loan application was reflected on the credit report.

With respect to the coborrower’s paystubs, First Tennessee officials acknowledged that they were not consecutive, but contended that they covered a 10-week period, which was more than required. However, the three nonconsecutive paystub did not cover 10 weeks, but rather six nonconsecutive weeks. Thus, the loan file did not contain the coborrower’s original paystubs covering the most recent 30-day period as required by HUD Handbook 4155.1, REV-5, paragraph 3-1 E. Nevertheless, despite First Tennessee officials’ inability to document the borrowers’ two-year employment histories, we removed the deficiency from the report because it was the only one remaining after First Tennessee officials provided documentation to support the removal of the deficiencies related to unsupported assets, and the inadequate verification of the transfer of gift funds and the borrower’s investment in the property. Further, the income stability deficiency by itself is not material to warrant punitive actions against the lender.

Comment 8 Regarding FHA Case Number 291-3491113, First Tennessee officials asserted that the significant compensating factor concerning the borrower’s \$4,682.27 in cash

reserves, which was 3.75 times the mortgage payment of \$1,246.09, justified the approval of the mortgage loan with a debt-to-income ratio exceeding HUD's benchmark guidelines. Nevertheless, since the borrower had verifiable assets of only \$1,895, the funds included as cash reserves would have come from the \$8,000 gift from the borrower's mother. HUD Handbook 4155.1, REV-5, paragraph 2-13G, expressly prohibits funds from gifts from any source to be included as cash reserves.

In addition, while we agree that the borrower's payment history on housing obligations holds significant importance and is at the top of the hierarchy of credit evaluation, the borrower's ability to make a \$375 rental payment for five years is inconsequential given that the proposed mortgage was more than three times that amount at \$1,246.09. Further, by itself, a conservative attitude towards the use of credit is not a valid compensating factor unless it is accompanied by the borrower's demonstrated ability to accumulate savings, which was not documented in this case. Therefore, the deficiency will remain in the report.

Comment 9 With respect to FHA Case Number 291-3491113, contrary to First Tennessee officials' contention, not only are lenders required to obtain a written explanation from the borrower for major indications of derogatory credit, which include judgments, collections, and other recent credit problems, but HUD Handbook 4155.1, REV-5, paragraph 2-3B, requires the lenders to obtain from the borrower a written explanation for all inquiries shown on the credit report in the last 90 days.

In addition, First Tennessee officials maintained that the Circuit Court reported not just that the borrower's attorney had filed for a satisfaction of judgment on March 25, 2005, due to a pending garnishment, but that a release of garnishment was filed and sent to the sheriff on March 29, 2005. Nevertheless, the credit reported, dated October 13, 2006, did not reflect that the judgment had been satisfied and released. Further, First Tennessee official's handwritten notation on the credit report indicated that the judgment would be paid at closing. The loan file contained a copy of a check in satisfaction of the judgment, which was issued by the title company on the date of closing, December 11, 2006. However, the file also contained a letter, dated December 20, 2006, from the loan originator requesting that the check be reissued to the borrower because "he had evidence that judgment had already been satisfied and released. Therefore, while the loan file suggested that the judgment had been paid, no conclusive evidence was documented. Nevertheless, since we confirm through an online research database that the judgment had been satisfied, we have removed the related credit deficiency from the report.

Comment 10 With respect to FHA Case Number 121-2299638, since the borrower's credit union account was not opened recently and the \$12,375 deposit occurred five months before the loan closed, we removed the deficiency related to unsupported assets and the loan from the report.

- Comment 11** Regarding FHA Case Number 321-2422822, given First Tennessee officials' response that the bank statement itself referenced the source of funds and there was no further requirement to substantiate the source of such deposits with additional documentation, we removed the deficiency related to unsupported assets and the loan from the report.
- Comment 12** Regarding FHA Case Number 332-4542658, First Tennessee officials contended that the earnest money deposit did not exceed 2 percent of the sales price and was not excessive based on the borrower's financial situation or deposit history. As a result, they were not required to verify with documentation the deposit amount and the source of the funds. We removed the deficiency related to unsupported assets from the report because we confirmed First Tennessee officials' reference to the other deposits in similar amounts reflected on the bank statements over the three-month period documented.
- Comment 13** With respect to FHA Case Number 521-6392924, First Tennessee officials acknowledged that the various fax headers on the verification of deposit created some confusion regarding the provision of the document and that the underwriter should have included clarification regarding the source of the document. Nevertheless, First Tennessee officials maintained that none of the fax headers indicated that the verification passed through the hands of an interested third party. In addition, there was no suggestion that the verification had been altered or that the borrower did not have the funds reflected therein. Further, First Tennessee officials stated that a recent quality control review performed by an independent third-party firm successfully re-verified the borrowers' assets. Since First Tennessee officials provided the re-verification of deposit, which was faxed from the depository on February 9, 2010, we removed the deficiency related to unsupported assets and the loan from the report.
- Comment 14** Regarding FHA Case Number 521-6392924, First Tennessee officials agreed that the date of the wire transfer was not noted in the details of the wire transfer documentation faxed by the settlement agent on May 31, 2007. As a result, First Tennessee officials recently obtained and have provided an email from the settlement agent confirming that the wire transfer was received on May 24, 2007, which was before the loan closed on May 31, 2010. Therefore, the deficiency regarding the inadequate verification of the transfer of gift funds has been removed from the report.
- Comment 15** Regarding FHA Case Number 241-7877788, First Tennessee officials were unable to obtain evidence from the settlement agent that the gift funds were received from the nonprofit at or before closing. Therefore, the deficiency regarding the inadequate verification of the transfer of gift funds will remain in the report.
- Comment 16** Without proper documentation of the wire transfer from the nonprofit to the settlement agent, there was no conclusive evidence that the gift funds did not ultimately come from an unacceptable source. While First Tennessee officials

provided a copy of an “Incoming Wire/Direct Deposit Confirmation” for FHA Case Number 151-8161023, the confirmation was neither signed nor dated by a settlement agent official evidencing the receipt of the gift funds from the nonprofit at or before closing. Regarding FHA Case Number 332-4507321, First Tennessee officials provided wire transfer documentation evidencing that the settlement agent received the gift funds from the nonprofit. As a result, the deficiency has been removed from the report. With respect to FHA Case Number 332-4542658, First Tennessee officials obtained a “Posted Receipt” for the wire transfer from the nonprofit; however, the receipt was not signed by a settlement agent official. Consequently, the deficiencies will remain in the report for FHA Case Numbers 151-8161023 and 332-4542658.

Comment 17 Regarding FHA Case Number 291-3491113, First Tennessee officials were unable to locate a copy of the gift donor’s bank statement to document the funds used to purchase the official check. Nevertheless, First Tennessee officials contended that the donor indicated in the gift letter that she would obtain the gift funds from her bank account and the official check was issued by her financial institution. However, without a copy of the donor’s bank statement, there was no assurance that the donor did not ultimately obtained the funds used to purchase the official check from an unacceptable source. In addition, First Tennessee officials provided another copy of the gift check it received from the settlement agent as confirmation of its receipt of the gift fund. While we acknowledged that the settlement agent did obtain sufficient funds needed to close the loan, First Tennessee officials did not provide conclusive evidence that the gift funds came from the donor’s personal account as required HUD Handbook 4155.1. REV-5, paragraph 2-10C. Accordingly, the deficiency will remain in the report.

Comment 18 At the time the loans in question were originated, the 3 percent minimum cash investment was a fundamental requirement of the FHA loan program. While FHA allowed an outright gift of the 3 percent cash investment, the lender was responsible for obtaining verification that the settlement agent received funds from the donor for the amount of the purported gift and those funds came from an acceptable source. Regardless of the source of funds to close the loans, the lender was ultimately responsible for verifying and documenting the borrowers’ investment in the property and that the funds were from acceptable sources.

First Tennessee officials state that rather than cite new allegations regarding the source of the borrowers’ funds to close, the report merely repeats the assertions made in the sections regarding gift fund documentation and the borrower assets. Although the examples cited in this allegation are the same, the allegation is neither repetitive nor inflammatory because without verifying and documenting the transfer of gift funds or the source of assets, First Tennessee officials did not properly substantiate the borrower’s investment in the property. Since one deficiency was dependent on the other, this section is a summary of the deficiency related to the borrowers’ investment. Further, in appendix B of the report, this allegation was not

presented as a separate deficiency, but in conjunction with the gift fund documentation and/or the borrower assets deficiencies.

- Comment 19** Regarding FHA Case Number 241-7821658, First Tennessee officials provided a copy of the Cashier's Check for \$4,555 that the borrower brought to closing. Thus, we removed the deficiency related to minimum cash investment and the loan from the report.
- Comment 20** Regarding FHA Case Number 441-7773869, we removed all references in the report, which suggested that sufficient documentary evidence did not exist to ensure that the borrower invested \$2,485 in the property. Nevertheless, the fact remains and First Tennessee officials acknowledged that the borrower invested \$155 less than the 3 percent minimum cash investment requirement of \$2,640, which resulted in the loan's over-insurance. Therefore, the deficiency will remain in the report and during the audit resolution process, HUD will make the decision regarding whether to allow the lender to buy down the loan.
- Comment 21** First Tennessee officials believe that the recommendations for remedies under the Program Fraud Civil Remedies Act, civil money penalties, and/or administrative action are unwarranted in connection with these 10 loans and should be omitted from the report. However, we did not revise our recommendations because violations of FHA requirements subject lenders to civil and administrative actions. Therefore, the report recommends that HUD as the action official, determine whether the deficiencies cited for the now five loans that remain in the report are legally sufficient to warrant the pursuit of remedies under the Program Fraud Civil Remedies Act, civil money penalties, and/or administrative action.