



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-1809

September 30, 2010

MEMORANDUM FOR: Vicki Bott, Deputy Assistant Secretary for Single Family Housing, 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: Sterling National Mortgage Company, Inc., Great Neck, NY, Did Not Properly Underwrite a Selection of FHA Loans

INTRODUCTION

We conducted a review of Federal Housing Administration (FHA) loans underwritten by Sterling National Mortgage Company, Inc. (Sterling), an FHA direct endorsement lender. The review was conducted as part of the Office of Inspector General's (OIG) 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 Sterling underwrote 20 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.

The draft memorandum report was provided to Sterling officials on September 10, 2010 and Sterling officials provided a written response on September 24, 2010. Sterling officials generally disagreed with our findings and recommendations. The complete text of Sterling officials' response, along with our evaluation of that response, can be found in appendix C of this memorandum, except for the exhibits, which were too voluminous to be included within the report. Adjustments were made to the report in some areas based on the additional documentation and comments provided in Sterling's written response.

METHODOLOGY AND SCOPE

Sterling is 1 of 15 direct endorsement lenders we selected from HUD's publicly available Neighborhood Watch¹ system (system) for a review of underwriting quality. These direct endorsement lenders all had a compare ratio² 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 loans from Sterling that had gone into claim status and defaulted within the first 30 months. These loans were (1) not streamline refinanced, (2) not electronically underwritten by Fannie Mae or Freddie Mac, and (3) associated with an underwriting lender identified as having a high number of loans going to claim. The sample of loans consisted of 1 purchase and 19 refinances. 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 Sterling, consider the results of previous audits, or communicate with Sterling'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 defaults 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

Sterling is a HUD-approved Title II non-supervised³ lender located in Great Neck, NY. Sterling became a direct endorsement lender on February 3, 1997. Under the direct endorsement program, lenders are allowed to underwrite FHA-insured single-family mortgages without prior review, but FHA lenders are responsible for complying with all applicable HUD regulations and are required to evaluate the borrower's ability and willingness to repay the mortgage debt. Lenders are protected against loss in case of default by FHA's Mutual Mortgage Insurance Fund, which is sustained by borrower premiums. Sterling was approved to participate in the Lender's Insurance (LI) program on September 6, 2007. 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 review⁴ being conducted by FHA. Under the LI program, the approved lender

¹ Neighborhood Watch is a Web-based data processing, automated query, reporting, and analysis system designed to highlight exceptions in lending practices for high-risk lenders so that potential problems are readily identifiable.

² HUD 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.

³ A non-supervised lender is a HUD/FHA-approved lending institution that has as its principal activity the lending or investment of funds in real estate mortgages and may be approved to originate, sell, purchase, hold, and/or service HUD/FHA-insured mortgages, depending upon its wishes and qualifications.

⁴ A pre-endorsement review of the FHA case binder is conducted by HUD's Homeownership Center staff 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.

performs its own pre-endorsement review and provides mortgage loan-level data to FHA via FHA Connection.⁵ 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. Sterling was removed from the LI program on September 23, 2009. HUD's Quality Assurance Division conducted its last review of Sterling on March 23, 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, Sterling endorsed 3,554 loans valued at more than \$758 million and submitted 31 claims worth more than \$5.1 million.

The objective was to determine whether Sterling underwrote the 20 selected loans in accordance with HUD/FHA requirements and if not, whether the underwriting reflected systemic problems.

RESULTS OF REVIEW

Sterling officials did not underwrite 6 of the 20 loans reviewed in accordance with HUD/FHA regulations. As a result, the FHA insurance fund suffered actual losses of more than \$429,703 on 5 loans and faces a potential loss of \$79,120 on 1 loan for total losses of more than \$508,823 as shown in the table below.

FHA /loan number	Closing date	Number of payments before first default	Acquisition cost	Unpaid balance	Original mortgage amount	Actual loss to HUD⁶	Potential loss to HUD (60% of unpaid balance)	Total actual and potential loss to HUD
022-1885701	08/31/2007	10	150,306	139,506	142,100	111,279		111,279
105-3453987	02/26/2008	3	147,794	141,420	142,871	61,050		61,050
361-3078756	05/09/2007	2	174,476	163,526	165,648	49,280		49,280
381-8219106	12/06/2007	9	141,057	131,866	134,445		79,120	79,120
412-5666814	12/04/2007	0	233,217	195,152	198,940	90,212		90,212
412-5681688	12/27/2007	1	146,215	122,704	125,098	117,882		117,882
					\$909,102	\$429,703	\$79,120	\$508,823

⁵ 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.

⁶ The 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.

The following table summarizes the material underwriting deficiencies that we identified in the 6 loans.

Area in which underwriting deficiencies were found	Number of loans⁷
Income	3
Liabilities	1
Assets	1
Borrower investment in property not verified	1
Skipped mortgage payments	3

Appendix A of this report shows a summary schedule of material deficiencies in each of the 6 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.

Unsupported Income or Questionable Employment History

Sterling officials incorrectly calculated the borrowers' income or did not verify employment stability for three loans. For loan number 412-5666814, Sterling officials incorrectly calculated borrower gross monthly income because Social Security income for the co-borrower was incorrectly calculated. Specifically, Sterling officials calculated the co-borrower's monthly Social Security income as \$2,312; however, documentation only verified \$1,360 in monthly Social Security income. Although we were unable to determine whether the borrowers were required to file a Federal income tax return, we "grossed up" the Social Security income by 25 percent, which results in monthly co-borrower Social Security income of only \$1,700 and not the \$2,312 used to qualify. Using the \$1,700 of co-borrower Social Security income increases the front ratio from 33.98 to 38.74 percent and the back ratio from 48.08 to 54.81 percent, requiring significant compensating factors to justify mortgage approval. The mortgage credit analysis worksheet listed compensating factors of "good mortgage payment history, reducing monthly mortgage payment, and consolidation of debts." "Good mortgage payment history" is not an acceptable compensating factor as defined by HUD Handbook 4155.1 REV-5, paragraph 2-13 because the borrowers paid their November 1, 2007, mortgage payment 30 days past due. Although the borrowers received \$9,821.48 in cash from this cash-out refinanced mortgage, they defaulted on this mortgage with zero payments made. Furthermore; the remaining two factors listed on the mortgage credit analysis worksheet are not acceptable compensating factors.

Underreported Liabilities

Sterling officials underreported liabilities for one loan. For loan number 105-3453987, Sterling officials did not include the monthly payments related to two student loans, totaling \$13,860

⁷ The deficiencies noted are not independent of one another, as one loan may have contained more than one deficiency.

(\$8,193 and \$5,667), in the calculation of the borrowers' debt-to-income ratios, and did not analyze and document whether the loans shown as deferred on the credit report were scheduled for repayment after the mortgage loan had been closed for a period of at least 12 months. Without documentation that these two debts would be deferred to a period outside of 12 months of the loan closing, there is no assurance that the borrowers' ratios were calculated correctly. Further, given that the back ratio was 44.29 percent and exceeded HUD's benchmark of 43 percent, including these debts in the underwriting analysis may have significantly affected the borrowers' ability to make their mortgage payments.

Unsupported Assets

Sterling officials did not adequately verify borrower assets for one loan. For loan number 022-1885701, Sterling officials did not verify or document that the borrowers had adequate assets to close on this refinance. The mortgage credit analysis worksheet showed that the borrowers needed \$904 to close, and the HUD-1 settlement statement, dated August 31, 2007, showed that the borrowers were required to pay \$1,694 at closing. Sterling's file only documented borrowers' assets totaling \$902 as shown on a bank account inquiry, dated August 31, 2007. Therefore, the borrowers needed an additional \$792 in cash to close on this refinance, and Sterling officials did not verify that the borrowers had sufficient funds to close.

Borrower Investment in Property Not Verified

Sterling officials did not ensure that the borrowers met the statutory investment requirement for one loan. For loan number 105-3453987, the mortgage credit analysis worksheet showed that the sales price for this purchase was \$144,000 and the statutory investment requirement was \$4,320. The HUD-1 settlement statement showed that the borrowers made a \$500 earnest money deposit and paid \$2,592 at closing, resulting in a total cash investment of only \$3,092. The HUD-1 settlement statement did not list any closing costs that were paid outside of closing by the borrowers. Therefore, the borrowers' statutory investment requirement was short by \$1,228, and Sterling officials did not verify that the borrowers' investment in the property was made.

Skipped Mortgage Payments

Contrary to requirements, Sterling officials allowed skipped mortgage payments on 3 refinanced loans. Each month's mortgage payment generally covers the previous month's interest and principal amounts due; therefore, when a conventional mortgage is refinanced into an FHA mortgage it is important that all prior payments due are not rolled into the FHA mortgage. For loan number 381-8219106, Sterling's file included a mortgage payoff statement, dated November 21, 2007, which was valid through December 12, 2007, and listed an unpaid principal balance of \$97,555.27. The HUD-1 settlement statement showed that this no-cash-out refinance loan closed on December 6, 2007, with a disbursement date of December 11, 2007, and a mortgage payoff amount of \$99,852.96, which included interest, late charges and other fees from November 1 through December 12, 2007. Since the files did not show that an adjustment was made to reduce the interest applicable to November 2007, we concluded that the borrowers did not make the December 1, 2007, mortgage payment. Therefore, Sterling officials allowed the borrowers on a no-cash-out refinance that was not current at the time of refinance, to skip the November 2007 conventional mortgage payment and roll it over into the new FHA mortgage

loan. Additionally, the borrowers did not make the December 1, 2007, payment due on their second mortgage, and it was also rolled into the new FHA mortgage loan.

Incorrect Underwriter's Certifications Submitted to HUD

We reviewed the certification for the 6 loans with material underwriting deficiencies for accuracy. Sterling's direct endorsement underwriters incorrectly certified that due diligence was used in underwriting these 6 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 a 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 provide 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 who knowingly violates any of the 14 violations listed, 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 Sterling and/or its principals for incorrectly certifying to the integrity of the data or that due diligence was exercised during the underwriting of 6 loans that resulted in actual losses of \$429,703 on 5 properties and a potential loss of \$79,120 on 1 property for a total loss of \$508,823, which could result in affirmative civil enforcement action of approximately \$1,062,646.⁸

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

- 1B. Take appropriate administrative action against Sterling 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.

⁸ Double damages for actual loss amounts related to 5 loans and potential loss related to 1 loan (\$508,823 x 2 = \$1,017,646) plus \$45,000, which is a \$7,500 fine for each of the 6 loans with material underwriting deficiencies, equals \$1,062,646.

SCHEDULE OF INELIGIBLE COSTS

Recommendation number	Ineligible 1/
1A	\$508,823
Totals	\$508,823

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 5 properties (\$429,703) and the potential loss related to 1 property (\$79,120).

Appendix A

SUMMARY OF MATERIAL UNDERWRITING DEFICIENCIES

FHA Number	Unsupported Income or Questionable Employment History	Underreported Liabilities	Unsupported Assets	Borrower Investment in Property not Verified	Skipped Mortgage Payments
022-1885701			X		X
105-3453987*		X		X	
361-3078756	X				
381-8219106*					X
412-5666814*	X				
412-5681688*	X				X
TOTALS	3	1	1	1	3

* 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 that the loans without the asterisk were originated before Sterling was approved to participate in the LI program on September 6, 2007.

Appendix B

LOANS WITH MATERIAL UNDERWRITING DEFICIENCIES

Loan number: 022-1885701

Mortgage amount: \$142,100

Section of Housing Act: 204 (b)

Loan purpose: No-cash-out refinance

Date of loan closing: 08/31/2007

Status as of June 30, 2010: Claim

Payments before first default reported: 10

Loss to HUD: \$111,279

Summary:

We found material underwriting deficiencies relating to a skipped mortgage payments and assets.

Skipped Mortgage Payments

Contrary to the requirements, Sterling officials did not ensure that the mortgage being refinanced was current and allowed the borrowers to skip their last two conventional mortgage payments and roll them over into the new FHA mortgage. Each month's mortgage payment generally covers the previous month's interest and principal amounts due; therefore, when a conventional mortgage is refinanced into an FHA mortgage it is important that all prior payments due are not rolled into the FHA mortgage. Sterling's file included a mortgage payoff statement, dated August 29, 2007, which was valid through September 18, 2007, and listed an unpaid principal balance as of July 1, 2007, of \$103,999.53. Added to this amount were interest of \$1,750.93 from July 1 to September 18, 2007 and various fees of \$194.11 for a total payoff of \$105,944.57. The HUD-1 settlement statement showed that this loan closed on August 31, 2007, with a disbursement date of September 6, 2007, and a mortgage payoff of \$105,798.67, which included interest, late, and other fees from July 1 to September 18, 2007. The difference of \$145.90 between the mortgage payoff statement and the HUD-1 settlement statement represents a reduction of 5 days of interest at \$29.18 per day. Nevertheless, if the borrower had made the July and August mortgage payments, the principal and interest amounts covering July and August 2007 would have been removed, but they were included in the payoff amount. Therefore, the borrowers did not make the July 1 and August 1, 2007, mortgage payments, and Sterling officials allowed a no-cash-out refinance on a mortgage that was not current at the time

of refinance and allowed skipped conventional mortgage payments to be rolled into the new FHA loan.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 1-10, provides that lenders are not permitted to allow borrowers to “skip” payments and the borrower is either to make the payment when it is due or bring the monthly mortgage payment check to settlement because FHA does not permit the inclusion of mortgage payments “skipped” by the homeowner in the new mortgage amount. For example, a borrower whose mortgage payment is due June 1 and who expects to close the refinance before the end of June is not permitted to roll the June mortgage payment into the new FHA loan amount.

Mortgagee Letter 2005-43, dated October 31, 2005, states that for no-cash-out (rate and term) refinances, the mortgage being refinanced must be current for the month due.

Unsupported Assets

Sterling officials did not verify or document that the borrowers had adequate funds to close on this refinance. The mortgage credit analysis worksheet showed that the borrowers needed \$904.07 to close, and the HUD-1 settlement statement, dated August 31, 2007, showed that the borrowers were required to pay \$1,694 at closing. Sterling’s file only documented borrowers’ assets totaling \$902 as shown on a bank account inquiry, dated August 31, 2007. Therefore, the borrowers needed an additional \$791.58 in cash to close on this refinance; however, Sterling officials did not document or verify that the borrowers had sufficient funds to close.

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.

Loan number: 105-3453987

Mortgage amount: \$142,871

Section of Housing Act: 203 (b)

Loan purpose: Purchase

Date of loan closing: 02/26/2008

Status as of June 30, 2010: Claim

Payments before first default reported: Three

Loss to HUD: \$61,050

Summary:

We found material underwriting deficiencies relating to the borrower's investment in the property and underreported liabilities.

Borrower Investment in Property Not Verified

Sterling officials did not ensure that the borrowers met the statutory investment requirement. The mortgage credit analysis worksheet showed that the sale price for this purchase was \$144,000 and the statutory investment requirement was \$4,320. The HUD-1 settlement statement showed that the borrowers made a \$500 earnest money deposit and paid \$2,592.45 at closing, resulting in a total cash investment of only \$3,092.45. The HUD-1 settlement statement did not list any closing costs that were paid outside of closing by the borrowers. Therefore, the borrowers' statutory investment requirement was short by \$1,227.55, and Sterling officials did not verify that the borrower investment in the property was made.

HUD/FHA Requirements:

Mortgagee Letter 98-29, dated October 22, 1998, states, "The National Housing Act requires the minimum cash investment to be 3 percent of the [HUD] Secretary's estimate of the cost of acquisition. FHA has determined that the minimum cash investment be based on sales price without considering closing costs to further Congressional objectives of simplifying the FHA maximum mortgage amount calculation without significantly increasing FHA's risk." Closing costs will not be included in calculating the 3 percent cash requirement but may be included in satisfying the 3 percent requirement. Mortgagee Letter 2003-01, dated January 14, 2003, made permanent the down-payment simplification procedures described in Mortgagee Letter 98-29.

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.

Underreported Liabilities

Sterling officials did not include the monthly payments related to two student loans, totaling \$13,860 (\$8,193 and \$5,667), in the calculation of the borrowers' debt-to-income ratios and did not analyze and document whether the loans shown as deferred on the credit report were scheduled for repayment after the mortgage loan had been closed for a period of at least 12 months. Without documentation that these two debts would be deferred to a period outside of 12 months of the loan closing, there is no assurance that the borrowers' ratios were calculated correctly. Further, given that the back ratio was 44.29 percent and exceeded HUD's benchmark of 43 percent, including these debts in the underwriting analysis may have significantly affected the borrowers' ability to make their mortgage payments.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-11C, states if a debt payment, such as a student loan, is scheduled to begin within 12 months of the mortgage loan closing, the lender must include the anticipated monthly obligation in the underwriting analysis unless the borrower provides written evidence that the debt will be deferred to a period outside this timeframe.

Mortgagee 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.

Loan number: 361-3078756

Mortgage amount: \$165,648

Section of Housing Act: 203 (b)

Loan purpose: Cash-out refinance

Date of loan closing: 05/09/2007

Status as of June 30, 2010: Claim

Payments before first default reported: Two

Loss to HUD: \$49,280

Summary:

We found material underwriting deficiencies relating to incorrect calculation of income, resulting in excessive ratios.

Incorrect Calculation of Income, Resulting in Excessive Ratios

Sterling officials incorrectly calculated the borrowers' overall effective monthly income by including \$4,083 in commission income related to the borrower without properly documenting that it had been received for the past two years and was likely to continue. Additionally, the co-borrower's gross monthly income of \$3,950 reported on the verification of employment was included in the calculation even though it was not supported by the pay stub. The borrower's verification of employment, dated April 16, 2007, showed that the borrower earned commission income of \$4,225 for 2007 for employment that began on February 5, 2007. Although verifications of employment from the borrower's two previous employers showed commission income, this income cannot be used to qualify because it would not continue through the first 3 years of the mortgage loan. Further, Sterling officials used the co-borrower's income of \$3,950 from a verification of employment, dated April 12, 1007; however, a copy of the co-borrower's pay stub, dated April 6, 2007, for the period March 26 to April 1, 2007, showed a weekly salary of \$1,046.25 and year-to-date earnings of \$10,449.30. Using the year-to-date earnings, we calculated the co-borrower's monthly income to be \$3,483.10 and not \$3,950.

While Sterling officials calculated the borrowers' overall effective monthly income as \$11,533, which consisted of the borrower's base pay of \$3,500, the borrower's commission income of \$4,083, and the co-borrower's base pay of \$3,950, only gross monthly income of \$6,983.10 was documented and verified. As a result of our income recalculation, the borrowers' qualifying ratios increased; specifically, the front ratio increased from 11.44 to 18.89 percent and the back ratio increased from 47.87 to 79.05 percent. Sterling officials documented the following compensating factors on the addendum to the mortgage credit analysis worksheet: "manual underwrite, own home 14 years, lowering rate/payments, average commission over 2 years, letter from borrower explains he is not currently paying alimony per divorce decree was only 12

months, employer pays Chrysler included in ratio, and excellent reserves.” Although “cash reserves” is a valid compensating factor, it is not considered significant enough to justify approving a mortgage with a back ratio of 79.05 percent, especially since the borrowers defaulted with only two mortgage payments made. The other compensating factors listed were not valid or not supported by adequate documentation.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-7D, states that commissions earned for less than 1 year are not considered effective income, commission income must be averaged over the previous 2 years, and the borrower must provide copies of signed tax returns for the last 2 years, along with the most recent pay stub. Paragraph 2-7 also states that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first 3 years of the mortgage loan.

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

Mortgagee Letter 2005-16, dated April 13, 2005, states that for manually underwritten mortgages, the qualifying ratios are raised to 31 and 43 percent and if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval.

HUD Handbook 4155.1, REV-5, paragraph 2-13, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed HUD benchmark guidelines; however, underwriters must note in the “remarks” section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation.

HUD Handbook 4155.1, REV-5, paragraph 1-11 B, cautions that cash-out refinances for debt consolidation represent a considerable risk, especially if the borrower has not had an attendant increase in income, and such transactions must be carefully evaluated.

Loan number: 381-8219106

Mortgage amount: \$134,445

Section of Housing Act: 203 (b)

Loan purpose: No-cash-out refinance

Date of loan closing: 12/06/2007

Status as of June 30, 2010: Claim

Payments before first default reported: Nine

Potential Loss to HUD: \$79,120

Summary:

We found a material underwriting deficiency relating to a skipped mortgage payment.

Skipped Mortgage Payment

Contrary to the requirements, Sterling officials did not ensure that the mortgage being refinanced was current and allowed the borrowers to skip their last conventional mortgage payment and roll it over into the new FHA mortgage. Each month's mortgage payment generally covers the previous month's interest and principal amounts due; therefore, when a conventional mortgage is refinanced into an FHA mortgage, it is important that all prior payments due are not rolled into the FHA mortgage. Sterling's file included a mortgage payoff statement, dated November 21, 2007, which was valid through December 12, 2007, and listed an unpaid principal balance of \$97,555.27. The HUD-1 settlement statement showed that this no-cash-out refinance loan closed on December 6, 2007, with a disbursement date of December 11, 2007, and a mortgage payoff amount of \$99,852.96, which included interest, late charges and other fees from November 1 through December 12, 2007. Since the files did not show that an adjustment was made to reduce the interest applicable to November 2007, we concluded that the borrowers did not make the December 1, 2007, mortgage payment. Therefore, Sterling officials allowed the borrowers on a no-cash-out refinance that was not current at the time of refinance, to skip the November 2007 conventional mortgage payment and roll it over into the new FHA mortgage loan. Additionally, the borrowers did not make the December 1, 2007, payment due on their second mortgage, and it was also rolled into the new FHA mortgage loan.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 1-10, provides that lenders are not permitted to allow borrowers to "skip" payments and the borrower is either to make the payment when it is due or bring the monthly mortgage payment check to settlement because FHA does not permit the inclusion of mortgage payments "skipped" by the homeowner in the new mortgage amount. For example, a borrower whose mortgage payment is due June 1 and who expects to close the

refinance before the end of June is not permitted to roll the June mortgage payment into the new FHA loan amount.

Mortgagee Letter 2005-43, dated October 31, 2005, states that for no-cash-out (rate and term) refinances, the mortgage being refinanced must be current for the month due.

Loan number: 412-5666814

Mortgage amount: \$198,940

Section of Housing Act: 203 (b)

Loan purpose: Cash-out refinance

Date of loan closing: 12/04/2007

Status as of June 30, 2010: Claim

Payments before first default reported: Zero

Loss to HUD: \$90,212

Summary:

We found material underwriting deficiencies relating to incorrect calculation of income, resulting in excessive ratios, and income stability not established.

Incorrect Calculation of Income, Resulting in Excessive Ratios

Sterling officials incorrectly calculated the borrower's gross monthly income because Social Security income for the co-borrower was incorrectly calculated. Specifically, Sterling officials calculated the co-borrower's monthly Social Security income as \$2,312; however, documentation only verified \$1,360 in monthly Social Security income. Although we were unable to determine whether the borrowers were required to file a Federal income tax return, we "grossed up" the Social Security income by 25 percent, which results in monthly co-borrower Social Security income of only \$1,700 and not the \$2,312 used to qualify. Using the \$1,700 of co-borrower Social Security income increases the front ratio from 33.98 to 38.74 percent and the back ratio from 48.08 to 54.81 percent, requiring significant compensating factors to justify mortgage approval. The mortgage credit analysis worksheet listed compensating factors of "good mortgage payment history, reducing monthly mortgage payment, and consolidation of debts." "Good mortgage payment history" is not an acceptable compensating factor as defined by HUD Handbook 4155.1 REV-5, paragraph 2-13 because the borrowers paid their November 1, 2007, mortgage payment 30 days past due. Although the borrowers received \$9,821.48 in cash from this cash-out refinanced mortgage, they defaulted on this mortgage with zero payments made. Furthermore; the remaining two factors listed on the mortgage credit analysis worksheet are not acceptable compensating factors.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-7E, states that retirement and Social Security income require verification from the source (former employer, Social Security Administration) or Federal tax returns. If any benefits expire within the first full 3 years, the income source may be considered only as a compensating factor.

HUD Handbook 4155.1, REV-5, paragraph 2-7Q, states that if a particular source of regular income is not subject to Federal taxes (e.g., certain types of disability and public assistance payments, military allowances), the amount of continuing tax savings attributable to the nontaxable income source may be added to the borrower's gross income. The percentage of income that may be added may not exceed the appropriate tax rate for that income amount, and no additional allowances for dependents are acceptable. The lender must document and support the adjustments (the amount the income is grossed up) made for any nontaxable income source. Child support income cannot be grossed up. The lender should use the tax rate used to calculate last year's income tax for the borrower. If the borrower is not required to file a Federal income tax return, the tax rate to use is 25 percent.

Mortgagee Letter 2005-16, dated April 13, 2005, states that for manually underwritten mortgages, the qualifying ratios are raised to 31 and 43 percent and if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval

HUD Handbook 4155.1, REV-5, paragraph 2-13, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed HUD benchmark guidelines; however, underwriters must note in the "remarks" section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation.

Income Stability Not Established

Sterling officials did not verify the borrower's employment for the most recent 2 full years; therefore, income stability was not established. The verification of employment from the borrower's current employer showed that the borrower was employed from September 19, 2007, to the date of the closing, December 4, 2007, which was a period of 2½ months. The verification of employment from the borrower's prior employer showed that the borrower was employed from December 17, 2006, to September 23, 2007, which is 9 months. Therefore, Sterling officials verified borrower employment for 11.5 months, and there was an unexplained gap in borrower employment of 12.5 months.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-6, states that the lender must verify the borrower's employment for the most recent 2 full years and the borrower must explain any gaps in employment spanning 1 month or more.

Loan number: 412-5681688

Mortgage amount: \$125,098

Section of Housing Act: 203 (b)

Loan purpose: No-cash-out refinance

Date of loan closing: 12/27/2007

Status as of June 30, 2010: Claim

Payments before first default reported: One

Loss to HUD: \$117,882

Summary:

We found material underwriting deficiencies relating to incorrect calculation of income, resulting in excessive ratios, and a skipped mortgage payment.

Incorrect Calculation of Income, Resulting in Excessive Ratios

Sterling officials incorrectly calculated borrower gross monthly income. Specifically, Sterling officials calculated the borrower's monthly base pay as \$2,004 using the annual salary of \$24,044 as shown on the verification of employment from the borrower's current employer. However, the borrower's pay stub from her current employer only showed year-to-date earnings through November 2, 2007, of \$19,247.58, which is an average of \$1,924.76 per month. Additionally, Internal Revenue Service forms W-2 for 2005 and 2006 from the same employer showed total earnings of \$11,082.07 and \$15,364.36, respectively. Using the \$1,924.76 for income increases the front ratio from 49.51 to 51.41 percent and the back ratio from 50.43 to 52.38 percent, requiring significant compensating factors. The mortgage credit analysis worksheet listed compensating factors of "using income for one child only, manual underwritten, income from paystubs/voe, loan to value of 88 percent, and rate and term refinance." There was no documentation in the file to support that the child support income for the borrower's other two children would continue for the first 3 years of the mortgage; however, the children were ages 19 and 20 at the time of loan closing. None of the remaining compensating factors is valid for approving a mortgage with a front ratio of 51.41 percent and a back ratio of 52.38 percent, considering that the borrower defaulted with only one mortgage payment made.

HUD/FHA Requirements:

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

Mortgagee Letter 2005-16, dated April 13, 2005, states that for manually underwritten mortgages, the qualifying ratios are raised to 31 and 43 percent and if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval

HUD Handbook 4155.1, REV-5, paragraph 2-13, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed HUD benchmark guidelines; however, underwriters must note in the “remarks” section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation.

Skipped Mortgage Payment

Contrary to the requirements, Sterling officials did not ensure that the mortgage being refinanced was current and allowed the borrower to skip the last conventional mortgage payment and roll it over into the new FHA mortgage. Each month’s mortgage payment generally covers the previous month’s interest and principal amounts due; therefore, when a conventional mortgage is refinanced into an FHA mortgage it is important that all prior payments due are not rolled into the FHA mortgage. Sterling’s file included a mortgage payoff statement, dated November 29, 2007, which was valid through December 26, 2007, and showed that the December 1, 2007, mortgage payment was due. The payoff statement also listed an unpaid principal balance of \$115,632.23. The HUD-1 settlement statement showed that this no-cash-out refinance loan closed on December 27, 2007, with a disbursement date of January 2, 2008, and a mortgage payoff of \$118,046.92, which included interest, late charges and other fees from November 8 to December 26, 2007. If the borrower had made the December 1, 2007, mortgage payment, the interest figure would have been reduced, but it was included in the payoff amount. Therefore, the borrower did not make the December 1, 2007, mortgage payment, and Sterling officials allowed the borrower on a no-cash-out refinance that was not current at the time of refinance, to skip the December 2007 conventional mortgage payment and roll it over into the new FHA mortgage loan.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 1-10E, provides that lenders are not permitted to allow borrowers to “skip” payments and the borrower is either to make the payment when it is due or bring the monthly mortgage payment check to settlement because FHA does not permit the inclusion of mortgage payments “skipped” by the homeowner in the new mortgage amount. For example, a borrower whose mortgage payment is due June 1 and who expects to close the refinance before the end of June is not permitted to roll the June mortgage payment into the new FHA loan amount.


Mortgagee Letter 2005-43, dated October 23, 2005, states that for no-cash-out (rate and term) refinances, the mortgage being refinanced must be current for the month due.

APPENDIX C

LENDER COMMENTS AND OIG's EVALUATION

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Lender Comments

 STERLING NATIONAL MORTGAGE COMPANY, INC.	<small>A Subsidiary of Sterling National Bank</small> 98 CUTTERMILL ROAD SUITE 200N GREAT NECK, NY 11021 PHONE 516-487-0018 FAX 516-487-0125
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September 22, 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: Sterling National Mortgage Company, Inc.
HUD OIG Draft Memorandum Report 2010-NY-10XX**

Dear Mr. Moore:

Sterling National Mortgage Company, Inc. ("Sterling National" or "Company") has received the revised Draft Memorandum Report ("Report"), dated August XX, 2010, from the U.S. Department of Housing and Urban Development's ("HUD" or "Department") Office of Inspector General ("OIG"), in which twenty Federal Housing Administration ("FHA") insured loans were selected as part of HUD and the OIG's "Operation Watchdog" initiative.

The OIG provided Sterling National with an opportunity to submit written comments for inclusion in the final report. We appreciate this opportunity to comment on the OIG's findings and recommendations and believe that this response and accompanying exhibits demonstrate that the Report's recommendations in connection with the cited loans are unwarranted. The Report's "Results of Review" allege that thirteen of the twenty loans contained underwriting deficiencies and, in each of these thirteen cases, the underwriters incorrectly certified that due diligence was used in underwriting the loans. As shown in the detailed response that follows we respectfully submit that our underwriters did exercise appropriate due diligence.

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I. BACKGROUND

A. STERLING NATIONAL MORTGAGE COMPANY, INC.

Sterling National is subject to the regulation and oversight of the Office of the Comptroller of the Currency. The Company enjoys excellent relationships with both consumers and investors. Sterling National is committed to its relationship with the Department and takes its responsibilities under the FHA program seriously.

To this end, Sterling National performs regular credit and compliance reviews. When we observed a rising trend in our traditionally low compare ratio on FHA's Neighborhood Watch we accelerated our extensive analysis of our defaulted loans, including examination of debt-to-income ratios, credit scores, transaction types, property types, origination groups, and the allocation of loans to various DE underwriters. As a result of these analyses we implemented increasingly restrictive underwriting criteria, layering guidelines over those recommended in FHA's 4155.1 (Rev 5).

The collective results of these efforts are directly reflected in Sterling National's national default/claim rates. Notably, as of August 31, 2010, the Company's nationwide compare ratio for FHA-insured loans originated during a two-year period is 174% (**Exhibit A-1**). This compare ratio drops substantially to 69% when measured for FHA-insured loans originated in a one-year period (**Exhibit A-1**). The Company remains earnest in its obligation to originate only the highest quality FHA loans, and these figures demonstrate that Sterling National is a responsible HUD-approved lender.

Sterling National continues to reassess and evolve our underwriting guidelines and quality control procedures. For example, the Company requires a processed IRS Form 4506 prior to submission of a loan to underwriting; evaluates tax return transcripts for job related expenses, rental property activity, and losses that would not otherwise be documented; runs searches through MERS (i.e., Mortgage Electronic Registration Systems) to determine whether there are any undisclosed mortgage liabilities that fail to appear on a borrower's credit report; prohibits "alternative" credit loans; orders FHA appraisals through an appraisal management firm that performs a quality control review of every appraisal before furnishing it to the Company; regularly orders occupancy inspections on refinance transactions; conducts a reverse search on each borrower's property address, telephone number, employer address, and employer telephone number; analyzes every loan through fraud detection software; reruns credit at closing to detect new inquiries and debt obligations; follows stringent procedures for streamline refinances of transactions that Sterling National did not originate; and, prohibits loans to applicants with qualifying ratios that exceed 31% and 43% when manually underwritten (except that Sterling National will consider making a loan to an applicant with a housing ratio up to 35% if his or her debt-to-income ratio is 40% or below).

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Finally, we note that the review covered loans originated by the Company between May 9, 2007 and June 18, 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 thirteen loans at issue demonstrates that nine of these borrowers reported curtailment of income, unemployment, illness, or marital difficulties, which often results in income loss, as the reason for the default.

B. THE "OPERATION WATCHDOG" REVIEW

While HUD and the OIG expressly stated that its review "was not based upon any evidence of wrongdoing" on the part of Sterling National or the other lenders subjected to this probe (**Exhibit A-2**), 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-3**). 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 Sterling National, subject to this particular review (**Exhibit A-3**).

Although the OIG acknowledged in the press release that it had no evidence of wrongdoing by the Company 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. The company is one of several of the identified lenders whose reputations suffered as a result of the public announcement of the "probe."

Sterling National 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 thirteen loans and recommends action by HUD and the Departmental Enforcement Center regarding these assertions. Upon receipt of the draft Report, Sterling National performed its own stringent analysis of the loans subject to the OIG's review. Based on

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our review, Sterling National disagrees with a number of the assertions in the Report and strongly objects to both the recommendation for administrative action and PFCRA penalties in the cited loans. 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 Company 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 Sterling National'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 requirements in connection with several cited loans, and set forth our opposition to the OIG's recommendations regarding action under PFCRA.

A. STERLING NATIONAL GENERALLY COMPLIED WITH HUD'S UNDERWRITING GUIDELINES

In the "Results of the Review" and Appendix B, the Report alleges that Sterling National did not underwrite thirteen of the twenty FHA loans reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) income verification and calculation; (2) assessment of borrower liabilities; (3) excessive qualifying ratios; (4) documenting borrower assets; (5) creditworthiness; (6) verification of the borrower's investment; and (7) skipped mortgage payments. We address a representative sample of these individual allegations in turn below.

1. Income Verification

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

a. FHA Case No. 137-3791174

In this loan, the Report alleges that Sterling National incorrectly calculated the borrower's monthly effective income. Specifically, the Report claims that the borrower's Verification of Employment ("VOE") only documents \$4,992 in monthly income, as opposed to the \$5,473 used to qualify the borrower. Had the Company used the \$4,992 figure to qualify the borrower, the Report asserts that the back-end ratio would have increased from 42.12% to 46.18%, which required significant compensating factors.

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Sterling National understands and appreciates HUD's requirement that a mortgage lender analyze and verify the income of each borrower to determine its likelihood of continuance, and it is the Company's policy and procedure to document each valid source of income used to qualify the borrower for an FHA-insured loan. See HUD Handbook 4155.1, REV-5, ¶ 2-7. FHA guidelines, however, do not dictate a specific formula to be used to calculate a borrower's qualifying income based on salaries and wages. Rather, the lender must use required documentation, including 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 other applicable documents supplied by a borrower's employer, to arrive at qualifying income. See HUD Handbook 4155.1 REV-5, ¶ 3-1(E).

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That said, the Company appreciates that the underwriter in this case should have qualified the borrower with a lower amount of monthly income. Even if this amount were as low as \$4,992, which would have resulted in a 46.18% back-end ratio, any oversight with regard to this calculation constituted, at worst, harmless error, and the borrower still qualified for FHA financing. Notably, a 46.18% back-end ratio would have only slightly exceeded HUD's benchmark guideline of 43%, see HUD Handbook 4155.1 REV-5, ¶ 2-12 and Mortgagee Letter 2005-16, and the loan file documented compensating factors that would have offset this slightly higher-than-average ratio. It is also important to emphasize that "FHA does not set an arbitrary percent by which ratios may be exceeded, but, rather, FHA relies on the underwriter to judge the overall merits of the loan application and to determine what compensating factors apply and the extent to which those factors justify exceeding the ratios." Mortgagee Letter 00-24 (emphasis added).

In accordance with these requirements, the underwriter in this case noted in the "Remarks" section of the Mortgage Credit Analysis Worksheet ("MCAW") that the borrowers experienced "no payment shock." In other words, the borrowers experienced a minimal \$54 increase in their mortgage payment (**Exhibit B-1**), which HUD has identified as a valid compensating factor. See HUD Handbook 4155.1 REV-5, ¶ 2-13(F). Although the Report attempts to suggest this factor is not compensating because the payoff statement in this case identified late charges, the instance of late fees over the course of a mortgage loan in no way indicates that a borrower did not make timely mortgage payments. Rather, while a lender may assess a late charge when a payment is not made by the 15th day of the month, as long as the borrower makes this payment before thirty days has elapsed, the borrower's mortgage remains current. Here, the borrowers' loan was current, which supports the borrowers' ability to make future mortgage payments (**Exhibit B-2**). As HUD guidelines expressly recognize that timely payments of housing obligation and a minimal increase in the mortgage payment are valid compensating factors, the borrowers would have qualified for the FHA-insured

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loan even with a lower amount of qualifying income and a back-end qualifying ratio of 46.18%. Thus, the underwriter reasonably approved this loan for FHA financing, and we request that this finding be removed from the final report.

As a final matter, we note that loan-level data in FHA Connection reports that the borrowers defaulted in this case because of unemployment. This data, therefore, confirms that reasons other than the Company's origination and underwriting practices caused the default in this instance.

b. FHA Case No. 241-7994157

In this FHA-insured loan, the Report alleges that Sterling National incorrectly calculated the borrower's overall effective monthly income by including overtime income that had only been received for one year. Notably, as the VOE documents 12 months of overtime income, and the employer responded "not applicable" to the question regarding whether overtime was likely to continue, the Report claims that overtime income should not have been used to qualify the borrower. Without this income, the Report suggests that significant compensating factors are required to justify the increase in qualifying ratios.

Contrary to the Report's allegations, the Company properly calculated the borrower's income using overtime. FHA guidelines provide that, with respect to the inclusion of overtime in qualifying income, "[p]eriods of less than two years may be acceptable provided the underwriter adequately justifies and documents his or her reason for using the income for qualifying purposes." HUD Handbook 4155.1 REV-5, ¶ 2-7(A). In this case, the fact that the borrower had not yet earned overtime income as of January 2008 did not indicate that such income was unlikely to continue. Rather, the borrower worked at a university, which did not commence regular spring classes until January 28, 2008 (**Exhibit C-1**). Even though the borrower returned to work following the Christmas and New Year's holidays in 2007 and during the "intersession" of classes, it is not likely that overtime would have been required of the borrower as an administrative coordinator prior to the start of the spring semester. Moreover, we understood the employer's unwillingness to comment on the borrower's receipt of overtime income as nothing more than a human resource policy. Thus, the Company maintains that the absence of overtime income in 2008 and the employer's comments regarding its policy were not reasons to doubt the borrower's continued receipt of overtime income. Rather, as the employer verified and documented the borrower's receipt of \$2,755.95 in overtime income in 2007 (**Exhibit C-2**), the inclusion of this income in the borrower's qualifying monthly income was proper based on the FHA guidelines.

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Yet, even if the Company had excluded the \$229.66 in overtime from the borrower's qualifying monthly income, Sterling National maintains that the borrower still qualified for FHA financing. In this case, \$229.66 less in qualifying income would have resulted in higher qualifying ratios, which were justified based on the compensating factors documented in the loan file. Notably, the MCAW listed a number of reasons to justify loan approval, including a satisfactory mortgage payment history, a loan-to-value ratio of 85%, and long-term, stable employment (**Exhibit C-3**). With regard to the final listed factor, the borrower had excellent job stability, as the loan file documented that the borrower had been employed in her position for nearly 17 years (**Exhibit C-4**). While Sterling National appreciates that HUD guidelines require job stability, lenders are required to document a borrower's employment for only two years prior to closing. See HUD Handbook 4155.1 REV-5, ¶ 2-6. Based on these guidelines, a 17-year history with the same employer demonstrates job stability above and beyond what is required by the Department's guidelines and compensates for higher-than-average ratios.

Moreover, the borrower's housing payment minimally increased by \$131.85, and the borrower maintained a mere \$40 in monthly recurring obligations. HUD guidelines expressly recognize that a minimal increase in housing expense and a conservative attitude towards the use of credit are compensating factors. See HUD Handbook 4155.1 REV-5, ¶ 2-13(A), (F). Sterling National, therefore, complied with HUD guidelines in documenting and analyzing the borrower's income in this loan and this allegation should be removed from the final report.

c. FHA Case No. 361-3078756

Comment 5

Here, the Report alleges that Sterling National incorrectly calculated the borrowers' overall effective monthly income by including \$4,083 in commission income without documenting that it had been received for the past two years and was likely to continue. Notably, the Report acknowledges that the VOEs from the borrower's two previous employers showed commission income, but the Report suggests this income could not be used to qualify the borrower, as the income would not continue through the first three years of the mortgage loan. Moreover, the Report asserts that the co-borrower's gross monthly income of \$3,950 as verified by the VOE was not supported by the pay stub and should not have been included in the qualifying income calculation.

Sterling National disagrees with the income analysis in the Report for this case and respectfully maintains that it complied with FHA guidelines. Initially, we note that the allegations in this case impose the underwriting standards for use of overtime or bonus income in qualifying a borrower, which require the borrower to have received the income for the past two years and the lender to determine the likelihood of continuance. See HUD Handbook 4155.1, REV-5, ¶ 2-7(A). The use of commission income, however, which is at issue in this case, is justifiable when the borrower has received

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between one and two years of commissions. Notably, HUD guidelines in effect in 2007 provided that commission income must be averaged over the previous two years. "Borrowers with commission income received for more than one but less than two years may be considered favorably provided the underwriter is able to make a sound rationalization for acceptance and can document the likelihood of continuance." HUD Handbook 4155.1, REV-5, ¶ 2-7(D). Moreover, while HUD's income guidelines generally require a lender to analyze a borrower's income to determine whether it will continue through the first three years of the mortgage loan, the use of commission income to qualify a borrower for FHA financing is not specifically conditioned on this analysis. Thus, as long as Sterling National verified the borrower's receipt of commission income over the previous one to two years and confirmed its likelihood of continuance, the Company's underwriter reasonably used such income to qualify the borrowers.

Comment 5

In this case, the Company documented the borrower's receipt of commission income since June 2003, which was more than enough verification to justify use of commission income. Notably, the VOEs supplied by the borrower's previous employers verified the borrower's receipt of \$38,525 and \$39,725 in annual commission income from June 2003 through December 2006 (**Exhibit D-1**). The borrower's current employer also verified the borrower's receipt of \$4,225 in commission income during the first two and a half months of employment, confirmed the borrower's general receipt of 8% in commissions for all sales, and indicated a good probability for continued employment (**Exhibit D-2**). In fact, the VOE referenced a pay raise the borrower was scheduled to receive on June 1, 2007, which is evidence of the borrower's promising future with this current employer. Moreover, the loan file contained a schedule of anticipated commissions provided by the borrower's employer that detailed over \$45,000 in commissions to be earned by the borrower through mid August 2007 (**Exhibit D-3**). Thus, contrary to the Report's allegations in this case, Sterling National more than adequately documented the borrower's consistent receipt of commission income over the previous four years and its likelihood of continuance. We have no doubt that the underwriter properly included the borrower's commission income in the overall qualifying monthly income.

Comment 5

Furthermore, nothing in the FHA guidelines require a lender to verify and calculate a borrower's qualifying income using year-to-date earnings, as opposed to the monthly salary verified and documented by the VOE from the borrower's employer. Rather, as noted above, the lender must use required documentation, including 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 other applicable documents supplied by a borrower's employer, to arrive at qualifying income. See HUD Handbook 4155.1 REV-5, ¶ 3-1(E). In this case, even if the Company had solely relied

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on the co-borrower's pay stub to calculate monthly income, the pay stub identified the borrower's weekly salary as \$1,046.25, which yielded \$4,533.75 in monthly income (**Exhibit D-4**). This amount is higher than the \$3,950 in monthly base income verified by the borrower's employer on the VOE (**Exhibit D-5**). Thus, when the underwriter elected to qualify the co-borrower with \$3,950 in monthly income, the underwriter actually used an amount more conservative than income otherwise verified and documented for the co-borrower on the pay stub. Nevertheless, as the co-borrower's employer verified her receipt of \$3,950 in monthly income, the Company justifiably used this amount as part of its calculation of overall effective monthly income.

The above discussion and attached documentation demonstrates that Sterling National strictly adhered to HUD guidelines to calculate and document the borrowers' qualifying monthly income. We also note that loan-level data in FHA Connection reports that the borrowers defaulted in this case because of unemployment. This data, therefore, confirms that reasons other than the Company's origination and underwriting practices caused the default in this instance, and this allegation should be removed from the final report.

d. FHA Case No. 381-8219106

In this loan, the Report alleges that Sterling National incorrectly calculated borrower gross monthly income by including the Social Security and pension income of a non-occupying co-borrower. Stated differently, without evidence to show that the second co-borrower was an occupant at the subject property, the Report claims the Company should not have used this co-borrower's income to qualify the loan.

Sterling National appreciates and understands that HUD guidelines for cash-out refinance transactions require any co-borrower or co-signer being added to the note to be an occupant of the property. Non-occupant owners may not be added in order to meet FHA's credit underwriting guidelines for the mortgage. See Mortgagee Letter 2005-43. This case, however, was not a cash-out refinance loan (Exhibit E), and HUD's prohibitions on the use of non-occupant co-borrowers to qualify a loan do not apply to traditional rate and term refinances. Accordingly, Sterling National reasonably used the Social Security and pension income of a non-occupant co-borrower to qualify this loan for refinance. Administrative action, therefore, is unwarranted, and we respectfully request that this allegation be removed from the final report.

Comment 6

As a final matter, we also note that loan-level data in FHA Connection reports that the borrowers defaulted in this case as a result of a curtailment in income after making nine mortgage payments. This data, therefore, confirms that reasons other than the Company's origination and underwriting practices caused the default in this instance.

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e. **FHA Case No. 412-566814**

The Report alleges in this case that Sterling National incorrectly calculated Social Security income for the co-borrower. Notably, the Report suggests that documentation in the loan file verified only \$1,360 in Social Security income, as opposed to the \$2,312 used to qualify the borrowers. Even after the \$1,360 is grossed up, the Report claims the Company should have used \$1,700 in Social Security income to qualify the co-borrower. With only \$1,700 in Social Security income, the Report suggests qualifying ratios for the borrowers increase above applicable thresholds, which require significant compensating factors.

Comment 7

With respect to the co-borrower's Social Security benefits, Sterling National generally grossed them up by 25%, as acknowledged in the Report. FHA guidelines expressly permit a mortgagee to include Social Security income in a borrower's qualifying income and to gross it up by either the borrower's tax rate or 25%. See HUD Handbook 4155.1 REV-5, ¶¶ 2-7(E), (Q). That said, we appreciate that \$1,700 should have been included in the total amount of Social Security income used for qualifying purposes, which would have increased the borrowers' qualifying ratios in this case. However, any oversight in this regard constituted, at worst, harmless error. Even if total qualifying income in this case were reduced, the loan file documented significant compensating factors that justified approval of the loan, and the borrowers qualified for FHA financing.

Comment 7

Notably, as acknowledged in the Report, the underwriter noted in the "Remarks" section of the MCAW that the borrowers maintained a "good mortgage payment history" (**Exhibit F-1**). Although the Report suggests this factor is not an acceptable compensating factor because the borrowers paid their November 1, 2007 mortgage payment 30 days late, the underwriter could not ignore the fact that the borrowers maintained three separate mortgage lines of credit in the past and made a combined 145 months of mortgage payments on time (**Exhibit F-2**). HUD's guidelines expressly state that if a borrower has successfully demonstrated the ability to pay housing expenses over the past 12-24 months, this constitutes a valid compensating factor. See HUD Handbook 4155.1, REV-5, ¶2-13(A). Here, there is no question that the borrowers had a long history of honoring their mortgage obligations, which was a significant compensating factor in this case. In addition, the underwriter noted on the MCAW that the borrower's loan-to-value ratio was only 80.82% and specifically referenced a decrease in the borrowers' mortgage payment (**Exhibit F-1**). Given that FHA guidelines recognize a minimal increase in housing obligation as a compensating factor, a \$61 reduction in the borrowers' mortgage payment further justified the underwriter's approval of this loan. While the Report highlights the borrowers' default on this loan with zero payments made, the conditions of the borrowers' default in no way detracts

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from the underwriting analysis made in this case based on the documentation available and the income and credit history of the borrowers prior to closing. Thus, even if a lower amount of Social Security income had been included in the overall qualifying income in this case, the borrowers were eligible for FHA financing. We respectfully request this allegation be removed from the final report.

As a final matter, we also note that loan-level data in FHA Connection reports that the borrowers defaulted in this case because of the illness of the primary mortgagor, which often results in income loss. This data, therefore, confirms that reasons other than the Company's origination and underwriting practices caused the default in this instance.

f. FHA Case No. 412-5681688

In this case, the Report asserts that the borrower's income was overstated, as the underwriter calculated earnings using the annual salary evidenced on the written VOE, rather than the year-to-date earnings reflected on the borrower's pay stub, which led to excessive qualifying ratios. The Report also alleges that child support income for two children was not an acceptable compensating factor, as the loan file did not document that this income would continue for the first three years of the mortgage.

Sterling National respectfully disagrees with the Report's assertions in this case. With regard to income documentation, Sterling National understands and appreciates that a lender must verify the borrower's employment for the most recent two full years and analyze the income to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage. See HUD Handbook 4155.1 REV-5, ¶¶ 2-6, 2-7. In compliance with these guidelines, Sterling National obtained a written and verbal VOE (**Exhibit G-1**), pay stubs (**Exhibit G-2**), and W-2 forms (**Exhibit G-3**) evidencing that the borrower had been employed by Margaretta Local Schools for over five years (**Exhibit G-1**). See HUD Handbook 4155.1 REV-5, ¶ 3-1(E). The written VOE documented that the borrower earned an annual salary of \$24,044 (**Exhibit G-1**), which the underwriter properly used to calculate the borrower's monthly earnings reflected on the MCAW (**Exhibit G-4**). While the borrower's pay stub reflected slightly lower year-to-date earnings as of November 2, 2007, we are not aware of, and the Report does not reference, any provision in FHA guidelines requiring a lender to utilize year-to-date earnings to calculate the qualifying income in FHA-insured loans. Sterling National used the borrower's annual salary as reflected on the written VOE, which it obtained directly from the borrower's employer, and the Company maintains that the income calculation in this case adhered to FHA requirements.

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Furthermore, even if the underwriter had calculated the borrower's income using the year-to-date earnings on the pay stub, the borrower's monthly earnings would have decreased by only \$80, which would have slightly increased the qualifying ratios in this case (**Exhibit G-4**). Contrary to the allegation in the Report, the loan file documented significant factors that would have compensated for the higher ratios in this loan. As indicated in the Report, the underwriter noted on the MCAW that the borrower's loan-to-value was only 88%, and that the borrower's qualifying income reflected child support income for only one child, even though the loan file documented that the borrower received child support for all three of her children (**Exhibit G-5**). As discussed above, Sterling National appreciates that, when calculating a borrower's qualifying income, FHA-approved lenders must analyze the income to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage. See HUD Handbook 4155.1 REV-5, ¶¶ 2-6, 2-7. This requirement, however, does not apply to income considered as a compensating factor in those cases with higher-than-average qualifying ratios. In these circumstances, HUD guidelines expressly state that the borrower's receipt of "documented compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage" is a significant compensating factor. See *id.* ¶ 2-13(E) (emphasis added). In this case, the loan file clearly documented that the borrower received regular child support income for three children (**Exhibit G-5**); however, the underwriter included income for only one child in the borrower's monthly earnings (**Exhibit G-4**). The documented child support income received for the remaining two children constituted a compensating factor pursuant to HUD requirements, regardless of whether such income would continue for the first three years of the mortgage. Thus, even if the underwriter had used the year-to-date earnings reflected on the pay stub to calculate the qualifying income, the borrower would have qualified for the FHA-insured loan.

The above discussion and attached documentation evidence that Sterling National strictly adhered to HUD guidelines in calculating the borrower's income and documenting significant compensating factors in this loan. We also note that loan-level data in FHA Connection reports that the borrowers defaulted in this case as a result of a curtailment in income. This data, therefore, confirms that reasons other than the Company's origination and underwriting practices caused the default in this instance, and this allegation should be removed from the final report.

2. Assessment of Liabilities

In three loans, the Report contends that the Company did not properly assess the borrowers' liabilities, as debts reflected on the credit reports or in file documentation were not included in the calculation of the borrowers' qualifying ratios. We address each of these three cases in turn below.

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a. FHA Case No. 105-3453987

In this case, the Report alleges that the monthly payments related to two student loans with outstanding balances of \$8,193 and \$5,667 were not included in the calculation of the borrowers' debt-to-income ratios and were not analyzed to determine whether the deferred loans were scheduled for repayment after the mortgage loan had been closed for a period of at least 12 months.

Sterling National understands and appreciates that, if a debt payment is scheduled to begin within 12 months of the mortgage loan closing, the lender is required to include the anticipated monthly obligation in its underwriting analysis, unless the borrower provides written evidence that the debt will be deferred for a period of time outside of this timeframe. See HUD Handbook 4155.1, REV-5, ¶ 2-11(C). In this case, as the borrowers' credit report identified the two student loans at issue as in deferred status (**Exhibit H-1**), the underwriter excluded these loans from its calculation of the borrowers' recurring monthly debt obligations. However, we appreciate that without confirmation of the loans' deferment period, the anticipated monthly payments should have been included in the calculation of the borrowers' qualifying ratios. That said, any oversight with regard to these debts constituted, at worst, harmless error. Assuming the combined monthly payments for both student loans would not exceed \$100,¹ including this amount in the borrowers' qualifying ratios would have minimally increased the back-end ratio from 44.29% to 46.52% (**Exhibit H-2**). While this ratio would have slightly exceeded HUD's benchmark guideline, see HUD Handbook 4155.1 REV-5, ¶ 2-12 and Mortgagee Letter 2005-16, the loan file documented compensating factors that would have offset this slightly higher-than-average ratio. For example, the underwriter documented on the MCAW that the borrowers maintained a good prior mortgage payment history and significant cash reserves of over \$3,200 after closing (**Exhibit H-2**). HUD guidelines expressly recognize that timely payments of housing obligation and substantial cash reserves are compensating factors. See HUD Handbook 4155.1 REV-5, ¶ 2-13(A), (G). Thus, even considering this student loan debt, the borrowers would have qualified for the FHA-insured loan.

The above discussion and attached documentation demonstrates that inclusion of two student loan debts would not have affected the borrowers' eligibility for FHA financing. The underwriter reasonably determined, based on this analysis, that the borrowers qualified for the FHA-insured loan at issue. For this reason, administrative action would be unwarranted. We also note that loan-level data in FHA Connection

¹ Because these loans are in deferred status, the borrowers' credit report does not identify monthly payment amounts. However, other student loans maintained by the borrowers with similar outstanding balances reflect an approximate \$50 monthly payment amount.

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reports that the borrowers defaulted in this case because of marital difficulties, which often leads to income loss. This data, therefore, confirms that reasons other than the Company's origination and underwriting practices caused the default in this instance, and this allegation should be removed from the final report.

b. FHA Case No. 241-7994157

Here, the Report asserts that a \$395 monthly car loan shown on the borrower's credit report was excluded from the borrower's liabilities without proper documentation of the loan as a contingent liability. The Report acknowledges that Sterling National's file documented that a relative of the borrower was responsible for the car loan payments, but the Report claims the Company did not document that the relative made the payments for a 12-month period. Without this documentation, the Report alleges the \$395 debt should have been calculated as part of the borrower's qualifying ratios.

The Company respectfully disagrees with the allegations in this case. Sterling National understands and appreciates that, to exclude a contingent liability where the borrower is a co-signer on the loan, the lender must document that the primary obligor has been making payments during the previous 12 months on a regular basis and does not have a history of delinquent payments on the loan. See HUD Handbook 4155.1, REV-5, ¶ 2-11(B). In accordance with these requirements, Sterling National obtained copies of the primary obligor's bank statements to reflect direct debits for this loan from January through December 2007 (**Exhibit I-1**). Although the statements evidence actual debits for seven months of payments, the bank statements cover a 12-month period and collectively demonstrate that the primary obligor had made the payments for this loan. Moreover, the borrower's credit report confirms that a total of 22 months' of payments had been made on this loan without any history of delinquency (**Exhibit I-2**). Based on this documentation, Sterling National adequately confirmed that the primary obligor was responsible for this debt, and the Company properly excluded the \$395 monthly payment from the borrower's qualifying ratios. Thus, administrative action in this case would be inappropriate, and we request that this finding be removed from the final report.

c. FHA Case No. 263-4019928

In this loan, the Report alleges that the borrower's back-end ratio underreported the borrowers' liabilities because the Company excluded a recurring credit card debt. Notably, the Report claims a credit card debt with monthly payments of \$15 and an outstanding balance of \$300 should have been included in the borrowers' back-end ratio, which increases the ratio from 47.29% to 47.87%.

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With regard to the revolving credit account, it is Sterling National's policy and practice to include all installment loans, revolving charge accounts, and other continuing obligations extending ten months or more in the borrower's qualifying ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-11(A). In this case, the Company excluded the \$15 monthly payment from its ratio calculation because this debt was slated to be paid off at the closing table by the borrower with the proceeds of the cash-out refinance. In fact, as demonstrated by the attached closing instructions (**Exhibit J-1**), the Company conditioned the closing of this loan on the payoff of all debts listed on the final loan application (**Exhibit J-2**), which included the \$300 outstanding balance to HSBC. Although it appears that the closing agent did not include this debt on the HUD-1 Settlement Statement ("HUD-1") to be paid with the proceeds of the loan (**Exhibit J-3**), this oversight does not change the fact that Sterling National underwrote this loan with the understanding that the credit card debt would be paid in full and, thus, excluded from the borrower's ongoing monthly recurring obligations. Accordingly, we believe the Company properly excluded the debt from its ratio calculations.

Moreover, even if the Company had included the \$15 monthly payment as part of its ratio calculations, the result would have been a mere .58% increase in the borrowers' back-end ratio. While this ratio would have slightly exceeded HUD's benchmark guideline, see HUD Handbook 4155.1 REV-5, ¶ 2-12 and Mortgagee Letter 2005-16, the loan file documented compensating factors that would have offset this slightly higher-than-average ratio. For example, the credit report documented that the borrowers had made 22 months of mortgage payments with only one late payment (**Exhibit J-4**), and the borrowers' housing payment only increased by \$89.39 (**Exhibit J-2**). HUD guidelines expressly recognize that timely payments of housing obligation for at least 12 months and a minimal increase in housing expense are compensating factors. See HUD Handbook 4155.1 REV-5, ¶ 2-13(A), (F). Moreover, the borrower had excellent job stability, as the loan file documented that the borrower had been employed in his position for twelve years (**Exhibit J-2**). While Sterling National appreciates that HUD guidelines require job stability, lenders are required to document a borrower's employment for only two years prior to closing. See HUD Handbook 4155.1 REV-5, ¶ 2-6. Based on these guidelines, a twelve-year history with the same employer demonstrates job stability above and beyond what is required by the Department's guidelines and compensates for higher-than-average ratios. Thus, even considering the \$15 monthly debt, the borrower would have qualified for the FHA-insured loan. Administrative action in this case would be inappropriate, and we request that this finding be removed from the final report.

As a final matter, we note that loan-level data in FHA Connection reports that the borrowers defaulted in this case because of marital difficulties, which often leads to

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income loss. This data, therefore, confirms that reasons other than the Company's origination and underwriting practices caused the default in this instance.

3. Qualifying Ratios

In one loan, **FHA Case No. 043-7417616**, the Report alleges that the borrower's back-end qualifying ratio of 48.62% exceeded HUD's recommended debt-to-income ratios without documented, valid compensating factors in the "Remarks" section of the MCAW. The Company respectfully disagrees with this assertion.

The Department expressly permits a mortgagee to approve FHA financing to a borrower with qualifying ratios that exceed the benchmark guidelines of 31% and 43% where significant compensating factors justify loan approval. See, e.g., HUD Handbook 4155.1, REV-5, ¶¶ 2-12, 2-13; Mortgagee Letter 2005-16. We note that the borrower's front-end ratio in this case was below the 31% threshold and the 48.62% back-end ratio exceeded HUD's benchmarks by only a few percentage points. The Department has professed that the "FHA does not set an arbitrary percent by which ratios may be exceeded, but, rather, FHA relies on the underwriter to judge the overall merits of the loan application and to determine what compensating factors apply and the extent to which those factors justify exceeding the ratios." Mortgagee Letter 00-24 (emphasis added). Thus, where a potential borrower's qualifying ratios are high, an underwriter has to consider all relevant circumstances and exercise discretion in deciding whether to approve or reject a loan. This discretion is particularly important when the same loans underwritten manually could be submitted through an automated underwriting system and approved with much higher qualifying ratios. With different standards for varying types of underwriting, the Department must rely on underwriters to adequately analyze a borrower's financial circumstances and take into account all relevant factors, including the range of acceptable levels in qualifying ratios. 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 Company's underwriter made a reasonable underwriting decision in light of the facts in each case.

It is Sterling National's policy to carefully consider each borrower's circumstances and document significant compensating factors in the "Remarks" section of the MCAW in compliance with HUD guidelines. Contrary to the Report's allegation, the loan file in this transaction documented significant compensating factors that justified approval of this borrower for FHA financing. Importantly, the underwriter noted on the MCAW that the borrower had an excellent payment history on his prior conventional mortgage (**Exhibit K-1**). Although the credit report does not evidence a full twelve-month history of timely mortgage payments on this loan (**Exhibit K-2**), the borrowers had made all prior mortgage payments on time, as well as timely paid all payments in connection with

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a separate home improvement loan. HUD guidelines expressly state that a borrower's successful demonstration of his or her ability to make timely payments or pay housing expenses compensates for higher-than-average ratios. HUD Handbook 4155.1 REV-5, ¶ 2-13(A). Given that the qualifying ratio in this case exceed the back-end threshold by a mere 5.62%, the borrower's timely payment of a combined 9 months of housing expenses was an important indicator of the borrower's ability to repay an FHA-insured loan.

In addition, the borrower's housing payment minimally increased by approximately \$117, which the underwriter described as "no payment shock" on the MCAW (**Exhibit K-1**). HUD guidelines expressly state that a minimal increase in housing expenses offsets higher ratios. *Id.*, ¶ 2-13(F). While Sterling National appreciates, as suggested in the Report, that a borrower must demonstrate the ability to repay the mortgage as a requirement for mortgage approval, the Company properly made this determination based on the complete credit history of the borrower, which the Report does not question. Accordingly, with a minimal increase in mortgage payment and an otherwise low front-end qualifying ratio, Sterling National documented a significant compensating factor in this case.

The loan file also documented that the borrower had accumulated over \$2,600 in cash reserves (**Exhibits K-1 and K-3**) and otherwise maintained few revolving credit accounts. Notably, other than mortgage-related loans and a car loan, both the borrower and co-borrower maintained a handful of credit card accounts, all with current balances (**Exhibit K-2**). These documents evidence that the borrower had the ability to accumulate savings, as well as a conservative attitude towards the use of credit, which HUD guidelines expressly recognize as compensating factors. *See* HUD Handbook 4155.1 REV-5, ¶ 2-13(C). These minimal monthly recurring obligations also demonstrated that the borrower could devote a greater portion of income to making mortgage payments, and the MCAW reflected that the loan-to-value ratio in this instance was only 85% (**Exhibit K-1**).

The above discussion demonstrates that both the MCAW and the loan file documentation supported numerous significant compensating factors in this loan – factors that HUD guidelines expressly state compensate against higher debt-to-income ratios. The underwriter reasonably determined that these valid compensating factors offset the 48.62% ratio in this case and properly noted several of these factors in the Remarks section of the MCAW. We maintain that the Company complied with HUD guidelines in this loan and, as a result, this allegation should be removed from the final report.

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4. Credit Analysis

In one loan, **FHA Case No. 011-5725717**, the Report takes issue with the Company's evaluation of the borrower's credit history, as the file contained a credit report that was missing the final three pages. The Report also claims the explanation provided by the borrower for derogatory items was not sufficient. Specifically, with regard to one account with an outstanding balance of \$3,001 and past-due amount of \$208, the borrower explained that the account was late because the creditor was not collecting the payments. The Report asserts that Sterling National should not have accepted this explanation.

Sterling National respects the importance of analyzing a borrower's credit performance and examining his or her attitude toward credit obligations. It is Sterling National's policy and practice, with respect to every FHA applicant, to scrutinize the applicant's credit record and reasonably determine the potential borrower's creditworthiness. Given the potential risks not only to the Department, but to the Company, of making a poor credit decision, the Company's management 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 in many areas, 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 Sterling National's policy to carefully scrutinize a borrower's credit history to 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 Company's underwriter made a reasonable underwriting decision in light of the facts in each case. Sterling National takes its underwriting responsibility seriously and would never knowingly approve a loan to an unqualified borrower.

In this transaction, Sterling National complied with FHA guidelines by examining the borrower's overall pattern of credit behavior and reasonably determining that the

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borrower qualified for FHA financing. The Company properly considered the borrower's credit report, previous housing obligations, recent and/or undisclosed debts, and credit explanations, and Sterling National's underwriter reasonably determined that past derogatory items did not reflect a current disregard for financial obligations. First, contrary to the Report's allegation that the file contained incomplete documentation, the loan file, in fact, contained all eight pages of the borrower's credit report (**Exhibit L-1**).

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Second, with regard to three outstanding accounts, Sterling National respectfully disagrees with the assertion that the borrower did not explain the reasons for late payments. Sterling National understands and appreciates that it must obtain a written explanation from the borrower regarding all delinquent inquiries shown on a credit report obtained prior to closing, and the Company obtained this required explanation. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3(B). Attached as **Exhibit L-2** is a letter from the borrower, which dictates the reasons for the identified derogatory accounts. While one such explanation is that the creditor was not accepting the borrower's payments, the underwriter reasonably determined there to be nothing insufficient about this explanation. The borrower indicated there was dispute with the Star card and that he was attempting to make the payments on this account. Without a reason to question the borrower's veracity in this explanation, Sterling National complied with FHA guidelines by obtaining a credit explanation from the borrower that sufficiently identified the reasons for the derogatory items.

Sterling National, therefore prudently exercised the discretion granted to it by the FHA in examining the borrower's credit history in this case. As the loan file contains all required credit documentation and the Company made a permissible and reasonable underwriting decision, administrative action in this instance is unwarranted. Thus, this allegation should be removed from the final report.

5. Verification of Borrower's Investment

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The Report alleges, in one loan, **FHA Case No. 105-3453987**, that the borrower did not meet the statutory investment requirement. Notably, the Report states that the MCAW reflected a sales price of \$144,000 and an investment requirement of \$4,320. Yet, the HUD-1 showed that the borrowers made a \$500 earnest money deposit and paid \$2,592.45 in closing costs, which equaled \$3,092.45 in total investment. The Report claims that the HUD-1 does not list any closing costs that were paid outside of closing by the borrowers, which suggests the borrower's statutory investment was short \$1,227.55.

Sterling National 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 \$4,320 (**Exhibit H-2**). As

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indicated in the Report, the borrowers contributed a total of \$3,092.45 in deposits and cash to close the loan, which is reflected on the HUD-1 (**Exhibit M-1**). Moreover, contrary to the Report's allegations, the borrowers paid an additional \$766 in fees outside of closing, including a \$395 underwriting fee to Sterling National (**Exhibit M-1**) and a \$371 fee in pre-paid homeowners insurance to Farm Bureau (**Exhibit M-2**). However, the Company acknowledges that the total amount of funds the borrower should have invested in the property was \$461.55 short of the three percent minimum investment the borrower was required to make and, as a result, the loan was over-insured by \$461.55. That said, the borrower maintained over \$3,000 in cash reserves and \$6,700 in assets (**Exhibit H-2**) and would have easily been able to bring the additional \$461.55 to closing in this case.

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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 Company would be willing to buy down the principal balance of this loan by \$461.55 to remedy the over-insured amount. Sterling National, however, maintains that further administrative action in this instance would be inappropriate, and requests that this recommendation be removed from the final report.

As a final matter, we note that loan-level data in FHA Connection reports that the borrowers defaulted in this case because of marital difficulties, which often leads to income loss. This data, therefore, confirms that the insufficient investment had no bearing on the borrower's default.

6. Skipped Mortgage Payments

In twelve refinance loans, the Report alleges that Sterling National allowed the borrower to skip the last conventional mortgage payment and roll it over into the new FHA mortgage. The Report asserts that each month's mortgage payment generally covers the previous month's interest and principal amounts due; therefore, when a conventional mortgage is refinanced into an FHA mortgage, it is important that all prior payments due are not rolled into the FHA mortgage. After reviewing the payoff statements and HUD-1 Settlement Statements in each of these twelve cases, the Report claims that if the borrowers had made the last mortgage payments, then the payoff amounts at closing would not have equaled an amount over and above the amounts reflected on the payoff statements. We respond to these allegations below in a representative sample of the twelve cases.

The Company understands and appreciates that, during the time these twelve loans were originated, HUD guidelines regarding refinances generally stated that the borrower is "either to make the payment when it is due or bring the monthly mortgage

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payment check to settlement." See HUD Handbook 4155.1 REV-5, ¶ 1-10(E). In accordance with these requirements, contrary to the Reports allegations in one loan **FHA Case No. 263-4019928**, the borrower paid all prior mortgage payments due on the loan. Notably, this cash-out refinance loan closed on June 29, 2007 (**Exhibit N-1**), and the payoff statement, dated June 26, 2007, showed that the loan was due for the July 1, 2007 payment (**Exhibit N-2**). Accordingly, the borrower in this case paid all prior mortgage payments, including the June 2007 payment, before obtaining the FHA refinance mortgage.

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Moreover, in nine of the loans at issue, the transactions were cash-out refinance loans, and the borrowers received cash back at closing as part of the transactions (**Exhibits N-3 through N-11**).² In these circumstances, had the Company required the borrower to bring the mortgage payment check to settlement, the settlement agent would have immediately returned those funds to the borrower in the form of the cash proceeds from the cash-out refinance transaction. To require the borrowers to bring the mortgage payment checks to closing in these circumstances would have constituted form over substance, as the borrowers had made timely payments for at least the previous twelve-month period in order to qualify for the FHA-insured cash-out refinance loan and would have received the funds reflected in the mortgage payment checks immediately upon closing the loan. Thus, for the ease of accounting in these cases, the closing agent included the current mortgage payment in the payoff amount to the existing lender and, as a result, reduced the cash proceeds to the borrower by the amount of the mortgage payment.

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In each of these cases, the inclusion of the mortgage payment for the current month in the payoff amount was done for accounting purposes and had no bearing on the borrower's eligibility for the FHA-insured refinance. Each of the nine borrowers satisfied HUD's criteria for the cash-out refinance loan and had demonstrated their ability to make timely mortgage payments on the existing loans. As the borrowers would have immediately received any mortgage payments brought to closing as part of the loan proceeds, we maintain that any concern regarding this issue was technical in nature and does not warrant indemnification, as these circumstances did not affect the borrowers' eligibility for FHA financing. Accordingly, any administrative action in this

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² These nine loans include: (1) FHA Case No. 011-5725717; (2) FHA Case No. 043-7417616; (3) FHA Case No. 105-3753842; (4) FHA Case No. 137-3791174; (5) FHA Case No. 241-7994157; (6) FHA Case No. 361-3078756; (7) FHA Case No. 371-3791979; (8) FHA Case No. 412-5666814; and (9) FHA Case No. 022-1885701. HUD previously reviewed FHA Case No. 105-3753842 as part of another audit review and identified no deficiencies in the Company's underwriting practices.

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instance would be inappropriate, and the Company requests that these allegations be removed from the final report.

B. STERLING NATIONAL STRONGLY OPPOSES THE RECOMMENDATION THAT PFCRA PENALTIES ARE APPROPRIATE IN THIS CASE

1. Sterling National Exercised Due Diligence in Underwriting the Loans at Issue

In addition to the underwriting deficiencies discussed above, the Report asserts that, in the thirteen 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 predicated on the OIG's determination that these thirteen 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, Sterling National takes exception to the allegations that these loans contained underlying origination deficiencies, as well as to 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 thirteen cases, the underwriters' certifications that due diligence was used in underwriting these loans are inaccurate. As demonstrated in the above discussion, however, in the thirteen cases cited, Sterling National 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, Sterling National 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 Sterling National or its employees intended to circumvent HUD underwriting guidelines

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in these cases. Rather, the certifications in these thirteen 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 Sterling National 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 sanctions, such as PFCRA penalties, HUD traditionally imposes less severe consequences for deficiencies caused by unintentional error. Additionally, Sterling National 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 or the performance of the loans. As indicated above, Sterling National believes that the final report should omit recommendations of administrative action in connection with many of these cases, making the recommendation of PFCRA penalties all the more severe under these circumstances.

Comment 17

We also note that, rather than cite new allegations, the PFCRA recommendation appears to be an attempt to pile on the allegations made against Sterling National'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 and route out fraud and criminal behavior, 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**

Comment 17

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

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independently examine the review findings and make an independent determination of whether such penalties are appropriate in these thirteen cases. As discussed at length earlier in this response, Sterling National 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 allegations that HUD pursue PFCRA remedies with the suggestion that the loans identified involve misrepresentations will have a material, adverse effect on the Company's business. This would be especially detrimental in this circumstance, as the public nature of the "Operation Watchdog" probe has already resulted in significant reputational damage to Sterling National.

If the OIG's goal is to present the reader with a full and accurate disclosure of this review and its implications to the Company, 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 Company's investors, customers, and the public.

iii. CONCLUSION

Sterling National takes the matters raised in the draft Report seriously. The Company 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, Sterling National's review of the loan files at issue indicated that the

Comment 17

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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 Sterling National, or do not affect the underlying loans' insurability or performance. The Company substantially complied with FHA underwriting requirements in almost all 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 Sterling National has demonstrated its compliance with HUD requirements.

Finally, Sterling National 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. Sterling National values its relationship with the Department and did not, in any manner, misrepresent any information to HUD. Sterling National believes that the various remedies available to HUD, short of the severe sanctions under PFCRA, are appropriate 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 Sterling National'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,



Michael Bizenov
President

Attachments

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

OIG's Evaluation of Lender Comments

- Comment 1** In their response, Sterling officials stated that increasingly restrictive underwriting criteria has been implemented due to the rising trend in its compare ratio, which has resulted in a compare ratio of 174 percent as of August 31, 2010. Since our review did not consider the internal controls of Sterling, we did not evaluate Sterling's new underwriting criteria; however, we note that Neighborhood Watch shows that Sterling's compare ratio is no longer more than 200 percent as of August 31, 2010.
- Comment 2** Sterling officials have taken issue with the press release announcing OIG's Operation Watchdog initiative; however, the January 12, 2010 HUD press release does 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 the 15 companies and whether there may have been wrongdoing involved. The detection and investigation of fraud is the responsibility of the Office of Inspector General in each of its audits and reviews. As such, the reviews are proactive in trying to identify systemic problems that HUD needs to address.
- Comment 3** For FHA loan number 137-3791174, Sterling officials agree that the underwriter in this case should have qualify the borrower with a lower amount of monthly income than what was used; however, Sterling officials disagree that compensating factors were not presented and documented. In their response, Sterling officials stated that the mortgage credit analysis worksheet noted no payment shock, which meant that the borrowers experienced a minimal increase of \$54 in their mortgage payment. Since Paragraph 2-13 F of HUD Handbook 4155.1 REV-5 lists a minimal increase in housing expenses as a valid compensating factor, we have revised the deficiency to state that borrower income was incorrectly calculated; however, a valid compensating factor was presented and documented, therefore, the deficiency and the loan was removed from the report.
- Comment 4** For FHA loan number 241-7994157, Sterling officials provided additional documentation supporting the use of overtime income to qualify; therefore, we have removed this deficiency and loan from the report.
- Comment 5** For FHA loan number 361-3078756, Sterling officials state that they documented that the borrower received commission income since 2003; therefore, it should have been included. We disagree because although the borrower had earned commission income in the past, he had only been employed with his current employer for more than two months at the time the verification of employment was signed and Paragraph 2-7 D of HUD Handbook 4155.1 REV-5 states that commissions earned for less than one year are not considered effective income. Regarding the co-borrower's income, Sterling officials state that there are no FHA guidelines requiring the use of year to date earnings to calculate qualifying income. Although this is correct, the verification of employment for the co-

borrower was faxed from the borrower's employer; therefore, it is questionable and should not have been used. By using the year to date earnings from the co-borrower's paystub, we obtain a more accurate calculation of income earned by the co-borrower. Therefore, this loan and deficiency will remain in the report.

Comment 6 For FHA loan number 381-8219106, based on Sterling comments and a second review of Mortgagee letter 2005-43, the material deficiency related to incorrect calculation of income, resulting in excessive ratio has been removed from the report.

Comment 7 For FHA loan number 412-5666814, Sterling officials acknowledge that the borrower's income was incorrectly calculated; however, officials maintain that the file documented significant compensating factors. We disagree because the compensating factors presented of good mortgage payment history, loan to value of 80.82 percent, and decrease in borrower's mortgage payment were not valid. Good mortgage payment history and decrease in mortgage payment are not valid because the borrowers paid their November 1, 2007 mortgage payment thirty days past due. Although HUD may consider a loan to value of 80.82 percent a valid compensating factor, it is not significant enough to justify approving a mortgage with a back ratio of 54.81 percent. In addition, Sterling officials stated that the borrower defaulted due to illness of the primary mortgagor; however, this is not a valid argument to justify not making any payments after receiving over \$9,821 at closing and defaulting on this mortgage with zero payments made. Therefore, this deficiency and the loan will remain in the report.

Comment 8 For FHA loan number 412-5681688, Sterling officials state that there are no FHA guidelines requiring the use of year-to-date earnings to calculate qualifying income and the file documented significant compensating factors. Although this is correct, the income shown on the verification of employment form and used to qualify was not supported by the borrower's pay stub; therefore, it should not have been used. By using the year to date earnings from the borrower's paystub, we obtain a more accurate calculation of income earned by the borrower. Regarding the documentation of significant compensating factors, Sterling officials contend that the child support income for the borrower's other two children, which was not used to qualify is a significant compensating factor regardless of whether such income was expected to continue for the first three years of the mortgage. We disagree because the borrower defaulted on this mortgage with only one payment made and the reason for default was curtailment of borrower income. Therefore, this loan and deficiency will remain in the report.

Comment 9 For FHA loan number 105-3453987, Sterling officials agreed that monthly payments for the two student loans should have been included in the borrowers' back ratio; however, officials stated that the file documented compensating factors of good prior mortgage and significant cash reserves of over \$3,200. We disagree because the borrowers' credit report show that the borrowers paid their July 2007 mortgage payment 30 days past due and paid their August 2007 mortgage payment 60 days past due. Additionally, the borrowers' bank

statements only showed cash of \$5,238.65 and the borrowers needed \$2,592.45 to close, which results in cash reserves of only \$2,646.20. This is only 2.5 months of cash reserves and not the three months required to be a valid compensating factor. Therefore, this loan and deficiency will remain in the report.

- Comment 10** For FHA loan number 241-7994157, Sterling officials agreed that 12 months of on-time payments should have been documented to support excluding the contingent liability of \$395; and officials state that the credit report shows that 22 months of payments have been made without any history of delinquency. Based on our review of the credit report and evaluation of Sterling official comments, we agree that 22 months of on time payments were made. As a result, we have removed the deficiency and the loan from the report.
- Comment 11** For FHA loan number 263-4019928, based on Sterling's response and the fact that the borrowers received cash back at closing of \$1,679.62, which was sufficient to pay off the \$300 credit card balance, we have removed the deficiency and the loan from the report.
- Comment 12** For FHA loan number 043-7417616, Sterling officials agreed that the borrower's back ratio exceeded HUD's benchmark. In their response, Sterling officials stated that the mortgage credit analysis worksheet noted no payment shock, which meant that the borrowers experienced a minimal increase of \$117 in their mortgage payment. Since Paragraph 2-13 F of HUD Handbook 4155.1 REV-5 lists a minimal increase in housing expense as a valid compensating factor, and based on Sterling officials comments, we have removed the excessive ratio deficiency and this loan from the report.
- Comment 13** For FHA loan number 011-5725717, Sterling officials provided all eight pages of the borrower's credit report and a letter of explanation for derogatory accounts; therefore, we have removed the deficiency and the loan from the report.
- Comment 14** For FHA loan number 105-3453987, Sterling officials provided documentation showing that the borrowers' paid a total of \$766 outside of closing for closing costs and was \$461.55 short of the three percent minimum investment. Sterling officials stated that they would be willing to buy down the principal balance of this loan by \$461.55 to remedy the over-insured amount. Since this loan has already gone to claim and HUD experienced a loss of \$61,050, buying down the principal will not provide a remedy. As a result, the deficiency and the loan remain in the report.
- Comment 15** For FHA loan number 263-4019928, Sterling officials provided documentation showing that the borrowers paid their last mortgage payments; therefore, the skipped mortgage payment deficiency and the loan have been removed from the report.

Comment 16 Sterling officials stated that since nine⁹ loans with skipped mortgage payments were cash-out refinances, the borrowers would have paid their last mortgage payments through a reduction in their cash payout. We believe that the Sterling official's explanation is reasonable in that if the borrower would have brought the last mortgage payment to closing, they would have received a higher payout in their cash out refinances. Therefore, we have removed the deficiency related to skipped mortgage payments for FHA loan numbers 011-5725717, 043-7417616, 105-3753842, 137-3791174, 241-7994157, 361-3078756, 371-3791979, and 412-5666814, and we have removed FHA loan numbers, 011-5725717, 043-7417616, 105-3753842, 241-7994157, and 371-3791979 from the report.

Note however, Sterling officials incorrectly stated that loan number 022-1885701 was a cash-out refinance, but it was a no-cash-out refinance. Furthermore, Sterling officials did not address the skipped mortgage payments for this loan and the other two no cash-out refinances (381-8219106, and 412-5681688); therefore, these deficiencies and loans will remain in the report.

Comment 17 Sterling officials believe that the recommendations for remedies under Program Fraud Civil Remedies Act, Civil Money Penalties, and/or administrative action are not appropriate and should be removed from the report. However, we did not change the recommendations because violations of FHA rules are subject to civil and administrative action. Nevertheless, the report does recommend that HUD make determinations of the legal sufficiency of the deficiencies cited and pursue remedies under the Program Fraud Civil Remedies Act, Civil Money Penalties, and/or administrative actions, if necessary.

⁹ Sterling officials mentioned nine cash-out refinance loans instead of eight because they inadvertently included FHA loan number 022-1885701, a no-cash-out refinance loan, in the discussion. While there are nine cash-out refinance loans, FHA loan number 263-4019928, a cash-out refinance loan, was discussed separately in comment 15 above.