



Issue Date	January 13, 2010
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Audit Report Number	2010-AT-1001
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TO: Vicki Bott, Deputy Assistant Secretary for Single Family Housing, (HU)

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FROM: James D. McKay, Regional Inspector General for Audit, Atlanta Region, 4AGA

SUBJECT: Mortgage Counseling Services, Inc., College Park, Georgia, Did Not Follow HUD Requirements in Originating and Closing Loans and Implementing Its Quality Control Program

HIGHLIGHTS

What We Audited and Why

We performed an audit of Mortgage Counseling Services, Inc. (Mortgage Counseling Services), a Federal Housing Administration (FHA)-approved nonsupervised lender, to determine whether the lender followed the U.S. Department of Housing and Urban Development's (HUD) requirements for (1) borrower eligibility and creditworthiness and property eligibility when underwriting loans and (2) implementing a quality control program. We selected this lender because of its high default rates. Based on information received during the audit, we expanded our audit objectives to include reviewing the closing process to determine whether Mortgage Counseling Services complied with HUD requirements when closing loans.

What We Found

Mortgage Counseling Services did not follow HUD requirements when underwriting 8 of 16 FHA loans. This noncompliance occurred because Mortgage Counseling Services experienced high employee turnover and did not adequately supervise the performance of the underwriters. As a result, HUD insured eight loans that unnecessarily placed the FHA insurance fund at risk for more than \$433,000.

Mortgage Counseling Services did not conduct its quality control reviews in a timely manner. In addition, the lender did not report a significant quality control violation to HUD. This noncompliance occurred due to lack of controls to ensure that the quality control function was continuously maintained. As a result, Mortgage Counseling Services did not ensure the accuracy, validity, and completeness of its loan originations.

Mortgage Counseling Services did not fully comply with HUD requirements in closing two loans. Specifically, the lender misrepresented a HUD-1 settlement statement to HUD. In addition, the lender collected an uncustomary and unreasonable appraisal fee after the loan closed. This noncompliance occurred due to a lack of controls to ensure that loans were closed in accordance with HUD requirements. As a result, HUD could not be assured that loans were properly closed, and the noncompliance could result in an increased risk to the FHA insurance fund.

What We Recommend

We recommend that the Deputy Assistant Secretary for Single Family Housing require Mortgage Counseling Services to indemnify HUD for the potential loss on the eight loans with material deficiencies, reimburse HUD for overinsuring one loan, and ensure that Mortgage Counseling Services conducts quality control reviews in a timely manner as required by HUD regulations. We also recommend that the Deputy Assistant Secretary for Single Family Housing take appropriate action against Mortgage Counseling Services for its noncompliance in closing two loans.

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

Auditee's Response

We discussed our review results with Mortgage Counseling Services and HUD officials during the audit. We provided a copy of the draft report to Mortgage Counseling Services officials on November 25, 2009, for their comments and discussed the report with the officials at the exit conference on December 8, 2009. Mortgage Counseling Services provided written comments on December 16, 2009. It generally disagreed with our findings.

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

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BACKGROUND AND OBJECTIVES

Mortgage Counseling Services, Inc., (Mortgage Counseling Services) is a Federal Housing Administration (FHA)-approved nonsupervised lender based in College Park, GA. Nonsupervised lenders can originate, sell, purchase, hold, and/or service FHA-insured mortgages. Mortgage Counseling Services became an authorized FHA loan originator in June 1987. It does not have any active branch offices.

From February 2007 through January 2009, Mortgage Counseling Services originated 204 FHA loans. As of January 31, 2009, 33 of the loans, valued at approximately \$4 million, were at least 30 days delinquent. Thirteen of those loans defaulted within the first six payments. Loans that default within the first six payments are classified as early default loans. Mortgage Counseling Services had a default rate of 13.73 percent. This is significantly higher than the 6.85 percent default rate for the Atlanta, GA, area.

As an FHA-approved lender, Mortgage Counseling Services must implement and continuously have in place a quality control plan for the origination of insured mortgages as a condition of receiving and maintaining FHA approval. Mortgage Counseling Services uses a third-party contractor to conduct its quality control reviews.

On July 23, 2009, we received information regarding some potential violations that occurred with four loans that were closed between April and July 2009. We reviewed the four loans to determine the validity of the alleged violations. The original loan amount of the four loans totaled \$325,311.

Our audit objectives were to determine whether Mortgage Counseling Services followed HUD requirements for (1) borrower eligibility and creditworthiness and property eligibility when underwriting loans and (2) implementing a quality control program. We expanded our audit objectives to include reviewing the closing process to determine whether Mortgage Counseling Services complied with HUD requirements when closing loans.

RESULTS OF AUDIT

Finding 1: Mortgage Counseling Services Did Not Follow HUD Requirements When Underwriting Eight Loans

Mortgage Counseling Services did not follow HUD requirements when underwriting 8 of 16 FHA loans. This noncompliance occurred because Mortgage Counseling Services experienced high employee turnover and did not adequately supervise the performance of the underwriters. As a result, HUD insured eight loans that unnecessarily placed the FHA insurance fund at risk for more than \$433,000.

Underwriting Did Not Meet HUD Standards

Mortgage Counseling Services did not follow HUD's requirements when underwriting eight FHA loans, originally valued at more than \$1 million. FHA-approved lenders must follow HUD Handbook 4155.1, REV-5, Mortgage Credit Analysis for Mortgage Insurance, One- to Four-Family Properties, and HUD mortgagee letters when underwriting FHA loans. Appendix C provides details of HUD underwriting requirements.

Examples of the underwriting deficiencies included the following:

Underreported Liabilities

Mortgage Counseling Services did not adequately assess liabilities of borrowers for two loans. HUD Handbook 4155.1, REV-5, chapter 2, section 4, paragraph 2-11A, requires the lender to include all recurring charges extending 10 months or more. Debts lasting 10 months or less must be counted if the amount of debt affects the borrower's ability to make the mortgage payments during the months immediately after loan closing.¹ For the deficient loans, the lender did not include all liabilities when calculating qualifying ratios and underwriting the loans.

For example, for FHA case number 105-2954735, with an unpaid balance of \$98,072, the lender did not include the income or child support payments of the borrower in qualifying the borrower for the loan. Based on court-ordered documents contained in the file, the borrower was responsible for \$271 in monthly child support payments. The underwriter used only the income of the coborrower in qualifying for this loan and did not include the income or child support payments of the borrower. The underwriter did not want to include the child support payments, so she excluded the income as well for this loan.

¹ See appendix C, criterion 9.

Maximum Mortgage Amount Exceeded

Mortgage Counseling Services did not ensure that the lower of the sales price or appraised value was used to calculate the maximum mortgage amount. HUD Handbook 4155.1, REV-5, chapter 1, section 2, paragraph 1-7, requires that the property's sales price, subject to certain required adjustments, or the appraised value, if less, be multiplied by a loan-to-value ratio. The resulting amount is the maximum mortgage that FHA will insure. The borrower must make a cash investment at least equal to the difference between the sales price and the resulting maximum mortgage amount. The lender must ensure that the appropriate value is used when determining the maximum mortgage amount.²

For FHA case number 105-3002046, originally valued at \$168,667, the lender did not use the appropriate value in determining the maximum insurable mortgage amount. The borrower purchased a newly constructed home. The initial sales contract was dated January 28, 2007, with a sales price of \$157,900. An appraisal was performed on the property on April 19, 2007, through which the property was valued at \$170,000. On April 23, 2007, after the appraisal was complete, the sales contract was amended to increase the sales price to \$170,000. The sales price cannot be increased after the completion of the appraisal to match the appraised value. The lender must use the lower of the sales price or appraised value to determine the maximum mortgage insurable amount. Therefore, the loan was overinsured.

Questionable Credit History

Mortgage Counseling Services did not adequately establish the credit history of the borrower for one loan. HUD Handbook 4155.1, REV-5, chapter 2, section 1, paragraph 2-3, requires the lender to develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider. The lender must document that the providers of nontraditional credit actually exist and verify the credit information.³

For FHA case number 105-3097672, originally valued at \$91,774, the lender did not establish a credit history for the borrower. The borrower provided no credit information in the credit report and did not provide nontraditional letters of credit. The underwriter obtained one utility payment referral, which showed that the borrower was an account holder and had not made a late payment in 12 months. However, there was no payment history information, such as length of service, which would indicate how long the borrower had used the utility service. The lender did not have any additional credit history information.

See appendix E for case studies of loans with significant deficiencies.

² See appendix C, criterion 6.

³ See appendix C, criterion 7.

Underwriters Did Not Perform Adequately

Mortgage Counseling Services experienced high employee turnover from 2007 through 2009. Several employees, including underwriters, did not work very long at Mortgage Counseling Services. Two underwriters, including one employee and the company's president, underwrote the 16 loans reviewed. However, some of the loans were not adequately reviewed before closing.

The president of Mortgage Counseling Services stated that she dismissed the other underwriter due to poor performance. Therefore, the president was the only remaining underwriter in the company. The president stated that she was not always available to review the work of the underwriter and believed that if the files had been reviewed, some of the deficiencies would have been detected before the loans closed.

Loans Containing Material Deficiencies Were Submitted for FHA Insurance

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

Mortgage Counseling Services submitted eight loans that had material deficiencies for FHA insurance. The loans' unpaid principal balances totaled more than \$1 million as of June 2009. Therefore, HUD insured eight loans with increased risk due to underwriting deficiencies. The loans unnecessarily placed the FHA insurance fund at risk for more than \$433,000 in potential losses that may occur if the FHA-insured properties are foreclosed upon and resold for less than the insured amount. HUD should seek indemnification from Mortgage Counseling Services.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing

- 1A. Require Mortgage Counseling Services to indemnify HUD \$433,826 for the eight actively insured loans with unpaid principal balances totaling \$1,032,918. The projected loss is \$433,826 based on the FHA insurance fund average loss rate of 42 percent for fiscal year 2008 (see appendix F).

- 1B. Determine the amount of the overinsured mortgage for FHA case number 105-3002046 and require the lender to repay the determined amount and provide evidence of the principal reduction of the loan.
- 1C. Require Mortgage Counseling Services to establish controls to ensure that the work performed by underwriters is supervised and reviewed before the loan is closed. In addition, the Assistant Secretary should require HUD's Quality Assurance Division perform a review of Mortgage Counseling Services within 9 months to determine whether it has established and implemented adequate controls to ensure that the types of underwriting deficiencies identified are minimized and the work performed by underwriters is supervised and reviewed before closing.

Finding 2: Mortgage Counseling Services Did Not Fully Comply With HUD Quality Control Requirements

Mortgage Counseling Services did not conduct its quality control reviews in a timely manner. In addition, the lender did not report a significant quality control violation to HUD. This noncompliance occurred due to a lack of controls to ensure that the quality control function was continuously maintained. As a result, Mortgage Counseling Services did not ensure the accuracy, validity, and completeness of its loan originations.

Quality Control Reviews Were Not Conducted As Required or on a Timely Basis

Mortgage Counseling Services did not ensure that its quality control reviews were conducted quarterly and within 90 days of closing as required by HUD Handbook 4060.1, chapter 7-6B, and its quality control plan. Because Mortgage Counseling Services closes fewer than 15 loans per month, HUD Handbook 4060.1, chapter 7-6B, requires it to conduct quality control reviews on a quarterly basis. From February 1, 2007, through April 16, 2009, Mortgage Counseling Services conducted only four quality control reviews. At least eight quarterly quality control reviews were required during that period. There were approximately 27 loans examined during the four quality control reviews, of which none was conducted within 90 days of closing.

In addition, Mortgage Counseling Services did not ensure that its early defaults⁴ were reviewed on a timely basis. From February 1, 2007, through April 16, 2009, the lender conducted only two quality control reviews of its early defaults, which were completed on January 14 and April 16, 2009. At least eight quarterly early default reviews were required during that period.

HUD Handbook 4060.1, REV-2, chapter 7, section 7-6A, states that lenders must ensure that quality control reviews are performed on a regular and timely basis, specifically within 90 days of closing. It also requires lenders to review all loans going into default within the first six payments. In addition, it states that lenders closing 15 or fewer loans monthly may perform quality control reviews on a quarterly basis.

⁴ Early payment defaults are loans that become 60 days past due.

Significant Quality Control Finding Was Not Reported to HUD

Mortgage Counseling Services did not report a significant finding contained in its quality control review to HUD. For FHA case number 105-3885875, the borrower forged a letter of employment. During the reverification of employment completed during the quality control review, the employer stated that the letter was forged and provided the authentic employment letter. The quality control contractor informed Mortgage Counseling Services of the forged letter; however, it did not report the violation to HUD. HUD Handbook 4060.1, REV-2, paragraph 7-3J, states that findings of fraud or other serious violations must be immediately referred, in writing (along with any available supporting documentation), to the Director of the Quality Assurance Division in the HUD Homeownership Center having jurisdiction (determined by the State where the property is located). In lieu of submitting a paper report, lenders must use the “lender reporting” feature in the Neighborhood Watch Early Warning System. The forged letter resulted in the termination of the borrower’s employment and contributed to the early default of this loan.

Mortgage Counseling Services experienced high employee turnover and at times did not have anyone in charge of approving its quality control reviews. In addition, the vice president, who was responsible for the quality control function, suffered a serious illness and did not work for an extended period. Mortgage Counseling Services did not have controls in place to ensure that the quality control function was maintained during periods of employee turnover or illness. HUD Handbook 4060.1, chapter 7-1 states that all FHA-approved lenders must implement and continuously have in place a quality control plan as a condition of receiving and maintaining FHA approval. Therefore, Mortgage Counseling Services must ensure that it implements its quality control plan in accordance with HUD requirements.

Mortgage Counseling Services adversely impacted HUD’s quality control program goals of ensuring compliance with HUD’s and the lender’s own origination or servicing requirements throughout its operations, which were designed to protect HUD and the lender from unacceptable risk. Quality control is intended to guard against errors, omissions, and fraud. Untimely quality control reviews do not ensure swift and appropriate corrective action.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing

- 2A. Require Mortgage Counseling Services to ensure that its quality control reviews are conducted in a timely manner and that early default loans are reviewed as required by HUD regulations.
- 2B. Require Mortgage Counseling Services to ensure that all significant quality control findings are reported to HUD as required.
- 2C. Require Mortgage Counseling Services to establish controls to ensure that the quality control function is continuously maintained. In addition, the Assistant Secretary should require the Quality Assurance Division to perform a review of Mortgage Counseling Services' controls within 9 months to determine whether adequate controls have been established to ensure that the quality control function is continuously maintained.

Finding 3: Mortgage Counseling Services Did Not Fully Comply With HUD Requirements in Closing Two Loans

Mortgage Counseling Services did not follow HUD requirements in closing two loans. Specifically, the lender misrepresented a HUD-1 settlement statement and collected an unreasonable and uncustomary fee. This noncompliance occurred because the lender did not have controls in place to ensure that loans were properly closed. As a result, HUD could not be assured that loans were closed in compliance with HUD requirements, which may result in an increased risk to the FHA insurance fund.

Misrepresentation of HUD-1 Settlement Statement

Mortgage Counseling Services submitted an altered HUD-1 settlement statement to HUD. In FHA case number 105-4913683, the lender revised the HUD-1 to reduce the amount of money the borrower owed at closing. The initial HUD-1 showed that the borrower owed \$2,320 at closing. The lender revised the HUD-1 to show that the borrower owed only \$804 at closing. The lender created a lender credit of \$675 and removed the loan discount of \$841, which decreased the amount the borrower owed at closing to \$804 ($\$2,320 - \$675 - \$841 = \804). The lender instructed the borrower to write two postdated checks as follows:

Check number	Check date	Check amount
1108	8/15/2009	\$400
1111	10/15/2009	<u>\$1,116</u>
Total		<u>\$1,516</u>
Note: The total amount in postdated checks (\$1,516) plus the amount paid at closing (\$804) totals the \$2,320 required on the initial HUD-1.		

According to bank statements dated June 15, 2009, the borrower had \$3,330 in her checking account. This loan closed on July 17, 2009. There were no additional verifications completed before the closing. Shortly before the loan closed, the borrower was contacted and told that she had to bring \$2,320 to closing. At that time (July 2009), the borrower stated that she did not have \$2,320 for closing. At this point, the lender should have terminated the loan for lack of sufficient funds to close. However, the president of Mortgage Counseling Services created another HUD-1, reducing the amount of funds needed to close from \$2,320 to \$804. The borrower must have sufficient funds to close the loan. HUD Handbook 4155.1, REV-5, chapter 2, section 3, paragraph 2-10, states that all funds for the borrower's investment in the property must be verified and documented. In addition, 24 CFR (Code of Federal Regulations) 3500.8(b)(1) states that the HUD-1 must show the actual charges paid by the borrower.

Mortgage Counseling Services' president stated that she was not aware of the two postdated checks. However, after we visited the lender in August 2009 to obtain the loan file, the president contacted the borrower and sent her a letter stating that it was improper to collect the additional postdated checks, and the president destroyed the checks. The president stated that the loan was not reviewed after closing, which is why there was no knowledge of the improper activity. The lender should have controls in place to ensure that loans are closed in accordance with HUD requirements.

Collection of Unreasonable and Uncustomary Fees From a Borrower

Mortgage Counseling Services improperly charged a borrower for appraisal fees after the loan closed. In FHA case number 105-4747554, the borrower paid \$1,200 for an appraisal, a credit report, and home inspection fees before closing. The lender was able to use an existing appraisal that was completed within 90 days of the loan closing; therefore, the HUD-1 settlement statement did not show appraisal fee charges. This loan closed in June 2009. After the loan closed, the appraiser submitted a bill to the lender for \$150 for additional work performed on the appraisal based on requirements of the second mortgage. The president contacted the borrower in July 2009 and instructed the borrower to pay the \$150 to prevent the loan from going through closing again. This fee was in excess of reasonable and customary loan fees. According to HUD's Quality Assurance Division, the lender could not require the borrower to pay for costs that were not listed on the HUD-1 and was responsible for absorbing the cost associated with the additional appraisal bill. Further, the lender had a check for \$1,200 from the borrower to cover the appraisal, credit report, and home inspection. The credit report fee was \$38, and the home inspection was \$500, leaving \$662 remaining from the \$1,200 check. Therefore, the additional funds were not required from the borrower after closing.

Mortgage Counseling Services' president stated that because the borrower did not have to pay the full appraisal amount, Mortgage Counseling Services saved the borrower money and was justified in requesting the additional \$150. HUD Handbook 4000.2, chapter 5-2, states that the lender may collect customary and reasonable fees and charges from the borrower. This additional appraisal fee after the loan closed was not customary or reasonable. Once we discussed the violation with the president in October 2009, the president corrected the HUD-1 settlement statement to reflect the additional \$150 charge and provided the corrected HUD-1 to the borrower. This action violated 24 CFR 3500.8(c), which states that a revised HUD-1 must be provided within 30 calendar days after settlement.

Conclusion

Mortgage Counseling Services did not fully comply with Federal requirements in closing two loans. The lender misrepresented the HUD-1 submitted to HUD by altering the charges and credits applied on the HUD-1 to decrease the amount of funds required for closing. In addition, the lender charged a borrower for an appraisal fee that was charged after the loan closed. Any charges that occur after the loan closes are customarily absorbed by the lender. These improper closing activities created an increased risk to the FHA insurance fund.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing

- 3A. Require Mortgage Counseling Services to indemnify HUD \$35,231 for the loan with the misrepresented HUD-1 and an unpaid principal balance of \$83,884. The projected loss is \$35,231 based on the FHA insurance fund average loss rate of 42 percent for fiscal year 2008.
- 3B. Take appropriate action against Mortgage Counseling Services for its noncompliance in closing two loans.
- 3C. Require Mortgage Counseling Services to establish controls to ensure that it follows HUD requirements when closing loans.

SCOPE AND METHODOLOGY

Mortgage Counseling Services originated 204 FHA-insured loans, valued at more than \$25 million, with beginning amortization dates from February 1, 2007, through January 31, 2009. Thirty-three of the loans were at least 30 days delinquent. Thirteen of the loans defaulted within the first six payments. We selected 16 of the defaulted loans, including five early defaults, based on the number of payments before default, loan amounts, and whether the loans were reviewed by HUD's Quality Assurance Division during its December 2007 review. We did not select any loans that were previously reviewed by the Quality Assurance Division. The remaining eight early default loans were not selected because they were either reviewed by the Quality Assurance Division or were refinance transactions. The original mortgage amounts for the 16 selected loans totaled \$2,052,905. On July 23, 2009, we received information regarding some potential violations that occurred with four loans that were closed between April and July 2009. We reviewed the four loans to determine the validity of the alleged violations. The original loan amount of the four loans totaled \$325,311. Our results only apply to the items selected and cannot be projected to the universe or population.

To accomplish the audit objectives, we

- Obtained an understanding of applicable laws and regulations that related to single-family requirements;
- Reviewed Mortgage Counseling Service's loan case files and analyzed the lender's evaluation and documentation of income, assets, credit histories, liabilities, borrower eligibility, qualifying ratios, and compensating factors;
- Reviewed Mortgage Counseling Service's quality control plan and quality control review reports and analyzed the plan and reports to determine whether they complied with HUD requirements;
- Reviewed Mortgage Counseling Service's management controls over originating FHA-insured loans;
- Reviewed the closing attorney's files associated with the four additional files selected;
- Interviewed Mortgage Counseling Service's staff to obtain information regarding its policies and procedures;
- Discussed findings with the Atlanta HUD Quality Assurance Division; and
- Obtained information and guidance on and discussed findings with the Washington D.C. HUD Quality Assurance Division.

We used data maintained by HUD in the Neighborhood Watch Early Warning System for background information and in selecting our sample of loans for review. The Neighborhood Watch Early Warning System is intended to aid HUD staff in monitoring lenders and programs and to aid lenders and the public in self-policing the industry. The system is designed to highlight exceptions so that potential problems are readily identifiable. In addition, the system gives the ability to identify and analyze patterns, by geographic area or originating lender, in loans which became 90 days delinquent during their first 2 years. We did not rely on the data as a basis for our conclusions. Therefore, we did not assess the reliability of the data.

We classified \$469,057 as funds to be put to better use. This is 42 percent of the \$1,116,802 in unpaid principal balances in nine FHA-insured loans that did not meet HUD's requirements. We used 42 percent because HUD has determined that upon sale of the mortgaged properties, FHA's average loss was about 42 percent of the unpaid principal balance for fiscal year 2008.

Our review generally covered the period February 1, 2007, through March 31, 2009, and was extended as necessary during the audit. We performed work at the Home Ownership Center in Atlanta, GA, and at Mortgage Counseling Service's home office located in College Park, GA. We performed the review from March to October 2009.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

INTERNAL CONTROLS

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

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

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

Relevant Internal Controls

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

- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that the loan origination process complies with HUD program requirements.
- Safeguarding of resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- Mortgage Counseling Services did not follow HUD requirements when underwriting eight loans (see finding 1).
- Mortgage Counseling Services did not fully comply with HUD quality control requirements (see finding 2).
- Mortgage Counseling Services did not fully comply with HUD requirements in closing two loans (see finding 3).

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

<u>Recommendation number</u>	<u>Funds to be put to better use 1/</u>
1A	\$ 433,826
3A	\$ 35,231
Total	<u>\$ 469,057</u>

1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified.

Implementation of our recommendations to require Mortgage Counseling Services to indemnify HUD for materially deficient loans will reduce the risk of loss to the FHA insurance fund. The amount above reflects that upon sale of the mortgaged properties, FHA's average loss experience is about 42 percent of the unpaid principal balance, based upon statistics provided by HUD.




Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Comment 1

	MORTGAGE COUNSELING SERVICES, INC.	
December 15, 2009		
Mr. James D. McKay Regional Inspector General for Audit U. S. Dept of Housing and Urban Development Region 4, Office of Inspector General 75 Spring Street, SW, Room 330 Atlanta, Ga. 30318-3369		
Dear Mr. McKay:		
Attached please find our response to the Audit conducted by your office. We have addressed each loan situation individually.		
The original auditors who conducted the audit relayed that we would be given the report and allowed time to respond to the report. When they originally left our office on May 21, 2009, we were told of only three issues. We realize that additional files were requested but because we were not advised of any additional findings in advance of your written report, we do not feel we have had sufficient time to fully respond.		
We would welcome the opportunity to speak with the auditors again in my office regarding the findings to further clarify their requests and provide additional documentation.		
The responses on loans on which there is a specific Federal Codes reference have been replied to without benefit of Legal Counsel due to your instructions not to disseminate the report.		
We would like to commend your staff on their professionalism. They were courteous and considerate to me and my staff.		
Sincerely,		
 Mary Ann White CEO/President	 EQUAL HOUSING OPPORTUNITY	
2565 Jolly Road Suite 250 Atlanta Georgia 30349		
Tel 404 767 5400 Fax 404 767 5559		
FLORIDA	GEORGIA	LOUISIANA

Quality Control Reviews

Your statement: "MCS did not conduct its quality control reviews in a timely manner. This non compliance occurred due to lack of controls....."

Our response: It appears from my records that HUD has conducted an audit of MCS every two years since 1990 and a review of our Quality Control Plan and Procedures was made in each of the previous audits. We have never failed to comply with QAD requirements in a timely manner and we have used the same controls to meet guidelines since receiving our DE.

The internal situation that caused the oversight on defaulted loans has been corrected and we do not anticipate this occurring in the future. One specific servicing lender failed to report changes in the CHUMS system in a timely manner which delayed the default information showing on Neighborhood Watch. We now transfer all servicing in this office when the loan is sold.

Defaults are audited when they appeared on our Neighborhood Watch report or were brought to our attention thru some other means. We audit not only early payment defaults but other defaults as well.

I would also like to note that we were audited by the Atlanta HUD QAD in December, 2007. They requested and were supplied all quality control reports for the previous year which included the period in dispute. No further action was required by them at that time.

We began doing business in Middle and South Georgia in 2007 and 2008 and also dealing with manufactured home business. We saw a tremendous change in our default ratio due to these non-performing loans. We no longer originate this type of business or in these underserved areas. We made changes to our credit standards and asset requirements before the market moved in a more conservative direction. We are concerned about our default rate and are making every effort to improve our loan quality.

Comment 2

FHA Case No. 105-3212712
Questionable Employment History

The Co-Borrower turned 18 years old in March 2007. She purchased in Sept 2007. We verified that she has been employed since her 18th birthday. Even if she had worked prior to her 18th birthday we would not have counted it in work history since she would not have been of legal age.

If we cannot discriminate because of age then the fact that she had limited or no work experience prior to turning 18 would not necessarily have prompted a rejection of the loan. We see many young people who do not attend college, leave school, begin employment, or marry and start families at a young age. This does not necessarily make them an unacceptable risk.

There was six months of reserves after closing. This amount is more than we see with purchasers twice their this age. There was no household debt and the property was a new home which would be energy efficient and require little or not maintenance in the early years.

We feel the underwriter should have required a longer employment history or proof of school attendance when accepting less than 2 years employment. This was clearly an error I judgment not an attempt to defraud HUD. This underwriter is no longer with the company. We have put additional underwriting controls in place to prevent this from happening in the future.

FHA Case No. 105-3885875
Forged Offer of Employment Letter

Please note that we voluntarily submitted this loan to the Auditor for review. It was not requested.

We attempted to contact the Borrower at work and discovered that she was not longer employed. Even though the loan was not in default at that time, we instituted a quality control review of the file. Upon the return of the quality control review and the report of the "supposed" fraud the file was returned to underwriting for additional review.

July 2007 –The Borrower came to the office to apply for a loan. The letter in question was provided August 13, 2007. She was denied the loan due to length of time on her job. We told her she could reapply once she had at least six months on the job.

May of 2008 – The Borrower returned to MCS to apply again for a loan for proposed construction that would be finished in July which would give her one full year of employment.

July 2008-The Borrower closes on her home loan.

Nov.2008-MCS discovers she is no longer on her job and we send file for qualify control.

December 17, 2008-We are advised that we have a forged document in our file.

December 2008-Upon reviewing our file we did not find the "forged" document in the copy of the case binder we have maintained in the office. Upon further review we find that the 2007 file has been commingled with the 2008 file when sent to quality control for review. We did not rely on the forged letter for approval. We do not accept letters from employers as documentation of employment. We had a written verification of employment, pay stubs, W'2's, and 4506 transcripts in the file to verify employment.

The letter contained some exaggerated references to the Borrower's abilities but the income earned amount was true and correct. Her employer was contacted as to the reason for the Borrower's discharge and she stated that it was not because of the letter. She only received the letter after the Borrower had been discharged.

Our failure to report this incident is a matter of interpretation of the guideline and what is deemed fraud.

Comment 3

Comment 4

FHA Case No. 105-3231684
Overstated Income/Excessive Ratios

The file was sent for quality control and was reviewed by the Investor prior to purchase so I know there was a pay stub reflecting the \$700.00 in the file, however, I could not locate in our copy so I requested a payroll history from her employer.

Attached is a copy of the "Employee Payroll Voucher Register" showing a start date of 9/17/2007 and weekly payroll of \$700.00 per week. She had previously been employed by the IHOP chain of restaurants and had moved from one franchisee to another.

The checks you were looking at were her "old" position with another franchisee, Solar International, prior to 9/17/2007.

Attachments: (2)

Comment 5

FHA Case No.. 105-2954735
Underreported Liabilities

The child support debt was on the 1003 signed at closing, so it was reported however the underwriter did not include the Borrower's debt or income as part of the loan transaction. The Borrower was supposed to have been deleted from the loan application but this was not properly processed. This was an oversight by the Underwriter and the closing department. The additional debt would increase the debt 48.6.

Due to the husband being a 1099 employee and his only employer was a small company that did not write checks, we would not allow the income to be used to qualify for the loan. The Borrower was paid in cash. The employer was willing to write a letter as to the amount paid to the Borrower but no weekly paychecks were issued. No quarterly tax payments were made as he had no tax liability due to earned income limits.

The tax returns of the Borrower were validated and the previous three years income was substantiated. He had worked thru the same employer for the previous three years. The bank account statement showed routine deposits. While the underwriter felt comfortable that the Borrower was earning the funds stated, the income was not included as effective income due to the overall "quality of the verification documentation". Had this been included it was more than sufficient to offset the debt.

The situation in the household would have been the same if the Borrower had been removed so the affect on the loan the loan would have been the same.

The initial contact with the Borrower's was made prior to the wife's graduation from Nursing School. We required her to graduate, have her state license and be employed before we would close the loan. We used no overtime, shift differential or weekend work income to qualify her or to offset the child support of the husband.

When we have investigated this loan we have found that the Borrower incurred a \$317.00 auto debt in April 2007 along with additional installment accounts. He quit his job subsequent to the closing of the loan. The wife is still working for the same employer. She has had steadily increasing income.

Comment 6

FHA Case No. 105-3097672
Questionable Credit History

Her VOR showed her being at 2942 Harland Drive, East Point, Ga. 30344 from December 2005 until May 2007. It is reasonable to assume that the utility period would also be from that date. The utility states that she had no late payments for the previous 12 months. 12 months is a length of service.

We also provided a prior rental history for 4 years from Feb. 2003 until Nov. 2005 and Dec. 2005 through May 2007 which reported no late payments on her rent.

The 2008-11 Mortgagee letter's guidance indicates she should have no history of delinquency on rent and no collection accounts. She also had no medical bills outstanding or any other form of delinquent credit.

We often find little or not credit history among low and moderate borrowers. We have never encouraged them to go out and get credit due to limited resources. We understand HUD's position on credit has changed and so we have followed suit on current Borrowers.

I have spoken to the Borrower and she is still at her same job. She was able to get credit after she got the house, unfortunately for her and us she could not control herself. She is currently in modification with CHASE.

Comment 7

FHA Case No. 105-4913683
Misrepresentation of HUD-1

December 2008- Borrower made application for a home loan and was provided a GFE showing her needing \$3,622.15 for closing. Property undetermined at this time.

May 2009- Borrower finds a property and a new GFE is issued stating that she needs \$448.53 for closing.

July 2009 –Borrower’s loan is underwritten and the underwriter determines that the GFE is incorrect and Borrower needs \$2,504.63 for closing.

A PRELIMINARY HUD-1 is prepared and circulated to the parties concerned for review. This is a foreclosure sale and the seller requires the HUD a minimum of 3 days in advance for closing.

After several discussions with the Borrower and Loan Officer regarding the failure of the loan officer to properly disclose the increase in funds needed for closing, we amended the closing costs to the Borrower and issued a new GFE disclosing the funds to close of \$804.63. The new HUD is sent to the Seller and the agents for review prior to closing.

This reduction in cost to the Borrower had nothing to do with available funds to close as we had verified \$5,038.18 available for closing. It had everything to do with the repeated attempts by this company to bring a “renegade” employee into compliance.

To my knowledge no additional verifications of funds prior to closing have to be performed once the underwriter has approved the file. We routinely update assets to within 30 days of closing as was the situation this time. The Borrower never stated she did not have the funds to close. She stated that she had planned a vacation and was not prepared to use all of her available funds for closing as she had not been previously told that she would need this amount for closing.

I did not feel it was in the Buyer’s interest to delay her closing or penalize her further for the loan officer’s failure to follow company policy. In the past 10 years hundreds of our files have been audited by HUD without any findings of impropriety. There has never been a complaint filed against my company at the State level or the Federal level and we pride ourselves on doing what is in the Borrower’s and HUD’s best interest even if it cost us money.

Every file is reviewed after closing by the shipping department. If the checks had been in the file they would have brought this to my attention immediately. I did what I was advised to do by counsel to correct the problem. There was no additional risk posed to HUD.

Comment 8

FHA Case No. 105-4747554

Collection of Unreasonable and Uncustomary Fees from a Borrower

The Borrower applied for a first and second mortgage with MCS. Both loans required appraisals. In addition, the second mortgage required a home and HQS inspection be provided with the underwriting file.

The cost of these upfront fees were approximately \$1,200.00

Appraisals \$800.00

Home Insp/HQS 400.00

When we ordered the case number we discovered that the appraisal had already been completed and paid for by another Borrower for another Lender. We requested that the appraisal be transferred.

In order for the appraisal to be acceptable for the second mortgage program there were additional items that had to be added to the appraisal. This allowed the same appraisal to satisfy both the first FHA and second loan requirements. The changes that were requested were billed by the Appraiser after closing but were a necessary part of the second mortgage approval process. The statement that it was the servicing lender's request is inaccurate. DCA supplied the funds for the second mortgage loan.

The loan closed on June 26, 2009 and the bill was tendered on June 29, 2009. On June 23, 2009 the appraiser did not indicate there was going to be any additional charge to the Borrower therefore we closed without the charge reflecting on the HUD. When we received the bill MCS sent a letter to the Borrower explaining the situation and requesting reimbursement of the expense. MCS paid the appraiser on 7/7/09. We paid this before there it was reimbursed by the Borrower since this could have become a potential lien on the Borrower's home and could have taken precedence over the first mortgage loan.

Perhaps the appraiser should reimburse the Borrower since he stated on June 23, 2009 that there was not going to be any additional charge.

The full amount the Borrower prepaid was credited back to the Borrower at closing. MCS did not retain any portion of the advanced funds as indicated in your letter. It is normal and customary to place all charges for services on the back of the HUD and monies paid upfront are credits placed on the front of the HUD as is shown on Mr. Mbenga's HUD-1. It also reflects that fact that he paid nothing for the appraisals.

It was at the suggestion of the auditor we sent a corrected HUD. The seller was Fannie Mae and they had refused to make any changes or accept a corrected HUD therefore we had not previously sent one to the Borrower. The fee was not unreasonable or uncustomary as is suggested. In fact our actions saved the Borrower \$650.00.

Comment 9

FHA Case No. 105-3105552
Underreported Liabilities – Rental Property Conversion

The co-borrower was leasing her home to move in with her daughter. The lease was signed and dated on 6/1/2007, This date appears on the last page of the lease.

The security deposit was documented as paid on 7/5/2007. We verified that the security deposit was received and deposited into the co-borrowers account on 7/6/07.

The actual residency by the tenant was to begin 8/1/2007.

The new property loan closed on July 27, 2007. If the owner is still in the home until 7/27/07 so the new tenant could not occupy before 8/1/2007.

We verified that the previous mortgage was current and paid on time for the previous twelve months and the co-borrower had sufficient cash reserves after closing to cover the previous housing debt for more than 12 months. The original date of acquisition of the “rental property” was 1997. Based on the guidelines in place at that time we properly reported the debt.

Comment 10

FHA Case No. 105-3002046
Maximum Mortgage Amount Exceeded

It is stated that the property was originally valued at \$168,667. I do not see anything in the file that relates to that value. The appraisal in the file shows the appraised value was always \$170,000.00.

The sales price did change. We are not a party to the sales contract according to the 4155.1 Rev-5, 3-9. The guidelines state that the loan amount be based on the lesser of the sales price or appraised value was followed. According to the 4155.1 Rev-5, 3-9, we closed the loan in accordance with HUD requirements.

The maximum insurable loan for a sales price and appraised value of \$170,000 was \$166175.00. We are in compliance with HUD guidelines.

Comment 11

FHA Case No. 105-3095528
Unpaid Tax Liens

FEDERAL TAX LIEN

IRS Publication 594-The IRS Collection Process, Page 4, Paragraph "TIME PERIOD FOR COLLECTING TAXES" clearly state that by law, the IRS has the authority to collect outstanding Federal taxes for 10 years from the date the tax liability was assessed. Page 7- Paragraph "RELEASING A LIEN" states that a lien releases automatically if the IRS does not file it again. ITEM 4 would have automatically released as it was more than ten years old.

The Federal Tax lien item 4 dated January 96 for \$7,434.00 was REFILED as part of tax lien item 1. We received from the IRS an updated LTR 2603C showing that 1996, 2001, 2002, 2003, 2004 and 2005 taxes were being filed as a lien and the balance due was \$13,899.00 with a monthly payment due of \$105.00. I feel certain that if their had been any other outstanding tax liability to the IRS at that time the IRS would have placed that information on the form 668 provided on April 4, 2007 and filed in the Clerk's Office.

If the IRS intended to enforce the lien filed in 1996 in California, then they would have had to file the lien again according to their publication 594. Per my conversation with the IRS regarding this matter, the 1996 debt was included in the lien filed in April 2007 in Georgia. This merger of the liens leaves only one IRS lien with a payment of \$105.00 per month and a balance of \$13,899.00.

We have always relied definitively on the 2603C letter for the monthly installment amount and the accompanying lien as proof of IRS debt. I do not know of any other way to verify the current amounts due the IRS.

STATE TAX LIEN

The State of California refused to provide any additional information to us other than the installment agreement was \$100.00 per month. This was additionally verified with copies of cancelled money orders. This is a "foreign" lien in that it has never been recorded in Georgia therefore it does not effect the title. We included this monthly debt in their ratio for qualifying.

OIG Evaluation of Auditee Comments

Comment 1 Mortgage Counseling Services stated that "the original auditors who conducted the audit relayed that we would be given the report and allowed time to respond to the report. When they originally left our office on May 21 2009, we were told of only three issues. We realize that additional files were requested but because we were not advised of any additional findings in advance of your written report, we do not feel we have had sufficient time to fully respond."

The OIG met with Mortgage Counseling Services on October 20, 2009, to discuss the additional finding that would be included in the report. In addition, we provided the draft audit report to Mortgage Counseling Services on November 25, 2009, and we discussed the report with them at the exit conference held on December 8, 2009.

Comment 2 Mortgage Counseling Services stated that they have been reviewed by HUD program staff every two years since 1990 and a review of its Quality Control Plan and Procedures was made in each of the previous audits. The lender stated they were also audited by the Atlanta HUD Quality Assurance Division in December 2007. The lender stated HUD requested and were supplied all quality control reports for the previous year which included the period in dispute. The lender contended no further action was required by them at that time.

Our audit period covered February 1, 2007 through March 31, 2009. The Quality Assurance Division reviewed Mortgage Counseling Services in December 2007. Their report contained one finding related to loan origination. In addition, the report also contains observations, which were issues that were discussed at the close-out conference and considered resolved. The report cited that Mortgage Counseling Services must ensure that their quality control contractor conducted reviewing according to HUD/FHA guidelines. Therefore, HUD's Quality Assurance Division did note deficiencies in Mortgage Counseling Services quality control plan and procedures.

Comment 3 Mortgage Counseling Services stated that although the forged letter contained some exaggerated references to the borrower's ability, the income earned amount was true and correct. The lender said it did not rely on this letter as income documentation for the borrower. In addition, the lender contended their failure to report this incident is a matter of interpretation.

Findings of fraud or other serious violations must be immediately referred, in writing, along with any available supporting documentation, to the Director of the Quality Assurance Division in the HUD Homeownership Center having jurisdiction determined by the State where the property is located. In lieu of submitting a paper report, mortgagees must use the Lender Reporting feature in the Neighborhood Watch Early Warning System report all fraudulent activities disclosed in its quality control reviews to HUD in accordance with HUD

requirements. Therefore, the lender should have notified HUD of the forged employment letter.

Comment 4 Mortgage Counseling Services stated there was documentation in the file to support the income; however, they could not locate the documentation. The lender requested the borrower's payroll history from the employer to show that the borrower earned \$700 a week.

The income documentation was from September 28, 2007 through December 31, 2007. This loan closed on October 15, 2007. Therefore the documentation provided did not fully support the income used to qualify the borrower for this loan.

Comment 5 Mortgage Counseling Services stated that the child support debt was reported on the Uniform Residential Loan Application at closing; however, the underwriter did not include the borrower's debt or income as part of the loan transaction. The borrower was supposed to be deleted from the loan application but this was not properly processed. This was an oversight by the underwriter and the closing department. Although the child support was reported, it was not used by the underwriter in qualifying the borrower for the loan. Mortgage Counseling Services also stated that due to the borrower being a 1099 employee and his only employer was a small company that did not write checks, they would not allow the income to be used to qualify for the loan. While the underwriter felt comfortable that the borrower was earning the funds stated, the income was not included as effective income due to the overall "quality of the verification documentation." Mortgage Counseling Services added that had this been included it was more than sufficient to offset the debt. The situation in the household would have been the same if the borrower had been removed so the affect on the loan would have been the same.

HUD requires that the borrower's liabilities be included to determine the borrower's ability to make mortgage payments. HUD also requires that the borrower and co-borrower's income, assets, liabilities, and credit history are considered in determining creditworthiness and the borrower's ability and willingness to repay the mortgage debt. Therefore, the lender should not have approved the loan without including the borrower's income and liabilities.

Comment 6 Mortgage Counseling Services stated that they obtained verification of rent from December 2005 through May 2007. They also obtained a verification of utility payments for 12 months.

The lender cited Mortgagee Letter 2008-11 as the basis for the nontraditional credit evaluation and verification. However, Mortgagee Letter 2008-11 was not effective until April 29, 2008. This loan closed on July 27, 2007, which is almost a year before the criteria became effective. In addition, Mortgagee Letter 2008-11 requires three credit references in verified non-traditional credit. The verification

of rent and one utility bill are not sufficient according to HUD requirements. The underwriter obtained one utility payment referral, which showed that the borrower was an account holder and had not made a late payment in 12 months. However, there was no payment history information, such as length of service, which would indicate how long the borrower had used the utility service. The lender did not have any additional credit history information. Therefore, the lender did not adequately establish acceptable credit history when using only one nontraditional letter of credit.

Comment 7 Mortgage Counseling Services stated that after several discussions with the borrower and loan officer regarding the failure of the loan officer to properly disclose the increase in funds needed for closing, they amended the closing costs to the borrower and issued a new good faith estimate disclosing the funds to close of \$804.63. In addition, Mortgage Counseling Services stated they did not feel it was in the buyer's interest to delay the borrower's closing or penalize the borrower further for the loan officer's failure to follow company policy.

The altered HUD-1 settlement statement resulted in a misrepresentation to HUD.

Comment 8 Mortgage Counseling Services stated that in order for the appraisal to be acceptable for the second mortgage program there were additional items that had to be added to the appraisal. This allowed the same appraisal to satisfy both the first FHA and second loan requirements. The changes that were requested were billed by the appraiser after closing but were a necessary part of the second mortgage approval process. Mortgage Counseling Services added that the loan closed on June 26, 2009, and the bill was tendered on June 29, 2009, for the additional items that were required on the appraisal for the second mortgage program. In addition, Mortgage Counseling Services stated the full amount the borrower prepaid was credited back to the borrower at closing and they did not retain any portion of the advance funds as indicated in your letter.

Based on our review, we determined the lender charged a borrower for an appraisal fee that was charged after the loan closed. Any charges that occur after the loan closes are customarily absorbed by the lender.

Comment 9 Mortgage Counseling Services stated that the co-borrower was leasing her home to move in with the borrower. The lease was signed on June 1, 2007, with a move-in date of August 1, 2007. This loan closed on July 27, 2007. The lender states that they verified that the previous mortgage was current and paid on time for 12 months, and the co-borrower had sufficient cash reserves after closing to cover the previous housing debt for more than 12 months.

The co-borrower's mortgage is a contingent liability. Therefore, the mortgage payment should have been included in the debt ratio calculation. In addition, the liability was large enough to adversely affect the borrower's ability to make the mortgage payment immediately after closing.

Comment 10 The \$168,667 is the original insured value of the loan. Our report does not state a property value of \$168,667. The report states the original sales price of the property was \$157,900. After the appraisal was completed with an appraised value of \$170,000, the sales price was increased to \$170,000 to match the appraised value. The lender must use the lower of the sales price or appraised value to determine the maximum mortgage insurable amount. Therefore, the loan was overinsured.

Comment 11 Mortgage Counseling Services stated that according to a conversation with IRS regarding this matter, federal tax lien item 4 was re-filed with another tax lien filed in April 2007. The lender added according to IRS Publication 954, tax liens are automatically released after 10 years. The lender also stated that the State of California refused to provide any additional information to them other than the installment agreement was \$100 per month.

The lender's files did not document the status of all five tax liens. The borrowers had five tax liens on their credit report at the time of loan closing. The lender documented a payoff on one tax lien and installment payment agreements on two other tax liens. However, the lender did not document the status of the remaining two tax liens, nor was there any documentation that provided explanations for the tax liens.

Appendix C

CRITERIA

Criterion 1

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

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

Criterion 2

HUD Handbook 4155.1, REV-5, chapter 2, section 3, paragraph 2-12, states that ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. The lender must compute two ratios:

- A. Mortgage payment expense to effective income. If the total mortgage payment (principal and interest, escrow deposits for real estate taxes, hazard insurance, the mortgage insurance premium, homeowners' association dues, ground rent, special assessments, and payments for any acceptable secondary financing) does not exceed 29 percent of the gross effective income, the relationship of the mortgage payment to income is considered acceptable. A ratio exceeding 29 percent may be acceptable only if significant compensating factors are documented and are recorded on the mortgage credit analysis worksheet. Typically, for borrowers with limited recurring expense, greater latitude is permissible on this ratio than on the total fixed payment ratio described below.
- B. Total fixed payment to effective income. If the total of the mortgage payment and all recurring charges does not exceed 41 percent of the gross effective income, the relationship of total obligations to income is considered acceptable. A ratio exceeding 41 percent may be acceptable only if significant compensating factors are documented and are recorded on the mortgage credit analysis worksheet.

Criterion 3

HUD Handbook 4060.1, REV-2, paragraph 7-3J, states that findings of fraud or other serious violations must be immediately referred, in writing (along with any available supporting documentation), to the Director of the Quality Assurance Division in the HUD Homeownership Center having jurisdiction (determined by the State where the property is located). In lieu of submitting a paper report, lenders must use the “lender reporting” feature in the Neighborhood Watch Early Warning System.

Criterion 4

HUD Handbook 4155.1, REV-5, chapter 2, section 1, paragraph 2-5B, states that if the borrower, as revealed by public records, credit information, or HUD’s Credit Alert Interactive Voice Response System, is presently delinquent on any Federal debt (e.g., U.S. Department of Veterans Affairs-guaranteed mortgage, Title I loan, Federal student loan, Small Business Administration loan, delinquent Federal taxes) or has a lien, including taxes, placed against his or her property for a debt owed to the United States, the borrower is not eligible until the delinquent account is brought current, paid, or otherwise satisfied or a satisfactory repayment plan is made between the borrower and the Federal agency owed and is verified in writing. Tax liens may remain unpaid provided the lien holder subordinates the tax lien to the FHA-insured mortgage. If any regular payments are to be made, they must be included in the qualifying ratios.

Criterion 5

HUD Handbook 4155.1, REV-5, chapter 2, paragraph 2-2A, states that borrowers and coborrowers take title to the property and are obligated on the mortgage note and must also sign the security instrument. The coborrower’s income, assets, liabilities, and credit history are considered in determining creditworthiness.

Criterion 6

HUD Handbook 4155.1, REV-5, chapter 1, section 2, paragraph 1-7, states that the property’s sales price, subject to certain required adjustments as described in A-C below, or the appraised value, if less, is multiplied by a loan-to-value ratio. The resulting amount is the maximum mortgage that FHA will insure. The borrower must make a cash investment at least equal to the difference between the sales price and the resulting maximum mortgage amount.

Criterion 7

HUD Handbook 4155.1, REV-5, chapter 2, section 1, paragraph 2-3, states that for those borrowers without established credit history and for those who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider. The lender must document that the providers of nontraditional credit do, in fact, exist and verify the credit information. Documents confirming the existence of a nontraditional credit provider may include a public record from the State, county, or city records or other means providing a similar level of objective confirmation. To verify the credit information, lenders must use a published address or telephone number for that creditor.

Criterion 8

HUD Handbook 4155.1, REV-5, chapter 2, section 2, paragraph 2-6, states that we do not impose a minimum length of time a borrower must have held a position of employment to be eligible. However, the lender must verify the borrower's employment for the most recent 2 full years. If a borrower indicates that he or she was in school or in the military during any of this time, the borrower must provide evidence supporting this claim, such as college transcripts or discharge papers. The borrower also must explain any gaps in employment spanning one month or more.

Criterion 9

HUD Handbook 4155.1, REV-5, chapter 2, section 4, paragraph 2-11A, states that the borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other recurring charges extending 10 months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts, alimony, etc. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing.

The following additional information deals with revolving accounts and alimony payments:

1. If the account shown on the credit report has an outstanding balance, monthly payments for qualifying purposes must be calculated at the greater of 5 percent of the balance or \$10 (unless the account shows a specific minimum monthly payment).
2. Because of the tax consequences of alimony payments, the lender may choose to treat the monthly alimony obligation as a reduction from the borrower's gross income in calculating qualifying ratios, rather than as a monthly obligation.

Criterion 10

HUD Handbook 4155.1, REV-5, chapter 3, section 1, paragraph 3-1E, states that the verification of employment and the borrower's most recent pay stub are to be provided. "Most recent" means at the time the initial loan application is made. If the document is not more than 120 days old when the loan closes (180 days old on new construction), it does not have to be updated.

As an alternative to obtaining a verification of employment, the lender may obtain the borrower's original pay stub(s) covering the most recent 30-day period, along with original Internal Revenue Service (IRS) Forms W-2 from the previous 2 years. The pay stub(s) must show the borrower's name, Social Security number, and year-to-date earnings. Any copies of the Form W-2 not submitted with the borrower's income tax returns are considered "original" W-2s. (These original documents may be photocopied and returned to the borrower.) The lender also must verify by telephone all current employers. The loan file must include a certification from the lender that original documents were examined and the name, title, and telephone number of the person with whom employment was verified. For all loans processed in this manner, the lender also must obtain a signed copy of Form IRS 4506, Request for Copy of Tax Form; Form IRS 8821; or a document that is appropriate for obtaining tax returns directly

from the IRS. The lender also may use an electronic retrieval service for obtaining W-2 and tax return information. If the employer will not give telephone confirmation of employment or if the W-2 indicates inconsistencies (e.g., FICA (Federal Insurance Contributions Act) payments not reflecting earnings), standard employment documentation must be used.

Criterion 11

HUD Handbook 4155.1, REV-5, chapter 2, section 2, paragraph 2-7, states that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first 3 years of the mortgage loan. If the borrower intends to retire during this period, the effective income must be the amount of documented retirement benefits, Social Security payments, or other payments expected to be received in retirement. No inquiry may be made regarding possible future maternity leave. In most cases, the borrower's income will be limited to salaries or wages. Income from other sources can be included as effective income with proper verification by the lender.

Criterion 12

HUD Handbook 4155.1, REV-5, chapter 2, section 1, paragraph 2-3C, states that court-ordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement. (An exception may be made if the borrower has agreed with the creditor to make regular and timely payments on the judgment and documentation is provided showing that the payments have been made in accordance with the agreement.) FHA does not require that collection accounts be paid off as a condition of mortgage approval. Collections and judgments indicate a borrower's regard for credit obligations and must be considered in the analysis of creditworthiness with the lender documenting its reasons for approving a mortgage when the borrower has collection accounts or judgments. The borrower must explain in writing all collections and judgments.

Criterion 13

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

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

Criterion 14

Regulations at 24 CFR 3500.8(b)(1) state that the settlement agent shall state the actual charges paid by the borrower and seller on the HUD-1 or by the borrower on the HUD-1A. The settlement agent must separately itemize each third-party charge paid by the borrower and seller. All origination services performed by or on behalf of the loan originator must be included in the

loan originator's own charge. Administrative and processing services related to title services must be included in the title underwriter's or title agent's own charge. The amount stated on the HUD-1 or HUD-1A for any itemized service cannot exceed the amount actually received by the settlement service provider for that itemized service, unless the charge is an average charge in accordance with paragraph (b)(2) of this section

Criterion 15

Regulations at 24 CFR 3500.8(c) state that an inadvertent or technical error in completing the HUD-1 or HUD-1A shall not be deemed a violation of section 4 of the Real Estate Settlement Procedures Act if a revised HUD-1 or HUD-1A is provided in accordance with the requirements of this section within 30 calendar days after settlement.

Criterion 16

HUD Handbook 4000.2, chapter 5, paragraph 5-2, states that below are the customary and reasonable fees and charges that may be collected from the borrower by the lender and used to meet the minimum investment requirement for purchases and added to the existing indebtedness for refinances. The cost for any item charged to the borrower must not exceed the cost paid by the lender or charged to the lender by the service provider.

- A. **Appraisal fee and inspection fee.** The borrower may be charged an appraisal fee. This fee may not exceed the actual appraisal fee, divided by the number of lots covered by the appraisal. Inspection fees may be collected from the borrower for any inspections that must be conducted on the property.

The appropriate Homeownership Center may authorize or reject any other charge or the amount of any charge, based on what is reasonable and customary in the area.

Criterion 17

HUD Handbook 4155.1, REV-5, chapter 2, section 3, paragraph 2-10, states that the cash investment in the property must equal the difference between the amount of the insured mortgage, excluding any up-front mortgage insurance premium, and the total cost to acquire the property including prepaid expenses and closing costs as described in paragraph 1-9. All funds for the borrower's investment in the property must be verified and documented. Acceptable sources of these funds include the following:

- A. **Earnest money deposit.** If the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds. Satisfactory documentation includes a copy of the borrower's cancelled check. A certification from the deposit holder acknowledging receipt of funds and separate evidence of the source of funds is also acceptable. Evidence of source of funds includes a verification of deposit or bank statement showing that at the time the deposit was made, the average balance was sufficient to cover the amount of the earnest money deposit.

- B. Savings and checking accounts.** A verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account or the account was opened recently, the lender must obtain a credible explanation of the source of those funds.

Criterion 18

HUD Handbook 4060.1, REV-2, chapter 7, paragraph 7-1 states that all FHA approved mortgagees, including loan correspondents, must implement and continuously have in place a quality control plan for the origination and/or servicing of insured mortgages as a condition of receiving and maintaining FHA approval.

Criterion 19

HUD Handbook 4060.1, REV-2, chapter 7, paragraph 7-6B states that for mortgagees closing more than 15 loans monthly, quality control reviews must be conducted at least monthly and must address one month's activity. Mortgagees closing 15 or fewer loans monthly may perform quality control reviews on a quarterly basis.

Criterion 20

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

Appendix D

SCHEDULE OF SIGNIFICANT UNDERWRITING DEFICIENCIES

FHA case number	Unpaid principal balance	Insurance status	Deficiency area(s)									
			Forged employment letter	Questionable credit history	Unpaid tax liens	Underreported liabilities	Excluded income	Overstated income	Excessive ratios	Maximum mortgage amount exceeded	Questionable employment history	Misrepresentation of HUD-1
105-3105552	\$ 179,391	Active				X			X			
105-3002046	\$ 164,690	Active								X		
105-3095528	\$ 150,267	Active			X							
105-3212712	\$ 122,455	Active									X	
105-3885875	\$ 114,856	Active	X									
105-3231684	\$ 113,014	Active						X	X			
105-2954735	\$ 98,072	Active				X	X					
105-3097672	\$ 90,173	Active		X								
105-4913683	\$ 83,884	Active										X
Total	<u>\$ 1,116,802</u>											

Appendix E

CASE STUDIES FOR LOANS WITH SIGNIFICANT DEFICIENCIES

Case number: 105-3105552

Insured amount: \$182,899

Section of Housing Act: 203(b)

Unpaid principal balance: \$179,391

Date of loan closing: July 27, 2007

Default reason: Curtailment of borrower's income

Underreported Liabilities

Mortgage Counseling Services did not include the coborrower's mortgage payments, totaling \$855 per month, in the debt-to-income ratios. The coborrower had converted her primary residence into a rental property. The lender documented the 2-year lease agreement; however, the lease did not take effect until August 1, 2007, which was after the July 27, 2007, closing date. Therefore, the mortgage payment should have been included in the debt ratio calculation. In addition, the liability was large enough to adversely affect the borrower's ability to make the mortgage payment immediately after closing. When the underreported liability of \$855 per month is applied to the ratios, the ratios increase to 38.41 and 63.42 percent.

HUD Requirements-Appendix C

HUD Handbook 4004.4, REV-1, CHG-2, paragraph 2-4C (criterion 1)

HUD Handbook 4155.1, REV-5, chapter 2, section 4, paragraph 2-11A (criterion 9)

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

Mortgagee Letter 2005-16 (criterion 13)

Case number: 105-3002046

Insured amount: \$168,667

Section of Housing Act: 203(b)

Unpaid principal balance: \$164,690

Date of loan closing: April 24, 2007

Default reason: Curtailment of borrower income

Maximum Mortgage Amount Exceeded

Mortgage Counseling Services did not use the appropriate value in determining the maximum insurable mortgage amount. The lender did not use the lower of sales price or appraised value to determine the maximum insurable mortgage amount. The borrower purchased a newly constructed home. The initial sales contract was dated January 28, 2007, with a sales price of \$157,900. An appraisal was performed on the property on April 19, 2007, during which the property was valued at \$170,000. On April 23, 2007, an amendment to the agreement was executed that increased the sales price to \$170,000.

HUD Requirements-Appendix C

HUD Handbook 4155.1, REV-5, chapter 1, section 2, paragraph 1-7 (criterion 6)

Case number: 105-3095528

Insured amount: \$152,793

Section of Housing Act: 203(b)

Unpaid principal balance: \$150,267

Date of loan closing: October 15, 2007

Default reason: Death of borrower's family

Unpaid Tax Liens

Mortgage Counseling Services did not ensure that all Federal tax liens had established payment plans. The borrowers had five tax liens on their credit report at the time of loan closing.

Tax lien	Type of tax lien	Amount	Date filed
1	Federal	25,200	March-95
2	State	11,700	September-95
3	Federal	13,899	April-07
4	Federal	7,434	January-96
5	State	512	February-06

The lender documented a payoff on tax lien no. 5 and installment payment agreements on tax liens nos. 1 and 3. However, the lender did not document the status of the remaining two tax liens (nos. 2 and 4), nor was there any documentation that provided explanations for the tax liens. The additional tax lien payments would have affected the borrowers' ability to make mortgage payments and should have been included in the qualifying ratios for this loan.

HUD Requirements-Appendix C

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

HUD Handbook 4155.1, REV-5, chapter 2, section 1, paragraph 2-5B (criterion 4)

HUD Handbook 4155.1, REV-5, chapter 2, section 1, paragraph 2-3C (criterion 12)

Case number: 105-3212712

Insured amount: \$124,615

Section of Housing Act: 203(b)

Unpaid principal balance: \$122,455

Date of loan closing: September 28, 2007

Default reason: Curtailment of borrower's income

Questionable Employment History

Mortgage Counseling Services did not establish an acceptable employment history for the coborrower or obtain adequate supporting documentation. The lender did not verify the coborrower's previous employment for the most recent full 2 years or obtain a verification of previous employment that would have indicated the borrower's rate of pay and duration of employment.

HUD Requirements-Appendix C

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

HUD Handbook 4155.1, REV-5, chapter 3, section 1, paragraph 3-1E (criterion 10)

HUD Handbook 4155.1, REV-5, chapter 2, section 2, paragraph 2-6 (criterion 8)

Case number: 105-3885875

Insured amount: \$115,983

Section of Housing Act: 203(b)

Unpaid principal balance: \$114,856

Date of loan closing: July 29, 2008

Default reason: Unemployment

Forged Offer of Employment Letter

Mortgage Counseling Services's third-party contractor conducted a quality control review. The quality control findings exposed a forged offer of employment letter obtained from the borrower's former employer. During the reverification of employment performed during the quality control review, the employer provided a written statement as well as the authentic offer of employment letter. The written statement stated, "that the letter, its contents, and its signature were fabricated and were not prepared, endorsed or authorized by any representative." As a result of the forged offer of employment letter, the employer terminated the borrower's employment, causing the borrower to default on the loan. Mortgage Counseling Services decided not to report the finding to HUD.

HUD Requirements-Appendix C

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

HUD Handbook 4060.1, REV-2, paragraph 7-3J (criterion 3)

Case number: 105-3231684

Insured amount: \$115,090

Section of Housing Act: 203(b)

Unpaid principal balance: \$113,014

Date of loan closing: October 15, 2007

Default status: Curtailment of borrower income

Overstated Income/Excessive Ratios

Mortgage Counseling Services overstated the borrower's employment income by \$200 per week, resulting in excessive qualifying ratios of 44.71 percent and 45.64 percent ($\$969 / \$2,167$ and $\$989 / \$2,167$). The lender relied on a verbal verification of employment, which stated a current gross base pay of \$700 weekly ($\$700 \times 52 \text{ weeks} / 12 = \$3,033$). However, pay stubs for the borrower documented a pay rate of \$500 per week ($\$500 \times 52 \text{ weeks} / 12 = \$2,167$). Therefore, the lender overstated the borrower's monthly income by \$867 ($\$3,033 - \$2,167$).

HUD Requirements-Appendix C

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

HUD Handbook 4155.1, REV-5, chapter 2, section 2, paragraph 2-7 (criterion 11)

Mortgage Letter 2005-16 (criterion 13)

Case number: 105-2954735

Insured amount: \$100,604

Section of Housing Act: 203(b)

Unpaid principal balance: \$98,072

Date of loan closing: March 23, 2007

Default reason: Excessive obligations

Underreported Liabilities and Income

Mortgage Counseling Services underreported the borrower's monthly child support payments by \$271. In addition, the underwriter did not include the borrower's income in determining the qualifying ratios. The lender excluded the borrower's income to offset the child support payments, which led to including only the coborrower's income to qualify for the loan. However, the lender was required to include all liabilities and income in determining the qualifying ratios.

HUD Requirements-Appendix C

HUD Handbook 4004.4, REV-1, CHG-2, paragraph 2-4C (criterion 1)

HUD Handbook 4155.1, REV-5, chapter 2, section 4, paragraph 2-11A (criterion 9)

Case number: 105-3097672

Insured amount: \$ 91,774

Section of Housing Act: 203(b)

Unpaid principal balance: \$90,173

Date of loan closing: July 27, 2007

Default reason: Curtailment of borrower income

Questionable Credit History

Mortgage Counseling Services did not establish a credit history for the borrower. The credit report did not contain any information about the borrower, and the borrower did not provide any nontraditional letters of credit. The underwriter obtained one utility payment referral, which showed that the borrower was an account holder and had not made a late payment in 12 months. However, there was no payment history information, such as length of service, which would indicate how long the borrower had used the utility service. The lender did not have any additional credit history information. Therefore, the lender did not adequately establish acceptable credit history when using only one nontraditional letter of credit.

HUD Requirements-Appendix C

HUD Handbook 4004.4, REV-1, CHG-2, paragraph 2-4C (criterion 1)

HUD Handbook 4155.1, REV-5, chapter 2, section 1, paragraph 2-3 (criterion 7)

Case number: 105-4913683

Insured amount: \$ 84,111

Section of Housing Act: 203(b)

Unpaid principal balance: \$83,884

Date of loan closing: July 17, 2009

Loan status: Current

Misrepresentation of HUD-1

Mortgage Counseling Services misrepresented a HUD-1 that was submitted for FHA insurance. The initial HUD-1 showed that the borrower owed \$2,320 at closing. The lender revised the HUD-1 to show that the borrower owed only \$804 at closing. The Mortgage Counseling Services president created a lender credit of \$675 and removed the loan discount of \$841, which decreased the amount the borrower owed at closing to \$804 ($2,320 - 675 - 841 = 804$). The lender instructed the borrower to write two postdated checks as follows:

Check number	Check date	Check amount
1108	8/15/2009	\$400
1111	10/15/2009	\$1,116
Total		\$1,516
Note: The total amount in postdated checks (\$1,516) plus the amount paid at closing (\$804) totals the \$2,320 required on the initial HUD-1.		

According to bank statements, dated June 15, 2009, the borrower had \$3,330 in her checking account. This loan closed on July 17, 2009. There were no additional verifications completed before the closing. Shortly before the loan closed, the borrower was contacted and told that she had to bring \$2,320 to closing. At that time (July 2009), the borrower stated that she did not have \$2,320 for closing. At this point, the lender should have terminated the loan for lack of sufficient funds to close. However, the president created another HUD-1, reducing the amount of funds needed to close from \$2,320 to \$804. The borrower must have sufficient funds to close the loan.

The Mortgage Counseling Services president stated that she was not aware of the two postdated checks. However, after we visited the lender in August 2009 to obtain the loan file, the president contacted the borrower and sent her a letter stating that it was improper to collect the additional postdated checks, and the president destroyed the checks. The president stated that the loan was not reviewed after closing, which is why there was no knowledge of the improper activity.

Federal Requirements-Appendix C

24 CFR 3500.8(b)(1) (criterion 14)

HUD Handbook 4155.1, REV-5, section 3, chapter 2, paragraph 2-10, (criterion 17)

Appendix F

SCHEDULE OF INDEMNIFICATION AMOUNTS

FHA case number	Unpaid principal balance	Loss percentage rate*	Indemnification amount
105-3105552	\$ 179,391	42	\$ 75,344
105-3002046	\$ 164,690	42	\$ 69,170
105-3095528	\$ 150,267	42	\$ 63,112
105-3212712	\$ 122,455	42	\$ 51,431
105-3885875	\$ 114,856	42	\$ 48,240
105-3231684	\$ 113,014	42	\$ 47,466
105-2954735	\$ 98,072	42	\$ 41,190
105-3097672	\$ 90,173	42	\$ 37,873
105-4913683	\$ 83,884	42	\$ 35,231
Totals	\$ 1,116,802		\$ 469,057

*We classified \$469,057 as funds to be put to better use. This is 42 percent of the \$1,116,802 in unpaid principal balances in nine FHA-insured loans that did not meet HUD's requirements. We used 42 percent because HUD has determined that upon sale of the mortgaged properties, FHA's average loss was about 42 percent of the unpaid principal balance for fiscal year 2008.