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MEMORANDUM NO:
2010-CH-1807

July 21, 2010

MEMORANDUM FOR: Vicki Bott, Deputy Assistant Secretary for Single Family, HU
Dane M. Narode, Associate General Counsel for Program Enforcement, CACC

FROM: Heath Wolfe, Regional Inspector General for Audit, 5AGA

SUBJECT: Birmingham Bancorp Mortgage Corporation, West Bloomfield, MI, Did Not Properly Underwrite a Selection of FHA Loans

INTRODUCTION

We reviewed 20 Federal Housing Administration (FHA) loans that Birmingham Bancorp Mortgage Corporation (Birmingham) underwrote as an FHA direct endorsement lender. Our review objective was to determine whether Birmingham underwrote the 20 loans in accordance with FHA requirements. This review is part of "Operation Watchdog," an OIG initiative to review the underwriting of 15 direct endorsement lenders at the suggestion of the FHA Commissioner. The FHA Commissioner expressed concern regarding the increasing claim rates against the FHA insurance fund for failed loans.

For each recommendation without a management decision, please respond and provide status reports in accordance with the U.S. Department of Housing and Urban Development's (HUD) Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the review.

We provided our discussion draft memorandum report to Birmingham's management during the review. We asked Birmingham to provide written comments on our discussion draft memorandum report by June 7, 2010. Birmingham's president provided written comments to the discussion draft report, dated June 8, 2010. The president disagreed with our finding and recommendations. The complete text of the lender's comments, along with our evaluation of that response, can be found in appendix C of this report, except for 61 exhibits of 170 pages of documentation that was not necessary to understand the lender's comments. We provided HUD's Deputy Assistant Secretary for Single Family Housing and Associate General Counsel for Program Enforcement with a complete copy of Birmingham's written comments plus the 170 pages of documentation.

METHODOLOGY AND SCOPE

Birmingham is 1 of 15 direct endorsement lenders we selected from the U.S. Department of Housing and Urban Development's (HUD) publicly available Neighborhood Watch[1] system (system) for a review of underwriting quality. These direct endorsement lenders all had a compare ratio[2] 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 that had gone into a claims status. We selected loans for Birmingham that defaulted within the first 30 months and were (1) not streamline refinanced, and (2) for manually underwritten loans, associated with underwriters (usually individuals) with a high number of claims.

BACKGROUND

Birmingham is a nonsupervised direct endorsement lender based in West Bloomfield, MI. FHA approved Birmingham as a direct endorser in July 1988. FHA's mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to approve mortgages for otherwise creditworthy borrowers that might not be able to meet conventional underwriting requirements by protecting the lender against default. The direct endorsement program simplifies the process for obtaining FHA mortgage insurance by allowing lenders to underwrite and close the mortgage loan without prior HUD review or approval. 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 default by FHA's mutual mortgage insurance fund, which is sustained by borrower premiums.

The goal of Operation Watchdog is to determine why there is such a high rate of defaults and claims. We selected up to 20 loans in claim status from 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, Birmingham endorsed 6,314 loans valued at more than $837 million and submitted 502 claims worth more than $50 million.

Our objective was to determine whether the 20 selected loans were properly underwritten and if not, whether the underwriting reflected systemic problems.

We performed our work from January through April 2010. We conducted our work in accordance with generally accepted government auditing standards, except that we did not

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[1] Neighborhood Watch is a system that aids HUD/FHA staff in monitoring lenders and its programs. This system allows staff to oversee lender origination activities for FHA-insured loans, and tracks mortgage defaults and claims.

[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.

consider the internal controls or information systems controls of Birmingham, consider the results of previous audits, or communicate with Birmingham's management in advance. We did not follow standards in these areas because our objective was to aid HUD in identifying FHA single-family insurance program risks and patterns of underwriting problems or potential wrongdoing in poor-performing lenders that led to a high rate of defaults and claims against the FHA insurance fund. To meet our objective it was not necessary to fully comply with the standards, nor did our approach negatively affect our review results.

RESULTS OF REVIEW

Birmingham did not properly underwrite 9 of the 20 loans reviewed because its underwriters did not follow FHA's requirements. As a result, FHA's insurance fund suffered actual losses of $643,340 as shown by the following table.

FHA loan number	Closing date	Number of payments before first default	Original mortgage amount	Actual loss to HUD
105-3017718	5/29/07	1	$89,248	$57,256
151-8410864	10/24/07	1	82,209	54,461
201-3487218	11/03/05	9	41,800	44,773
261-9009876	3/31/06	4	96,019	114,361
261-9071686	5/25/06	19	59,073	63,185
262-1681931	9/14/07	7	56,000	57,931
263-3870605	3/30/06	3	90,578	86,252
263-3922022	10/27/06	N/A	74,825	79,696
263-3938261	11/20/06	0	101,408	85,425
	Totals		$691,160	$643,340

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

Area of noncompliance	Number of loans
Income	4
Liabilities	1
Excessive ratios	2
Assets	2
Gift funds	1
Credit report	4
Verification of rent	4

Appendix A shows a schedule of material deficiencies in each of the nine loans. Appendix B provides a detailed description of all loans with material underwriting deficiencies noted in this report.

Income

Birmingham did not properly calculate borrower's income or determine income stability for four loans. HUD does not allow income to be used in calculating a borrower's income ratios if it cannot be verified, is not stable, or will not continue. Birmingham is required to analyze whether income is reasonably expected to continue through at least the first 3 years of the mortgage loan (see appendix B for detailed requirements).

For example, for loan number 105-3017718, Birmingham overstated the borrowers' monthly income by $701. Birmingham calculated the borrowers' monthly income as $3,008 ($1,560 for the borrower and $1,448 for the coborrower). We calculated the borrowers' monthly income as $2,307 ($869 for the borrower and $1,438 for the coborrower). To calculate the borrower's average monthly income, Birmingham used the current rate of pay of $9 per hour or $1,560 per month. The borrower had not earned this income on a consistent basis for the last 12 months although he had worked for the same employer for more than 1 year. The borrower's stability of income was questionable. His 2006 average monthly income of $626 was significantly less than his average monthly income of $1,484 for the first 3 months of 2007. Birmingham should have verified with the borrower's employer whether his income was subject to seasonal influences and determine why his monthly income more than doubled from 2006 to 2007. We contacted the borrower's employer, who verified that the employment was seasonal. We recalculated the borrower's monthly income for the 12 months before his loan closing to be $869. We also found that the coborrower's monthly income was overstated by $10 due to a calculation error by Birmingham.

For loan number 151-8410864, Birmingham's underwriter overstated the borrower's gross monthly income by $829. The underwriter did not use the full wage and employment information available in the loan file and only used partial information to calculate the average monthly income of $2,731. The partial information was more beneficial to the borrower. Using the full available wage and employment information, we recalculated the borrower's average monthly income as $1,902. The underwriter used the year-to-date earnings of $9,559 reported on the September 29, 2007, pay stub from the borrower's recent employer, divided by 3.5 months. At this time, the borrower had received wages for more than 5 months. We recalculated the borrower's gross monthly income as $1,902 ($9,987 divided by 5.25), using the latest pay stub for the period ending October 6, 2007, available in the loan file.

Liabilities

Birmingham did not properly assess the borrowers' financial obligations for one loan. HUD requires lenders to consider debts if the amount of the debts affects the borrower's ability to make the mortgage payment during the months immediately after loan closing (see appendix B for detailed requirements).

For example, for loan number 105-3017718, the borrower's child support wage garnishment of $40 per week was not reported on the loan application or the mortgage credit analysis worksheet[3]. The weekly child support payments computed to a monthly payment of $173 ($40 per week times 52 weeks divided by 12 months). This exclusion from the total monthly obligations caused the fixed payment-to-income ratio to be understated on the worksheet. When the fixed payment-to-income ratio was recalculated to include all of the borrower's monthly obligations, the ratio exceeded the qualifying percentage. Therefore, the exclusion of child

[3] The mortgage credit analysis worksheet is used to analyze and document mortgage approval.

support from monthly obligations was material, and Birmingham should not have approved the loan.

Excessive Ratios

Birmingham improperly approved two loans when the borrowers' ratios exceeded FHA's requirement. Effective April 13, 2005, the fixed payment-to-income and debt-to-income ratios were increased from 29 and 41 percent to 31 and 43 percent, respectively. If either or both ratios are exceeded on a manually underwritten mortgage, the lender is required to describe the compensating factors used to justify the mortgage approval (see appendix B for detailed requirements).

For loan number 105-3017718, the combination of overreported income and unreported liabilities caused the debt-to-income ratios to be understated on the mortgage credit analysis worksheet. The monthly mortgage payment-to-income ratio increased from 24.5 to 31.955 percent, and the total monthly fixed payment-to-income ratio increased from 33.31 to 50.963 percent, exceeding HUD's qualifying ratios of 31 and 43 percent, respectively. The worksheet did not include compensating factors.

For loan number 263-3870605, the borrower's mortgage payment-to-income ratio exceeded HUD's allowable ratio of 31 percent. The ratio reported on the mortgage credit analysis worksheet was 33.515 percent. Birmingham's underwriter justified the excessive ratio by using the borrower's ability to pay housing expenses greater than the proposed monthly housing expenses. However, Birmingham did not obtain independent verifications, such as cancelled checks or receipts, of the borrower's rental payments. Further, both verifications of rent were faxed from the borrower's employer.

Assets

Birmingham did not properly document the source of the borrowers' funds to close for two loans. HUD requires the lender to verify and document the borrower's investment in the property (see appendix B for detailed requirements).

For loan number 262-1681931, although the loan file included the borrower's bank statement, the loan file did not include an explanation for the large deposits. Birmingham's underwriter was unable to provide documentation or an explanation for the large deposits.

For loan number 263-3870605, the loan file included bank account activity reports from February 24 to March 13, 2006. The reports did not show the name of the institution or the borrower's name. The reports showed a large deposit of $6,171, dated February 24, 2006. The loan file included a copy of a cashier's check, dated February 23, 2006, written to the borrower and his wife for $6,171. The loan file also included a hand-written note stating that the reason for the large deposit was a tax refund. However, Birmingham did not explain why the borrower provided a copy of a cashier's check from HSBC as support for his tax refund and not a copy of either the tax return or a copy of his tax refund check.

Gift Funds

Birmingham did not properly document gift funds received by borrower for one loan. HUD requires that the lender be able to determine that gift funds ultimately were not provided by an unacceptable source (see appendix B for detailed requirements).

For loan number 261-9071686, Birmingham's underwriter did not verify that the gift funds came from an acceptable source. Both of the loan applications (initial and final) showed that the borrower's source of the downpayment and/or closing costs was her checking/savings account. A statement signed by the borrower 2 days before the closing indicated that her cousin gave her a gift to ensure that she would be able to buy the home. The loan file included a copy of a gift letter and a $2,500 gift check. We contacted the borrower, who stated that the gift donor was not her cousin, but rather the seller of the property. The borrower also said that the loan officer told her to purchase a $2,000 cashier's check to bring to the closing.

Credit Report

Birmingham did not properly evaluate the borrowers' credit history for four loans. HUD requires the lender to consider collection accounts in analyzing a borrower's creditworthiness. The lender must explain all collections in writing (see appendix B for detailed requirements).

For example, for loan number 261-9009876, Birmingham did not obtain independent verification from the borrower's creditors to support loan approval. The borrower's credit report, dated March 3, 2006, showed that the borrower had several collection accounts including collections-related debts with Comcast and Southwestern Bell Communications (SBC). The loan files contained documents showing that the Comcast collection was satisfied by the return of the equipment and the SBC collection was paid off. However, both of the documents were dated March 20, 2006, and they were faxed to the mortgage company from the seller, an interested party, on the same date.

Verification of Rent

Birmingham did not properly verify borrowers' rental histories for four loans. HUD notes that the payment history of the borrower's housing obligations holds significant importance in evaluating credit. The lender must determine the borrower's housing payment history through acceptable means, including verification of rent directly from the landlord or through cancelled checks covering the most recent 12-month period (see appendix B for detailed requirements).

For example, for loan number 201-3487218, Birmingham did not obtain additional documentation from the borrower to prove that a rental agreement existed and residency at the property had been established for at least 6 months. Otherwise, the loan amount would have been limited to 85 percent of the lower of the sales price or appraised value of the subject property (85 percent loan to value). Since the borrower did not have any assets, the loan would have been ineligible.

For loan number 261-9009876, Birmingham approved the loan without resolving inconsistencies with the borrower's rental history. There were no canceled checks or a lease agreement to support the borrower's rental history.

For loan number 263-3870605, Birmingham used verification of rent to establish credit history. However, Birmingham's underwriter did not obtain independent verification of the borrower's monthly housing expenses. Since both verifications were signed by the same individual for properties located in California and Mississippi, Birmingham should have documented an explanation of why the same individual signed both verifications and why both were faxed from the borrower's employer.

<u>Incorrect Underwriter's Certifications Submitted to HUD</u>

We reviewed the certifications for the nine loans with material underwriting deficiencies for accuracy. Birmingham's direct endorsement underwriters incorrectly certified that due diligence was used in underwriting the nine 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.

The Program Fraud Civil Remedies Act of 1986 (231 U.S.C. (United States Code) 3801) provides Federal agencies, which are the victims of false, fictitious, and fraudulent claims and statements, with an administrative remedy (1) to recompense such agencies for losses resulting from such claims and statements; (2) to permit administrative proceedings to be brought against persons who make, present, or submit such claims and statements; and (3) to deter the making, presenting, and submitting of such claims and statements in the future.

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 against Birmingham and/or its principals for incorrectly certifying to the integrity of the data or that due diligence was exercised during the underwriting of 9 loans that resulted in losses to HUD totaling $643,340, which could result in affirmative civil enforcement action of approximately $1,354,180[4].

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

1B. Take appropriate administrative action against Birmingham 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.

[4] Double damages plus a $7,500 fine for each of the nine incorrect certifications.

Schedule of Ineligible Cost 1/

Recommendation number	Amount
1A	$643,340

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

Appendix A

SUMMARY OF MATERIAL UNDERWRITING DEFICIENCIES

FHA loan number	Unsupported income or questionable employment history	Underreported liabilities	Excessive debt-to-income ratios	Unsupported assets	Insufficient gift documentation	Significant credit-related deficiencies or no credit	Incomplete verification of rent history
105-3017718	X	X	X			X	
151-8410864	X						
201-3487218	X						X
261-9009876						X	X
261-9071686					X		
262-1681931				X			
263-3870605			X	X		X	X
263-3922022	X					X	
263-3938261							X

Appendix B

LOANS WITH MATERIAL UNDERWRITING DEFICIENCIES

Loan number: 105-3017718

Mortgage amount: $89,248

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: May 29, 2007

Status: Claim

Payments before first default reported: One

Loss to HUD: $57,256

Summary:

We found material underwriting deficiencies relating to the borrowers' credit, liabilities, income and employment, and/or debt-to-income ratios.

Credit:

Birmingham did not adequately review the coborrower's credit history before approving the loan. The coborrower had poor credit including several unpaid collections and recent credit inquiries. The recent collections were major indications of derogatory credit, and the recent credit inquiries required written explanations from the coborrower. The coborrower wrote a letter, which stated that she was unaware of the collection accounts, she would work with the creditors, and the multiple credit inquiries were her attempt to "build" credit quickly. Birmingham did not document an analysis of the credit history to determine whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the coborrower.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejecting the loan application. We also recognize that some prospective borrowers may not have an established credit history. For those borrowers 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 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.

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that when analyzing a borrower's credit history, the lender should examine the overall pattern of credit behavior rather than isolated occurrences of unsatisfactory or slow payments. When delinquent accounts are revealed, the lender must document its analysis regarding whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including delayed mail delivery or disputes with creditors.

Major indications of derogatory credit–including all judgments, all collections, and any other recent credit problems–require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

Liabilities:

The borrower's child support wage garnishment of $40 per week was not reported on the loan application or the mortgage credit analysis worksheet. The weekly child support payment computes to a monthly child support payment of $173 ($40 per week times 52 weeks divided by 12 months). This exclusion from the total monthly obligations caused the fixed payment-to-income ratio to be understated on the worksheet. When the fixed payment-to-income ratio was recalculated to include all of the borrower's monthly obligations, the ratio exceeded the qualifying ratio. Therefore, the exclusion of child support from monthly obligations was material, and Birmingham should not have approved the loan.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-11A, states that recurring obligations must be considered in qualifying borrowers. The borrower's recurring obligations 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, etc.

Income:

The borrowers' monthly income was overstated by $701 per month. Birmingham calculated monthly income as $3,008 ($1,560 for the borrower and $1,448 for the coborrower). We calculated the borrowers' monthly income as $2,307 ($869 for the borrower and $1,438 for the coborrower).

Birmingham used the current rate of pay of $9 per hour to calculate the borrower's monthly income as $1,560. The borrower had not earned this income for the last 12 months although he had worked for the same employer for more than 1 year. The borrower's stability of his income was questionable. Although he had worked a little more than 1 year for his current employer, Birmingham did not document a stable rate of pay for the borrower.

His 2006 average monthly income of $626 was significantly less than his average monthly income of $1,484 for the first 3 months of 2007. Birmingham did not determine the reason for this wage increase. It needed to verify with the borrower's employer whether his income was subject to seasonal influences or determine why the average monthly income more than doubled from 2006 to 2007. We contacted the borrower's employer, who verified that the employment was seasonal.

Since there was no verification documenting the reason for the borrower's increased earnings from 2006 to the first 3 months of 2007, we recalculated the borrower's income for the most recent 12-month period as $869. As a result, Birmingham overstated the borrower's income by $691 ($1,560 minus $869). We also determined that the coborrower's income was overstated on the mortgage credit analysis worksheet by $10 due to a calculation error.

<u>HUD/FHA Requirements</u>:

HUD Handbook 4155.1, REV-5, paragraph 2-6, states that FHA does 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. The borrower also must explain any gaps in employment spanning 1 month or more. Allowances for seasonal employment, such as is typical in the building trades, may be made if documented by the lender.

<u>Excessive Debt-to-Income Ratios</u>:

The combination of overreported income and unreported liabilities caused the debt-to-income ratios to be understated on the mortgage credit analysis worksheet. The monthly mortgage payment-to-income ratio increased from 24.5 to 31.955 percent, and the total monthly fixed payment-to-income ratio increased from 33.31 to 50.963 percent, exceeding HUD's qualifying ratios of 31 and 43 percent, respectively. The worksheet did not include compensating factors.

<u>HUD/FHA Requirements</u>:

HUD Handbook 4155.1, REV-5, paragraphs 2-12, and Mortgagee Letter 2005-16 state that for manually underwritten mortgages for which the direct endorsement underwriter must make the credit decision, the qualifying ratios were raised to 31and 43 percent, respectively. 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.__

Loan number: 151-8410864

Mortgage amount: $82,209

Section of Housing Act: 234 (c)

Loan purpose: Purchase

Date of loan closing: October 24, 2007

Status: Claim

Payments before first default reported: One

Loss to HUD: $54,461

Summary:

We found a material underwriting deficiency relating to the borrower's income.

Income:

Birmingham's underwriter overstated the borrower's gross monthly income by $829 by using partial employment information which was more beneficial to the borrower rather than using the complete employment information in the loan file. The underwriter calculated the average monthly income of $2,731 by using the partial employment information available in the loan file. Using the complete employment information, we calculated the borrower's average monthly income as $1,902.

The underwriter calculated the monthly income as $2,731 by using the year-to-date earnings of $9,559 reported on the September 29, 2007, pay stub divided by 3.5 months. This pay stub was not the latest pay stub available, and as of September 29, 2007, the borrower had worked 5 months at this job, not 3.5 months. Further, the pay stub reported 40.80 hours worked, and Federal taxes were not withheld.

We calculated the borrower's gross monthly income as $1,902. We used the latest pay stub available for the period ending October 6, 2007, which reported the year-to-date earnings of $9,987 divided by 5.25 months, the number of months the borrower had been employed. The borrower started employment on May 1, 2007. This pay stub showed that the borrower worked 28.90 hours and Federal taxes were withheld. The borrower was previously unemployed for 9 months prior to starting this employment. The borrower explained the employment gap which was included in the loan file. Prior to the employment gap, the borrower was employed for more than 4 years.

Using the average monthly income of $1,902 increased the qualifying ratios above the allowable ratios of 31and 43 percent. The mortgage payment-to-income ratio increased to 43 percent from

29.953 percent ($818 mortgage payment divided by $1,902). The total fixed payment-to-income ratio also increased to 61.25 percent from 42.659 percent ($1,165 total fixed payment divided by $1,902).

In a condition to close, Birmingham required the loan correspondent to provide a full verification of employment from the borrower's current employer with an explanation as to why the pay stubs did not show Federal withholdings. Also, the correspondent was to confirm that the borrower was an Internal Revenue Service (IRS) Form W-2 employee. A letter of explanation was required to account for the inconsistency in withholding Federal taxes. One month of consecutive pay stubs showing 40 hours worked per week and Federal taxes being deducted from the pay stubs were also required. Further, the condition stated that if the documents were not provided, the loan approval would be "null and void."

The loan file did not include documentation of 1 full month of consecutive pay stubs showing a 40-hour work week or an explanation for the Federal taxes not having been withheld as required by the underwriter's condition.

<u>HUD/FHA Requirements</u>:

HUD Handbook 4155.1, REV-5, paragraph 3-1, states that the application package must contain all documentation supporting the lender's decision to approve the mortgage loan.

Mortgagee Letter 2005-16, dated April 13, 2005, increased the payment-to-income and debt-to-income ratios from 29 and 41 percent to 31 and 43 percent, respectively. If either or both ratios are exceeded on a manually underwritten mortgage, the lender is required to describe the compensating factors used to justify the mortgage approval.

Loan number: 201-3487218

Mortgage amount: $41,800

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: November 3, 2005

Status: Claim

Payments before first default reported: Nine

Loss to HUD: $44,773

Summary:

We found material underwriting deficiencies relating to the borrower's income and verification of rent.

Income:

Birmingham approved the loan based on income which was not stable and was computed using questionable pay stubs. The borrower applied for the loan in June 2005 when he was working as a restaurant manager earning approximately $1,247 per month. Two months before loan closing, the borrower, according to file documents, switched his employment from that of restaurant manager to sand blaster in an auto body work shop, a totally different industry. The borrower's employment change increased his monthly earnings by $919, a 73.66 percent increase. Birmingham accepted four pay stubs from the borrower's new employment and used these pay stubs to compute the borrower's income. The borrower's pay stubs showed that no Federal income tax was withheld and the amounts withheld for both the Federal Insurance Contributions Act (FICA) and Medicare were not accurate. The FICA tax for employees is 6.2 percent of earned wages, and the Medicare tax for employees is 1.45 percent of earned wages. The pay stubs showed that the FICA withholding was 7.885 percent and the Medicare withholding was 2.175 percent. Birmingham's underwriter should have questioned the pay stubs and followed up with additional verification, such as contacting the employer, qualifications for the job and training, etc.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-6, states that FHA does not impose a minimum length of time a borrower must have held a position of employment to be eligible. To analyze and document the probability of continued employment, lenders must examine the borrower's past employment record, qualifications for the position, and previous training and education and the employer's confirmation of continued employment. A borrower who changes jobs frequently within the same line of work but continues to advance in income or benefits should be considered favorably. In this analysis, income stability takes precedence over job stability.

Rental Verification:

The loan files did not document proper verification of rent. The borrower was residing in the property he purchased. The seller, who was the landlord, provided the verification of rent to Birmingham and the credit reporting agency. However, there was no other documentation. As the seller was an identity of interest in the real estate transaction, Birmingham needed to obtain additional documentation from the borrower to prove that a rental agreement existed and residency at the property had been established for at least 6 months. Otherwise, the loan amount would have been limited to 85 percent of the lower of the sales price or appraised value of the subject property (85 percent loan to value). Since the borrower did not have any assets, the loan would have been ineligible.

HUD/FHA Requirements:

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

HUD Handbook 4155.1, REV-5, paragraph 1-8A, states that identity-of-interest transactions on principal residences are restricted to a maximum loan-to-value ratio of 85 percent. Identity of interest is defined as a sales transaction between parties with family relationships or business relationships. However, maximum financing above the 85 percent loan-to-value ratio is permissible if a current tenant purchases the property that he has rented for at least 6 months immediately predating the sales contract. To meet this exclusion, a lease or other written evidence must be submitted to verify occupancy.

HUD Handbook 4155.1, REV-5, chapter 3, states the lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation.

Loan number: 261-9009876

Mortgage amount: $96,019

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: March 31, 2006

Status: Claim

Payments before first default reported: Four

Loss to HUD: $114,361

Summary:

We found material underwriting deficiencies relating to the borrower's credit history and verification of rent.

Credit:

Birmingham did not obtain independent verification from the borrower's creditors to support loan approval. The borrower's credit report, dated March 3, 2006, showed that the borrower had several collection accounts including collections-related debts with Comcast and Southwestern Bell Communications (SBC). The loan files contained documents showing that the Comcast collection was satisfied by the return of the equipment and the SBC collection was paid off. However, both of the documents were dated March 20, 2006, and they were faxed to the mortgage company from the seller, an interested party, on the same date.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 3-1, states that the lender may not accept or use documents relating to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties (e.g., real estate agents, builders, sellers) or by using their equipment.

Verification of Rent:

Birmingham approved the loan without resolving inconsistencies with the borrower's rent history. There were inconsistencies in the borrower's rental history in Birmingham's file. A verification of rent was completed by a managing partner for the landlord, who was also the seller of the subject property (an identity-of-interest transaction). According to this verification of rent, the borrower had rented at the property since January 1, 2005 (more than 1 year), which contradicted the duration of .4 years listed on the uniform residential loan application signed by the borrower on March 31, 2006. There were no canceled checks or a lease agreement to support the borrower's rental history.

The borrower's credit report, dated March 3, 2006, showed an address discrepancy alert indicating there was a substantial difference between the address used for the credit inquiry and the addresses on file. The subject property location was not one of the addresses listed for the borrower on the credit report. Further, Birmingham had not submitted documentation to support whether the borrower lived at the property. The borrower's driver's license in Birmingham's file showed an address that was different from that of the subject property.

Another verification of rent or mortgage form, dated November 15, 2005, was completed for the borrower for another address, and it showed that the borrower rented at that address from June 7, 2004, through November 15, 2005. However, this rental period overlapped the timeframe listed on the previously mentioned verification of rent completed by the seller.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3A, states that the lender must determine the borrower's payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity of interest with the borrower), or canceled checks covering the most recent 12-month period.

HUD Handbook 4155.1, REV-5, paragraph 1-8A, states that the maximum financing above the 85 percent loan-to-value ratio is permissible when a current tenant purchases the property that he or she has rented for at least 6 months immediately predating the sales contract (a lease or other written evidence must be submitted to verify occupancy).

HUD Handbook 4155.1, REV-5, chapter 3, states that the lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation, source of funds for the transaction, and the intended use of the property. All information must be verified and documented. Further, paragraph 3-1 of the handbook states that the application package must contain all documentation supporting the lender's decision to approve the mortgage loan. When standard documentation does not provide enough information to support this decision, the lender must provide additional explanatory statements, consistent with other information in the application, to clarify or to supplement the documentation submitted by the borrower.

Loan number: 261-9071686

Mortgage amount: $59,073

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: May 25, 2006

Status: Claim

Payments before first default reported: 19

Loss to HUD: $63,185

Summary:

We found a material underwriting deficiency relating to the borrower's gift funds.

Gift Funds:

Birmingham's underwriter did not verify that the gift funds came from an acceptable source. Both loan applications (initial and final) showed that the borrower's source of the downpayment and/or closing costs was her checking/savings account. The loan file contained a statement from the borrower that she could not use her savings/checking account because it had not been open for at least 60 days. This statement was signed 2 days before closing. The statement further stated that her cousin gave her a gift to ensure that she would be able to buy the home. The loan file included a copy of the gift letter and a $2,500 gift check.

We contacted the borrower, who stated that the gift donor was not her cousin, but the seller of the property. The borrower said that the loan officer told her to purchase a $2,000 cashier's check to bring to the closing.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10 C(2), states that regardless of when the gift funds are made available to the home buyer, the lender must be able to determine that the gift funds ultimately were not provided from an unacceptable source and were indeed the donor's own funds. When the transfer occurs at closing, the lender remains responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source.

Loan number: 262-1681931

Mortgage amount: $56,000

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: September 14, 2007

Status: Claim

Payments before first default reported: Seven

Loss to HUD: $57,931

Summary:

We found a material underwriting deficiency relating to the borrower's assets.

Assets:

Birmingham did not obtain an explanation of the source of funds for the borrower's downpayment and/or closing costs. The loan application reported that the source of the borrower's downpayment and/or closing costs was his own funds. The loan file included the borrower's bank statement for the period June 1 to June 30, 2007, which showed the beginning balance on of $49.49 on June 1 and the ending balance of $7,155 on June 30. The statements showed that three large deposits were made during the month of June ($4,337, $4,237, and $3,700, respectively). The deposit of $3,700 was withdrawn on the same day. Birmingham's loan file did not document an explanation for the large deposits.

Birmingham's underwriter was unable to provide an explanation because Birmingham's loan file was not available. She stated that there may have been additional documents to explain the large deposits in the loan file, which were not included in the FHA case file. We obtained the loan file from the loan servicer, Nationwide Advantage Mortgage Company, but it contained no explanation for the large deposits.

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. Paragraph 2-10B states that 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.

Loan number: 263-3870605

Mortgage amount: $90,578

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: March 30, 2006

Status: Claim

Payments before first default reported: Three

Loss to HUD: $86,252

Summary:

We found material underwriting deficiencies relating to the borrower's assets, liabilities, and ratios.

Assets:

Birmingham's underwriter did not obtain an explanation for the source of funds for the borrower's downpayment/closing costs. The loan application showed that the source of funds was cash on hand. The loan file included bank account activity reports from February 24 to March 13, 2006. The reports did not show the name of the institution or the borrower's name. The reports showed a large deposit of $6,171 on February 24, 2006. The loan file included a copy of a cashier's check, dated February 23, 2006, from HSBC that was written to the borrower and his wife for $6,171. The loan file also included a hand-written note stating that the reason for the large deposit was a tax refund. However, Birmingham did not provide an explanation of why the borrower provided a copy of a cashier's check from HSBC as support for his tax refund and not a copy of either the tax return or a copy of his tax refund check.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10B, states that 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. Paragraph 3 states that the lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation, the source of funds for the transaction, and the intended use of the property. All information must be verified and documented.

<u>Credit</u>:

Birmingham's underwriter did not obtain independent verification from the borrower's creditors to support loan approval. Since the credit report did not list any open accounts, the underwriter developed a credit history by documenting two instances of alternative credit. However, in both instances, letters were faxed by the borrower from his employer. One letter stated that the borrower purchased a 1991 Chrysler New Yorker from a private seller for $1,300 and was making $100 monthly payments. The letter was signed by the borrower and seller of the vehicle. No other evidence was included in the file to show that the borrower purchased the vehicle. The second letter stated that the borrower purchased a computer and mattress and box spring from Aarons, his employer, and made monthly payments of $62.85 for the computer and $40.80 for the mattress and box spring. The letter was signed by the store's general manager. The file did not document receipts to show the purchases.

<u>HUD/FHA Requirements</u>:

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejecting the loan application. FHA also recognizes that some prospective borrowers may not have an established credit history. For those borrowers 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 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.

<u>Verification of Rent</u>:

Birmingham used two verifications of rent to establish credit history. However, Birmingham's underwriter did not obtain independent verification of the borrower's monthly housing expenses. The loan file included two verifications of rent, one dated January 30, 2006, from the borrower's landlord before he purchased the subject property. The verification reported the borrower's residency in Lake Isabella, CA, between March 2, 2005, and January 30, 2006, with a monthly rent of $1,000. The second verification was also dated January 30, 2006, and was from the same landlord. It listed the rental property as being in Bay St. Louis, MS, with a rent of $850 from May 1, 2000, to February 24, 2005. As both verifications were signed by the same individual for properties located in California and Mississippi, Birmingham should have documented an explanation of why the same individual signed both verifications and why both were faxed from the borrower's employer.

<u>HUD/FHA Requirements</u>:

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

<u>Excessive Ratio</u>:

The borrower's mortgage payment-to-income ratio exceeded HUD's allowable ratio of 31 percent. The ratio reported on the mortgage credit analysis worksheet was 33.515 percent. Birmingham's underwriter justified the excessive ratio by using the borrower's ability to pay housing expenses greater than the proposed monthly housing expenses.

The verification of rent reported the borrower's rent payment as $1,000 for the past 11 months. The proposed mortgage payment was $781, resulting in a monthly cost savings of $219. Another verification of rent reported the borrower's rent payment as $850 for the previous 12 months. However, Birmingham did not obtain independent verifications, such as cancelled checks or receipts, of the borrower's rental payments. Further, both verifications of rent were faxed from the borrower's employer.

<u>HUD/FHA Requirements</u>:

HUD Handbook 4155.1, REV-5, 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. If the mortgage payment expense-to-effective income ratio exceeds 29 percent, it may be acceptable only if significant compensating factors, as discussed in paragraph 2-13, are documented and are recorded on the mortgage credit analysis worksheet.

Mortgagee Letter 2005-16, dated April 13, 2005, increased the payment-to-income and debt-to-income ratios from 29 and 41 percent to 31 and 43 percent, respectively. If either or both ratios are exceeded on a manually underwritten mortgage, the lender is required to describe the compensating factors used to justify the mortgage approval.

HUD Handbook 4155.1, REV-5, paragraph 2-13, states that FHA underwriters must record in the remarks section of HUD Forms 92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation. Paragraph 2-13A states that the borrower has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12-24 months.

Loan number: 263-3922022

Mortgage amount: $74,825

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: October 27, 2006

Status: Claim

Payments before first default reported: Not available

Loss to HUD: $79,696

Summary:

We found material underwriting deficiencies relating to the borrower's rental income and credit history.

Income:

Birmingham's underwriter did not verify that the borrower owned the property scheduled to be used for rental income. The net rental income of $216 was used to calculate the borrower's gross income. However, there was insufficient documentation in the loan files to support that the borrower owned the property.

The loan application, dated October 27, 2006, showed that the borrower owned a mobile property valued at $15,000 and that he was living at the property at the time of the loan application and closing. However, the 2005 Spring Arbor Township property assessment document indicated that the taxpayer for the mobile property was someone other than the borrower.

A quit claim deed[5] transfer occurred on August 31, 2006, 2 months before closing, for all of the rights, title, interest, and claim to the parcel of land and improvements and appurtenances in Jackson County for the mobile property from the grantor to the borrower (grantee). However, this did not guarantee that the grantor had ownership rights to the property or that the property was free of debt.

Birmingham's underwriter should not have used net rental income. Using the borrower's average monthly employment income would increase the mortgage payment-to-income ratio

[5] A Quitclaim deed is a type of deed that releases the grantor's ownership interest in a property to the grantee. However, the grantor does not make any guarantee that: (1) the property is free of debt, (2) no one else claims to own the property, or (3) he or she has any ownership interest in the property.

from 33.779 to 37.517 percent ($732.24 divided by $1,951.73). The total fixed payment-to-income ratio would increase from 38.671 to 42.948 percent ($838.24 divided by $1,951.73).

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-7M, states that rent received for properties owned by the borrower is acceptable if the lender can document that the rental income is stable. Examples of stability may include a current lease, an agreement to lease, or rental history over the previous 24 months that is free of unexplained gaps greater than 3 months. A Schedule E of IRS Form 1040 and current leases are required to verify all rental income. If a property was acquired since the last income tax filing and is not shown on Schedule E, a current signed lease or other rental agreement must be provided.

HUD Handbook 4155.1, REV-5, chapter 3, states that the lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation, the source of funds for the transaction, and the intended use of the property. All information must be verified and documented.

Credit:

Birmingham should not have approved this loan because the borrower had not demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12 to 24 months or the borrower's ability to accumulate savings.

The borrower's total monthly mortgage payment was $732. Before the loan closing, the borrower was not known to have a rental or mortgage payment history except monthly payments of $84. The borrower's highest balance in his credit union account was $172. Further, Birmingham's underwriter did not show that the change in the housing expenses would not be minimal. The change in the housing expenses was an increase of 773 percent, from $84 to $732.

To establish alternative credit, the borrower's payment to a rental company was used. The verification of loan, dated August 24, 2006, revealed that the borrower had one rent-to-own account with a current balance of $1,149 and an installment payment of $34. The borrower had seven late payments on this account. The borrower also had 18 late payments on another rent-to-own account, which had a zero balance.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-1, states that the purpose of underwriting is to determine a borrower's ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties and to examine the property offered as security for the loan to determine whether it is sufficient collateral.

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower’s future actions. If the credit history, despite adequate income to support obligations, reflects continuous slow payments and delinquent accounts, strong compensating factors will be necessary to approve the loan. The lender must document its analysis regarding whether the late payments were based on disregard for financial obligations or otherwise. Further, paragraph 2-3C states that collections and judgments must be considered in the analysis of creditworthiness with the lender documenting its reasons for approving a mortgage when the borrower has collection accounts and judgments. The borrower must explain in writing all collections and judgments.

Loan number: 263-3938261

Mortgage amount: $101,408

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: November 20, 2006

Status: Claim

Payments before first default reported: Zero

Loss to HUD: $85,425

Summary:

We found a material underwriting deficiency relating to the borrower's verification of rent.

Verification of Rent:

The borrower and coborrower were living in the property they were purchasing. However, Birmingham's underwriter did not address inconsistencies reported on the loan applications and the verification of rent pertaining to their rental history found in Birmingham's file. The final loan application, dated November 20, 2006, signed by the borrower and coborrower reported that they had been renting the subject property for 3 years. The application did not report their monthly rent. Birmingham's file included two separate initial loan applications, both dated September 27, 2006. The borrower's signed application reported that she had rented the subject property for 3 years and her monthly rent was $600. The coborrower's application only reported that she had lived at the same property; however, it did not report how long she had lived there or her housing expenses.

Birmingham's file included a verification of rent from the landlord/owner, dated September 28, 2006. The verification showed the borrower had resided at the subject property since November 1, 2005, less than 1 year from the date of the loan application, and reported $930 as monthly rent.

The file did not include documentation resolving the differences between the loan applications and the verification of rent regarding how long the borrower and coborrower had lived at the subject property and their monthly rent. Further, Birmingham did not obtain a letter of explanation from the borrower and coborrower addressing these inconsistencies. However, the loan officer provided a certification on behalf of the borrower, stating that the borrower was unable to provide canceled checks for the rental payments because the majority of the payments were paid in cash.

HUD/FHA Requirements:

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

HUD Handbook 4155.1, REV-5, paragraph 3, describes the documentation requirements for each loan submitted for mortgage insurance and the specific requirements lenders must observe in processing and underwriting FHA-insured mortgages. The lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation. All information must be verified and documented. Paragraph 3-1 states that the application package must contain all documentation supporting the lender's decision to approve the mortgage loan. Paragraph 3-1L states that explanatory statements or additional documentation necessary to make a sound underwriting decision are to be included in the case binder.

APPENDIX C

LENDER COMMENTS AND OIG's EVALUATION

Ref to OIG Evaluation **Lender Comments**

BIRMINGHAM BANCORP MORTGAGE CORP.
6230 Orchard Lake Rd. • Suite 280 • West Bloomfield, MI 48322
Phone: (248) 737-2929 • Fax: (248) 855-2031

June 8, 2010

Mr. Muhammad M. Akhtar
Supervisory Forensic Auditor
HUD-OIG
77 West Jackson, Room No. 2646
Chicago, IL 60604

Dear Mr. Akhtar:

We have received a copy of the Discussion Draft which was sent to us on May 24, 2010, and appreciate the opportunity to respond. We have reviewed the 10 loan files identified in great detail both with respect to the reliability of the documentation and the approval decisions reached by our underwriters. As with your Discussion Draft, I will first address the broader issues you have raised with respect to the integrity of our processes and procedures. At the end of this response I have then attached individual responses on each loan, with Exhibits and attachments following after that.

If there are any other comments that your office intends to add, we would appreciate the chance to respond to them prior to the publication of your findings.

BACKGROUND

Birmingham Bancorp Mortgage is a non- supervised FHA Underwriter which became Direct Endorsed in 1988. In nearly 22 years of underwriting service for the Federal Housing Administration there have been very few loans in which any agency, investor or servicer has successfully disputed the merit of Birmingham Bancorp's underwriting. Out of an estimated 25,000 loans this is especially low, considering the overwhelming majority of loans were manually underwritten loans from third party lenders.

The breakdown of the original 20 loans selected for the audit is as follows:

17 out of 20 were down payment assistance
10 out of 20 were in Michigan
13 out of 20 were in underserved markets
All of the loans were purchased from third party broker originators

Ref to OIG Evaluation **Lender Comments**

During the time frame of January 1, 2005 and December 31, 2008, Birmingham Bancorp purchased 2777 third party broker loans through Loan Correspondents and originated 522 retail loans, not including Streamlines, through its own retail loan originators. However, there were no loans selected in this second category for review.

RESPONSE TO REVIEW

The Office of the Inspector General has drawn a set of very general conclusions from the review of 10 out of over 3000 loans closed by Birmingham Bancorp during the applicable time frame, and those 10 that were selected came from the most unfavorable demographics of all of our loans.

Of the 10 loans that the OIG found fault with:

7 out of 10 were down payment assistance
6 out of 10 were in Michigan
7 out of 10 were in underserved markets
All were purchased from third party broker originators

FHA Loan #	Originated by Third Party Broker	Down Payment Assistance Program	Located in HUD Underserved Area	State
093-6128495	X	X		FL
105-3017718	X	X	X	GA
151-8410864	X	X		IN
201-3487218	X	X	X	KY
261-9009876	X	X	X	MI
261-9071686	X		X	MI
262-1681931	X		X	MI
263-3870605	X		X	MI
263-3922022	X	X	X	MI
263-3938261	X	X		MI

Because all of the loans selected by the OIG were from our wholesale division, it must be pointed out and understood that the origination and processing of all these loans was done by 10 different HUD Approved Correspondent Lenders. Birmingham Bancorp Mortgage Corporation (BBMC) received all documentation from these brokers and did not have direct access to the Borrowers. The review of our performance, therefore, must focus on what documentation BBMC actually had in it's possession to review and verify, and be limited to the activities performed only by BBMC. If there were any improprieties on the part of the third party brokers, BBMC should not be held accountable for them.

Ref to OIG Evaluation	Lender Comments

It should also be noted that these loans were originated as long as five years ago and mostly underwritten by an underwriter no longer employed by Birmingham Bancorp. Our ability to respond to the OIG's findings is made more difficult by this gap. In many cases, the OIG is not disputing the facts of the file, but only stating that more documentation, or different documentation, should have been collected to arrive at the same conclusion. In other cases, the OIG is simply disputing the conclusion reached by the underwriter based on accurate, acceptable documentation. The majority of these loans were underwritten by our most senior underwriter, with over 10 years experience in FHA underwriting at the time. As a DE Underwriter she was authorized by FHA to make credit judgment decisions.

Income

Birmingham did properly calculate income on loans reviewed by the OIG.

Comment 1

On loan number 105-3017718, the Borrower's income was calculated using $9 per hour, the rate shown on his most recent pay stub (Exhibit 24), times 40 hours per week, with no consideration given to the OT earned year to date, giving $1,560 per month. Since the Borrower is hourly and we did not use overtime, income was not averaged over the entire employment period since 4/06. However, base income shown on the Borrower's pay stub thru April 1, 2007, was $4,844 before overtime, which is a monthly average of $1,615 and higher than what was actually used by the Underwriter.

The OIG Auditor stated that the Borrower's employer stated the work was seasonal. The owner, [redacted], said, in fact, that seasonal did not mean the Borrower only worked certain times of the year, but that as a cabinet maker, their business fluctuated with the economy. When asked about the low 2006 earnings, the employer stated that [redacted] had injured himself and was off for several months due to the injury. Therefore, the underwriter's calculation of income was correct.

Comment 2

For loan number 151-8410864, the OIG Auditor used the wrong date from which to calculate income. The Verification of Employment from "The Work Number" (Exhibit 25) shows a hire date of 5/1/2007, but a Start Date of 6/12/2007. The Auditor incorrectly used the 5/1/2007 Hire Date when calculating average income. The average income was correctly calculated by the Underwriter from the 6/12/2007 start date. This is what is on the MCAW (Exhibit 26):

Income Calculation:

Paystub #1 Paid thru date	9/29/07
YTD Income	$9,558
Months since start date of 6/12/2007	3.5
Average Monthly Income	$2,731
Ratios	29.95/42.65

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The Verification of Employment also shows an hourly wage as $15.90 per hour, which for a normal 40 hour week works out to $2,756 per month.

The underwriter questioned the fact that there were no federal taxes withheld and so an additional pay stub (Exhibit 27) was provided. Even though the pay stub for this particular week showed less than 40 hours, the ratios can be supported by calculating the average weekly income over 16 weeks, and then annualizing this and dividing by 12. Also, please find attached a copy of the Seller's Homeowners Association Bill (Exhibit 28) which shows that the housing payment was overstated by $11 per month. The ratios would then be:

Pay stub #2 Paid thru date	10/6/07
YTD Income	$9,987
Weeks since start date of 6/12/2007	16
Average Weekly Income	$624
Average Monthly Income	$2,705
Ratios	29.83/42.66

Liabilities

Birmingham Bancorp is always careful to include all liabilities, but on one of the loans cited by the OIG Auditor, a liability for child support was inadvertently omitted from the MCAW. However, the loan was within ratios even when this liability is included. On the other loan the liabilities were properly documented.

Comment 3

For loan number 093-6128495, the Borrower had four open accounts all paid as agreed. There were 3 small non-medical collection accounts from 3, 4 & 5 years previous, listed multiple times making the list seem longer (Exhibit 1). The Borrower had rented from the same landlord for four years and, in addition to the VOR (Exhibit 2), provided 12 months of cancelled rent checks (Exhibit 3). The Co-Borrower had a limited credit history on the credit report including one open credit card account for 3 months paid as agreed and a medical collection account from 2000. In addition, the VOR shows that the lease was in both the Borrower's and Co-Borrower's names and paid as agreed. This credit, when combined with the more substantial credit history for the Co-Borrower, including 12 months canceled checks for the rent, was considered sufficient by the underwriter.

Per the closing instructions (Exhibit 4), the Borrower was required to bring a certified check for $3,129 payable to the Department of Revenue, State of Colorado, to pay off the tax lien. This is the exact amount necessary to pay the lien in full per the payoff (Exhibit 5). Prior to closing, the Borrower provided a 401k statement (Exhibit 6) evidencing sufficient funds to pay off the lien and proof that the withdrawal request had been processed (Exhibit 7). Attached are a copy of the check (Exhibit 8) and the Fed-Ex label showing the funds being sent by the closing agent to the State of Colorado (Exhibit 9).

Ref to OIG Evaluation	Lender Comments
Comment 4	For loan number 105-3017718, it appears that the underwriter did not include the child support of $160 per month, on the MCAW. However, when this is included the ratios are still only 24.62/39.25, without counting any overtime for the Borrower. These ratios are still well within HUD guidelines. The OIG Auditor had previously miscalculated income (see comments above under Income), which was what caused the ratios to appear over HUD guidelines.
	Excessive Ratios
	Birmingham Bancorp was cautious about exceeding ratios and never did so without indicating legitimate compensating factors. On the 10 loans that we are responding to, the ratios are 30/41, 27/41, 34/39, 30/43, 19/21, 32/34, 25/39, 20/42, 34/34, 17/26.
Comment 5	In loan number 105-3017718, the ratios were 24.62/39.25. This is the same loan that the OIG has listed twice previously because of the miscalculated income from the Hire Date rather than the Start Date of employment (see sections "Income" and "Liabilities" above).
Comment 6	For loan number 263-3870605, the actual ratios were 33.515/33.515. Not only was Borrower's housing expense going down by $220 from the previous VOR, but the Borrower had no other monthly debt, leaving a very conservative total debt ratio. The underwriter wrote "Housing Decreasing" on the MCAW (Exhibit 53) as a compensating factor, and could also have put that the Borrower was a conservative user of credit as evidenced by the low total debt ratio.
Comment 7	On loan number 263-3922022, which was the only other loan of the 10 that was approved over ratio, the ratios were 33.78/38.67 (Exhibit 56). Again, a slightly higher front ratio was balanced out by a very conservative back ratio. In this instance, the Borrower had been employed at the same job for 6 years. In addition to the 2 compensating factors listed by the underwriter as "stable employment" and "overtime not used in income", this file, too, could have included "conservative user of credit" because of the low total debt ratio.
	Assets
	BBMC always documented sufficient assets to close. Of the original 20 loans selected, eighty-five percent used Down payment Assistance Programs for funds to close.
Comment 8	In loan number 262-1681931, this loan was approved through the TOTAL automated system (Exhibit 44). With an automated approval we are only required to verify the current balance. Funds are not required to be seasoned.
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Condition #28 on the approval states:

"Information about assets furnished on the loan application was used to underwrite this case. The Depository assets totaling $7,155.00 must be verified by one of the following: a) VOD; b) most recent statement showing the previous month's balance; or c)most recent two months statements to verify sufficiency of funds required to close."
Condition #29, on the other hand, states:

"If the amount of earnest money deposit exceeds 2% of the sales price or appears excessive based on the Borrower's history of accumulating savings, the lender must verify the deposit amount and the source of funds according to the current FHA guidelines. The lender must also determine that any recent debts were not incurred for any part of the cash investment on the property being purchased."

DU findings are to be followed literally. The earnest money deposit was only $500, (less than 1%) so condition #29 does not apply. Condition # 28 does not require the lender to document the source of funds or any large deposits, only that the funds are sufficient. The broker could have chosen to document the funds needed for closing with a VOD, which would not show and details of activity, instead of a bank statement. In either event, the automated condition to verify assets of $7,155 was satisfied.

Comment 9

On loan number 263-3870605, the 1003 signed by the Borrower on 3/16/06 (Exhibit 45) stated that the source of funds for closing was cash on hand and a tax refund. In addition, on page 3 of the application the Borrower listed under assets:

TAX RETURN – 2005	$6,171.05
Bank of America	$2,828.03

The Bank Statement provided from the Borrower showed the tax return funds deposited on 2/24/06, 3 weeks prior to application. As proof of these funds, a check from HSBC for $6,171.05, dated 2/23/06 (Exhibit 46), was provided to the underwriter by the third party loan correspondent and would have been explained to the underwriter as a tax advance loan. In addition there was a completed Verification of Deposit from Bank of America (Exhibit 47) showing a current balance of $3,100.30 and an average balance for the previous two months of $3,000 which exceeded the $2,700 the Borrower needed to bring to closing.

Gift Funds

Birmingham Bancorp always followed HUD guidelines in determining and documenting the source of gift funds for all loans.

Comment 10

For loan number 093-6128495, the gift funds were not transferred to the Borrower either before or after the closing. The funds were sent directly to the closing agent, Title Consulting Services, and were credited on the HUD 1. The First Lien letter from Title

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Consulting Services (Exhibit 10) certifies that the loan was closed per our Closing Instructions (Exhibit 11), including receipt of the gift funds from Dove Foundation. Enclosed, also is a copy of the HUD 1 (Exhibit 12) showing that the closing agent was Title Consulting Services. Also enclosed is the Closing Protection Letter from Old Republic National Title Insurance Company (Exhibit 13) which guarantees the performance of Title Consulting Services. Since the closing agent is an independent third party to the transaction, their certification that the funds were received, guaranteed by the Title Insurance Company, should be sufficient. However, also attached is the wire transfer advice (Exhibit 14) from the Closing Agent verifying receipt of the gift funds on the closing date, which we requested earlier this week. We did change our procedures several years ago to get this advice as well.

Comment 11

For loan number 261-9071686, all the documentation on this file was received through the third party mortgage broker who originated the loan, Dynamic Mortgage Inc. According to our files, the Borrower did intend to use her own funds. Her credit union statement showed four open accounts: 00 Regular Savings, 01 Four Bedroom House, 06 2001 Kia Optima SE, and 11 Unsecured Loan. However, since the funds for the home were not seasoned 60 days, they could not be used for closing. Therefore, in order to close she obtained a gift from her cousin.

The documentation of funds to close met the HUD guidelines. We had a fully executed gift letter (Exhibit 39) from [redacted] who the Borrower also identified as her cousin (Exhibit 40). We also had a copy of a cashier's check (Exhibit 41) made out jointly to the Borrower and the Title Company from [redacted] account, and a copy of the withdrawal slip from the Donor's Account dated 3 days prior to closing indicating that the funds had been withdrawn and the donor still had a balance, after the gift, of $56,000 (also Exhibit 41). After closing, this loan was selected for review in our monthly 10% Q/C reviews and sent to our outside Q/C firm, Wetzel-Trott, who re-verified the legitimacy of the check. Attached is a copy of the response they received from Wings Financial Credit Union (Exhibit 42). Because the check was made out to the Title Company and the Borrower jointly, the funds were never deposited into the Borrowers account, but given directly to the closing agent.

The Auditor has stated that when contacted, the Borrower said that gift funds of $2,000 were actually brought to the closing by the Seller at the instruction of the loan officer. Birmingham Bancorp has no evidence of this taking place. This loan was originated by a third party broker approved by HUD as a Correspondent Lender. The documentation that we were provided seemed perfectly legitimate, and to follow HUD guidelines. We have been unable to contact the Borrower or the Donor directly.

Credit Report

Birmingham Bancorp had more experience than most companies in analyzing credit. Our underwriters at the time were more mature and had gained their experience in the years prior to automated underwriting. A high percentage of our loans were manually

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underwritten and had no minimum credit score requirements, which requires a more experienced underwriter than companies that relied primarily on automated approvals.

Comment 12

For loan number 093-6128495, the Borrower had four open accounts all paid as agreed. There were 3 small non-medical collection accounts from 3, 4 & 5 years previous, listed multiple times making the list seem longer (Exhibit 1). The Borrower had rented from the same landlord for four years and, in addition to the VOR (Exhibit 2), provided 12 months of cancelled rent checks (Exhibit 3). The Co-Borrower had a limited credit history on the credit report including one open credit card account for 3 months paid as agreed and a medical collection account from 2000. In addition, the VOR shows that the lease was in both the Borrower's and Co-Borrower's names and paid as agreed. This credit, when combined with the more substantial credit history for the Co-Borrower, including 12 months canceled checks for the rent, was considered sufficient by the underwriter.

Comment 13

For loan number 105-3017718, the breakdown of accounts for Borrower, Co-Borrower and Joint credit is listed below. Typically we do not put much weight on medical collection accounts since they are usually due to charges the Borrower does not understand, are sold to multiple collection agencies, and are often the result of billing errors. What is left shows the Borrower with 1 individual and 3 joint paid as agreed accounts, 1 collection and one unable to identify. The co-borrower, likewise, then shows 8 individual and 3 joint paid as agreed, 2 collection and 2 unable to identify or disputed. The LOX in the file addresses most of these accounts. Middle credit scores for the Borrower and Co-Borrower were 578/573. This credit was typical of many Borrowers applying for FHA loans during this time frame. There was one open paid as agreed account with First National as well as a Verification of Rent for with no late for 36 months. We also obtained an alternative credit for insurance from Polk County Farm Bureau so as to have three current credit references. In the opinion of the underwriter, the credit was acceptable.

Borrower:	1	Paid as Agreed
	2	Medical Collection
	1	Other-Collection
	1	Borrower Unable to Identify
Co-Borrower:	8	Paid as Agreed
	3	Medical Collection
	2	Other-Collection
	1	Borrower Unable to Identify
	1	Dispute
Joint:	3	Paid as Agreed

Comment 14

In loan number 263-3922022, the Borrower had a middle credit score of 601. [redacted] adequately explained the derogatory accounts on his credit report. The Auditor states that

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the two rent to own loans were late 7 and 18 times, respectively. However, this is misleading in that these were not 30 day late payments. The verification (Exhibit 58) further states that [redacted] never paid more than 11 days from the due date. The industry standard definition of a late payment is a payment that is 30 days late.

Comment 15

Verification of Rent

In loan number 201-3487218, Birmingham Bancorp did have independent verification of the rent payments and time in the property. In addition to the completed Verification of Rent from the landlord, there was also a verification done by the credit bureau on page 5 of their report (Exhibit 31). The information reported by the credit bureau agreed with the VOR.

Comment 16

In loan number 261-9009876, the Borrower's address history is adequately documented. At the time of application [redacted] was living in the property that she was purchasing. This is documented by her 1010 affidavit and by a VOR from the landlord. I assume the VOR from the seller was misdated and should have been 1/1/06 rather than 1/1/05, which would have been consistent with the .4 years on the 1003, the VOR for [redacted] Street showing she was there through November of 2005 (Exhibit 35), and the two appraisals. (The November 2, 2005 appraisal (Exhibit 36) indicated that the property was vacant/owner occupied and the pictures showed no furniture, whereas the 3/10/06 appraisal Exhibit 37 indicated tenant occupied.) We were not able to get cancelled checks or money orders, which often happens when Borrowers are paying cash for their rent. In such situations, rather than rejecting the Borrower for paying cash, it was our policy still to get the VOR as additional documentation, but not to rely on it for credit underwriting purposes. Prior to this, she lived at [redacted] from 6/7/2004 to 11/15/05 and prior to that at [redacted]. The copy of the Drivers License (Exhibit 38a) shows this as well with the [redacted] address on the front and the change of address on the back to [redacted] St. The VOR for [redacted] for 1.5 years was what was used to support prior housing history.

Comment 17

In another file, loan number 105-3017718, the Auditor stated that

> "Birmingham obtained two verifications of rent from the Borrower's current and former landlords, which reported the borrower's residency for the period November 2003 to April 2007. However, the credit reporting agency was unable to verify either of the rental property addresses. Further, we could not verify that these properties existed when we searched the county property records and Google Maps."

However, contrary to the findings of the Auditor, Birmingham was able to Google Identify the addresses on both of the VOR's (Exhibits 15 and 16). Further, the address that the Borrowers lived at from November, 2003 to November 2006, [redacted] was identified on the credit report (Exhibit 17), and is on the 2005 W2's for both the Borrower (Exhibit 18) and the Co-Borrower (Exhibit 19). The second VOR for

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[redacted] only covered a short recent period of time (11/13/06 thru 4/10/07) and may not have been reported to the credit agencies. We were able to contact the landlord on this property, [redacted], who verified that the VOE was accurate. In addition, the 2006 W2 for the Co-Borrower (Exhibit 20) showed this address as well. We were also able to corroborate this address in the county records under the landlord's name (Exhibit 21). Lastly, we sent an inspector to both property addresses on 6/4/10 who confirmed that there were people living at both addresses. Attached are pictures of both residences (Exhibits 22 and 23a&b).

Comment 18

Incorrect Underwriters Certifications Submitted to HUD

We absolutely disagree with the OIG's statement that there was a lack of due diligence on the part of our underwriter's or that the general integrity of the data is suspect. If there were any mistakes or misjudgments, they were simple human error, infrequent and completely unintentional. If, in spite of the utmost due diligence, there was a problem with the origination or processing by the HUD approved correspondent it was not readily detectable by Birmingham Bancorp. The underwriting of these files met both HUD guidelines and industry standards.

Comment 19

RESPONSE TO RECOMMENDATIONS

1A. Remedies under the Fraud Civil Remedies Act are not appropriate. The report indicates that our underwriters "incorrectly certified" that due diligence was used in underwriting 10 loans. We dispute that the ten loans in question were not underwritten correctly. However, if minor errors occurred it is certainly not fraud. Suggesting that this *incorrect* certification somehow constitutes a "false, fictitious, [or] fraudulent claim," in violation of 31 U.S.C. § 3802 is clearly a misapplication of the statute. Not every mistake arises from failure to exercise due diligence.[1]
The Program Fraud Civil Remedies Act is commonly known as the Mini-False Claims Act.[2] Both acts target fraud. The standard of knowledge required under both acts is the same.[3] Under both acts, to be liable a party must make a false claim and must "know that

[1] *Savings Bank v. Ward*, 100 U.S. 195, 198 (1879).

[2] See EPA Committee on Integrity and Management Improvement, "Program Fraud Civil Remedies Act," Bulletin 94-1, EPA 350-F-93-003, December 1993; Gary Thompson & Sabrina Yohai, "Stimulus Bill And Strings: Massive Federal Spending Will Be Accompanied By Increased Inspectors General Oversight And Investigations," The Metropolitan Corporate Counsel April 2009 at 12.

[3] NASA Office of Inspector General, "Remember the PFCRA," http://www.hq.nasa.gov/office/oig/hq_old/PFCRA.pdf ("The PFCRA's substantive provisions are essentially the same as the False Claims Act, *e.g.*, same standard of knowledge, same burden of proof.")

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the claim or statement is false, or be deliberately ignorant of its truth or falsity, or act in reckless disregard of its truth or falsity.[4]"

Under the False Claims Act, courts have rejected claims based on bad math,[5] differences in interpretation,[6] or mere negligence or innocent mistakes.[7] Proof that a party signed a presentation that may be incorrect is not sufficient to establish liability.[8] As the Ninth Circuit put it in *Northern Telecom*: " 'Bad math is no fraud,' proof of mistakes 'is not evidence that one is a cheat,' and 'the common failings of engineers and other scientists are not culpable under the Act' . . . . 'known to be false' 'does not mean 'scientifically untrue'; it means 'a lie.'"

Action against the principals of the Company is similarly inappropriate. The principals did not make any certifications upon which action can be based.

1B. Administrative action is also not appropriate. Birmingham Bancorp has had regular formal HUD Audits, an Audit by your own office in 2006 (copy attached) and responded to multiple audits of third party brokers with whom we did business. In substantially all of those audits, our underwriting decisions were upheld by the auditors involved.

Comment 20

PRIOR UNDERWRITING REVIEWS

In reviewing our prior audits, you will find that all loans were underwritten to FHA's guidelines in effect at the time they were originated. This conclusion has been reached repeatedly by auditors of the Department of HUD during their normal bi-annual audits, as well as by your own office during the time frames in question. In the OIG audit completed in 2006 (attached) your office concluded: "Birmingham substantially complied with HUD's underwriting requirements…". In recent years we have gone through the following audits, all resulting in agreement with our loan underwriting on

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[4] EPA Committee on Integrity and Management Improvement, "Program Fraud Civil Remedies Act," Bulletin 94-1, EPA 350-F-93-003, December 1993

[5] *United States ex rel. Anderson v. Northern Telecom, Inc.*, 52 F.3d 810, 815-816 (9th Cir. 1994).

[6] *United States ex rel. Norbeck v. Basin Electric Power Cooperative*, 248 F.3d 781, 792 (8th Cir. 2001).

[7] *Hindo v. University of Health Sciences/The Chicago Medical School*, 65 F.3d 608, 613 (7th Cir. 1995); *United States ex rel. Hopper v. Anton*, 91 F.3d 1261, 1267; *Godley v. United States*, 26 Cl. Ct. 1075, 1090 (1992) *vacated on other grounds*, 5 F.3d 1473 (Fed. Cir. 1993).

[8] *Woodbury v. United States*, 232 F. Supp. 49, 55 (D. Ore. 1964), *rev'd in part on other grounds*, 359 F.2d 370 (9th Cir. 1966).

every loan examined. **The feedback we received from these audits was critical to shaping our policies on what was or was not credit worthy under FHA guidelines.**

Nov 04	HUD	24 loans
Jan 06	OIG	17 loans
Jan 07	HUD	60 loans
Nov 09	HUD	50 loans

In addition to the above audits, HUD performed numerous audits of our brokers that we also responded to, all of which were cleared as well, including the following:

Audit Date	Third Party Broker Originator
October 2009	Lewis Hunt Enterprises, dba Interactive Financial
December 2008	ABS Financial, Inc. dba Greater Ohio Mortgage
January 2009	One World Mortgage Corporation
June 2008*	First National Mortgage Banc, Inc.

I am pointing this out because it is important to understand that we rely on these audits as guidance and a reflection of HUD's agreement with our underwriting procedures and conclusions. Even under current FHA guidelines, and more so in the past, some analysis is left to underwriter discretion. During the period of January 2005 through December 2009, 100% of our loans that were audited were confirmed as in compliance with HUD guidelines.

* HUD completed a review of First National Mortgage Banc, Inc. on June 17, 2008 and requested documentation on two loans originated by them then sold to us which went into foreclosure in 2006. The documentation was deemed acceptable and the findings closed. One of the loans in the current list being reviewed by the OIG ([redacted] 201-3487213) was also originated by First National Mortgage Banc and went into foreclosure in 2006. I assume that HUD reviewed this file as well in the June, 2008, audit and found it acceptable at that time.

DEFAULT ANALYSIS

When originally contacted for the subpoenaed files, we were told that the reason for the investigation was to try to determine broader loan characteristics that transcended individual lenders, and that might be cause for higher delinquencies. We, too, have tried in the past to determine patterns or characteristics common to defaulted loans. Using our internal review sheets, we created an extensive database of current and defaulted loans and subjected it to a number of statistical inquiries. We concluded that third party broker originations, Down Payment Assistance Programs, and states with the worst adverse economic conditions, such as Michigan and Florida, explain the majority of the defaults.

Birmingham Bancorp Mortgage was selected for an OIG/HUD audit because it had a higher delinquency and default ratio than average. During the years of 2005-2008, the make up of the company's book of business was the following:

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1. 84% third party broker originated FHA loans, excluding Streamline Refinances
2. Approximately 69% of all third party broker originated purchases were down payment assistance.
3. 51% were in Michigan or Florida.
4. A larger percentage of underserved markets.

The breakdown of the 20 loans selected for the audit were as follows:

1. 17 out of 20 were down payment assistance
2. 10 out of 20 were in Michigan
3. 13 out of 20 were in underserved markets
4. All of the loans were purchased from third party broker originators

This data indicates that Birmingham Bancorp Mortgage's delinquency and default is more directly correlated to the type of loan products and their source, than to Birmingham's underwriting processes.

1. It has always been common knowledge that Borrowers with no money invested in a property have a higher tendency to default. Ninety percent of the loans originated were to 1st time Homebuyers and 90% were purchases using Down Payment Assistance programs approved by HUD. HUD itself reported that the default rate on DPA loans was three times as high as on other loans and had to fight a two year legal battle to eventually discontinue the use of these programs. Add to this a declining economy and housing market, and the fact that half of these loans were in Michigan, and the result of higher defaults is not only predictable, but inevitable.

2. HUD has also now discontinued the use and approval of Loan Correspondents, presumably because they found fault with this process as well. Therefore 100% of the loans selected by the OIG were, in fact, originated through a Loan Correspondent program that HUD has now discontinued as unworkable. And since each of the 10 loans was originated by a different broker, it does not appear that only certain brokers were a higher risk. As noted earlier, during the time frame from January 1, 2005 to December 31, 2008, Birmingham Bancorp purchased 2777 third party broker loans through Loan Correspondents and originated 522 retail loans, excluding streamline refinances, through its own retail loan originators. However, there were no loans selected in this second category, presumably because of a much lower default rate for these loans when the entire origination process was controlled by Birmingham Bancorp. At the end of 2008, we realized that third party broker originations were performing at a higher default rate and we made the decision to exit the third party business entirely, a year before HUD came to the same conclusion.

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ADDITIONAL DUE DILIGENCE

Our approach was not to second guess HUD's guidelines and make them tougher, but to follow the guidelines as written and be prudent. We underwrote strictly to FHA guidelines and for a while did not have restrictions based on DPA, FICO scores or automated approvals. Even then, we still had some add-ons that were required by our investors. It is interesting to note that in our November 04 HUD audit we were questioned heavily for rejecting streamline loans that had recent delinquencies. We were told by the auditors that we could not reject a Streamline loan for credit since HUD had no credit guidelines for Streamlines, and we replied that we had to follow the dictates of those to whom the loans were being sold.

We implemented other internal procedures to try to improve our loan quality:

Fraud Check thru Interthinx Dissco	2007
Verbal Reverifications of Employment	2007
Reverify Tax Returns on all Self-employed Borrowers	2008
Staff appraiser to order AVM's and review all appraisals from Brokers.	2008
Additional Review Underwriter to re-underwrite each loan before closing	2008
Verbal Reverifications of Rent & Alt Credit	2008
Countless Corporate Training Seminars	2009

EXIT STRATEGY FOR WHOLESALE

We exited the third party broker originated business in the fourth quarter of 2008, recognizing the extent to which the adverse selection process was affecting our results in spite of our best efforts. In fact, we were rejecting 4 times as many loans as we closed. The percentage of loans underwritten and rejected, by year, was as follows:

Year	Percentage of Apps Rejected
2005	60.57%
2006	63.10%
2007	77.45%
2008	79.15%

In addition to the rejection ratio, we became increasingly concerned about the quality of both the brokers and the borrowers in a variety of states.

Our current business profile is as follows:

1. 640 and higher FICO scores only
2. No third party broker originations
3. No 30 day lates on mortgage history
4. An intense double and triple check system of all files before disbursement

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Approximately 25% of our entire staff has an underwriting background or is part of our compliance team. Our attention to detail and due diligence is higher than any company we are aware of in the industry.

We are confident that we have acted with proper due diligence in our underwriting of the 10 final loans in question.

CONCLUSION

We now originate only FHA loans with credit scores over 640, and may soon increase those standards to a minimum of 660. Our volume is much lower which hurts our ability to grow out of the default legacy of the earlier third party broker originated loans, but we are starting to see some improvement in our Neighborhood Watch numbers and are confident that we will continue to meet HUD guidelines in this area.

We are respectful of the obstacles FHA/HUD is facing in this housing crisis. FHA has always had the mission to help promote housing to those citizens least served by the private market. In the 2005-2008 period, HUD's market share was small and their programs were focused on those programs that could provide the opportunity for homeownership to individuals that could not otherwise qualify. I applaud that goal and the increase in homeownership created by all the federal agencies. However, these were the very same borrowers most adversely affected by the consequent collapse of the economy and the housing market. It is this perfect storm of record homeownership goals; expansive underwriting guidelines such as DPA, no required reserves and HUD-approved Loan Correspondents; rapidly increasing home prices; and the consequent collapse of the housing market that primarily caused the high rate of defaults in these programs.

Birmingham Bancorp Mortgage follows all FHA/HUD underwriting guidelines. Birmingham Bancorp Mortgage personnel are trained to use the utmost due diligence in their processing and review of mortgage loans and documentation. We respectfully believe we have done our part in managing the toughest segment/market in the industry.

Respectfully,

Mark E. McCartin
President

Appendix A

Responses to Individual Loan Reviews

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Comment 21

AUDIT RESPONSE – 6/6/10

FHA Case # 093-6128495
Borrower name: [redacted]
Co-Borrower: [redacted]

Credit History for Co-Borrower:

For loan number 093-6128495, the Borrower had four open accounts all paid as agreed. There were 3 small non-medical collection accounts from 3, 4 & 5 years previous, listed multiple times making the list seem longer (Exhibit 1). The Borrower had rented from the same landlord for four years and, in addition to the VOR (Exhibit 2), provided 12 months of cancelled rent checks (Exhibit 3). The Co-Borrower had a limited credit history on the credit report including one open credit card account for 3 months paid as agreed and a medical collection account from 2000. In addition, the VOR shows that the lease was in both the Borrower's and Co-Borrower's names and paid as agreed. This credit, when combined with the more substantial credit history for the Co-Borrower, including 12 months canceled checks for the rent, was considered sufficient by the underwriter.

State Tax Lien

Per the closing instructions (Exhibit 4), the Borrower was required to bring a certified check for $3,129 payable to the Department of Revenue, State of Colorado, to pay off the tax lien. This is the exact amount necessary to pay the lien in full per the payoff (Exhibit 5). Prior to closing, the Borrower provided a 401k statement (Exhibit 6) evidencing sufficient funds to pay off the lien and proof that the withdrawal request had been processed (Exhibit 7). Attached are a copy of the check (Exhibit 8) and the Fed-Ex label showing the funds being sent by the closing agent to the State of Colorado (Exhibit 9).

Gift Funds:

For loan number 093-6128495, the gift funds were not transferred to the Borrower either before or after the closing. The funds were sent directly to the closing agent, Title Consulting Services, and were credited on the HUD 1. The First Lien letter from Title Consulting Services (Exhibit 10) certifies that the loan was closed per our Closing Instructions (Exhibit 11), including receipt of the gift funds from Dove Foundation. Enclosed, also is a copy of the HUD 1 (Exhibit 12) showing that the closing agent was Title Consulting Services. Also enclosed is the Closing Protection Letter from Old Republic National Title Insurance Company (Exhibit 13) which guarantees the performance of Title Consulting Services. Since the closing agent is an independent third party to the transaction, their certification that the funds were received, guaranteed by the Title Insurance Company, should be sufficient. However, also attached is the wire transfer advice (Exhibit 14) from the Closing Agent verifying receipt of the gift funds on

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the closing date, which we requested earlier this week. We did change our procedures several years ago to get this advice as well.

Reason for Default:

Per the Case Status Details in Neighborhood Watch, the reason for Default was "Curtailment of Income". The Borrower at that time had been employed for over 8 years with Pepsi, and the Co-Borrower was on pension and social security income. Stability of income was one of the strengths of the file and could not have been anticipated. This reason for default has nothing to do with the credit.

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Comment 22

AUDIT RESPONSE – 6/7/10

FHA Case # 105-3017718
Borrower name: [redacted]
Co-Borrower name [redacted]

Credit History:

Credit: The breakdown of accounts for Borrower, Co-Borrower and Joint credit is listed below. Typically we do not put much weight on medical collection accounts since they are usually due to charges the Borrower does not understand because they are sold to multiple collection agencies and are often the result of billing errors. What is left shows the Borrower with 1 individual and 3 joint paid as agreed accounts, 1 collection and one unable to identify. The co-borrower, likewise, then shows 8 individual and 3 joint paid as agreed, 2 collection and 2 unable to identify or disputed. The LOX in the file addresses most of these accounts. Middle credit scores for the Borrower and Co-Borrower were 578/573. This credit was typical of many Borrowers applying for FHA loans during this time frame. There was one open paid as agreed account with First National as well as a Verification of Rent for with no lates for 36 months. We also obtained an alternative credit for insurance from Polk County Farm Bureau so as to have three current credit references. In the opinion of the underwriter, the credit was acceptable.

Borrower:	1	Paid as Agreed
	2	Medical Collection
	1	Other-Collection
	1	Borrower Unable to Identify
Co-Borrower:	8	Paid as Agreed
	3	Medical Collection
	2	Other-Collection
	1	Borrower Unable to Identify
	1	Dispute
Joint:	3	Paid as Agreed

Address History and Verification of Rent:

Contrary to the findings of the Auditor, Birmingham was able to Google Identify the addresses on both of the VOR's (Exhibits 15 and 16). Further, the address that the Borrowers lived at from November, 2003 to November 2006, [redacted], was identified on the credit report (Exhibit 17), and is on the 2005 W2's for both the Borrower (Exhibit 18) and the Co-Borrower (Exhibit 19). The second VOR for [redacted]

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[redacted]. only covered a short recent period of time (11/13/06 thru 4/10/07) and may not have been reported to the credit agencies. We were able to contact the landlord on this property, [redacted], who verified that the VOE was accurate. In addition, the 2006 W2 for the Co-Borrower (Exhibit 20) showed this address as well. We were also able to corroborate this address in the county records under the landlord's name (Exhibit 21). Lastly, we sent an inspector to both property addresses on 6/4/10 who confirmed that there were people living at both addresses. Attached are pictures of both residences (Exhibits 22 and 23a&b).

Income:

The Borrower's income was calculated using $9 per hour, the rate shown on his most recent pay stub (Exhibit 24), times 40 hours per week, with no consideration given to the OT earned year to date, giving $1,560 per month. Since the Borrower is hourly and we did not use overtime, income was not averaged over the entire employment period since 4/06. However, base income shown on the Borrower's pay stub thru April 1, 2007, was $4,844 before overtime, which is a monthly average of $1,615 and higher than what was actually used by the Underwriter.

The Auditor stated that the Borrower's employer stated the work was seasonal. The owner, [redacted], said, in fact, that seasonal did not mean the Borrower only worked certain times of the year, but that as a cabinet maker, their business fluctuated with the economy. When asked about the low 2006 earnings, the employer stated that [redacted] had injured himself and was off for several months due to the injury. Therefore, the underwriter's calculation of income was correct.

The Co-Borrower appears to have left her previous job about a month earlier. She was making $7.57 per hour and left to make $8.82 per hour with no appreciable time off. Her first two pay periods averaged just over 75 hours. $8.82 for 75 hours every two weeks = $1,433.25 per month. The number on the MCAW for the Co-Borrower was $1,447.58, $14 a month higher.

Liabilities and Ratios:

When adjusted for the $14 error, the income per month should have been $2,993 per month. It appears that the underwriter did not include the child support of $160 per month. However, when this is included the ratios are still only 24.62/39.25, without counting any overtime for the Borrower. Since these ratios are still well within HUD guidelines, unused overtime was not included as a compensating factor on the MCAW.

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Comment 23

AUDIT RESPONSE-6/6/10

Loan number: 151-8410864
Borrower Name: [redacted]

Income Calculation:

The auditor used the wrong date from which to calculate income. The Verification of Employment from "The Work Number" (Exhibit 25) shows a hire date of 5/1/2007, but a Start Date of 6/12/2007. The Auditor incorrectly used the 5/1/2007 Hire Date when calculating average income. The average income was correctly calculated by the Underwriter from the 6/12/2007 start date. This is what is on the MCAW (Exhibit 26):

Income Calculation:

Paystub #1 Paid thru date	9/29/07
YTD Income	$9,558
Months since start date of 6/12/2007	3.5
Average Monthly Income	$2,731
Ratios	29.95/42.65

The Verification of Employment also shows an hourly wage as $15.90 per hour, which for a normal 40 hour week works out to $2,756 per month.

The underwriter questioned the fact that there were no federal taxes withheld and so an additional paystub (Exhibit 27) was provided. Even though the paystub for this particular week showed less than 40 hours, the ratios can be supported by calculating the average weekly income over 16 weeks, and then annualizing this and dividing by 12. Also, please find attached a copy of the Seller's Homeowners Association Bill (Exhibit 28) which shows that the housing payment was overstated by $11 per month. The ratios would then be:

Paystub #2 Paid thru date	10/6/07
YTD Income	$9,987
Weeks since start date of 6/12/2007	16
Average Weekly Income	$624
Average Monthly Income	$2,705
Ratios	29.83/42.66

Documentation to Close

The Underwriter received a verbal explanation for the lack of federal withholding taxes as an error. To document this, the additional paystub (Exhibit 27) was received which did show federal taxes being withheld. Since a complete VOE (The Work Number Exhibit 25) was received, a full month of paystubs was not required by FHA so the underwriter waived that condition.

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AUDIT RESPONSE-6/6/10

Ref to OIG Evaluation	**Lender Comments**

Comment 24

AUDIT RESPONSE – 6/6/10

FHA Case # 201-3487218
Borrower name: [redacted]

Income:

This loan was originated by a third party broker, First National Mortgage Banc, and so all contact with the Borrower was handled through the broker. The broker submitted a completed VOE (Exhibit 29) along with the pay stubs (Exhibits 30a&b). Since it appeared that the payroll accounting was done by hand (bank check with separate schedule of deductions instead of a regular payroll check) the VOE was the primary document used for income qualifying.

Verification of Rent:

Birmingham Bancorp did have independent verification of the rent payments and time in the property. In addition to the completed Verification of Rent from the landlord, there was also a verification done by the credit bureau on page 5 of their report (Exhibit 31). The information reported by the credit bureau agreed with the VOR.

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Comment 25

AUDIT RESPONSE-6/7/10

FHA Case # 261-9009876
Borrower name: [redacted]

Gift Funds:

The two requirements for the gift funds were imposed by the HOME Investment Partnerships Program and were not underwriting requirements. [redacted] applied for a home loan utilizing a $30,000 grant for the down payment. It was her responsibility to meet the conditions necessary to qualify for the gift.

The gift funds were not transferred to the Borrower either before or after the closing. The funds were sent directly to the closing agent, Lamont Title Corporation, and were credited on the HUD 1. The First Lien letter from Lamont title (Exhibit 32a) certifies that the loan was closed per our Closing Instructions (Exhibit 32b), including receipt of the gift funds from the City of Detroit. Enclosed, also is a copy of the HUD 1 (Exhibit 32c) showing that the closing agent was Lamont Title Corporation. Also enclosed is the Closing Protection Letter from Old Republic National Title Insurance Company (Exhibit 32d) which guarantees the performance of Title Consulting Services. Since the closing agent is an independent third party to the transaction, their certification that the funds were received, guaranteed by the Title Insurance Company, should be sufficient.

Credit:

[redacted] was not a regular user of credit. The only open credit that she had at the time of application were two student loans which were paid as agreed. [redacted] had no evidence of credit card or auto debt at all on her credit report. She explained the two open collections as a result of identity theft from a family member against whom she was not pressing charges. [redacted] provided evidence of both accounts being paid prior to closing. These are the two documents referred to by the Auditor as having been faxed on March 20, 2006. However, the underwriter did not require them to be paid and so the source of the fax was not an issue. They were merely included as additional documentation. In addition to the two paid as agreed accounts on the credit report, however, we did have an additional credit reference dated January 18, 2006, from E&A Insurance (Exhibit 34) that shows E&A Insurance as the originator of the fax. The evidence that [redacted] was not a regular user of credit, the two current student loans, plus the alt credit were considered sufficient by the underwriter.

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Address History and Verification of Rent:

The Borrower's address history is adequately documented. At the time of application [redacted] was living in the property that she was purchasing. This is documented by her 1010 affidavit and by a VOR from the landlord. I assume the VOR from the seller was misdated and should have been 1/1/06 rather than 1/1/05, which would have been consistent with the .4 years on the 1003, the VOR for [redacted] Street showing she was there through November of 2005 (Exhibit 35), and the two appraisals. (The November 2, 2005 appraisal (Exhibit 36) indicated that the property was vacant/owner occupied and the pictures showed no furniture, whereas the 3/10/06 appraisal Exhibit 37) indicated tenant occupied.) We were not able to get cancelled checks or money orders, which often happens when Borrowers are paying cash for their rent. In such situations, rather than rejecting the Borrower for paying cash, it was our policy still to get the VOR as additional documentation, but not to rely on it for credit underwriting purposes. Prior to this, she lived at [redacted] Street from 6/7/2004 to 11/15/05 and prior to that at [redacted]. The copy of the Drivers License (Exhibit 38a) shows this as well with the Tacoma address on the front and the change of address on the back to [redacted] St. The VOR for [redacted] for 1.5 years was what was used to support prior housing history.

The Borrower did not live in the property she purchased for six months prior to the purchase. Therefore, under HUD guidelines for identity of interest, she was limited to an 85% LTV. As shown on the MCAW, (Exhibit 38b), the LTV on this loan was only 77.541%.

Reason for Default:

Per the Case Status Details in Neighborhood Watch, the reason for Default was "Curtailment of Income". The Borrower at that time had been employed for two years with Trott & Trott, a local law firm. We extensively documented [redacted]'s income there including paystubs, VOE, W2's for 2004 & 2005, and tax returns for the most recent year available (2004). In addition, we obtained substantial documentation for the alimony/child support used including Michigan Friend of the Court Reports, Court Orders, and bank statements showing receipt of the funds. The Auditor is not disputing the income calculation. With this income the Borrower's ratios were 31/33, a very affordable home for the Borrower with almost 25% equity. It is obvious that the Borrower's loss of income was the contributing factor to the foreclosure and not the underwriting of the file.

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Comment 26

AUDIT RESPONSE-6/7/10

FHA Case # 261-9071686
Borrower name: [redacted]

Gift Funds:

All the documentation on this file was received through the third party mortgage broker who originated the loan, Dynamic Mortgage Inc. According to our files, the Borrower did intend to use her own funds. Her credit union statement showed four open accounts: 00 Regular Savings, 01 Four Bedroom House, 06 2001 Kia Optima SE, and 11 Unsecured Loan. However, since the funds for the home were not seasoned 60 days, they could not be used for closing. Therefore, in order to close she obtained a gift from her cousin.

The documentation of funds to close met the HUD guidelines. We had a fully executed gift letter (Exhibit 39) from [redacted], who the Borrower also identified as her cousin (Exhibit 40). We also had a copy of a cashier's check (Exhibit 41) made out jointly to the Borrower and the Title Company from [redacted] account, and a copy of the withdrawal slip from the Donor's Account dated 3 days prior to closing indicating that the funds had been withdrawn and the donor still had a balance, after the gift, of $56,000 (also Exhibit 41). After closing, this loan was selected for review in our monthly 10% Q/C reviews and sent to our outside Q/C firm, Wetzel Trott, who re-verified the legitimacy of the check. Attached is a copy of the response they received from Wings Financial Credit Union (Exhibit 42). Because the check was made out to the Title Company and the Borrower jointly, the funds were never deposited into the Borrowers account, but given directly to the closing agent.

The Auditor has stated that when contacted, the Borrower said that gift funds of $2,000 were actually brought to the closing by the Seller at the instruction of the loan officer. Birmingham Bancorp had no evidence of this taking place. HUD guidelines state that "If the gift funds are to be provided at closing and are in the form of a certified check from the donor's account, obtain a bank statement showing the withdrawal from the donor's account and a copy of the certified check." The documentation that we were provided followed HUD guidelines.

Reason For Default

The reason for default listed in Neighborhood watch was "Unable to Contact Borrower". However, according to the OIG's chart this Borrower made 19 payments prior to default. After this period of time, whatever happened to cause the Borrower to default had nothing to do with the gift or the underwriting.

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Comment 27

AUDIT RESPONSE-6/6/10

FHA Case # 262-1681931
Borrower name: [redacted]

Assets:

Birmingham Bancorp was finally able to locate the original file. This loan was approved through the TOTAL automated system (Exhibit 44). With an automated approval we are only required to verify the current balance. Funds are not required to be seasoned.

Condition #28 on the approval states:

"Information about assets furnished on the loan application was used to underwrite this case. The Depository assets totaling $7,155.00 must be verified by one of the following: a)VOD; b)most recent statement showing the previous month's balance; or c)most recent two months statements to verify sufficiency of funds required to close."

Condition #29, on the other hand, states:

"If the amount of earnest money deposit exceeds 2% of the sales price or appears excessive based on the Borrower's history of accumulating savings, the lender must verify the deposit amount and the source of funds according to the current FHA guidelines. The lender must also determine that any recent debts were not incurred for any part of the cash investment on the property being purchased."

DU findings are to be followed literally. The earnest money deposit was only $500, (less than 1%) so condition #29 does not apply. Condition # 28 does not require the lender to document the source of funds or any large deposits, only that the funds are sufficient. The broker could have chosen to document the funds needed for closing with a VOD, which would not show and details of activity, instead of a bank statement. In either event, the automated condition to verify assets of $7,155 was satisfied.

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Comment 28

AUDIT RESPONSE-6/7/10

FHA Case # 263-3870605
Borrower name: [redacted]
Co-Borrower name [redacted]

Assets:

The Auditor stated that the source of funds was cash on hand. In fact, the 1003 signed by the Borrower on 3/16/06 (Exhibit 45) stated that the source of funds for closing was cash on hand and a tax refund. In addition, on page 3 of the application the Borrower listed under assets:

TAX RETURN – 2005	$6,171.05
Bank of America	$2,828.03

The Bank Statement provided from the Borrower showed the tax return funds deposited on 2/24/06, 3 weeks prior to application. As proof of these funds, a check from HSBC for $6,171.05, dated 2/23/06 (Exhibit 46), was provided to the underwriter by the third party loan correspondent and would have been explained to the underwriter as a tax advance loan. There was a completed Verification of Deposit from Bank of America (Exhibit 47) showing a current balance of $3,100.30 and an average balance for the previous two months of $3,000 which exceeded the $2,700 the Borrower needed to bring to closing. There was no evidence in the file to suggest that funds to close had come from anywhere other than the Borrower's own funds.

Credit:

Since the Borrower was not a user of credit, alternative credit was difficult to collect. The two pieces of credit we got were the best that were available. There were no set guidelines for alt credit by HUD at that time. When alt credit was developed, the standard method was through letters from creditors that did not report to the bureaus.

Address History and Verification of Rent:

There were two VOR's in the file, one for a residence in California (Exhibit 48)and the other in Mississippi (Exhibit 49). [redacted] 2004 W2 (Exhibit 50) shows the Mississippi address, as does the Credit Report. His 2005 W2 (Exhibit 51) and his Driver's license (Exhibit 52) show that he resided in California at that time. HUD guidelines at the time did not require independent verification other than the VOR.

Ratios:

The Borrower's most recent VOR showed his housing payment at $1,000 per month for the previous 12 months. The VOR for the 5 years prior to that was for $850 per month.

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The Borrower's new housing payment was $780 per month. Based on the most recent 12 months rent payment of $1,000, the Underwriter, on the MCAW (Exhibit 53), listed that the Housing Expense was decreasing as a compensating factor. Since the Borrower had very little other debt, the underwriter would have been justified in using the Borrower's ability to devote a greater portion of his resources to housing as a compensating factor as well. It should be noted that even though the housing payment ratio (33.515%) was over the HUD limit of 31%, the overall debt ratio was also 33.515%, which was substantially below HUD's limit of 43%.

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Comment 29

AUDIT RESPONSE-6/6/10

FHA Case # 263-3922022
Borrower name: [redacted]

Rental Income:

[redacted] took title to the property at [redacted] August 31st, 2006, per recorded Quit Claim Deed from [redacted] (Exhibit 54). [redacted] had owned the property on a Land Contract since December 19th, 1988. A Warranty Deed to [redacted] in fulfillment of that contract (Exhibit 55) was not recorded until September 1, 2006, although the deed was executed on February 2, 2004. This is why the tax records still show [redacted], the grantor to [redacted], as the property owner.

Birmingham Bancorp did use net rental income, as suggested by the Auditor. The lease for the mobile home property was for $400 per month. There was no other debt on the property so income was calculated as: $400 rent - $84 maintenance – $100 vacancy factor(25% of $400) = $216 per month net rental income, which resulted in ratios of 33.78/38.67.

The underwriter cited two compensating factors on the MCAW (Exhibit 56) for exceeding the housing ratio: employment stability (employed at same job since July, 2000) and overtime income not used (overtime averaged over $800 a month thru 8/12 of that year).

Credit:

Although [redacted]'s housing expense was going up, so was his income as shown on the VOE (2004-$21,449, 2005-$24,991, thru 8/18/06-$20,527) (Exhibit 57). As explained above, if overtime had been included his monthly income would be $439 per month higher, and ratios would have been 31/39 even before the rental income. [redacted] had very little other debt and so would be easily able to pay the higher housing expense.

The Borrower had a middle credit score of 601. [redacted] adequately explained the derogatory accounts on his credit report. The Auditor states that the two rent to own loans were late 7 and 18 times, respectively. However, this is misleading in that these were not 30 day lates. The verification (Exhibit 58) further states that [redacted] never paid more than 11 days from the due date. The industry standard definition of a late payment is a payment that is 30 days late.

Reason for Default:

The reason for default, as reported in Neighborhood Watch, was curtailment of Borrower Income. [redacted] had been employed at this company for six years with steadily

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increasing income. His VOE rated his probability of continued employment as good. This was one of the strengths of the file. A loss of income shortly after closing could not have been foreseen by the underwriter.

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Comment 30

AUDIT RESPONSE-6/6/10

FHA Case # 263-3938261
Borrower name: [redacted]
Co-Borrower name [redacted]

Verification of Rent :

This loan was originated by a Broker, Bretlin Home Mortgage. The original 1003 for the Co-Borrower was incomplete when submitted to us and we obtained the remaining information prior to closing. The Borrower and Co-Borrower purchased the home they were renting. We had independent verification that they had been living in the building through W2's from 2004 (Exhibits 59) and 2005 (Exhibits 60 & 61), credit references, asset documentation and the Drivers Licenses of both borrowers (Exhibit 62). The Landlord was also the Seller of the property, and the Borrower paid rent in cash. This situation occurs with many first time home buyers, and there is simply no way to verify the housing payments. Rather than reject a Borrower for paying cash, our policy at Birmingham Bancorp was to put no weight on the VOR for underwriting purposes when this was the case and to make a decision on the rest of the file documentation, so the document was not material to the underwriting decision.

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OIG's Evaluation of Lender Comments

Comment 1 For loan number 105-3017718, Birmingham stated that it calculated the borrower's income by using $9 per hour, the rate shown on his most recent pay stub, times 40 hours per week. Further, Birmingham asserted that the borrower's work was not seasonal but the business fluctuated with the economy. As stated in our review, we disagreed with Birmingham's calculations because the borrower's income was not stable and he did not always work 40 hours each week. Therefore, we calculated the borrower's average monthly income based on his income for the most recent 12-month period. The borrower's employer told us that the borrower's income was subject to seasonal influences. In other words, the income was not the same every week, and it varied based on business conditions. As the stability of income was questionable and it was not the same every week, Birmingham's underwriter should have taken the average monthly income for the most recent 12-month period. Birmingham stated that the income was low in 2006 because the borrower missed work due to an injury. However, the borrower's loan file did not indicate that this was the case.

Comment 2 For loan number 151-8410864, Birmingham asserted that we used the wrong date from which to calculate income and stated that the borrower's hire date was May 1, 2007, but the start date was June 12, 2007. Birmingham based its calculation on the assumption that the borrower earned $9,558 over a 3.5-month period. According to the borrower's loan file, the employment start date was May 1, 2007, and we used this date to calculate the average monthly income. We based our calculations on the assumption that $9,558 was earned over a 5-month period. After we received Birmingham's comments, we contacted the borrower's employer, who told us that the borrower started employment on May 1, 2007, as a part-time employee and his status changed to full-time employment on June 12, 2007.

Comment 3 For loan number 093-6128495, Birmingham stated that the verification of rent showed that the lease was in both the borrower's and coborrower's names and they paid as required by the lease. We disagree. During our review, we found that the verification of rent did not show that the lease was in both the borrower's and coborrower's names. The coborrower's name was listed on the verification of rent by Birmingham as part of the information to be verified. Further, the canceled checks for the rent supported that the payments were made by the borrower only. There was no lease agreement in the loan file supporting that the coborrower was part of the rental property.

Birmingham provided documentation from the closing agent, a copy of the cashier's (teller) check for $3,129. The check was payable to the Department of Revenue, State of Colorado. We accepted the documentation verifying that the liabilities were satisfied and revised the memorandum report.

Comment 4 For loan number 105-3017718, Birmingham agreed that the underwriter did not include the child support payments but asserted that the ratios were still acceptable based on Birmingham's income calculations. We disagree and did not accept Birmingham's calculation of income. The combination of our income calculations and unreported liability increased the total monthly fixed payment-to-income ratio from 33.31 to 50.963 percent, exceeding HUD's qualifying ratio.

Comment 5 For loan number 105-3017718, Birmingham asserted that the ratios were acceptable based on its calculations. As explained in our response to comment 4, the ratios were not acceptable.

Comment 6 For loan number 263-3870605, Birmingham asserted that its underwriter wrote "housing decreasing" on the mortgage credit analysis worksheet as a compensating factor. Birmingham explained that according to the verification of rent, the borrower's housing expense was going down by $220. We disagree with the compensating factor because the verification of rent was questionable. As explained in our individual loan review, the loan file contained two verifications of rent. One reported the borrower's rental payment as $1,000 for the past 11 months, and another reported the rental payment as $850 for the previous 12 months. Both verifications were signed on the same date and by the same individual, but one was for a property in California and the other for a property in Mississippi. They were also faxed from the borrower's employer. Birmingham did not obtain independent verifications, such as cancelled checks or receipts of the rental payments.

Comment 7 For loan number 263-3922022, Birmingham stated that the slightly higher ratio was compensated by stable employment and overtime not used in the borrower's income. In our individual loan review, we stated that Birmingham should not have used the unsubstantiated rental income of $216 from the mobile home to calculate the borrower's gross income. Using the borrower's average monthly income, without the rental income, would increase the borrower's mortgage payment-to-income ratio from 33.779 to 37.517 percent. HUD's acceptable ratio is 31 percent.

Comment 8 For loan number 262-1681931, Birmingham stated that it was only required to verify the current balance because the loan was approved through the automated system. We disagree. According to the FHA Total Mortgage Scorecard User Guide, the entire loan package must meet all FHA requirements except for those specifically excluded. FHA requires adherence to all eligibility rules and the documentation requirements as described in HUD Handbook 4155, REV-5. In our review, we stated that Birmingham did not obtain an explanation of the source of three recent large deposits of $4,337, $4,237, and $3,700 into the borrower's account. These funds were the source of borrower's downpayment.

Comment 9 For loan number 263-3870605, Birmingham asserted that the source of funds was cash on hand because the application signed by the borrower on March 16, 2006, showed that the source of funds for closing was cash on hand and a tax refund. Birmingham also claimed that a check from HSBC for $6,171 was provided to the underwriter by the third-party loan correspondent and would have been explained to the underwriter as a tax advance loan. Birmingham did not explain why the borrower did not provide a copy of either the tax return or his tax refund check to verify a tax refund of $6,171.

Comment 10 For loan number 093-6128495, based on the evidence provided by Birmingham that the gift funds were sent directly to the closing agent, we excluded it as a material deficiency and revised our memorandum report.

Comment 11 For loan number 261-9071686, Birmingham stated that this loan was originated by a third-party broker and the documentation provided to it seemed perfectly legitimate. Birmingham provided a copy of the gift check and a gift letter. The borrower identified that the gift donor was her cousin. These documents were in the loan file, and we reviewed them. Birmingham did not provide any new documentation. As explained in our review, Birmingham's underwriter did not verify that the gift funds came from an acceptable source. Both loan applications (initial and final) showed that the borrower's source of the downpayment and/or closing costs was her checking/savings account. The borrower told us that the gift donor was not her cousin but the seller of the property.

Comment 12 For loan number 093-6128495, Birmingham asserted that the verification of rent showed that the lease was in both the borrower's and coborrower's names and paid as required by the lease. The verification of rent did not show that the lease was in both the borrower's and coborrower's names. The coborrower's name was listed on the verification of rent by Birmingham as part of the information to be verified. Further, the canceled checks for the rental payments supported that the payments were made by the borrower only. There was no lease agreement in the file supporting that the coborrower was part of the rental property.

Comment 13 For loan number 105-3017718, Birmingham provided additional documentation from county records, pictures of the rental property, and a statement from the landlord verifying that the rental properties existed and the verifications of rent were proper. We accepted Birmingham's documentation and removed the deficiency regarding the borrower's credit history. However, Birmingham did not provide an explanation regarding the coborrower's poor credit including several unpaid collections and recent credit inquiries.

Comment 14 For loan number 263-3922022, Birmingham asserted that our statement that 2 rent-to-own loans were late 7 and 18 times, respectively, was misleading because they were not 30-day late payments but were only late from the due date. We cited what the creditor reported on the verification document.

Comment 15 For loan number 201-3487218, Birmingham stated that it had independent verification of rent from the landlord and the credit bureau. This information was in the loan file, and we reviewed it. However, Birmingham did not address the material deficiency noted in our review. We stated that the seller was an identity of interest in the real estate transaction because the seller was also the landlord. Therefore, Birmingham should have obtained additional documentation from the borrower to prove that a rental agreement existed and residency at the property had been established for at least 6 months. A residency of 6 months is required for identity-of-interest transactions for financing above the 85 percent loan-to-value ratio.

Comment 16 For loan number 261-9009876, we disagree with Birmingham's explanation that the rental and address history was properly documented by the borrower's affidavit and verification of rent. As cited in our review, these documents did not resolve the inconsistencies in the borrower's rental history. Birmingham did not provide any additional documentation. Birmingham indicated that it was unable to obtain canceled checks or a lease agreement to support the borrower's rental history.

Comment 17 See comment 13.

Comment 18 Birmingham disagreed with our statement that there was a lack of due diligence on the part of its underwriters. The results of our review outlined in this report show that Birmingham's underwriters did not use due diligence to underwrite the nine loans.

Comment 19 Birmingham believes that our recommendations for remedies under the Program Fraud Civil Remedies Act and administrative action are not appropriate. We did not change our recommendations because the recommendations are appropriate based on the issues cited in the memorandum. Violations of FHA rules are subject to civil and administrative action. The appropriateness of the civil money penalties will be determined by HUD.

Comment 20 Birmingham stated that according to the prior audits and reviews performed by OIG and HUD, all loans were underwritten according to FHA's guidelines. In our review, we did not evaluate the prior audits or reviews.

Comment 21 Based upon the documentation provided by Birmingham, we removed this loan as a materially deficient loan from this memorandum report.

Comment 22 See comments 4 and 13.

Comment 23 See comment 2.

Comment 24 See comment 15.

Comment 25 For loan number 261-9009876, Birmingham provided documentation from the closing agent verifying that all conditions cited in our review were met and the funds were sent directly to the agent. As a result, we removed this as material deficiency.See comment 16.

Comment 26 See comment 11.

Comment 27 See comment 8.

Comment 28 See comments 6 and 9.

Comment 29 See comments 7 and 14.

Comment 30 For loan number 263-3938261, Birmingham stated that the landlord was also the seller of the property and the borrower paid rent in cash. Birmingham further stated that rather than reject a borrower for paying cash, Birmingham's policy was to put no weight on the verification of rent, and it did not consider the verification of rent to be a material document for the underwriting decision. Birmingham should have put weight on the verification of rent because the payment of the borrower's housing obligations holds significant importance in evaluating credit. Birmingham's response did not address the inconsistencies cited in our review. The borrower's application reported that the rent was $600 per month, and the verification of rent showed a rent of $930 per month. In addition, the loan officer provided a certification on behalf of the borrower, stating that the borrower was unable to provide canceled checks for the rental payments because a majority of the payments were made in cash. Birmingham should have explained why this certification did not come from the borrower. Neighborhood Watch showed that the borrower did not make any mortgage payments before foreclosure.