



U.S. DEPARTMENT OF
HOUSING AND URBAN DEVELOPMENT
OFFICE OF INSPECTOR GENERAL

March 8, 2013

**MEMORANDUM NO:
2013-PH-1802**

Memorandum

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

//signed//

FROM: John P. Buck
Regional Inspector General for Audit, Philadelphia Region, 3AGA

SUBJECT: New Day Financial, LLC, Fulton, MD, Ensured Loans Met FHA Requirements

INTRODUCTION

We reviewed 32 Federal Housing Administration (FHA) loans that New Day Financial, LLC, underwrote as a U.S. Department of Housing and Urban Development (HUD) FHA direct endorsement lender. Our objective was to determine whether New Day underwrote the loans in accordance with FHA requirements and if not, whether the underwriting reflected systemic problems. We conducted the review as a result of a risk model assessment that identified mortgage lenders that were at high risk to cause losses to the FHA insurance fund. New Day was one of the lenders identified that made insurance claims within the first 2 years of insurance endorsement and underwrote loans that went into default within the first 90 days of endorsement.

METHODOLOGY AND SCOPE

We performed our work from October 2011 through November 2012. The audit covered the period December 2007 through December 2009. To accomplish our objective, we reviewed applicable HUD handbooks, mortgagee letters, and reports from HUD's Quality Assurance Division. We obtained a download from HUD's Neighborhood Watch¹ system. We identified 39 loans that went into default within the first 6 to 24 months of endorsement. All 39 loans were refinance transactions, with the majority being cash-out refinances for debt consolidation. Initially, we selected and reviewed the 10 loans with the largest mortgage amount. The original mortgage amounts of these 10 loans totaled \$2.5 million. We initially determined that 3² of the

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

² New Day later provided documents to resolve issues with all 3 loans.

10 loans had material underwriting deficiencies and we reported our results to New Day in a discussion draft report on July 3, 2012. After that date, at the request of the Assistant United States Attorney, we expanded our review. Although we planned to review all of the other 29 loans, we reviewed only 22 of them because we determined that based on our review of the 32 loans with the largest mortgages totaling \$5.9 million, there was a low likelihood of us identifying material deficiencies in the remaining loans.³ This audit memorandum addresses the results of our review of the 32 loans.

We conducted our work in accordance with generally accepted government auditing standards except that we expanded our review at the request of the Assistant United States Attorney, after we issued the discussion draft report to New Day on July 3, 2012. As a result, we did not communicate the results from the expanded review to New Day in advance. To meet our objective, it was not necessary to fully comply with the standards, and our approach did not negatively affect our results.

BACKGROUND

New Day Financial, LLC, doing business as New Day USA, is a HUD-approved nonsupervised direct endorsement lender. The lender was first approved to participate in the FHA program on September 26, 2007. A nonsupervised lender is a financial entity that has as its principal activity the lending or investing of funds in real estate mortgages. The direct endorsement program simplified the process for obtaining FHA mortgage insurance by allowing lenders to underwrite and close mortgage loans 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 Fund⁴, which is sustained by borrower premiums. 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 and projects that might not be able to meet conventional underwriting requirements by protecting the lender against default.

New Day's headquarters is located at 8171 Maple Lawn Boulevard, Suite 300, Fulton, MD. The lender has three nontraditional branch offices located in Delaware, California, and Illinois. The nontraditional branch offices serve as call centers. New Day did not service the loans it originated; rather, it sold its loans to other companies. Between 2008 and 2009, New Day endorsed 8,804 loans valued at more than \$1.4 billion. We selected 32 loans that went into early default and claims were paid.

The objective of our review was to determine whether New Day underwrote loans in accordance with FHA requirements and if not, whether the underwriting reflected systemic problems.

³ From the sample of 22 loans, we identified underwriting issues with 1 loan.

⁴ The Mutual Mortgage Insurance Fund is a fund that insures mortgages made by FHA on single-family homes. The fund pays the lender if the mortgagor defaults.

RESULTS OF REVIEW

New Day underwrote 31 of the 32 refinanced loans we reviewed in accordance with FHA requirements. The one loan with underwriting deficiencies had an original mortgage amount totaling \$192,850 and was refinanced as a cash-out refinance debt consolidation loan. HUD considers these loans to represent considerable risk.⁵ The FHA insurance fund suffered actual losses of \$99,502 on the one loan.

For loan number 105-3334436, the underwriter included income from the co-borrower that was not adequately verified. The co-borrower of the loan reported that she received \$1,067 in monthly Social Security benefits. The underwriter did not require the borrower to provide an award letter from the Social Security Administration or a copy of a Federal tax return to demonstrate the income received. The underwriter only required the co-borrower to provide a copy of one month's bank statement to demonstrate monthly deposits of \$1,067. HUD Handbook 4155.1, REV-5, paragraph 2-7(E), requires that Social Security income must be verified from the source or Federal tax returns and if the benefits expire within the first full 3 years, the income can be used only as a compensating factor. Section 2 of the handbook also requires that income may not be used in calculating the borrower's income ratios if it comes from a source that cannot be verified, is not stable, or will not continue. We recalculated the debt-to-income ratios⁶, excluding the income that was not verified. The recalculated total fixed payment-to-income ratio increased from 42 to 52 percent. HUD Mortgagee Letter 2005-16, requires that for manually underwritten mortgages where the direct endorsement underwriter made the credit decision, the total fixed payment-to-income ratio should not exceed 43 percent. If a qualifying ratio exceeds a HUD standard ratio, then compensating factors were needed to justify the approval of the loan. For this loan, the underwriter used the reduction in the housing payment as a compensating factor for the higher total fixed payment-to-income ratio however, HUD does not consider this an acceptable compensating factor. This problem did not appear to be systemic and after further review of additional information and documentation provided by the lender after the audit we determined that there was insufficient cause to pursue remedies under the Program Fraud Civil Remedies Act.

RECOMMENDATIONS

This report contains no recommendations.

⁵ HUD Handbook 4155, REV-5, paragraph 1-11(B), states that cash-out refinances for debt consolidation represent considerable risk, especially if the borrowers have not had a related increase in income. Such transactions must be carefully evaluated.

⁶ There are two debt-to-income ratios: a mortgage payment-to-income ratio (front end ratio) and a total fixed payment-to-income ratio (back end ratio).

Appendix

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Page 1 of 6



February 15, 2013

John Buck, Regional Inspector General for Audit
HUD-OIG Audit
100 Penn Square East, Suite 10205
Philadelphia, PA 19107

**RE: Response to Draft Audit Memorandum # 2013-PH-XXX
New Day Financial LLC, Fulton MD
Department of Housing and Urban Development Office of the Inspector General**

Dear Mr. Buck:

New Day Financial, LLC ("NewDay") appreciates being given the opportunity to provide comments with respect to the February 12 discussion draft of a Memorandum ("Draft Memorandum") from you to Dane M. Narode, Associate General Counsel for Program Enforcement, CACC, reporting on your audit of NewDay. We also appreciate the indication in the Draft Memorandum that the audit you have conducted has been long and arduous, taking over 16 months of your staff's time, and requiring NewDay to provide documents and information to you relating to 39 loans originated in 2007 and 2008. While we respect the effort you have made, we ask that you correct significant and substantive errors in the Draft Memorandum.

New Day's employees, management, and directors are proud of their commitment to disciplined underwriting and a policy and culture of regulatory compliance. New Day has been an FHA approved lender since April 2006. We became an FHA Direct Endorsement lender in September 2007 and have originated over 13,000 FHA loans. As a Direct Endorsement lender, we appreciate the trust that the Department has placed in New Day and take these responsibilities very seriously. New Day fully understands its obligations to underwrite FHA loans in a prudent and professional manner as detailed in FHA Handbooks and Mortgage Letters. Since New Day values its partnership with FHA, we also place great emphasis on maintaining a vigilant quality control process to ensure compliance with FHA requirements. New Day's commitment to the FHA program is demonstrated by its current performance metrics and is validated by two reviews by HUD quality assurance staff and by the fact that your office stopped before reviewing all 39 loans because, to quote your report, "there was a low likelihood of us identifying material deficiencies in the remaining 7 loans."

As a result, New Day is surprised and very disappointed by the recommendations in the Draft Memorandum. As an independent mortgage banker, we are deeply concerned that the Inspector General's recommendation will be seen by consumers, investors, business partners (e.g. warehouse banks or affinity partners), and regulators as the Department's final decision.

Comment 1

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Comment 1

Not one fact is recited in the Draft Memorandum that would even suggest that NewDay or its officers have ever lied to or attempted to defraud FHA. As a matter of logic as well as justice, you should feel compelled to remove the recommendations in the Draft Memorandum that this case is appropriate for evaluation under the Program Fraud Civil Remedies Act (PFCRA), and for consideration of the imposition of civil money penalties. A review of published actions by HUD's Mortgage Review Board would indicate that such severe penalties as PFCRA and civil money penalties are reserved for instances of a pattern of material findings. In this case, there are no material findings and no pattern of misconduct. The Draft Memorandum tentatively identifies deficiencies in only two files. The findings noted are not similar and therefore, no pattern of any violations of FHA requirements was discovered.

After this lengthy risk-based examination, you have found only two loans about which you can even tentatively raise concerns. Even such a small failure rate, though, would not be consistent with how we intend to run our program. Rather, we believe that we can demonstrate to your satisfaction that even those tentative concerns about those two loans are unwarranted. A complete absence of concerns would be more consistent with the examinations of NewDay's care in underwriting as documented in the past by the FHA Quality Assurance Division (QAD). The May 2010 QAD compliance review covering the period of November 2007 to April 2010 (25 loans) made no adverse findings and made no requests for indemnification. The February 2011 QAD review of loans made in 2010 (41 loans) again made no adverse findings and no requests for indemnification. Similarly, the Veteran Administration's Loan Guaranty Service Monitoring Unit October 2011 review of loans made from 2009 to 2011 made no indemnification requests and only required a refund of fees that totaled \$205 (after looking at 85 loans). NewDay's 60+ day delinquency rate on its GNMA portfolio is currently only at 2.89%.

Because the strength of NewDay's underwriting program has been repeatedly recognized, and is evident as well from an objective review of the results of your audit, your concluding recommendation that HUD evaluate whether claims should be made under PFCRA, and the suggestion that civil money penalties should be evaluated as well, are completely unwarranted and needlessly derogatory. In light of the damage this unwarranted recommendation can do to our business reputation, we request that OIG remove the recommendations that HUD evaluate pursuit of PFCRA claims and civil money penalties. If such recommendations are not deleted, we ask that the entirety of this response to the Draft Memorandum accompany any final version of the Memorandum and also be included in any public disclosure of the Memorandum.

OIG Errors in Criticisms of Underwriting of Specific Loans**Loan # 011-6287867****Comment 1**

The Draft Memorandum asserts that the automated underwriting requirements were not followed with respect to Loan # 011-6287867. The Draft Memorandum bases that conclusion on the further assertion that omission of a short term installment liability of \$829 scheduled to be paid off in 8 months with monthly payments of \$103 was inadequately documented.

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Comment 1

That is simply wrong. The credit report in the file clearly documents the amount, payment and short term nature of the liability. The underwriter clearly recognized and documented that the loan was scheduled to be paid off in less than 10 months because he added a notation of “(<10)” next to that liability on the borrower’s form 1003 Uniform Residential Loan Application. No other documentation is required.

HUD Handbook Rev-5 4155.1 4.C.4.b instructs that installment debts with fewer than ten payments remaining must be included **only if** the amount of the debt will affect the borrower’s ability to pay the mortgage in the months immediately after the loan closing. The Handbook does not suggest that the underwriter must document a lack of such an effect. Wisely, the Draft Memorandum does not assert that the scheduled payments of barely more than a hundred dollars a month would have significantly affected the borrower’s ability to pay, when the borrower had reduced his total debt payments by over a thousand dollars a month by virtue of the transaction. But absent such an assertion, the claim that the loan was inadequately documented is obviously and clearly wrong.¹

It is important to note specifically that, in light of the fact that this loan was fully documented, the only permissible conclusion is that NewDay correctly certified to the integrity of the data used to determine the quality of the loan in underwriting the loan using an automated system.² Because the OIG has no basis for finding this loan to be noncompliant, this loan should be removed from the Draft Memorandum.

Comment 2**Loan # 105-3334436**

The conclusions of the Draft Memorandum with respect to Loan #105-3334436 are premature and unwarranted. We recognize and acknowledge that this loan file does not include the secondary documentation verifying the co-borrower’s income. But it is NewDay’s consistent policy to obtain verification of the income of a co-borrower. We do not know why that document is not in this file. But we believe it is a logical leap for OIG to conclude that the current absence of the document from the file necessarily demonstrates that the verification was not in the file at the time the loan was underwritten.

The underwriter who worked on this loan has separated from NewDay years ago and we have

¹ In further support of the view that no documentation is required of things that do not exist, the current FHIA TOTAL Mortgage Scorecard Guide says that debts with fewer than 10 payments may be omitted **unless** manual underwriting is required. If so, the underwriter must determine that short-term debt will not negatively affect the borrower’s ability to pay in the early months. Clearly, then, an underwriter has **no** obligation to explicitly make further determinations when the AUS does not demand manual underwriting. Such manual underwriting was not required for this loan – the AUS generated an Approve/Eligible finding.

² Incidentally, the current version of the Draft Memorandum failed to catch all of the edits required to address the removal of two loans that had been included in an earlier draft. For example, on page 3, the sentence before the chart refers to deficiencies identified in “four loans” when the Draft Memorandum now addresses only two. The chart on that page recognizes that the audit now criticizes only one loan as noncompliant for income and one regarding AUS requirements. Similarly, at the beginning of the section titled “Automated Underwriting Requirements Not Followed” on page 4, the Draft Memorandum recognizes that it is talking about only one loan, and yet at the end of that section, on page 5, the Draft Memorandum mistakenly claims that automated underwriting requirements were not followed for the “above two cases.”

not tried to track him down to ask whether he recalls that verification was obtained at the time. (We realize that his memory about one loan among many from so long ago may not be reliable). But the characteristics of the loan that is revealed in the file and in the report of the servicing of the loan suggests that it is more reasonable to conclude that the loan was properly underwritten at the time it was originated.

Comment 2

First, it is important to note that the loan did not default for 15 months after it closed. This was not an early payment default. A loan that performs for more than a year is generally considered to be a seasoned mortgage and much more likely to perform over the long term. That fact alone suggests that it was unlikely that there was any failure in underwriting the loan. That conclusion is further buttressed by the report of the servicer at the time of the default that the reason for the default was the illness of the primary borrower. We have recently learned that the borrower died in March 2012. Those facts lend support to the idea that the primary borrower's sudden and deadly illness (undoubtedly with significant medical expenses) was the cause of default, and that the default was not an indication of a failure in the underwriting of the loan.

Examination of the documents in the file also demonstrates that it would have been reasonable to expect the continued receipt of the co-borrower's income. The bank statement showing the deposit of the co-borrower's income reveals that the payment was a Veteran's Administration survivor's disability benefit. (The bank statement lists it as "VA Disability"). The initial income worksheet completed by the Account Executive noted that her income was a survivor's benefit and the credit report notes that she was a widow with a "SSI SVA LIFE". The only way a recipient of a survivors' benefit could possibly lose that income would be if the recipient re-married. The borrower and co-borrower had jointly owned their house, without marrying, for five years before obtaining the loan from NewDay. The tax return filed by the borrower showed that he was providing support to both of the co-borrower's children, claiming them as dependents even though they had her last name, not his. Since the co-borrower's income was not taxable, she was not required to file a tax return, and she was not listed on his tax return since they were not married. This refinance enabled the borrowers to lower their monthly mortgage expense by \$288 a month. Because the borrowers had demonstrated an ability to pay a housing expense that was greater than the monthly housing expense for the new mortgage, it was reasonable to expect the same payment performance on the new loan. So this was a loan that appears to have been fully justified³ and it is more likely than not that the loan was properly underwritten.

Given the above facts, it is more reasonable to conclude that the lack of a document from the file now does not mean the loan was improperly underwritten at the time it was originated. Direct endorsement lenders are only required to retain underwriting documentation for two

³ Even if the co-borrower's income had been excluded, raising the DTI to 34/51, this refinance enabled the borrower to lower their mortgage payment by \$288/month, so the loan could have been approved based on the FHA compensating factor that the borrower had successfully demonstrated the ability to pay a housing expense greater than or equal to the monthly housing expense proposed for the new mortgage.

Comment 1

years.⁴ While our policies and experience give us reason to believe we successfully maintain complete files for much longer, we cannot know whether this loan is an exception to our ordinarily successful standard underwriting practices or an exception to our ordinarily successful standard document retention practices.

In connection with its recent rulemaking intended to strengthen the FHA lender indemnification process, HUD stated its intention to seek to force indemnification only for “serious and material” violations of FHA origination requirements.⁵ When doing so, HUD specifically recognized that it was unreasonable and overly burdensome to pursue lenders even for serious and material underwriting mistakes (not accompanied by fraud or intentional misrepresentations) more than five years after the date of mortgage insurance endorsement. The reasons underlying that policy, the burden on the lender of keeping files for extended periods of time and the risks of innocent losses of documentation, would warrant the same consideration here.

In sum, there is good reason to believe, despite the absence of such documentation now, that the underwriter actually did obtain a verification of the co-borrower’s income from the VA, in accordance with NewDay’s consistent business policies and practices. The significant performance on the loan, the default being caused by the primary borrower’s illness, and the evidence in the file that the co-borrower’s income was being received as a survivor’s benefit, all provide support for the conclusion that the loan was correctly underwritten and that somehow, over time, the document has been lost from the file. Moreover, if a mistake was made by the underwriter, it was not material in light of the other information that was available in the file and that fully justified making the loan.

It is inappropriate for OIG to issue a recommendation that HUD seek indemnification on this loan, both because the factual underpinning of the audit fails to demonstrate that the original underwriting was defective and because it would be inconsistent with HUD’s stated policy on seeking indemnification.

Conclusion

Comment 1

There is not one fact recited in the Draft Memorandum that would suggest that NewDay or its officers have ever misrepresented or attempted to defraud FHA. The recommendation in the Draft Memorandum that this case is appropriate for evaluation as a claim under the Program Fraud Civil Remedies Act, and the implication that this case warrants consideration of the

⁴ See HUD Handbook REV-5 4155.1 1.B.1.k Policy on Use of Electronic Signatures on Third Party Documents: “Lenders must ... maintain the origination case binder in either hard copy or electronic format for two years from the date of endorsement.”

⁵ “While HUD will seek indemnification in cases of fraud or misrepresentation at any time, the Department intends to codify a ‘reasonable time period’ for requiring indemnification in cases where the mortgagee failed to meet FHA requirements. For those cases not involving fraud or misrepresentation, it has been HUD’s long-standing practice of requiring indemnification ‘within five years from the date of mortgage insurance endorsement.’ The date of endorsement is a fixed date, and therefore has the benefit of being known to both HUD and the lenders with the authority to self insure mortgages. HUD believes five years is a reasonable ‘seasoning’ period for a particular mortgage loan to either perform or go into default and for the Department to ascertain whether origination errors were made.” Emphasis added. 75 Federal Register 62335 (October 8, 2010).

Comment 1

imposition of civil money penalties, should be removed.

It is not appropriate for FHA to seek to impose a civil money penalty unless FHA can demonstrate that a person or entity **knowingly and materially** demonstrates a pattern of egregious violations of FHA policy or submits false information or false certifications to the FHA.⁶ No fact recited in the Draft Memorandum would support the conclusion that NewDay, or anyone connected with it, has knowingly and materially engaged in a pattern of egregious violations of FHA policy or knowingly submitted false information or certifications. A single instance of a missing document is not a pattern, let alone a pattern of *egregious* violations. It is equally clear that any lack of verification of income, if indeed lacking, was not "material" because it did not have any financial impact on FHA in light of the subsequent performance of the loan and the actual cause of its eventual default. We ask, respectfully, that you delete any recommendation or suggestion that the imposition of civil money penalties be considered in this case.

Finally, the prerequisites for making a claim under the Program Fraud Civil Remedies Act are plainly not met. The underwriting of Loan # 011-6287867 was completely proper. Even though there clearly is a document now absent with respect to Loan # 105-3334436, nothing recited in the Draft Memorandum suggests that anyone at NewDay knew, deliberately ignored, or recklessly disregarded whether this document was missing. Without such an allegation, the suggestion that this case warrants review under PFCRA is unjustifiable. We ask, respectfully, that you delete such recommendation.

Thank you for this opportunity to respond to the Draft Memorandum. We look forward to your revision of the Draft Memorandum correcting the significant and substantive errors we have identified in your analysis.

Respectfully submitted,



Robert Posner
President and CEO, NewDay Financial

⁶ See HUD Handbook REV-5 4155.2 9.D.5.a.

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OIG Evaluation of Auditee Comments

- Comment 1** After further review of additional information and documentation provided by the lender after the audit we revised the report. We now agree that there is insufficient cause to pursue remedies under the Program Fraud Civil Remedies Act; thus the final audit memorandum does not include any recommendations. In accordance with our standard reporting process however, this final audit memorandum includes the lender's written reply to the discussion draft memorandum report.
- Comment 2** For loan number 105-3334436, the lender agrees that the loan file did not contain the required income verification documentation. HUD Handbook 4155.1, REV-5, paragraph 2-7 E, states that Social Security income must be verified from the source. Section 2 of the handbook also states that income may not be used in calculating the ratios if it comes from a source that cannot be verified, is not stable, or will not continue. However, this problem did not appear to be systemic and after further review of additional information and documentation provided by the lender after the audit we agree that there is insufficient cause to pursue remedies under the Program Fraud Civil Remedies Act for this isolated discrepancy.