Issue Date June 22, 2010
Audit Report Number 2010-PH-1010

TO: Vicki Bott, Deputy Assistant Secretary for Single Family Housing, HU

//signed//

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

SUBJECT: Prospect Mortgage, LLC, Fairfax, VA, Generally Complied With HUD Requirements Regarding FHA-Insured Single-Family Loans

HIGHLIGHTS

What We Audited and Why

We audited the Fairfax, VA, branch office (branch office) of Prospect Mortgage, LLC (Prospect Mortgage), because it had one of the highest default rates for U.S. Department of Housing and Urban Development (HUD)-approved lenders for loans issued in the State of Maryland. Our objective was to determine whether Prospect Mortgage and its branch office complied with HUD regulations, procedures, and instructions in the origination and quality control review of single-family mortgage loans insured by the Federal Housing Administration (FHA).

What We Found

Prospect Mortgage generally complied with HUD requirements in its origination and quality control review of FHA loans. However, its branch office did not underwrite one of five defaulted loans reviewed in accordance with HUD requirements. In addition, Prospect Mortgage did not always perform quality control reviews of its FHA-insured loans in a reasonably timely manner. These deficiencies were caused by a misinterpretation of HUD guidance at the branch office and Prospect Mortgage's failure to consistently be prudent in the implementation of its quality control process. As a result, the FHA insurance fund was exposed to an unnecessarily increased risk, and the effectiveness of Prospect Mortgage's quality control process was lessened.

What We Recommend

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing (1) require Prospect Mortgage to indemnify $193,357[1] for the loan, which it issued contrary to HUD's loan origination requirements, and (2) direct Prospect Mortgage to improve its quality control process and follow up in 6 months to ensure the lender's compliance.

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

Auditee's Response

We provided a draft report to Prospect Mortgage on March 31, 2010. We discussed the audit results with Prospect Mortgage during the audit and at an exit conference on April 14, 2010, and issued a revised draft report on April 28, 2010. Prospect Mortgage provided written comments to our draft report on May 3, 2010. It generally disagreed with our report. The complete text of its response, along with our evaluation of that response, can be found in appendix B of this report.

[1] This amount is the unpaid principal balance for the loan. The projected loss to HUD is $116,014 (see appendix C).

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BACKGROUND AND OBJECTIVE

The U.S. Department of Housing and Urban Development's (HUD) strategic plan states that part of its mission is to increase homeownership, support community development, and increase access to affordable housing free from discrimination.

The National Housing Act, as amended, established the Federal Housing Administration (FHA), an organizational unit within HUD. FHA provides insurance for lenders against loss on single-family home mortgages.

In 1983, HUD implemented the direct endorsement program, which authorized approved lenders to underwrite loans without HUD's prior review and approval. There are two types of approved direct endorsement lenders—supervised and nonsupervised. A supervised lender is an FHA-approved financial institution that is a member of the Federal Reserve System or an institution with accounts insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration. A nonsupervised lender is an FHA-approved lending institution that has as its principal activity the lending or investing of funds in real estate mortgages. HUD requires lenders to use its Neighborhood Watch system to monitor and evaluate their performance and has many sanctions available for taking actions against lenders that abuse the direct endorsement program.

Prospect Mortgage, LLC (Prospect Mortgage), is a nonsupervised direct endorsement lender of FHA loans. The branch office reviewed was located in Fairfax, VA. The branch office issued 51 FHA loans valued at $14.2 million between June 2007 and May 2009 that defaulted within the first 2 years. Of the 51 loans, 27 remained after terminations and refinances were eliminated. These loans were valued at more than $7.4 million. We reviewed five of the loans valued at approximately $1.2 million.

On October 19, 2009, HUD terminated the branch office's FHA loan origination approval agreement for the Washington, DC, jurisdiction because of its relatively high default and claim rate. The termination would have precluded the office from originating single-family loans within the stated geographic area. However, the branch office was closed down (October 16, 2009) immediately before HUD's termination.

Our objective was to determine whether Prospect Mortgage and its branch office complied with HUD regulations, procedures, and instructions in the origination and quality control review of FHA-insured single-family loans.

RESULTS OF AUDIT

Finding: Prospect Mortgage Generally Complied With HUD Requirements Regarding FHA-Insured Single-Family Loans

Prospect Mortgage generally complied with HUD requirements regarding FHA loans. However, its branch office did not originate one of five loans reviewed in accordance with HUD requirements. The branch office approved the borrower for a loan originally valued at approximately $196,900; however, the borrower had debt ratios in excess of HUD guidelines and the branch office did not justify the approval with adequate compensating factors as required. In addition, Prospect Mortgage did not always perform quality control reviews of its FHA-insured loans in a reasonably timely manner. These deficiencies were caused by a misinterpretation of HUD guidance at the branch office as well as Prospect Mortgage's failure to consistently be prudent in the implementation of its quality control process. The improperly underwritten loan exposed the FHA insurance fund to an unnecessarily increased risk. Therefore, Prospect Mortgage should indemnify more than $193,300 for the defaulted loan.

Loan Approved With High Ratios and Inadequate Compensating Factors

HUD Handbook 4155.1, REV-5, paragraphs 2-12 and 2-13, specify acceptable parameters for debt ratios in the absence of what HUD refers to as "compensating factors" for loans that are manually underwritten by the lender (as opposed to loans in which an automated underwriting system is used). HUD Mortgagee Letter 2005-16 provides that the ratio of the total mortgage payment to effective income (front ratio) may not exceed 31 percent and the ratio of total fixed payments to effective income (back ratio) may not exceed 43 percent. If either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. Compensating factors include but are not limited to the following: (1) demonstrated ability to pay housing expenses equal to or greater than the proposed new mortgage payment, (2) a downpayment of at least 10 percent, (3) demonstrated ability to accumulate savings and conservative use of credit, (4) ability to devote a greater portion of income to housing expenses, (5) at least 3 months worth of documented cash reserves, and (6) a potential for increased earnings.

In one of the cases reviewed, the branch office failed to provide valid or adequate compensating factors to justify its approval for a borrower with debt-to-income ratios in excess of HUD requirements. The borrower's front and back ratios were 42.2 and 48.5 percent, respectively. The underwriter indicated the following compensating factors: half down from own funds, conservative use of credit, satisfactory rental history, and borrower in same line of work (6 years) with new employment that offers higher salary and potential for increased earnings. These compensating factors were not valid or adequate based on HUD requirements. The borrower did not make a downpayment of at least 10 percent. Also, the conservative use of credit in and of itself was not an adequate compensating factor. In addition, the satisfactory rental history is a requirement and not a compensating factor; and in this particular case, the mortgage payment was actually about three times the current monthly housing expense. Lastly, the borrower obtained a new job in the same line of work before applying for the mortgage. The underwriter stated that the borrower had a potential for increased earnings as indicated by job training or education in the borrower's profession. However, there was no related rationale or explanation (see appendix D).

Quality Control Reviews Were Not Always Performed in a Reasonably Timely Manner

HUD Handbook 4060.1, paragraph 7-6A, requires lenders to review loans routinely selected for quality control reviews within 90 days from the end of the month in which the loan closed. This requirement is intended to ensure that problems left undetected before closing are identified as early after closing as possible. Further, paragraph 7-6D requires lenders to review all early payment defaults. HUD defines early payment defaults as loans that become 60 days past due within the first 6 payments. HUD does not indicate a timeframe within which these loans must be reviewed; however, HUD states that one of the basic overriding goals of quality control is to assure swift and appropriate corrective action. Therefore, prudence would dictate that these loans be reviewed shortly after being identified as early payment defaults.

Prospect Mortgage did not always perform quality control reviews of its early payment defaults in a reasonably timely manner. It reviewed all 27 of its early payment defaults for our review period. However, 6 of the loans were reviewed between 250 to 499 days after default, indicating that more than 20 percent of the early payment defaults were reviewed more than 8 months after default. Therefore, although Prospect Mortgage reviewed the loans, its review process did not fully meet the intent of the quality control process as defined by HUD. Prospect Mortgage must improve its quality control process to ensure that it performs timely assessments of its loan origination process and takes measures as appropriate to prevent noncompliance with HUD requirements that could result in an unnecessarily increased risk to the FHA insurance fund.

Lender Misinterpreted HUD Guidance and Failed To Be Consistently Prudent

The loan origination deficiencies occurred because an underwriter at Prospect Mortgage's branch office misinterpreted HUD guidance as indicated by the factors that were used to justify the approval of the loan discussed above. Feedback from HUD indicated that the compensating factors provided by the underwriter were not valid.

Prospect Mortgage was not consistently prudent in the implementation of its quality control process. Although it reviewed all early payment defaults that occurred within our review period, approximately 22 percent of the loans were reviewed more than 8 months after default. Therefore, its quality control process did not meet one of the basic goals of quality control which is to assure swift and appropriate corrective action.

Conclusion

Prospect Mortgage generally complied with HUD requirements in its origination and quality control review of FHA loans. However, its branch office did not fully comply with HUD requirements in originating one of five loans reviewed. In addition, Prospect Mortgage did not always perform quality control reviews in a reasonably timely manner. These deficiencies were caused by a misinterpretation of HUD guidance at the branch office and Prospect Mortgage's failure to consistently be prudent in the implementation of its quality control process. As a result, FHA's insurance fund was exposed to an unnecessarily increased risk, and the effectiveness of Prospect Mortgage's quality control process was lessened. Prospect Mortgage should indemnify $193,357 for the defaulted loan which it issued contrary to HUD requirements (see appendixes C and D for more detail).

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing

1A. Require Prospect Mortgage to indemnify $193,357[2] for one loan, which it issued contrary to HUD requirements.

[2] See footnote 1.

1B. Direct Prospect Mortgage to improve its quality control process to ensure that it performs timely assessments of its loan origination process and follow up in 6 months to ensure the lender’s compliance.

SCOPE AND METHODOLOGY

We performed our on-site audit work between June and August 2009 at Prospect Mortgage's branch office located at 10201 Lee Highway, Suite 570, Fairfax, VA. Our review period was from June 2007 to May 2009 but was expanded when necessary to include current data through February 2010.

We queried HUD's Neighborhood Watch system for information on lenders' default rates. HUD's Neighborhood Watch system is a Web-based software application that displays loan performance data for lenders and appraisers by loan types and geographic areas, using FHA-insured single-family loan information. The loan information is displayed for a 2-year origination period and is updated monthly. HUD requires lenders to use the Neighborhood Watch system to monitor and evaluate their performance.

Based on the Neighborhood Watch query results, we identified and selected one of Prospect Mortgage's two branches located in Fairfax, VA, for review. The branch selected was chosen because its percentage of defaults by 2 years for loans originated within the State of Maryland was 15 percent, compared with the State average of 6.77 percent.

Prospect Mortgage originated 51 FHA loans, valued at approximately $14.2 million, between June 1, 2007, and May 31, 2009, that defaulted within the first 2 years. After eliminating refinanced and terminated loans, 27 defaulted loans remained. The 27 loans, valued at more than $7.4 million, defaulted with 12 payments or fewer. We originally selected five of the loans for a preliminary review. The sample selection was based on the five loans with the highest debt-to-income ratios as indicated by the Neighborhood Watch system. Due to the closure of the branch office under review and its loss of HUD approval to originate FHA loans, we did not perform any additional loan reviews.

To determine whether Prospect Mortgage complied with HUD regulations, procedures, and instructions in its origination of FHA loans, we performed the following:

- Reviewed applicable HUD handbooks and mortgagee letters,
- Reviewed case files for the five sample loans,
- Examined records and related documents of Prospect Mortgage, and
- Conducted interviews with officials and employees of Prospect Mortgage as well as HUD employees.

In addition, we relied in part on data maintained by HUD in its Neighborhood Watch system. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequately reliable for our purposes.

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

INTERNAL CONTROLS

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

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

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

Relevant Internal Control

We determined that the following internal control was relevant to our audit objective:

- Loan origination process – Policies and procedures that management has in place to reasonably ensure that the loan origination process complies with HUD program requirements.

We assessed the relevant control identified above.

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

Significant Weakness

Based our review, we believe that the following item is a significant weakness:

- Prospect Mortgage did not consistently perform quality control reviews in a reasonably timely manner, and therefore, its quality control process did not fully meet the intent of quality control as defined by HUD.

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use 1/
1A	$116,014

1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this instance, implementation of our recommendation to indemnify the loan that was not originated in accordance with HUD requirements will reduce the risk of loss to the FHA insurance fund. The above amount reflects HUD statistics, which show that FHA, on average, lost 60 percent[3] of the unpaid balance as of the claim date for each property during 2009 (see appendix C).

[3] Actuarial Review of the FHA Mutual Mortgage Fund for Fiscal Year 2009, dated November 12, 2009.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

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PROSPECT MORTGAGE

April 30, 2010

VIA UNITED POSTAL SERVICE

Mr. John P. Buck
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U.S. Department of Housing
and Urban Development
Office of the Inspector General
Region 3AGA
The Wannamaker Building
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Philadelphia, PA 19107-3380

RE: Prospect Mortgage, LLC
HUD OIG Draft Audit Report

Dear Mr. Buck:

Prospect Mortgage, LLC ("Prospect" or "Company") is in receipt of the revised Draft Audit Report ("Report"), dated April 28, 2010, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of Inspector General ("OIG"). The Report is based on a review of the Company conducted between June and August 2009. The audit covers five loans originated by the Company during the period June 1, 2007 through May 31, 2009.

The Report states that its objective was to determine whether Prospect's Fairfax, Virginia branch office complied with HUD requirements in the origination and Quality Control review of Federal Housing Administration ("FHA") insured loans. The Report states that Prospect generally complied with HUD requirements, but contains one finding alleging underwriting deficiencies in one case and concerns with the timeliness of the Company's Quality Control reviews of early payment default loans. Based on this finding, the Report recommends that HUD require Prospect to: (1) indemnify the Department in connection with one loan involving underwriting findings; and (2) improve its Quality Control procedures to ensure that it performs timely reviews and follow up in six months to ensure compliance.

The OIG provided Prospect with an opportunity to submit written comments for inclusion in the final report. This response summarizes Prospect's history and

Comments 1 and 8

Comment 2

operations, including the Fairfax, Virginia office, and addresses the individual findings in the Report. We believe that this response and accompanying exhibits demonstrate that the Report's recommendation in connection with the cited loan is unwarranted. For this reason, and given that the Report cites only one loan, we respectfully request that the OIG refrain from publishing a report in this case and handle this matter on an informal basis with the Department. We appreciate this opportunity to comment on the OIG's findings and recommendations.[1]

I. **BACKGROUND**

Prospect received approval as a Direct Endorsement mortgagee in July of 1999. Headquartered in Sherman Oaks, California, Prospect operates in several states through over two hundred FHA-approved branch offices and employs approximately 2,500 individuals. Prospect sells all loans that it originates into the secondary market on a servicing-released basis, and its primary investors include Wells Fargo Home Mortgage and GMAC Mortgage. It is an authorized agent for three principals and acts as principal for seven authorized agents. The Company enjoys excellent relationships with both consumers and its investors, and Prospect's employees consistently strive to produce high quality loans in compliance with HUD/FHA standards.

FHA lending constitutes approximately 60% of Prospect's business operations. Because FHA lending represents a substantial portion of Prospect's overall production, the Company takes its responsibilities under the FHA program seriously. We strive to comply with applicable rules and regulations and are committed to educating and training our employees on issues of FHA compliance. In addition, Prospect is dedicated to customer service. We aim to make the lending process as simple as possible for borrowers and work closely with each individual applicant to ensure that he or she receives the type of financing that best fits his or her needs. Throughout our existence, we have endeavored to provide dependable and professional service and have repeatedly demonstrated our commitment to borrowers and allegiance to the FHA Program.

We believe it is important to note that the FHA-insured loan cited in the Report was originated in one former branch office of the Company located in Fairfax, Virginia

[1] In the event that the OIG goes forward with publication of the Report, we understand that final audit reports routinely include auditors' comments about the audited lender's written response, but that the company is not provided an opportunity to respond to these additional comments. Often, these comments include substantive allegations or statements that were not a part of the draft audit report provided to the company. To the extent that the OIG makes such additional substantive comments in this instance, we respectfully request an opportunity to respond to these additional statements to ensure that a full picture of the audited issues presented in the final report.

Comment 2

Comment 3

Comment 3

Comment 1

and underwritten by an individual who is no longer employed by the Company. Prospect voluntarily withdrew the Fairfax office's FHA approval in October of 2009. Given these circumstances, we believe that the issue raised in the Report has effectively been resolved. Nevertheless, the Company has made significant changes to its FHA-insured loan program to improve loan quality and performance. For instance, Prospect retained a new senior management team, including several key compliance officers who began employment with the Company in early 2009. Upon arrival, these senior managers conducted a full-scale review of the Company's existing policies, procedures, and internal controls and made several changes and enhancements to improve loan quality and performance. The Company established Regional Underwriting Managers to implement Company-wide underwriting standards who report to the Chief Credit Officer and Chief Operations Officer. All underwriters report directly to the Regional Underwriting Managers, who are located at underwriting centers throughout the Company to provide enhanced quality, monitoring, management support, and training to Prospect's underwriters. The Company also employs Escalation Underwriters, who are responsible for addressing data discrepancies identified in the underwriting process.

The Company has also strengthened its underwriting guidelines over the past year. For example, Prospect conducts income verifications prior to closing for all loans by obtaining a processed IRS Form 4506. Prospect also formed an Enterprise Risk Management Committee ("ERM"), which is comprised of senior managers including, among others, the Chief Credit Officer, General Counsel, Chief Compliance Officer, and Quality Control Manager. To date, the ERM has implemented several policies and procedural changes to mitigate risk trends in the Company's loan portfolios, including: (1) running FraudGuard on all loans; (2) reprogramming its loan origination system to limit the employees authorized to approve loans with higher risk scores and require specific approval from authorized staff for loans with certain risk characteristics; (3) implementing maximum debt ratio overlays to automated underwriting systems; (4) screening all loans through ComplianceEase four times throughout the underwriting process to ensure that loans comply with applicable federal and state guidelines; and (5) establishing an Appraisal Management group to oversee and centralize the ordering of appraisals and appraiser management. These changes have greatly improved the quality and performance of the Company's FHA-insured loan portfolio.

II. RESPONSE TO THE FINDING

The Report concludes that Prospect generally complied with HUD requirements in its origination and Quality Control review of FHA-insured loans, but asserts that the Company did not originate one loan in accordance with HUD requirements and did not conduct Quality Control reviews of early payment default loans in a timely manner.

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Comment 1

Upon receipt of the draft Report, Prospect conducted a thorough review of the findings and examined applicable HUD/FHA guidelines and internal Company procedures at the time these loans were originated in an effort to provide pertinent information and documentation with this response. Our review indicated that the finding in the Report are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability. While we recognize that there is always room for improvement, at no time did the Company intentionally disregard HUD guidelines or knowingly misrepresent information to the Department. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate Prospect's general compliance with HUD/FHA requirements and adherence to prudent lending standards. Below we reply to the individual matters raised in the Report, evidence our adherence to FHA requirements in connection with the cited loan, and set forth our opposition to the manner in which the recommendations are presented in the Report.

Comment 4

A. PROSPECT COMPLIED WITH HUD's UNDERWRITING GUIDELINES

The Report asserts that the Company did not originate one loan, [redacted] **FHA Case No. 241-7969493**, in compliance with HUD requirements. Specifically, the Report alleges that the borrowers exceeded HUD's recommended debt-to-income ratios without documented, valid compensating factors in the "Remarks" section of the Mortgage Credit Analysis Worksheet ("MCAW"). Prospect respectfully disagrees with this assertion.

The Department has acknowledged that "[u]nderwriting is more of an art than a science and requires the careful weighing of circumstances that affect the borrower's ability and willingness to make timely mortgage payments." Mortgagee Letter 00-24; see also Mortgagee Letter 95-07. Underwriting requires the subjective evaluation of information based on experience in determining whether a potential borrower is creditworthy. An underwriter must carefully weigh all aspects of an individual's case and, were two underwriters to review the same file, one might approve a loan where the other would deny a loan. Significantly, each underwriter may have made a reasonable and prudent underwriting decision.

Furthermore, the Department expressly permits a mortgagee to approve FHA financing to a borrower with qualifying ratios that exceed the benchmark guidelines of 31% and 43% where significant compensating factors justify loan approval. See, e.g., HUD Handbook 4155.1, REV-5, ¶¶ 2-12, 2-13; Mortgagee Letter 2005-16.[2] The

[2] While the Department has issued a new online version of Mortgage Credit Analysis Handbook, 4155.1, the new Handbook became effective for loans originated on or after May 11, 2009, after the cited loan

Department has professed that the "FHA does not set an arbitrary percent by which ratios may be exceeded but rather FHA relies on the underwriter to judge the overall merits of the loan application and to determine what compensating factors apply and the extent to which those factors justify exceeding the ratios." Mortgagee Letter 00-24 (emphasis added). Thus, where a potential borrower's qualifying ratios are high, an underwriter has to consider all relevant circumstances and exercise discretion in deciding whether to approve or reject a loan. This discretion is particularly important when the same loans underwritten manually could be submitted through an automated underwriting system and approved with much higher qualifying ratios. With different standards for varying types of underwriting, the Department must rely on underwriters to adequately analyze a borrower's financial circumstances and take into account all relevant factors, including the range of acceptable levels in qualifying ratios.

Comment 4

It is Prospect's policy to carefully consider each borrower's circumstances and document significant compensating factors in the "Remarks" section of the MCAW in compliance with HUD guidelines. Contrary to the Report's allegation, the loan file in the [redacted] case documented significant compensating factors that justified approval of these borrowers for FHA financing. For instance, the underwriter noted on the MCAW that the borrowers had made a significant downpayment in this case from their own funds **(Exhibit A-1)**. While the Report notes that the downpayment did not amount to ten percent of the sales price, the file contained the borrowers' bank statement, which evidenced that these assets were accumulated by the borrowers and demonstrated their ability to save **(Exhibit A-2)**. HUD guidelines state that a documented ability to save compensates against higher-than-average debt ratios such as those in this case. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C). Prospect maintains that this compensating factor, combined with the borrowers' significant downpayment, justified approval for FHA financing in the [redacted] loan.

Comment 5

In addition, the underwriter noted several more compensating factors on the MCAW that were supported by loan file documentation and offset the higher ratios in this case. For instance, as acknowledged in the Report, the borrowers were conservative users of credit, a compensating factor expressly identified by the Department. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C). The underwriter noted that the borrower had satisfactory credit scores **(Exhibit A-1)**, and the borrower's credit report evidenced that the borrower conservatively utilized his installment and revolving credit accounts **(Exhibit A-3)**. Moreover, the rental verification in the loan file demonstrates that the borrowers had made timely rental payments for the past nine years **(Exhibit A-4)**. While Prospect agrees that satisfactory rental history is a

Comment 6

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was originated and closed. We therefore rely on the prior Handbook, 4155.1 REV-5, and accompanying Mortgagee Letters in this response.

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requirement, rather than a compensating factor, HUD guidelines expressly state that a borrower's "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" is a compensating factor. See HUD Handbook 4155.1 REV-5, ¶ 2-13(A). While the Report notes that the borrowers' housing payment increased as a result of the loan, Prospect disagrees that this rendered the borrowers' nine-year rental history invalid. As noted above, during that period, the borrowers were able to accumulate over $10,000 in savings **(Exhibit A-2)**. This ability to save and make timely rent payments evidenced their capacity to maintain a larger housing payment, which HUD also expressly identifies as a compensating factor. See HUD Handbook 4155.1 REV-5, ¶ 2-13(D). Here, the borrowers' excellent nine-year rental history, coupled with their ability to accumulate savings during that period, compensated against higher ratios in this case.

Comment 6

Finally, the underwriter noted that the borrower had the potential for increased earnings, as he had recently taken a new position at a higher salary in the same line of work in which he had been employed for the past six years **(Exhibit A-1)**. HUD has expressly recognized that such increased earning potential compensates for higher ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(I). The Report asserts that this compensating factor was "not valid" as the loan file did not contain a related explanation; however, Prospect respectfully disagrees. The loan file contained a W-2 Form from the borrower's prior employer, which documented $1,473 in monthly earnings **(Exhibit A-5)**. The employment documentation for his current employer evidenced $2,142 in monthly income **(Exhibit A-6)**. This $669 increase in monthly earnings supported the underwriter's conclusion that the borrower had increased earning potential that would offset the higher-than-average ratios in this case.

Comment 7

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

Comment 1

Comment 8

B. PROSPECT OPPOSES THE RECOMMENDATIONS

In addition to opposing the individual allegation contained in the Report, Prospect disagrees with certain aspects of the recommendation made in connection with the [redacted] loan. As you know, the Report recommends, among other things, that the Department require the Company to indemnify HUD for $193,357, which constitutes the unpaid principal balance of the cited loan. The Report notes that the "projected loss" to

HUD is $116,014, or 60% of the unpaid principal balance in this case. According to Appendix A, this multiplier was selected based on information provided by HUD showing that its losses on sales average 60 percent of the claim paid.

Prospect would not take issue with the OIG's inclusion of the Department's actual or potential losses in connection with a loan for which a claim has been made. The Company does, however, take strong exception to inclusion of the unpaid principal balance and estimated loss in this case. First, we note that citing the unpaid principal balance of the loan suggests that the Company will be liable to HUD for that amount in the event the Department were to pursue indemnification of this case. However, the Report itself acknowledges, by citing to a projected loss figure based on a percentage of the unpaid principal balance, that the estimated losses in this case would be less than the currently unpaid principal if this loan were to result in a claim. Thus, the use of the unpaid principal balance amount throughout the Report unnecessarily suggests higher liability to HUD and the Company in connection with this loan.

Moreover, neither the $193,357 figure nor the $116,014 in estimated losses represents a payment that the Report recommends Prospect pay to HUD. Rather, these figures reflect the current amount due on the loan and a mere estimate of the losses the Department could incur if the loan ultimately results in a claim to HUD. The Report only recommends that HUD request indemnification, but any amount paid to HUD in connection with any indemnification will be determined based on the actual losses to HUD upon resolution of the claim made to the Department, rather than the unpaid principal balance or estimate included in this document. The loan at issue remains active. Prospect appreciates that this loan may have entered default at some point; however, it has not resulted in an insurance claim to the Department. To date, HUD has not incurred any loss in connection with this loan and it is not possible to determine whether the Department will ever incur losses in this case. Moreover, in the event that HUD does pay a claim this case, there is no guarantee that the Department will sustain monetary loss, as HUD may be able to recoup the claim amount in the sale of the underlying property.

Notwithstanding these facts, the Report "projects" that the Department will experience losses in the amount of 60% of the unpaid principal balance of the loan, and lists the financial risk to the Department, which it defines as "funds to be put to better use," as $116,014. This calculation assumes that the loan will result in a claim to HUD. Such an assumption would be supportable if 100% of the loans that enter default resulted in claims to HUD; however, that percentage of claims paid by HUD is substantially and significantly lower than the 100% figure suggested by the OIG. Thus, absent evidence that the loan at issue will result in an actual claim to the Department, the potential loss figure is greatly inflated and does not paint an accurate picture of the risks associated with this matter.

Moreover, as noted above, this arbitrary monetary figures cited in the Report are included with a mere recommendation to the Department to require the Company to indemnify it in connection with the cited loan. Upon receiving the final report, the Department will have an opportunity to independently review the audit findings and make an independent determination of whether indemnification is warranted in this case. As discussed at length earlier in this response, Prospect disagrees that the Report's finding warrants indemnification. HUD may also disagree with the Report's assertions and decide not to pursue indemnification in this instance. Notwithstanding the fact that the finding is preliminary, the OIG's recommendations assume that HUD will accept the Report's allegation and pursue indemnification.

In addition, while the audit process is still ongoing at the time the OIG issues its "final" report, the Report and the OIG's recommendations are made public on the OIG website. As a result, a lender's investors and peers are able to access the preliminary recommendations of the OIG before a final assessment as to their merit can be made by the Department. These entities often misinterpret the OIG's recommendations to be final actions by the Department, and also frequently misunderstand the potential losses cited to be the actual financial penalties assessed by HUD on the audited FHA lender. Under these circumstances, making these preliminary recommendations public and including inflammatory monetary figures suggesting the Company will be responsible for the entire unpaid principal balance or a "projected" loss figure based on the unsupported assumption that the loan will result in a claim to HUD will have a material, adverse effect on the business of the audited FHA lender. If the OIG's goal is to present the reader with a full and accurate disclosure of the audit and its implications to the audited lender, the Report should include the following disclosure on the first page in bold, capitalized lettering:

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

The above discussion demonstrates that the unpaid principal balance and estimated loss figures are unrepresentative of the Department's actual loss risk in connection with the active loan cited in the draft Report. Inclusion of these overstated

[redacted]

figures in the Report unfairly represents the loss exposure to HUD, and ultimately the Company, as a result of this audit. Therefore, Prospect strongly opposes the inclusion of these figures in the final report and requests that they be removed or amended to portray a more accurate picture of the potential losses in the FHA loan cited in the Report. As the recommendation is that the Company indemnify HUD, the Report should merely state this recommendation without citing to the unpaid principal balance or including estimated losses that are difficult, if not impossible, to predict accurately in this case. At the very least, if the final report continues to include the average claim loss paid for this loan as the potential financial risk to HUD and the Company, the Report should also clarify the percentage of defaulted loans that result in a claim to HUD. This figure would present readers with a more accurate and fair picture of the financial risks associated with the loans identified in the Report.

Comment 9

C. PROSPECT ADHERED TO FHA QUALITY CONTROL REQUIREMENTS

In Finding 2, the Report alleges that the Company did not perform Quality Control reviews of early payment default loans in a timely manner, as reviews in six such loans were conducted between 480 and 616 days after closing. As a result, the draft Report recommends that HUD direct Prospect to conduct Quality Control reviews within the required timeframe and follow up in six months to ensure compliance.

Prospect understands and appreciates that, in addition to the required routine reviews of ten percent of its FHA-insured loan portfolio, HUD guidelines require the Company to review all loans that become 60 days past due within the first six payments. See HUD Handbook 4060.1 REV-2, ¶ 7-6(D). The Report acknowledges that the Company performed Quality Control reviews of all early payment default loans during the review period. With regard to the timing of these reviews, the Report cites the time period between the closing date and the date on which the Quality Control review was performed. While routine Quality Control reviews must be conducted within 90 days of closing, a lender cannot conduct a Quality Control review of such loans until the default occurs, or at least 60 days after the first payment is due. Thus, to determine whether a lender conducts timely reviews of loans with early payment defaults, the appropriate period to analyze is the time between the default date and the review date, rather than the closing dates referenced in the Report. With regard to the review dates, the dates used in the Report are the dates of the Company's internal reviews of these cases. During the time period reviewed in this audit, Prospect outsourced the review of early payment defaults to a third-party vendor. After June of 2009, the Company re-reviewed all current defaults that had defaulted in the first six payments, even if the loan had previously been reviewed by the outside vendor, to acquire as much data on our defaulted loans into our internal Quality Control system as possible to allow for better trending and reporting of defaulted loans. The date of Prospect's internal review may have been well after the loans defaulted, and well after the initial Quality Control review performed by our vendor. Thus, the use of these internal review dates to determine the timeliness of the Company's Quality Control reviews is inappropriate.

Prospect maintains that it adhered to HUD guidelines in conducting Quality Control reviews of all loans entering early payment default during the review period, and did so within a reasonable period of time after the loan went into default. Moreover, the Company conducted additional internal reviews of these cases to further understand the reasons for the defaults and improve loan quality. Therefore, we respectfully request that this finding be removed from the final report.

D. PROSPECT PROPERLY INTERPRETED HUD REQUIREMENTS AND DILIGENTLY ORIGINATED FHA LOANS

Comments 9 and 10

Finally, although the Report concludes that Prospect generally adhered to HUD guidelines, it includes an allegation that the Company's underwriters in the Fairfax branch office did not properly interpret HUD guidelines and were not "consistently prudent" in implementing its Quality Control process. The Report bases this assertion on repeated allegations regarding the compensating factors in the [redacted] loan, as well as the assertion that Quality Control reviews of early payment default loans were not completed in a timely manner.

Comments 1 and 8

Prospect strongly objects to the inclusion of these allegations in the final report. The assertions made in this section of the draft Report merely reiterate allegations already made earlier in the Report's and/or in Appendix D. This section of the Report is unnecessarily repetitive, especially given the fact that the Report cites only one loan and examines Quality Control reviews based on closing, rather than default, dates and internal versus external review dates. Moreover, as demonstrated above, Prospect properly interpreted and strictly adhered to HUD guidelines in underwriting the loan at issue and performed Quality Control reviews of all early payment default loans. For these reasons, these repetitive and unnecessary allegations are unwarranted and should be removed from the final report.

Comments 1 and 8

III. CONCLUSION

Prospect takes the matters raised in the draft Report seriously. Because FHA lending comprises a significant portion of Prospect's overall business operations, the Company is committed to educating and training its employees on issues regarding FHA compliance and to assuring their adherence to HUD's rules and regulations. As discussed above and acknowledged in the Report, Prospect substantially complied with FHA underwriting requirements and made loans to qualified FHA borrowers. Prospect's thorough review of the findings set forth in the Report indicated that they are at variance with the facts, do not constitute violations of HUD/FHA requirements on the part of Prospect, or do not affect the underlying loans' insurability. Moreover, since the loans cited in the Report were originated, the Company has made several improvements to its Quality Control procedures and has continued to enhance its underwriting practices.

We believe that this response and accompanying exhibits demonstrate that the Report's recommendation in connection with the cited loan is unwarranted. For this reason, and given that the Report cites only one loan, we respectfully request that the OIG refrain from publishing a report in this case and handle this matter on an informal basis with the Department. In the alternative, we ask that the OIG revise its recommendation to fit the facts of this case and remove allegations for which Prospect has demonstrated its compliance with HUD requirements.

If you have any additional questions, or if you need additional information, please do not hesitate to contact our Washington counsel, Krista Cooley, at (202) 778-9257.

Thank you for your kind consideration.

Sincerely,

Donald Bundy
General Counsel

cc: Krista Cooley, Esq.

Comment 5

Mortgage Credit Analysis Worksheet
Purchase Money Mortgages
See page 2 for Public Burden and Sensitive Information statements

U.S. Department of Housing and Urban Development
Office of Housing
Federal Housing Commissioner

OMB Approval No. 2502-0059

All numbered entries in $ except where noted.

Case number: 241-7969493-703
Section of the Housing Act: 203 (b)
Check one: [X] Existing Construction [ ] Proposed Construction

1a. Borrower's name: [redacted]
2a. Social Security Number: [redacted]
1b. Co-Borrower's name: [redacted]
2b. Social Security Number: [redacted]

3a. Mortgage without Upfront MIP	3b. Total UFMIP	3c. Mortgage with UFMIP	4. Appraised Value (without CC)	5. a. Total Closing Costs (CC)	
$194,000.00	$2,910.00	$196,910.00	$203,000.00		$8,146.30
				b. Less Paid by Seller	$0.00
				c. Equals Borrower's CC	$8,146.30

6. Current housing expenses	7. Term of loan	8. Interest rate	9. Adj. buy-down interest rate
$535.00	30 years	6.500 %	%

10. Statutory Investment Requirements	
a. Contract Sales Price	200,000.00
b. Borrower-Paid Closing Costs (from 5c)	$8,146.30
c. Unadjusted Acquisition (10a + 10b)	$208,146.30
d. Statutory Investment Requirement (10a x 0.03)	$6,000.00
11. Maximum Mortgage Calculation	
a. Lesser of Sales Price (10a) or Value (from 4)	$200,000.00
b. Required Adjustments (+ / -)	$0.00
c. Mortgage Basis (11a + 11b)	$200,000.00
d. Mort Amt. (11c x LTV Factor 97.75% or Less)	$194,000.00
12. Cash Investment Requirements	
a. Minimum Down Payment (10c-11d) (This amount must be equal or exceed 10d)	$14,146.30
b. Prepaid Expenses	$941.52
c. Discount Points	$2,953.65
d. Repairs/Improvements (Non-Financeable)	$0.00
e. Upfront MIP Paid in Cash	$0.00
f. Non-Realty and Other Items	$499.00
g. Total Cash to Close (Sum of 12a thru 12f)	$18,540.47
h. Amount Paid (Earnest Money, etc.)	$0.00
i. Amount of Gift Funds (Source NEHEMIAH)	$9,501.00
j. Assets Available	$10,090.66
k. 2nd Mort (if applicable) (Source)	$0.00
l. Cash Reserves (Sum 12h thru 12k, minus 12g)	$1,051.19
13. Monthly Effective Income	
a. Borrower's base pay	$2,142.57
b. Borrower's other earnings (explain)	$0.00
c. Co-borrower's base pay	$1,534.00
d. Co-borrower's other earnings (explain)	$0.00
e. Net income from real estate	$0.00
f. Gross monthly income	$3,676.57

14. Debts & Obligations	Monthly Payment	Unpaid Balance
a. Total installment debt	$230.00	$6,133.00
b. Child support, etc.	$0.00	
c. Other	$0.00	$0.00
d. Total monthly payments	$230.00	

15. Future monthly payments	
a. Principal & Interest - 1st mortgage	1,244.51
b. Monthly MIP	80.42
c. Homeowners Association Fee	30.00
d. Ground rent	0.00
e. Principal & Interest - 2nd mortgage	0.00
f. Hazard Insurance	45.67
g. Taxes & special assessments	151.09
h. Total mortgage payment	$1,551.79
i. Recurring expenses (from 14d)	$230.00
j. Total fixed payment	$1,781.79

Attachment D3

16. Ratios	
a. Loan-to-value (11d divided by 11a)	97.000%
b. Mortgage Payment-to-income (15h divided by 13f)	42.208%
c. Total fixed payment-to-income (15j divided by 13f)	48.463%

Attachment D1

17. Borrower rating (enter "A" for acceptable or "R" for reject)	
a. Credit characteristics	A
b. Adequacy of effective income	A
c. Stability of effective income	A
d. Adequacy of available assets	A

18. Borrower's CAIVRS Number	Co-borrower's CAIVRS Number
[redacted]	[redacted]
LDP/GSA (page no. & date) 0 20071126	LDP/GSA (page no. & date) 0 20071126

Attachment A Information
A1. Contract Sales Price of Property (line 10a above): 200,000.00
A2. 6% of line A1: $12,000.00
A3. Total Seller Contribution: $80.00
A4. Excess Contribution

Attachment D2

Remarks (attach additional paper if needed)
CREDIT SCORES: (B) 691/682/698; (CB) NO SCORES
FHA TOTAL SCORECARD LP FINDINGS - REFER, AUS KEY #53472379
COMPENSATING FACTORS: CONSERVATIVE USE OF CREDIT;
SATISFACTORY RENTAL HISTORY SINCE 01/08/1999 VERIFIED (MGMT.
CO.); HALF OF THE DOWN PAYMENT FROM OWN FUNDS; BORROWER
WITH NEW EMPLOYER THAT OFFERS HIGHER SALARY AND POTENTIAL
FOR INCREASED EARNINGS (STATE) - IN SAME LINE OF WORK FOR 5
YEARS.

Final application decision	Examiner's signature & date	Underwriter's signature & date	CHUMS ID Number
[X] Approve [ ] Reject	X 12/4/07	X Deborah Brooks	CM57

Previous editions are obsolete — form HUD-92900-PUR (10/98)
ref. handbook 4155.1
-45P (9810).04
Page 1 of 2 VMP MORTGAGE FORMS - (800)521-7291

tabbies
EXHIBIT
A-1

Comment 5

Fax:301-944-8002 Nov 30 2007 15:40 P.02

Provident BANK

Statement

www.provbank.com

[illegible] PAGE 1 OF 2

[redacted]

[redacted]

[redacted]

Date of this statement
October 5, 2007

Date of last statement
September 14, 2007

[illegible]

[illegible]	Account # [redacted]	[illegible]	
[illegible]	Account #	[illegible]	

Account Summary

[illegible] Account # [redacted]

Balance last statement	[illegible]	Avg daily balance	[illegible]
Total checks & deductions (7)	[illegible]	Low balance	[illegible]
Total deposits & credits (2)	[illegible]	Days in period	[illegible]
Service charges	.00		
Balance this statement	[illegible]		

Transaction Detail

Date	Amount	Description		Balance
Sep [illegible]	[illegible]	Debit Card Purchase Merchant Purchase Terminal [illegible] [redacted]	[illegible]	[illegible]
Sep [illegible]	[illegible]	[illegible] Deposit [redacted]	[illegible]	
Sep [illegible]	[illegible]	[redacted] Cash Withdrawal Terminal [illegible] [redacted]	[illegible]	[illegible]
Oct 3	[illegible]	Debit Card Purchase Merchant Purchase Terminal [illegible] [redacted]	[illegible]	[illegible]
Oct [illegible]	[illegible]	[illegible] Deposit [redacted]	[illegible]	
Oct [illegible]	[illegible]	ATM Withdrawal [illegible] Cash Withdrawal Terminal [illegible] [redacted]	[illegible]	
Oct [illegible]	[illegible]	Debit Card Purchase Merchant Purchase Terminal [illegible] [redacted]	[illegible]	
Oct [illegible]	[illegible]	Debit Card Purchase Merchant Purchase Terminal [illegible] [redacted]	[illegible]	[illegible]

Continued on next page

Customer Service: [redacted], 1-800-[redacted]

Member FDIC

See the enclosed disclosure entitled
"Important Information About Your Provident Bank Account Statement."

[redacted]

Exhibit 2-4

EXHIBIT

A-2

tabbies

Comment 6

LandAmerica
2 Concourse Parkway
Suite 400
Atlanta, GA 30328
PHONE: (770)729-1775
FAX: (770)729-1760

REPORT NBR: [redacted]
REPORT TYPE: INFILE BFX/TRW/TU $16.
TOTAL: $16.
PAGE 1 OF 5

FIDELITY & TRUST DIV OF MMC
[redacted]

CUSTOMER NO: [redacted]
ORDERED ON: 08/30/07
ORDERED BY: ERIC ODAME
INFILE DATE: 08/30/07
DATE COMPLETE: 08/30/07

REFERENCE: NOT ASSIGNED
Property Address: ,

APPLICANT	CO-APPLICANT
[redacted]	[redacted]
[redacted] ✓ AGE/DOB	[redacted] ✓ AGE/DOB
Marital Status:	
NUMBER OF DEPENDENTS:0	

Current Address: [redacted]
Previous Address: [redacted]
Previous Address:

T O T A L S

ACCT TYPE	NBR	H/BAL	BALANCES	PAYMENTS	PASTDUE	30	60	90+
REAL ESTATE	0	0	$0	$0	$0	0	0	0
INSTALLMENT	11	1	$5,597	$185	$0	11	9	33
REVOLVING	7	5	$566	$55	$0	0	0	0
COLLECTION	0	0	$0	$0	$0	0	0	0
OTHER	0	0	$0	$0	$0	0	0	0
TOTAL:	18	6	$6,163	$240	$0	11	9	33

REVOLVING CREDIT AVAILABLE:92% OF $7,200

ACCOUNTS PAID AS AGREED:	13
ACCOUNTS CURRENTLY DELINQUENT:	1
ALL DELINQUENT ACCOUNTS:	6
INQUIRIES:	5
PUBLIC RECORDS:	0

PUBLIC RECORDS BREAKDOWN

LIENS:	0
JUDGEMENTS:	0
FORECLOSURES:	0
BANKRUPTCIES:	0
OTHER:	0

**** RISK SCORING RESULTS ****

Exhibit 2-1

EXHIBIT
A-3

Comment 6

11/27/2007 05:41 [redacted] PAGE 02/04

Residency Verification
Hendersen-Webb, Inc.
1025 Cranbrook Road
Cockeysville, Maryland 21030
Phone: (410) 628-4320
Fax: (410) 628-7887

Resident Information:
Resident Name: [redacted]
Property Name: [redacted]
Resident Address: [redacted]

Status: Current
Move-in Date: 01/06/1999
Move-out Date:
Lease Expiration Date: 01/31/2008
Notice Given:

Monthly Rent Amount: 535.00
Number of Lates: 2 NOT PAST 30 DAYS.
Number of Occupants: 1
Balance Due: $0.00
Pets:
Lease Fulfilled?

Comments:

Name: D moore 11/27/07
Verification Department

ORIGINAL
MC 11/27/07

Attachment D4

[redacted]

EXHIBIT
A-4

Comment 7

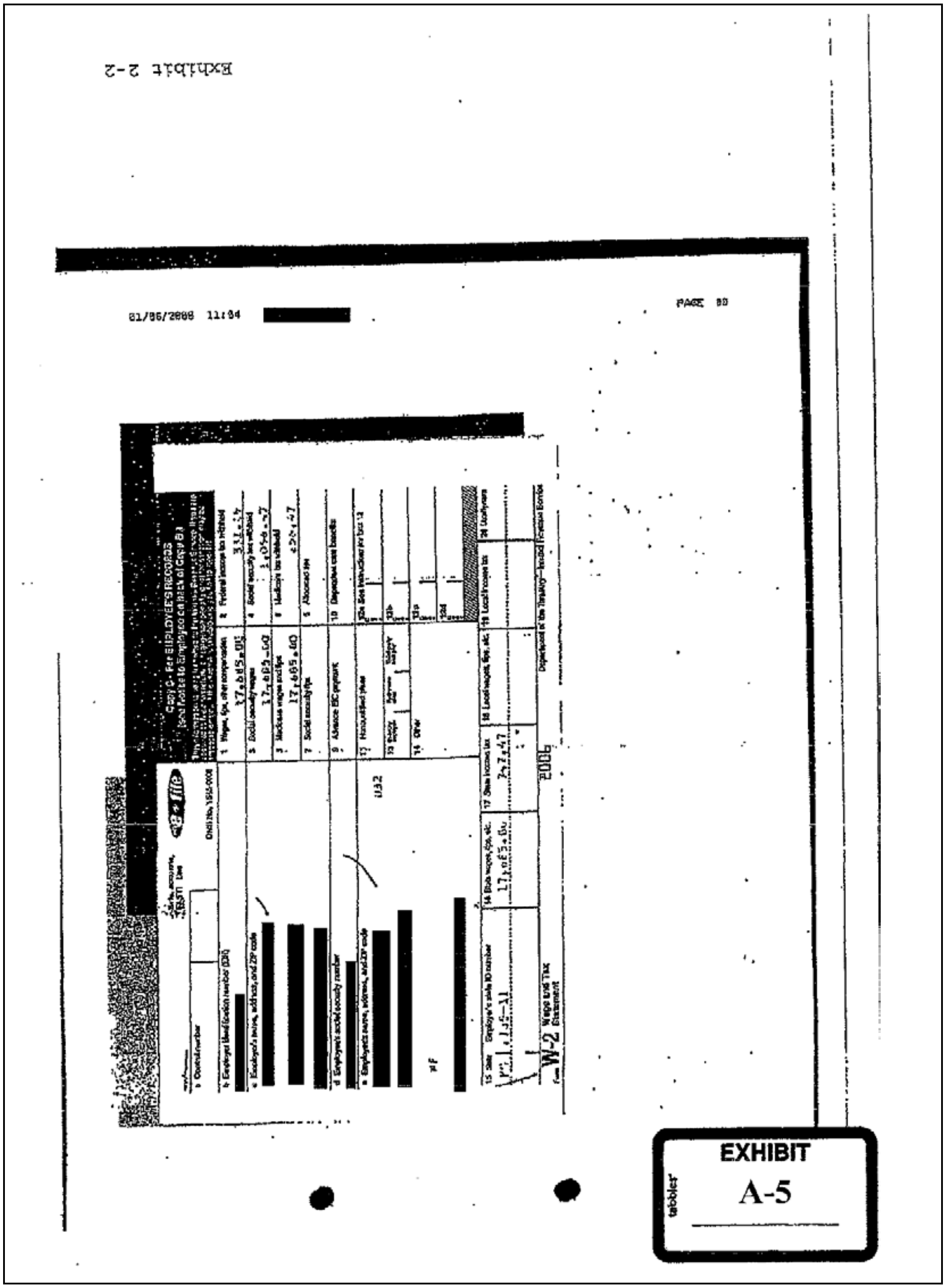
Exhibit 2-2

01/06/2008 11:04 [redacted]

PAGE 08

Copy C—For EMPLOYEE'S RECORDS

W-2 Wage and Tax Statement 2006

EXHIBIT

A-5

Attachment E1

Employee's Earnings Statement

[redacted]

084

Name	Document ID
[redacted]	[redacted]

Regular Pay Rate	Pay Period Ending Date	Check/Advice Number
988.88	09-25-2007	[redacted]

Mar. Stat.	Fed. Ex.	Additional Fed. Tax	St. Ex.	Additional St. Tax	County Code
M	2		2		3C

EARNINGS	HOURS	CURRENT	YEAR TO DATE
EGULAR	800	98888	197776
VERTIME	35	6489	6489
ST PD BENEFITS			
ICA SUBSIDY		8061	15626
ET/PEN SUB		8810	17628
NEMPL INS SUB		211	409

TAXES/DEDUCTIONS	CURRENT	YEAR TO DATE
FEDERAL TAX	4467	15718
FICA/MED	8061	15626
STATE TAXES	6179	12695
ST EMP ALT PEN	3977	7954
DIRECT DEPOSIT	82713	82713

	Earnings		Taxes		Deductions		Net Pay
Current	105377	–	18687	–	3977	=	82713
Year To Date	204265		44039		7954		152272

51 151

[redacted]

"STAY ALCOHOL-FREE DURING PREGNANCY" [redacted]

DIRECT DEPOSIT ADVICE
THIS IS NOT A CHECK
DO NOT CASH

ADVICE NO. [redacted]

DATE 10-03-2007

BANK NAME

BANK OF AMERICA N A

DEPOSIT TO THE ACCOUNT OF: [redacted]

[redacted]

THIS IS NOT A CHECK -- NON NEGOTIABLE

[redacted]

EXHIBIT
A-6

Fidelity & Trust

Fidelity & Trust Mortgage, Inc.

TELEPHONE EMPLOYMENT VERIFICATION

APPLICANT'S NAME: [redacted]

EMPLOYER'S NAME: [redacted]

EMPLOYER'S ADDRESS: [redacted]

EMPLOYMENT VERIFIED BY: [redacted]

TITLE OF CONTACT: Supervisor PHONE NUMBER: [redacted]

EMPLOYMENT INFORMATION

Present Employment Yes Previous Employment ____

Start Date: 8, 29, 07 From: / / To: / /

Applicant's position/title with this employer: Lab Tech I General

Probability of Continued Employment: Good

Applicant's income: $______ per ______ or state "refused" if refused: ______

Frequency of pay: ( ) Weekly ( ) Bi-weekly ( ) Monthly ( ) Bi-monthly ( ) Hourly ( ) Other

Is overtime or bonus continuance likely? Overtime: ____ Yes ____ No
Bonus: ____ Yes ____ No

VERIFICATION COMPLETED BY

(1.) I hereby certify that I have confirmed the employer's name, address and phone number with:

411.com

(2.) I hereby certify that I have spoken to the individual named above (contact) at the phone number given. The contact person verified that our applicant is/was employed by the company shown and that the information referenced by asterisk (**) is not available as a matter of company's policy. In addition, I certify as indicated by the area marked by "X" below:

_✓_ I certify that I have made contact with the Human Resources or Personnel Department as shown above and that all information listed is stated exactly as conveyed to me by the contact.

___ I certify that the employer shown above does not have a Human Resources or Personnel Department. I therefore made contact with the applicant's supervisor and information listed is exactly as conveyed to me by the contact.

Certification by: Mona Curbme Title: Processor Date: 11/28/07

Re-certification by: ______ Date: ______

Recertification to be performed a maximum of 7 days prior to funding.

Verbalvoe.doc

OIG Evaluation of Auditee Comments

Comment 1 We reviewed Prospect Mortgage's response and the accompanying exhibits and determined that it has not provided any information that we did not previously review during the audit. Also, we believe our report is appropriate in tone since our overall conclusion is that Prospect Mortgage generally complied with HUD requirements. Therefore, as outlined in the comments below, we maintain our position in regard to our audit conclusion and recommendations.

Comment 2 Prospect Mortgage's withdrawal of its branch office's FHA approval does not resolve the issue discussed in the report. We continue to recommend that HUD require Prospect Mortgage to indemnify HUD against future losses for the loan which its branch office improperly originated.

Comment 3 We commend Prospect Mortgage for its efforts to make changes geared toward improving loan quality and performance for its FHA-insured loan program.

Comment 4 We recognize that HUD guidelines award lenders the flexibility to exercise discretion in the underwriting of home mortgages. However, HUD also expects lenders to exercise both sound judgment and due diligence in underwriting. Also, as acknowledged by Prospect Mortgage, HUD permits lenders to approve FHA financing for a borrower with qualifying ratios in excess of the benchmark guidelines when **significant** compensating factors justify loan approval. We did not find adequate evidence of significant compensating factors that would justify the approval of the loan cited in the report.

Comment 5 There were four compensating factors listed on the attached mortgage credit analysis worksheet (exhibit A-1), which are as follows: conservative use of credit, satisfactory rental history since 01/06/1999, half of the downpayment from own funds, and borrower with new employer that offers higher salary and potential for increased earnings. Based on HUD guidelines and HUD staff feedback, these compensating factors were either not valid or inadequately supported.

According to HUD, a large downpayment constitutes 10 percent or more paid toward the purchase of the property. Although not included in the underwriter's justification on the mortgage credit analysis worksheet, Prospect Mortgage asserts that a case could be made that the borrowers demonstrated an ability to accumulate savings. We agree that this would be a valid compensating factor if accompanied by a conservative use of credit as stipulated by HUD; however, the lender did not adequately document the borrowers' ability to accumulate savings. A demonstrated ability to accumulate savings should have been supported by a pattern of savings. Prospect Mortgage provided no convincing evidence to indicate that the borrowers **demonstrated** an ability to accumulate savings. Prospect Mortgage's assertion that the borrowers demonstrated the ability to accumulate savings is based on bank statements for a 58-day period. The statements provided did not constitute sufficient evidence that the borrowers accumulated or saved the reflected account balances over a period of time. Although the attached bank statement (exhibit A-2) reflects ending balances of $10,930 and $727, respectively, there were no savings during the 58-day period. Contrary to Prospect Mortgage's assertions, this documentation by itself does not demonstrate that the borrowers saved the money, only that the account balance was perhaps relatively high.

Comment 6 As stated above, we agree that a demonstrated ability to accumulate savings along with a conservative use of credit would constitute a valid compensating factor. However, as discussed above, we did not find sufficient evidence to indicate that the borrowers **demonstrated** an ability to accumulate savings. Also, although the borrower (coborrower had no credit history) appeared to have conservatively used installment and revolving credit based on the credit report excerpt attached (exhibit A-3), the full credit report provided during the audit reflected risk scoring results from three credit reporting agencies which indicated certain negative factors. All three agencies indicated the following negative factors: serious delinquency and a relatively high number of accounts with recent delinquency. Two of the reporting agencies indicated that there had been too many attempts by the borrower to obtain credit in the previous 12 months.

The borrowers' rental payment history (exhibit A-4) is not relevant in this discussion. As acknowledged by Prospect Mortgage, the satisfactory history of paying rent would only be a compensating factor if the borrowers successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage for a period of 12-24 months. In this case, the borrowers' proposed monthly housing expense was almost three times their rent. Therefore, the satisfactory rental history as a compensating factor was invalid. Prospect Mortgage states that the borrowers made timely rental payments for 9 years and that they accumulated $10,000 in savings during that period. However, Prospect Mortgage did not document adequate support to show that the borrowers accumulated the savings over that period or over a reasonable period of time. Therefore, we do not agree that the lender adequately compensated against the higher ratios.

Comment 7 Based on HUD guidelines, potential for increased earnings as a compensating factor must be supported by evidence of job training or education in the borrower's profession. We did not find documentation in the loan file to support a potential for increased earnings. Prospect Mortgage provided documentation for the borrower's prior annual earnings and current monthly earnings (exhibits A-5 and A-6, respectively). However, since the borrower was qualified for the loan based on the current earnings, the potential for increased earnings would only be valid if the lender provided adequate documentation to show that there was a potential for the current earnings to increase.

Comment 8 Our audit conclusions, related recommendations, and associated reporting were developed and prepared based on audit work performed in accordance with generally accepted government auditing standards, as well as our operations policy. It is HUD OIG's policy to estimate potential savings to HUD from indemnifications associated with improperly originated loans using an average loss severity rate supported by an actuarial review of the FHA Mutual Mortgage Fund. The average loss rate is applied against the unpaid principal balance of the loan. The potential savings estimated in this report are based on the Actuarial Review of the FHA Mutual Mortgage Fund for Fiscal Year 2009. We did not deviate from our standard policy in reporting our audit conclusions and related recommendations.

Comment 9 We did not state that Prospect Mortgage did not comply with FHA quality control requirements. We only seek for Prospect Mortgage to improve its quality control process as indicated in recommendation 1B of the report. Although Prospect Mortgage complied with the requirement to review all early payment default loans, it did not review the loans in a reasonably timely manner. According to HUD, early payment defaults are typically indicative of significant underwriting deficiencies. Therefore, the review of these loans must be a priority for lenders, especially since HUD also states that one of the basic overriding goals of quality control is to assure swift and appropriate corrective action. HUD agreed that Prospect Mortgage should not have waited as long as it did to perform quality control reviews of the six loans cited in the report. We have revised the report to reflect calculations based on the default date of the loans instead of the closing date of the loans. Even with this revision, our results indicate that the loans in question were reviewed more than 8 months after default. The quality control review dates we used were based on quality control review reports that Prospect Mortgage provided during the audit. Although Prospect Mortgage states that the loans were previously reviewed by a third-party vendor, it did not provide supporting documentation to substantiate its statement.

Comment 10 We concluded that the underwriting staff misinterpreted the requirements related to compensating factors because several compensating factors provided were either not valid or inadequately supported. We found this to be the case with the loan cited and with another loan reviewed. The other loan was not recommended for indemnification because one of four compensating factors used by the underwriter to justify approval of the loan was valid and adequately supported. Nevertheless, three of the compensating factors were either not valid or inadequately supported, and in the case of the loan cited in this report, none of the compensating factors used by the underwriter was valid and/or adequately supported. HUD confirmed that the compensating factors, as indicated on the mortgage credit analysis worksheet, were either not valid or not adequately supported. Therefore, as stated above, we maintain our position in regard to our conclusion and recommendations.

Appendix C

SCHEDULE OF CASE FILE DISCREPANCIES

Case number	Excessive debt ratios	Unsupported compensating factors	Mortgage amount	Unpaid principal balance	60% loss rate *
241-7969493	X	X	$196,910	$193,357	$116,014
Totals			**$196,910**	**$193,357**	**$116,014**

* This amount was calculated by taking 60 percent of the unpaid principal balance for the loan as of February 1, 2010. HUD statistics show that FHA, on average, lost 60 percent[4] of the unpaid balance as of the claim date for each property during 2009.

[4] See footnote 1.

Appendix D

NARRATIVE CASE PRESENTATIONS

Case number: 241-7969493

Payments before first default reported: Six

Mortgage amount: $196,910

Unpaid principal balance: $193,357

Date of loan closing: December 5, 2007

Summary:

The borrower had high debt ratios with unsupported compensating factors and improper transmittal of documentation from third parties

Pertinent Details:

HUD Handbook 4155.1, REV-5, paragraphs 2-12 and 2-13, specify acceptable parameters for debt ratios in the absence of what HUD refers to as "compensating factors" for loans that are manually underwritten by the lender. HUD Mortgagee Letter 2005-16 states that the ratio of the total mortgage payment to effective income (front ratio) may not exceed 31 percent and the ratio of total fixed payments to effective income (back ratio) may not exceed 43 percent unless significant and valid compensating factors are provided. Compensating factors include but are not limited to the following: (1) demonstrated ability to pay housing expenses equal to or greater than the proposed new mortgage payment, (2) a downpayment of at least 10 percent, (3) demonstrated ability to accumulate savings and conservative use of credit, (4) ability to devote a greater portion of income to housing expenses, (5) borrower's documented compensation or income not reflected in effective income but directly affecting the ability to pay the mortgage, (6) at least 3 months worth of documented cash reserves, and (7) a potential for increased earnings.

The borrower had high front and back ratios (approximately 42 and 49 percent, respectively). The lender indicated the following compensating factors: "half down from own funds, conservative use of credit, satisfactory rental history, and borrower in same line of work (6 years) with new employment that offers higher salary and potential for increased earnings." These compensating factors were not valid based on HUD requirements. The borrower did not make a downpayment of at least 10 percent. Also, the conservative use of credit in and of itself was not an adequate compensating factor. In addition, the satisfactory rental history is a requirement and not a compensating factor; and in this particular case, the mortgage payment was actually about three times the current monthly housing expense. Lastly, the borrower obtained a new job in the same line of work before applying for the mortgage. The underwriter stated that the borrower had a potential for increased earnings, as indicated by job training or education in the borrower's profession. However, there was no related rationale or explanation.

Recommendation: Indemnify HUD $116,014 for this loan.