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MEMORANDUM NO:
2010-CH-1808

July 22, 2010

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

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

SUBJECT: Mac-Clair Mortgage Corporation, Flint, MI, Did Not Properly Underwrite a Selection of FHA Loans

INTRODUCTION

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

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

We provided our discussion draft memorandum report to Mac-Clair's management during the review. We asked Mac-Clair to provide written comments on our discussion draft memorandum report by June 7, 2010. Mac-Clair's president provided written comments to the discussion draft report, dated June 7, 2010. The president disagreed with our finding and recommendations. The complete text of the lender's comments, along with our evaluation of that response, can be found in appendix C of this report, except for 45 exhibits of 121 pages of documentation that was not necessary to understand the lender's comments. We provided HUD's Deputy Assistant

Secretary for Single Family Housing and Associate General Counsel for Program Enforcement with a complete copy of Mac-Clair's written comments plus the 121 pages of documentation.

METHODOLOGY AND SCOPE

Mac-Clair is 1 of 15 direct endorsement lenders we selected from HUD's publicly available Neighborhood Watch[1] system (system) for a review of underwriting quality. These direct endorsement lenders all had a compare ratio[2] in excess of 200 percent of the national average as listed in the system for loans endorsed between November 1, 2007, and October 31, 2009. We selected loans that had gone into a claims status. We selected loans for Mac-Clair that defaulted within the first 30 months and were: (1) not streamline refinanced, (2) not electronically underwritten by Fannie Mae or Freddie Mac, and (3) associated with an underwriter (usually an individual) with a high number of claims.

BACKGROUND

Mac-Clair is a nonsupervised direct endorsement lender based in Flint, MI. FHA approved Mac-Clair as a direct endorser in November 1994. FHA's mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to approve mortgages for otherwise creditworthy borrowers that might not be able to meet conventional underwriting requirements by protecting the lender against default. The direct endorsement program simplifies the process for obtaining FHA mortgage insurance by allowing lenders to underwrite and close the mortgage loan without prior HUD review or approval. Lenders are responsible for complying with all applicable HUD regulations and are required to evaluate the borrower's ability and willingness to repay the mortgage debt. Lenders are protected against default by FHA's mutual mortgage insurance fund, which is sustained by borrower premiums.

The goal of Operation Watchdog is to determine why there is such a high rate of defaults and claims. We selected up to 20 loans in claims status from each of the 15 lenders. The 15 lenders selected for Operation Watchdog endorsed 183,278 loans valued at $31.3 billion during the period January 2005 to December 2009. These same lenders also submitted 6,560 FHA insurance claims with an estimated value of $794.3 million from November 2007 through December 2009. During this period, Mac-Clair endorsed 2,856 loans valued at more than $309 million and submitted 458 claims worth more than $41.4 million.

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

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

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

[2] HUD defines "compare ratio" as a value that reveals the largest discrepancies between the direct endorser's default and claim percentage and the default and claim percentage to which it is being compared. FHA policy establishes a compare ratio over 200 percent as a warning sign of a lender's performance.

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

RESULTS OF REVIEW

Mac-Clair did not properly underwrite 7 of the 20 loans reviewed because its underwriters did not follow FHA's requirements. As a result, FHA's insurance fund suffered actual losses of $562,551, as shown in the following table.

FHA/loan number	*Closing date*	*Number of payments before first default*	*Original mortgage amount*	*Actual loss to HUD*
261-9230184	7/31/07	2	$56,535	$47,525
262-1625921	7/14/06	4	129,959	119,746
262-1628044	8/14/06	3	92,449	82,764
262-1636498	10/20/06	3	66,431	75,225
262-1652638	4/06/07	4	125,352	96, 364
262-1653481	3/23/07	4	44,457	46,849
262-1673933	7/13/07	0	106,160	94,078
	Totals		$621,343	$562,551

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

Area of noncompliance	*Number of loans*
Income	4
Liabilities	4
Excessive ratios	1
Gift funds	2
Credit report	3
Verification of rent	1

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

Income

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

For example, for loan number 261-9230184, Mac-Clair used the borrower's current pay rate. However, the borrower's rate of pay had only recently increased by 72 percent. Further, the same borrower had held five different jobs in the previous 2 years. Using the borrower's average monthly income for the previous 2-year period instead of his most recent rate of pay resulted in a mortgage payment-to-income ratio of 138 percent.

For loan number 262-1673933, Mac-Clair's underwriter considered the borrower's relative's Social Security income to be the borrower's income. The borrower was the Social Security recipient's representative payee. However, the loan file did not document the recipient's intention to live at the subject property.

Liabilities

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

For example, for loan number 262-1628044, Mac-Clair did not consider a debt because there were less than 10 payments remaining on the debt. The loan application showed that the borrower had a bank loan of $2,685 with monthly payments of $300. However, Mac-Clair's underwriter did not consider that the borrower had no cash assets remaining after loan closing. For loan number 262-1652638, two monthly installment loans totaling $199 were listed on the borrower's credit report, but were not shown on the loan application or the mortgage credit analysis worksheet[3].

Excessive Ratios

Mac-Clair improperly approved loan number 262-1652638 when the borrower's total fixed payment-to-income ratio exceeded FHA's requirement of 43 percent. Effective April 13, 2005, the mortgage payment-to-income and total fixed payment-to-income ratios were increased from 29 and 41 percent to 31 and 43 percent, respectively. If either or both ratios are exceeded on a manually underwritten mortgage, the lender is required to describe the compensating factors used to justify the mortgage approval (see appendix B for detailed requirements).

The total fixed payment-to-income ratio reported on the mortgage credit analysis worksheet was 45.62 percent. As a compensating factor, Mac-Clair's underwriter used the borrower's previous history of paying housing expenses greater than the proposed mortgage payment. However, the loan processor was unable to contact the borrower's landlord to verify past rental payments.

Gift Funds

Mac-Clair did not properly document gift funds received by borrowers for two loans. HUD requires that the lender must be able to determine that gift funds ultimately were not provided by an unacceptable source (see appendix B for detailed requirements).

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

For loan number 261-9230184, the gift fund donor was the borrower's spouse. The bank account from which the gift funds were paid was the same bank account listed by the borrower as an asset on his uniform residential loan application. Also, the bank account was opened approximately 2 months before the borrower applied for the home mortgage. There were two deposits to the account that corresponded to the amount of both the earnest money deposit and the cash to close. Mac-Clair did not verify the source of these deposits.

For loan number 262-1652638, the loan file did not document the withdrawal of the gift funds from the donor's account. As a condition to close, Mac-Clair's underwriter was to obtain the withdrawal slip from the donor's bank account. However, the underwriter did not do so.

Credit report

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

For example, for loan number 262-1652638, the loan file did not include letters of explanation for past-due accounts or evidence of payoff for collection accounts. One of the conditions to close was payoff of the collection accounts. The condition was not met at closing.

Verification of Rent

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

For loan number 262-1625921, one of the conditions to close was to obtain 12 months of cancelled checks to verify the rental payment history. The loan file only included an account history for a 7-month period for the borrower's wife's bank account, showing withdrawals at the end of each month. The loan file did not include cancelled checks or other explanations for the rental payments.

Incorrect Underwriter's Certifications Submitted to HUD

We reviewed the certifications for the seven loams with material underwriting deficiencies for accuracy. Mac-Clair's direct endorsement underwriters incorrectly certified that due diligence was used in underwriting the seven loans. When underwriting a loan manually, HUD requires a direct endorsement lender to certify that it used due diligence and reviewed all associated documents during the underwriting of a loan.

The Program Fraud Civil Remedies Act of 1986 (231 U.S.C. (United States Code) 3801) provides Federal agencies, which are the victims of false, fictitious, and fraudulent claims and

statements, with an administrative remedy (1) to recompense such agencies for losses resulting from such claims and statements; (2) to permit administrative proceedings to be brought against persons who make, present, or submit such claims and statements; and (3) to deter the making, presenting, and submitting of such claims and statements in the future.

RECOMMENDATIONS

We recommend that HUD's Associate General Counsel for Program Enforcement

1A. Determine legal sufficiency and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act against Mac-Clair and/or its principals for incorrectly certifying to the integrity of the data or that due diligence was exercised during the underwriting of seven loans that resulted in losses to HUD totaling $562,551 which could result in affirmative civil enforcement action of approximately $1,177,602[4].

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

1B. Take appropriate administrative action against Mac-Clair and/or its principals for the material underwriting deficiencies cited in this report once the affirmative civil enforcement action cited in Recommendation 1A is completed.

Schedule of Ineligible Cost 1/

Recommendation number	Amount
1A	$562,551

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

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

Appendix A

SUMMARY OF MATERIAL UNDERWRITING DEFICIENCIES

FHA loan number	Unsupported income or questionable employment history	Underreported liabilities	Excessive debt-to-income ratio	Insufficient gift documentation	Significant credit-related deficiencies or no credit	Incomplete verification of rent history
261-9230184	X			X	X	
262-1625921	X	X				X
262-1628044		X				
262-1636498		X				
262-1652638	X	X		X	X	
262-1653481			X		X	
262-1673933	X					

Appendix B

LOANS WITH MATERIAL UNDERWRITING DEFICIENCIES

Loan number: 261-9230184

Mortgage amount: $56,535

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: July 31, 2007

Status: Claim

Payments before first default reported: Two

Loss to HUD: $47,525

Summary:

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

Income:

Mac-Clair used excessive income to approve the loan. There was no documentation to show why the borrower's income that almost doubled just 30 days before closing would continue.

Mac-Clair's underwriter calculated the borrower's income as $500 per week. The income amount was based on a letter from the borrower's employer, dated June 4, 2007, stating that the borrower would begin to work for a salary of $500 per week on June 25, 2007. Further, the loan file contained pay stubs for pay periods ending July 6 and July 20, 2007, that showed a biweekly salary of $1,000.

Documents in the loan file showed that the borrower was an hourly employee for the same employer for the period November 17, 2006, to June 22, 2007. The employee's hourly rate of pay was $7.00 from November 2006 to April 2007 and $7.25 from May to June 2007. During this period, the borrower worked an average of 28 hours per week. During 2005 and 2006, the borrower also worked for four other employers.

For the 2-year period before the loan closing, the borrower's average monthly income was $465. Using this average for the previous 2-year period would increase the mortgage payment-to-

income ratio from 29.77 to 138.60 percent ($644.50 mortgage payment divided by $465 average monthly income equals 138.60 percent). The total fixed payments-to-income ratio would also increase from 29.77 to 138.60 percent.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, section 2, states that income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue. Paragraph 2-6 states that HUD does not impose a minimum length of time a borrower must have held a position of employment to be eligible. However, the lender must verify the borrower's employment for the most recent 2 full years. Paragraph 2-7 states that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage loan.

Gift Funds:

Mac-Clair's underwriter did not verify the source of gift funds. Given that the donor and borrower shared the same bank account, the source of the gift funds should have been verified.

The borrower's wife provided gift funds of $2,815 to the borrower. The loan file contained a transaction history for a TCF Bank account in the name of the borrower's wife for the period May 2 to July 18, 2007. The uniform residential loan application listed the same account as an asset of the borrower. The transaction history showed that the account was opened with a deposit of $3,000 on May 2, 2007. Another deposit of $500 was made on June 15, 2007. On July 2, 2007, $504 was withdrawn from the account. The transaction history included a notation that this withdrawal was for the earnest money deposit.

The loan file also contained copies of two separate withdrawal slips from TCF Bank, dated July 31, 2007. One withdrawal of $2,115 came from the aforementioned account, and another withdrawal of $200 came from a different account. These withdrawals were purportedly used for the borrower's cash to close.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10C2, states that regardless of when gift funds are made available to the home buyer, the lender must be able to determine that the gift funds ultimately were not provided by an unacceptable source and were indeed the donor's own funds.

Credit:

Mac-Clair did not document its reason(s) for not considering collection accounts, especially a recent collection account of $2,490.

The borrower's credit report showed two open medical collection accounts, one an old one opened in August 2005 for $161 and another recent account for $2,490 opened in March 2007.

The first account was opened in August 2005 and showed a balance of $161. The second account was opened in March 2007 and showed a balance of $2,490. The borrower wrote a letter of explanation stating that the collections resulted because he did not have medical insurance.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3C, states that FHA does not require that collection accounts be paid off as a condition of mortgage approval. Collections and judgments indicate a borrower's regard for credit obligations and must be considered in the analysis of creditworthiness with the lender documenting its reasons for approving a mortgage when a borrower has collection accounts or judgments.

One of the collection accounts was opened only 5 months before the loan closing.

Loan number: 262-1625921

Mortgage amount: $129,959

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: July 14, 2006

Status: Claim

Payments before first default reported: Four

Loss to HUD: $119,746

Summary:

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

Income:

The uniform residential loan application stated that the borrower had been self-employed in the construction business for 1 year. The borrower's monthly self-employment income was calculated as $5,416 per month. The loan file contained a copy of the borrower's 2005 Federal income tax return showing self-employment income. The loan file also contained a copy of the profit and loss statement for the borrower's business for the first 6 months of 2006. The loan application stated that the borrower was previously employed by a vocational school and he taught construction trades. The borrower's average monthly teaching income for the previous 2 years was $2,344. If the two occupations were not considered related, self-employment income of less than 2 years duration would not have been considered in the mortgage approval process.

Using only the borrower's average monthly employment income would increase the mortgage payment-to-income ratio from 21.73 to 50.20 percent ($1,177 divided by $2,344). The total fixed payments-to-income ratio would increase from 24.09 to 55.66 percent ($1,305 divided by $2,344).

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-9A, states that income from self-employment is considered stable and effective if the borrower has been self-employed for 2 or more years. Paragraph 2-9A1 states that an individual self-employed between 1 and 2 years must have at least 2 years of documented previous successful employment in the line of work in which the borrower is self-employed or in a related occupation to be eligible.

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

Liabilities:

The borrower's credit report showed a past-due credit card bill for $376. The credit report included a statement that the account was closed by the credit grantor. There was also a handwritten note stating, "Paid see receipt." The loan file did not include documentation showing that the account was paid off.

One of the conditions to satisfy before loan closing required the borrower to provide proof of payoffs for all past-due accounts.

Credit:

The loan file contained a verification of rent for the period February 2004 to July 2006 to establish the borrower's credit history. The loan file also contained an account history from the Flint Area School Employees Credit Union, account number 62438, for the period January 1 to July 12, 2006. The account holder was the borrower's wife. There was a handwritten notation stating, "Bank statements from Jan. to show rent payments." The account history only showed large withdrawals at the end of each month.

The loan file did not contain cancelled checks. Mac-Clair should have required the borrower to provide cancelled checks before sending the loan for closing.

One of the conditions to satisfy before loan closing required the borrower to provide verification of rent for the current residence along with 12 months of cancelled rental checks.

Loan number: 262-1628044

Mortgage amount: $92,449

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: August 14, 2006

Status: Claim

Payments before first default reported: Three

Loss to HUD: $82,764

Summary:

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

Liabilities:

The initial uniform residential loan application, dated July 10, 2006, showed a bank loan balance of $4,842 and monthly payments of $300. The borrower used a gift of $1,603 from his parents to partially pay down the bank loan. The final uniform residential loan application, dated August 14, 2006, showed the bank loan balance as $2,685 with nine payments of $300 remaining. The final loan application showed no liquid assets remaining after loan closing. Including the bank loan monthly payment of $300 would increase the total fixed payments-to-income ratio from 33.08 to 46.23 percent.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-11A, states that debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing, especially if the borrower will have limited or no cash assets after loan closing.

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

Loan number: 262-1636498

Mortgage amount: $66,431

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: October 20, 2006

Status: Claim

Payments before first default reported: Three

Loss to HUD: $75,225

Summary:

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

Liabilities:

Our review of the loan file disclosed an unrecorded biweekly installment of $160 or monthly payments of $320. On April 29, 2006, the borrower purchased a Chevy Trailer Blazer from Mike's Used Cars for $9,401 with a downpayment of $550. The installment invoice documented biweekly payments of $160 applied to the outstanding balance of $8,851. As of September 25, 2006, the balance of the installment was $5,971. This liability was not reported on the borrower's mortgage credit analysis worksheet or uniform residential loan application, nor was it listed on the borrower's credit report. As a result, the borrower's monthly debt and obligations were understated by $320. The total fixed payment-to-income ratio increased from 32.52 to 52.16 percent when the installment was included in the calculation.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-11, states the types of liabilities that must be considered in qualifying borrowers. Paragraph 2-11A states that the borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other recurring charges extending 10 months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc.

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

Loan number: 262-1652638

Mortgage amount: $125,352

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: April 6, 2007

Status: Claim

Payments before first default reported: Zero

Loss to HUD: $96,364

Summary:

We found material underwriting deficiencies relating to the borrower's income, liabilities, gift funds, and credit history.

Income:

Mac-Clair's underwriter overstated the borrower's monthly income by $1,131. Unsupported self-employment income of $583 and unemployment income of $415 were included in the calculation of the borrower's income. We used the hourly rate of pay from the verification of employment to calculate the monthly income. To support the self-employment income, the loan file contained the borrower's 2006 Federal income tax return. The tax return listed other income of $7,000 described as "spouse child care business." The borrower filed as head of household, listing his children as his dependents. There was no documentation, such as Internal Revenue Service Form 1099 or W-2, verification of employment, or letter of explanation, in the loan file supporting this income and reporting the period in which the income was earned. The borrower's 2005 Federal income tax return did not include self-employment income. Further, the loan file did not support that the self-employment income earned was from an occupation related to the borrower's current employment as a driver with Penske.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-9A1, states that an individual self-employed between 1 and 2 years must have at least 2 years of documented previous successful employment (or a combination of 1 year of employment and formal education or training) in the line of work in which the borrower is self-employed or in a related occupation to be eligible. Paragraph 2-9A2 states that the income from a borrower self-employed less than 1 year may not be considered effective income.

The loan file did not document the continuance of unemployment income. The verification of employment disclosed that the borrower worked an average of 40 hours per week. The employer did not indicate that his employment was seasonal.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-7L, states that unemployment income must be documented for 2 years. Reasonable assurance of its continuance is also required.

Liabilities:

When calculating the borrower's monthly liabilities, Mac-Clair's underwriter did not include two monthly installments of $95 and $104 that were disclosed on the borrower's credit report. The liabilities were not reported on the mortgage credit analysis worksheet or the borrower's loan application.

As identified on the credit report, the borrower had a monthly installment loan with Nelnet Loans. The account was opened in January 2007. As of April 5, 2007, the date of the credit report, the balance was $10,303 with a monthly payment of $95. The borrower opened a credit card account with Discover Financial in September 1996. According to the credit report, the last activity on the account was in February 2007. The balance on the account was $5,176 with a minimum monthly payment of $104.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-11, states that the borrower's liabilities include all installment loans, revolving charge accounts, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other recurring charges extending 10 months or more.

The inclusion of the monthly liabilities and the exclusion of borrower's self-employment and unemployment income would have disqualified him for the loan. We recomputed the qualifying ratios excluding the self-employment and unemployment incomes and including the monthly installment loan payments. The revised qualifying ratios (mortgage payment to income and total fixed payment to income) would be 52.79 and 79.16 percent, well above the allowable ratios of 31 and 43 percent.

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

Gift:

The borrower received a gift of $9,816 from his spouse for the purchase of the property. The loan file did not document the withdrawal of the gift funds from the donor's account. A bank

statement was provided for the donor's account to Mac-Clair. It showed that funds were available for the amount of the gift. However, the withdrawal of the gift funds was not shown on the bank statement.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10C2a, states that if the transfer of the gift funds is by certified check made on the donor's account, the lender must obtain a bank statement showing the withdrawal from the donor's account, as well as a copy of the certified check.

Condition #17 reported by Mac-Clair's underwriter on attachment 1 to the mortgage loan commitment, under the conditions to satisfy before a loan closing is scheduled, required a copy of the withdrawal slip from the donor's account showing $9,816 coming out of the account.

Credit:

Mac-Clair's underwriter did not adequately evaluate the borrower's credit history. A review of the borrower's credit report disclosed 20 past-due collection accounts from 2002 through 2005 totaling $4,625. The loan file did not include letters of explanation for the past-due accounts, nor did it address payment of the outstanding collections as identified as a condition to close by the underwriter. The borrower paid three additional past-due collection accounts at closing totaling $1,461.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions. If the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan.

HUD Handbook 4155.1, REV-5, paragraph 2-3C, states that collections and judgments indicate a borrower's regard for credit obligations and must be considered in the analysis of creditworthiness with the lender documenting its reasons for approving a mortgage when the borrower has collection accounts or judgments. The borrower must explain all collections in writing.

Condition #16 reported by Mac-Clair's underwriter on attachment 1 to the mortgage loan commitment, under the conditions to satisfy before a loan closing is scheduled, required proof of payoffs for all judgments, collections, and past-due accounts.

In December 2001, the borrower filed for Chapter 7 bankruptcy protection. The borrower received a discharge from his debts on April 19, 2002. The underwriter claimed that the previously mentioned outstanding collection accounts were discharged in the bankruptcy. However, evidence supporting the debts discharged was not maintained in the loan file. As noted above, the credit report specifically identified collections that were not included in the

bankruptcy. Also, as indicated on the credit report, the date of last activity for some of the collections occurred after the date of discharge. Therefore, Mac-Clair's underwriter should have obtained letters of explanation from the borrower for these outstanding collections as required by HUD and considered these in determining the borrower's creditworthiness. To comply with Mac-Clair's condition to close, the collection accounts should have been satisfied.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3E, states that a Chapter 7 bankruptcy (liquidation) does not disqualify a borrower from obtaining an FHA-insured mortgage if at least 2 years have elapsed since the date of the discharge of the bankruptcy. Additionally, the borrower must have reestablished good credit or chosen not to incur new credit obligations. The borrower must have demonstrated a documented ability to responsibly manage his or her financial affairs.

HUD Review:

Each year HUD performs post-endorsement technical reviews on a percentage of the FHA-insured loans. These reviews are performed to monitor the performance of lenders, underwriters, and lenders' technical staff. Loan number 262-1652638 was reviewed by HUD. Initially, Mac-Clair received an unacceptable rating during HUD's post-endorsement technical review. In a letter, dated May 3, 2007, HUD informed Mac-Clair that a rating of unacceptable meant that deficiencies were identified that resulted in a change in the eligibility of the borrower or property or a significant increase in mortgage risk. HUD cited the following deficiencies:

- Unsupported self-employment income of $583. HUD requested 2 years of Federal tax returns to support the self-employment income. Also, the returns were to include the unemployment income paid during years 2005 and 2006. HUD explained that income ratios would be increased without inclusion of the self-employment income and cited the increase in ratios and a lack of compensating factors.

- The credit report showed open collection accounts and charge-offs after Chapter 7 bankruptcy, demonstrating a poor credit risk for loan approval.

In a letter, dated May 14, 2007, Mac-Clair's quality control division provided a response to the deficiencies identified by HUD. Mac-Clair provided the borrower's 2006 Federal income tax return as support for the self-employment income. Mac-Clair explained that the borrower had been self-employed for 16 months as a child care bus driver. Further, it stated that while there were collections and charge-offs after bankruptcy, these occurred several years ago. Mac-Clair believed that the borrower had demonstrated his ability and willingness to pay by establishing good credit within the past 16 months, citing five new accounts that were opened since 2006 with excellent credit history.

HUD accepted the response and in June 2007, HUD informed Mac-Clair that it considered the issues satisfactorily addressed. As a result, HUD revised Mac-Clair's rating of the loan in FHA's Connection system.

The support provided for the self-employment income did not specify the period during which this income was earned in 2006. Further, Mac-Clair did not provide documentation verifying income earned from self-employment after December 31, 2006. Therefore, the 16-month period of self-employment was not supported.

Concerning the borrower's credit history, the recent accounts cited by Mac-Clair were opened in October and November 2006, only 5 to 6 months before the loan closing. Therefore, the 16-month period of good credit was not supported. Also, neither HUD nor Mac-Clair addressed the two outstanding liabilities previously discussed, which were not included when calculating the borrower's monthly obligations.

Loan number: 262-1653481

Mortgage amount: $44,457

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: March 23, 2007

Status: Claim

Payments before first default reported: Four

Loss to HUD: $46,849

Summary:

We found material underwriting deficiencies relating to the borrower's debt ratio and credit history.

Excessive Debt Ratio:

The borrower's total fixed payment-to-income ratio exceeded HUD's allowable ratio of 43 percent. The ratio reported on the mortgage credit analysis worksheet was 45.62 percent. As a compensating factor to justify the excessive ratio, Mac-Clair's underwriter used the borrower's previous ability to pay housing expenses greater than the proposed monthly housing expense.

The verification of rent reported the borrower's rent payment as $636 for the past 9 months. The proposed mortgage payment was $432, resulting in a monthly cost savings of $204. However, the loan file did not include documentation supporting the borrower's rent payment history over the past 12-24 months.

The loan processor was only able to verify past rent for a 9-month period. The processor was unable to contact the borrower's previous landlord to verify past rent payments beyond the 9-month period. The loan processor also did not obtain evidence from the borrower for rental payments made to the previous landlord.

HUD/FHA Requirements:

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

HUD Handbook 4155.1, REV-5, paragraph 2-13A, states that compensating factors include successfully demonstrating 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.

Condition #26 reported by Mac-Clair's underwriter on attachment 1 to the mortgage loan commitment, under the conditions to satisfy before a loan closing is scheduled, stated that the verification of rent for the current residence was to cover 12 months.

Credit History:

Mac-Clair's underwriter did not adequately evaluate the borrower's credit history or obtain strong compensating factors to support loan approval. The borrower's credit report disclosed only one current installment and many recent collection accounts for utilities.

The loan was approved using alternative credit reference letters. One credit letter, dated February 20, 2007, was provided by Consumers Energy. It stated that the borrower's length of service was 7 months, during which the borrower received two notices of delinquency. The borrower provided a letter of explanation claiming that the delinquencies were due to a change in payment due dates. The second credit letter, dated March 14, 2007, was provided for child care services. The loan file did not contain a third credit reference letter.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions. If the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan.

Condition #16 reported by Mac-Clair's underwriter on attachment 1 to the mortgage loan commitment, under the conditions to satisfy before a loan closing is scheduled, stated that three alternative credit references covering 12 months were required.

Loan number: 262-1673933

Mortgage amount: $106,160

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: July 13, 2007

Status: Claim

Payments before first default reported: Zero

Loss to HUD: $94,078

Summary:

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

Income:

The borrower's monthly income included $1,526 from Social Security disability income. The recipient of the income was not the borrower or coborrower on the loan. An undated letter from the Social Security Administration stated that the borrower was the recipient's representative payee. The letter stated that the funds were to be used for the recipient's needs.

The loan file did not document that the recipient was a dependent of the borrower, nor did it document the recipient's intention to reside at the subject property. Further, the loan file did not document that the income would be available to be used for the monthly mortgage payment.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, section 2, states that income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue.

Excluding the $1,526 monthly benefit payment from the borrower's monthly income, increased the mortgage payment-to-income ratio from 27.52 to 49.56 percent ($944.53 mortgage payment divided by $1,906 in average monthly income). The total fixed payments-to-income ratio increased from 35.09 to 63.19 percent ($1,205 mortgage payment divided by $1,906 in average monthly income).

Mortgagee Letter 2005-16, dated April 13, 2005, increased the payment-to-income and debt-to-income ratios from 29 and 41 percent to 31 and 43 percent, respectively. It stated that if either or

both ratios are exceeded on a manually underwritten mortgage, the lender is required to describe the compensating factors used to justify the mortgage approval.

APPENDIX C

LENDER COMMENTS AND OIG's EVALUATION

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Mac-Clair Mortgage

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June 7, 2010

VIA FEDERAL EXPRESS

Mr. Muhammad Akhtar
Supervisory Forensic Auditor
U.S. Department of Housing
and Urban Development
Office of the Inspector General
Region V
77 West Jackson Boulevard
Suite 2646
Chicago, Illinois 60604

RE: **Mac-Clair Mortgage Corporation**
HUD OIG Draft Memorandum Report

Dear Mr. Akhtar:

Mac-Clair Mortgage Corporation ("MCMC" or "Company") is in receipt of the revised Draft Memorandum Report ("Report"), dated May 20, 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 twenty Federal Housing Administration ("FHA") insured loans selected as part of HUD and the OIG's "Operation Watchdog" initiative to examine the underwriting of fifteen lenders at the suggestion of the FHA Commissioner. The twenty loans were endorsed for FHA insurance between November 1, 2007 and October 31, 2009, defaulted within the first 30 months, and have since gone into claim status.

The Report states that its objective was to determine whether the Company underwrote the twenty selected loans in accordance with FHA requirements and, if not, whether the underwriting reflected systemic problems. The Report's "Results of Review" allege that seven of the twenty loans contained underwriting deficiencies and, in each of these seven cases, the underwriters incorrectly certified that due diligence was used in underwriting the loans. Based on these assertions, the Report recommends that HUD: (1) take appropriate administrative action with regard to the underwriting deficiencies; and (2) in connection with the underwriting certifications, determine the legal sufficiency and, if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act, 31 U.S.C. §§ 3801 <u>et seq</u>. ("PFCRA").

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The OIG provided MCMC with an opportunity to submit written comments for inclusion in the final report. This response summarizes MCMC's history and operations and addresses the individual findings cited in the Report. We believe that this response and accompanying exhibits demonstrate that the Report's recommendations in connection with the cited loans are unwarranted. We appreciate this opportunity to comment on the OIG's findings and recommendations. That said, we understand that final reports routinely include auditors' comments about the 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 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 issues is presented in the final Report.

I. BACKGROUND

A. MAC-CLAIR MORTGAGE CORPORATION

MCMC received approval as a Direct Endorsement mortgagee in November of 1994. Headquartered in Flint, Michigan, MCMC operates in two states through six FHA-approved offices and employs approximately 55 individuals. MCMC sells all loans that it originates into the secondary market on a servicing-released basis, and its primary investors included Franklin American, M&T Bank, and U.S. Bank. It is an authorized agent for three principals and acts as principal for twelve authorized agents. MCMC's employees consistently strive to produce high quality loans in compliance with HUD/FHA standards.

FHA lending has constituted approximately 65% of MCMC's business operations from 2007 through the present. Because FHA lending has represented a substantial portion of MCMC'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. 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 also note that the review covered loans originated between September 1, 2005 and December 31, 2007. As you know, during and immediately following this period, the United States experienced a dramatic financial crisis that resulted in record-breaking unemployment, and loan default and foreclosure activity. The state of Michigan, in which MCMC is headquartered, was particularly devastated by the financial crisis and ensuing economic downturn. Our analysis of the loans reviewed in this

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matter demonstrates that all but one of the borrowers defaulted after making multiple mortgage payments. This payment activity suggests that these borrowers defaulted as a result of unforeseen economic or personal setbacks as a result of this crisis, rather than because of poor origination or underwriting decisions. In fact, loan servicing data for the loans reviewed demonstrates that at least six of these borrowers reported curtailment of income or illness, which often results in income loss, as the reason for the default.

B. THE "OPERATION WATCHDOG" REVIEW

As an initial matter, we would like to take this opportunity to point out that this review was not conducted in the typical manner in which the OIG Audit Division performs audits. As acknowledged in the Report, the OIG did not follow its standard procedures of considering the Company's internal or information systems controls or the results of previous audits, and did not communicate with MCMC's management in advance of issuing the Report. Moreover, instead of reviewing a statistically random sample of loans originated by MCMC during the review period, the OIG examined loan files for an adverse sample of 20 loans in which the borrowers had defaulted and the lenders had made a claim to HUD for FHA insurance benefits. Rather than request that the Company provide information and loan files in the cases reviewed, which MCMC would have promptly supplied, the OIG subpoenaed loan file documentation simultaneously from fifteen FHA-approved lenders, including MCMC, in connection with the "Operation Watchdog" probe. While HUD and the OIG expressly stated that there was "no evidence of wrongdoing" on the part of MCMC or the other lenders subjected to this probe **(Exhibit A-2)**, the Department and OIG nevertheless issued a press release announcing the "probe" before reviewing any of the loan files at issue in this matter **(Exhibit A-2)**. Typically, HUD and the OIG refuse to disclose the names of entities subject to ongoing reviews by the Department; however, in this instance, the press release included the names of the fifteen lenders, including MCMC, subject to this particular review **(Exhibit A-2)**.

Although the OIG acknowledged in the press release that it had no evidence of wrongdoing by the Company at that time, by stating that the Department would "aggressively pursue indicators of fraud," the announcement gave the public the impression that the subject lenders had engaged in misconduct or otherwise posed some risk to the FHA Insurance Fund. Given the scrutiny by warehouse lenders and investors of originating lenders in this market, these companies immediately chose to take action against the fifteen lenders subjected to the "probe," rather than wait for the results of the Department's review. Consequently, many of the fifteen lenders involved in this matter, including MCMC, lost their investors, warehouse lines, and customer base upon issuance of the press release announcing the review. MCMC is one of

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several of the subject lenders that have been forced to cease business operations as a result of this review. The Company is in the process of winding down its loan origination business and closing its doors. Nevertheless, MCMC has throughout its existence been committed to complying with HUD requirements and originating quality FHA-insured loans. Therefore, upon receiving the draft Report, we conducted a thorough review of the loan file documentation in light of the issues raised. We address the concerns identified in the Report below.

II. RESPONSE TO RESULTS OF REVIEW

As previously noted, the Report alleges noncompliance with HUD requirements in seven loans and recommends action by HUD and the Departmental Enforcement Center regarding these assertions. Upon receipt of the draft Report, MCMC performed its own stringent analysis of the loans subject to the OIG's review. Based on MCMC's diligent examination, the Company disagrees with a number of the assertions in the Report and takes strong exception to certain of the recommendations made in the Report, including the suggestion that the Department consider pursuing remedies under PFCRA. Our review indicated that several of the findings in the Report are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability. While we recognize that there is always room for improvement, at no time did the Company intentionally disregard HUD guidelines or knowingly misrepresent information to the Department. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate MCMC's general compliance with HUD/FHA requirements and adherence to prudent lending standards. Below we reply to the individual matters raised in the Report, evidence our adherence to FHA requirements in connection with several cited loans, and set forth our opposition to the to the OIG's recommendations regarding action under PFCRA.

A. MCMC GENERALLY COMPLIED WITH HUD's UNDERWRITING GUIDELINES

In the "Results of the Review" and Appendix B, the Report alleges that MCMC did not underwrite seven of the twenty FHA loans reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) income verification; (2) assessment of borrower liabilities; (3) excessive qualifying ratios; (4) documenting the source of funds to close; (5) documenting the source of gift funds; (6) credit history analysis; and (7) rent verification. We address each of these individual allegations in turn below.

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1. **Income Verification**

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

a. [redacted] – FHA Case No. 261-9230184

Comment 1

In the [redacted] loan, the Report alleges that the Company used excessive income to approve the borrower for the mortgage without documenting why the borrower's income would continue, and suggests that using an average monthly income from the past two years would have increased the debt-to-income ratios to an unacceptable level.

With regard to income documentation, MCMC understands and appreciates that a lender must verify the borrower's employment for the most recent two full years and analyze the income to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage. See HUD Handbook 4155.1 REV-5, ¶¶ 2-6, 2-7.[1] MCMC complied with these requirements in the [redacted] loan. The loan application indicated that the borrower had been employed as a security guard by [redacted] for the past ten months **(Exhibit B-1)**. MCMC obtained a Verification of Employment ("VOE") **(Exhibit B-2)**, pay stubs **(Exhibit B-3)**, and a compensation report from [redacted] **(Exhibit B-4)** to document the borrower's current employment in compliance with HUD requirements. See HUD Handbook 4155.1 REV-5, ¶ 3-1(E).

These documents demonstrated that the borrower had been employed with [redacted] since November of 2006. While the borrower had previously been paid on an hourly basis, the loan file also contained a letter evidencing that the borrower's employer began paying Mr. [redacted] on a salary basis, at a rate of $500 per week, on June 25, 2007 **(Exhibit B-5)**. The VOE, pay stubs, and compensation report confirmed that the borrower was in fact receiving $500 in weekly salary at the time the loan closed on July 31, 2007 **(Exhibit B-6)**. Moreover, the employer stated in the VOE that the borrower's likelihood of continued employment was "HIGH" **(Exhibit B-2)**. As

[1] 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 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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these documents clearly evidenced the borrower's current income and likelihood of continuance, the underwriter reasonably used the $500 in weekly salary to calculate the borrower's effective income on the Mortgage Credit Analysis Worksheet ("MCAW") **(Exhibit B-7)**.

Nevertheless, the Report asserts that, as the loan file did not document why the borrower's income would continue, the underwriter should have used average monthly income for the two-year period before closing. MCMC respectfully disagrees. We are not aware of, and the Report does not reference, any requirement in FHA guidelines requiring a lender to document the reasons for a borrower's pay raise, or why such a pay raise will continue. Rather, HUD guidelines require lenders to document the borrower's employment for the past two years, and analyze the likelihood that the employment will continue. MCMC adhered to these requirements in the [redacted] loan. As discussed above, the loan file properly documented the borrower's current employment and $500 weekly salary. The file also clearly evidenced that the borrower had a high likelihood of continued employment with this company **(Exhibit B-2)**.

With regard to job stability, HUD guidelines expressly state that the Department does not impose a minimum length of time a borrower must have held a position of employment to be eligible for FHA financing. See HUD Handbook 4155.1 REV-5, ¶ 2-6. Although the borrower had not been employed at his current position for a full two-years prior to closing, the loan file documented that he had consistently been employed during the past two years, and had been working for [redacted] for the past ten months. As the Report points out, the borrower's hourly earnings had increased during his time with this employer, and he had received a pay raise upon transitioning to a salary prior to the loan closing **(Exhibit B-5)**. Based on the borrower's current income, the fact that he had been employed at that job for ten months, and the employer's indication that the likelihood of his continued employment was high, the underwriter reasonably determined that the borrower had demonstrated sufficient job stability to warrant loan approval. The underwriter properly used the borrower's current, documented income to calculate the borrower's debt-to-income ratios, and the borrower qualified for FHA financing. MCMC complied with HUD guidelines in documenting and analyzing the borrower's income in this loan and this allegation should be removed from the final Report.

Comment 2

b. [redacted] – FHA Case No. 262-1625921

In the [redacted] loan, the Report suggests that self-employment income of less than two years should not have been considered, as the borrower's self-employment and previous occupation were unrelated. Using only the borrower's average monthly income from his prior employment, the Report asserts that the debt-to-income ratios would have increased to an unacceptable level.

Contrary to these assertions, the Company adhered to FHA requirements regarding self-employment earnings in this case and properly included income from this source in the borrower's effective income. Here, the borrower had been self-employed in the construction business for one year prior to closing on July 14, 2006 **(Exhibit C-1)**. When a loan applicant has been self-employed between one and two years, HUD requires that the borrower "have at least two years of documented previous successful employment (or a combination of one year of employment and formal education or training) in the line of work in which the borrower is self-employed or in a related occupation to be eligible." HUD Handbook 4155.1 REV-5, ¶ 2-9(A). In this case, the borrower had been employed as a teacher at a vocational school at which he taught the construction trade for four years prior to his self-employment **(Exhibit C-2)**. MCMC strongly disagrees with the suggestion in the Report that these two occupations, the construction business and the teaching of construction skills, may be unrelated. The loan file clearly evidenced that the borrower had previous successful employment of four years teaching others how to succeed in the construction business and, one year prior to closing, decided to use the skills he had been teaching to pursue his own self-employment in this field.

To document the borrower's income, in compliance with HUD guidelines, MCMC obtained a 2004 W-2 Form from his teaching position **(Exhibit C-3)**, a 2005 W-2 Form **(Exhibit C-3)** and 2005 tax return **(Exhibit C-4)** from his self-employment, and a 2006 Profit and Loss Statement evidencing his self-employment income for the year-to-date prior to closing **(Exhibit C-5)**. See HUD Handbook 4155.1 REV-5, ¶ 2-9(B). Using only the borrower's income reflected on the 2004 W-2 Form from his teaching position and the 2005 self-employment income reflected on the tax return would yield an average monthly income of $4,191.40.[2] This reflects a conservative figure, as it does not consider the increasing monthly income reflected on the borrower's Profit and Loss Statement for 2006. This average monthly income would have resulted in qualifying ratios of 28.07%/31.13% **(Exhibit C-6)**, which are well within HUD guidelines.

In summary, MCMC complied with HUD guidelines in documenting the borrower's self-employed income in the [redacted] case. Using a conservative average of income documented in the file for 2004 and 2005, the borrower qualified for FHA financing. Administrative action in connection with this allegation would be unwarranted and, thus, this assertion should be removed from the final Report.

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[2] This average was calculated as follows: 2004 income of $28,054.68 + $72,539 in income reported on the 2005 tax return = $100,593.68. $100,593.68/ 24 months = $4,191.40.

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2. **Assessment of Liabilities**

In four of the loans reviewed by the OIG, the Report contends that the Company did not properly assess the borrowers' liabilities. MCMC respectfully disagrees with the allegations in several of the cited cases, and our individual responses to a representative sample of these loans are set forth below.

Comment 3

a. [redacted] – FHA Case No. 262-1625921

In this case, the Report asserts that, although the underwriter conditioned approval of the loan on the payoff of a $376 past-due credit card bill, the file did not contain evidence that the borrower satisfied this debt prior to closing.

MCMC maintains that it adhered to HUD requirements in underwriting and approving the [redacted] loan for FHA financing. While the credit report evidenced an outstanding balance of $376 on an Assoc/Citi credit card, as acknowledged in the Report, the credit report contained a hand-written note indicating that this account had been paid, per an attached receipt **(Exhibit D-1)**. Moreover, the borrower indicated in his explanation letter regarding this debt that he had satisfied this obligation prior to closing **(Exhibit D-2)**. Unfortunately, it appears that a copy of the referenced receipt showing the borrower's satisfaction of this obligation was inadvertently excluded from the loan file. The Company understands and appreciates the importance of maintaining copies of all relevant documentation related to loan approval in the loan file, and we have counseled our employees on the importance of copying all relevant documentation and maintaining it for the requisite time period. We are confident that this was an isolated incident.

Nevertheless, even if the borrower had not satisfied this debt prior to closing, the loan would have qualified for FHA financing. HUD guidelines expressly state that "FHA does not require that collection accounts be paid off as a condition of mortgage approval." HUD Handbook 4155.1 REV-5, ¶ 2-3(C). While the underwriter may have initially conditioned loan approval on the satisfaction of this debt, HUD has delegated to the underwriter the discretion to waive and/or clear underwriting conditions, provided such decisions conform to HUD requirements. In this instance, FHA guidelines did not require that the borrower satisfy this debt prior to closing. Thus, while it appears that the borrower provided evidence of the payment of the credit card bill at issue, even if he had not satisfied this condition before loan closing, the borrower would have qualified for FHA financing and the underwriter could have waived the condition. As a result, administrative action in this case would be inappropriate and we request that this allegation be removed from the final Report.

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b. [redacted]- FHA Case No. 262-1628044

In this case, the Report asserts that monthly payments of $300 on a bank loan had less than ten payments remaining; however, as the borrower did not have cash assets after closing, this debt should have been included in the calculation of the borrower's qualifying ratios, which would have increased to 33.08%/46.23%.

As you know, HUD guidelines expressly state that lenders "must include the monthly housing expense and all other additional recurring charges *extending ten months or more.*" HUD Handbook 4155.1 REV-5, ¶ 2-11(A) (emphasis in original). In compliance with this requirement, the underwriter excluded the $300 debt, as the borrower had less than ten payments remaining on this obligation after closing. That said, MCMC understands and appreciates that debts lasting less than ten months must be included "if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing." Id. In this case, while the inclusion of the $300 payment would have increased the borrower's qualifying ratios, the debt would not have affected the borrower's ability to make the mortgage payment. As evidenced by the MCAW, the underwriter used a very conservative calculation of the borrower's income, which included an 18.75 month average and unemployment income for a portion of 2006 **(Exhibit E-1)**, to calculate the borrower's ratios. The loan file, however, demonstrated that the borrower had in fact earned more income than reflected on the MCAW. In 2005, the borrower earned $29,326 **(Exhibit E-2)**, or $2,443 in monthly earnings ($29,326/12=$2,443). After a brief and unexpected layoff resulting from a permit dispute by his employer that caused temporary cessation of the business **(Exhibit E-3)**, the borrower had returned to work and was earning average monthly income in 2006 of $2,510 ($3,640/1.45=$2,510) **(Exhibit E-2)**, which was $67 more per month than he earned in 2005. Using only the borrower's documented 2005 monthly earnings of $2,443, and including the $300 debt in the calculation, the borrower's qualifying ratios would have been 30.86%/43.14% **(Exhibit E-4)**. These ratios are within HUD guidelines and demonstrate that this debt would not have affected the borrower's ability to make the mortgage payment.

MCMC maintains that it adhered to FHA guidelines in excluding this debt, as it had less than ten payments remaining. Moreover, even if the underwriter had included the $300 debt, the loan file demonstrates that the borrower had sufficient income to qualify for FHA financing in this case. As a result, administrative action is unwarranted and this loan should be removed from the final Report.

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Comment 5

c. [redacted] – FHA Case No. 262-1636498

Here, the Report asserts that the borrower's qualifying ratios did not include a $320 monthly payment on an automobile loan, and inclusion of this debt would have increased the borrower's debt-to-income ratios to an unacceptable level.

As discussed above, MCMC understands and appreciates that HUD guidelines state that lenders "must include the monthly housing expense and all other additional recurring charges ... including payments on installment accounts." HUD Handbook 4155.1 REV-5, ¶ 2-11(A). It is the Company's policy and practice to include all installment debts evidenced in the loan file in the calculation of a borrower's qualifying ratios. In this case, although not referenced on the borrower's credit report, MCMC acknowledges that the underwriter should have included the $320 monthly payment for the car loan in the qualifying ratio calculation, as the loan file documented this liability. This oversight was an isolated incident, and the Company has counseled its employees on the importance of documenting and including all borrower liabilities into the consideration of a borrower's qualification for FHA financing.

Nevertheless, any oversight in the [redacted] case regarding the exclusion of the $320 monthly payment constituted, at worst, harmless error. As noted by the underwriter on the MCAW, the borrower earned regular overtime income that was not included in the qualifying ratios **(Exhibit F-1)**. Both the VOE and the borrower's pay stub reflected overtime earnings **(Exhibit F-2)**. As of October 2, 2006, the borrower had earned an average of $170 per month in overtime income ($1,564 in earnings / 9.06 months = $172) **(Exhibit F-2)**. Had the underwriter considered both the $320 monthly payment and the $170 in monthly overtime earnings, the borrower's ratios would have been 29%/47%, and the borrower would have qualified for the FHA-insured loan. Therefore, we believe that administrative action would be inappropriate, and ask that this allegation be removed from the final Report.

3. Excessive Qualifying Ratios

Comment 6

In one loan, [redacted] – **FHA Case No. 262-1653481**, the Report alleges that the borrower exceeded HUD's recommended debt-to-income ratios without documented, valid compensating factors in the "Remarks" section of the MCAW. The Company respectfully disagrees with this assertion.

The Department 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. We note that the borrower's ratios in this case were 23%/45%. Thus, the borrower's front-end ratio was less than 31%, and the back-end ratio only slightly exceeded HUD's benchmark of 43%. The Department has professed that the "FHA does not set an arbitrary percent by which ratios may be exceeded but rather FHA relies on the underwriter to judge the overall merits of the loan application and to determine what compensating factors apply and the extent to which those factors justify exceeding the ratios." Mortgagee Letter 00-24 (emphasis added). Thus, where a potential borrower's qualifying ratios are high, an underwriter has to consider all relevant circumstances and exercise discretion in deciding whether to approve or reject a loan. This discretion is particularly important when the same loans underwritten manually could be submitted through an automated underwriting system and approved with much higher qualifying ratios. With different standards for varying types of underwriting, the Department must rely on underwriters to adequately analyze a borrower's financial circumstances and take into account all relevant factors, including the range of acceptable levels in qualifying ratios.

It is MCMC'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 this borrower for FHA financing. The Report takes issue with the underwriter's notation that the borrower's monthly housing payment would decrease from $636 to $432 **(Exhibit G-1)**, as the loan file only documented a nine-month rental history. While MCMC appreciates that HUD guidelines reference a borrower's 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, the Department nevertheless acknowledges that decreasing a borrower's monthly housing obligation is a significant compensating factor. See HUD Handbook 4155.1 REV-5, ¶ 2-13(A). Here, while the Company was unable to verify the borrower's rental history with her previous landlord **(Exhibit G-2)**, the loan file contained a Verification of Rent ("VOR") from her current landlord evidencing an excellent payment history for the past nine months **(Exhibit G-3)**. Moreover, the borrower's housing payment in fact decreased from $636 to $432 **(Exhibits G-1, G-3)**,

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which the underwriter reasonably deemed to be a significant factor that would help compensate against the slightly above-average back-end ratio.

In addition, contrary to the suggestion in the Report, the borrower's housing payment history was not the only compensating factor present that counseled in favor of loan approval in this case. The MCAW and loan file documentation demonstrate additional compensating factors in this case. For instance, the underwriter noted on the MCAW that the borrower had good job stability **(Exhibit G-1)**, and the loan file evidenced that the borrower was employed as a certified nurse aid **(Exhibit G-4)**. This position requires annual continuing education and leads to the potential for increased earnings, which HUD expressly acknowledges is a compensating factor for higher-than-average ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(I). The MCAW also demonstrated that the borrower had approximately $1,000 in cash reserves after closing, which would have covered at least two mortgage payments **(Exhibit G-1)**. HUD guidelines state that cash reserves compensate against higher-than-average debt ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(G). Moreover, the subject property appraised for $56,000, which was more than $10,000 over the sales price **(Exhibit G-1)**. The underwriter noted this significant factor, which provided the borrower with some initial equity in the property, on the MCAW **(Exhibit G-1)**.

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.

4. Source of Funds to Close

Comment 7

In one loan, [redacted] **– FHA Case No. 262-1625921**, the Report asserts that the loan file did not document the source of the borrower's funds to close, as the bank statement did not evidence the withdrawal of the $5,134 Cashier's Check used to close the loan.

MCMC understands and appreciates that all funds for the borrower's investment in the property must be verified and documented. See HUD Handbook 4155.1 REV-5, ¶ 2-10. MCMC complied with this requirement in the [redacted] loan. HUD guidelines require that, to document a borrower's funds held in a bank account, the lender should obtain a Verification of Deposit ("VOD") and most recent bank statement or, in the alternative, bank statements covering the two most recent, consecutive bank statements, provided they show the previous month's balance. See id. ¶¶ 2-10, 3-1. As

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acknowledged in the Report, the loan file contained the borrower's bank statements for account number 4993555397 with ELGA Credit Union covering May 1, 2006 through July 13, 2006, which demonstrated that the borrower had sufficient assets to close **(Exhibits H-1, H-2)**. This loan closed on July 14, 2006, with $5,108.97 of funds provided by the borrower **(Exhibit C-1)**. As of July 13, 2006, the borrower had a balance of $5,659 **(Exhibit H-1)**, and the file contained a Cashier's Check, issued by ELGA Credit Union to the borrower on July 14, 2006 in an amount of $5,133.97 **(Exhibit H-3)**, which was sufficient to cover the funds needed to close **(Exhibit C-1)**.

The Report nevertheless takes issue with the fact that the bank account statement indicates that it covered transactions through July 20, 2006, but did not reflect the issuance of the Cashier's Check on July 14, 2006 from this account. A review of the account transaction history demonstrates that this history was pulled and faxed on July 13, 2006, and clearly documents only those transactions that occurred through July 13, 2006 **(Exhibit H-1)**.[3] As the Cashier's Check was not issued until July 14, 2006, it was not reflected on this document. HUD guidelines, however, do not require the lender to obtain evidence of the withdrawal of the funds from a borrower's bank account. Rather, the Department merely requires lenders to obtain documentation showing that the borrower had the funds available, which was contained in the loan file in this case. In this case, the borrower had sufficient funds in his ELGA Credit Union account as of July 13, 2006, and obtained a Cashier's Check from ELGA Credit Union the next day to cover the funds necessary to close this transaction.

The above discussion and attached documentation evidence that the account statements and Cashier's Check contained in the loan file document the source of funds used to close the [redacted] loan in compliance with HUD guidelines. Therefore, we request that this allegation be removed from the final Report.

5. Source of Gift Funds

In two loans, the Report asserts that the borrowers obtained gifts as the source of funds to close the loans; however, the loan files did not adequately document these gift funds. Based on our review of these files, MCMC maintains that administrative action would not be appropriate in either of these cases.

Comment 8

For example, in the [redacted] loan, **FHA Case No. 261-9230184**, the Report asserts that the Company did not verify the source of the gift funds, as the donor and borrower

[3] We note that the prior month's bank statement indicated that the document covered transactions through July 14, 2006; however, reflected only those transactions that occurred through July 7, 2006, when the document was printed **(Exhibit H-2)**. Additional transactions occurred between July 7 and July 14, 2006, which were reflected on the borrower's most recent account history statement **(Exhibit H-1)**.

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shared a bank account and, therefore, the source of the donor's funds should have been documented. MCMC respectfully disagrees with this assertion.

With regard to gift funds obtained from a relative, as in this case, HUD guidelines require a lender to obtain: (1) a gift letter specifying, among other items, the dollar amount given, the donor's name, address, telephone number, and relationship to the borrower, and stating that no repayment is required; and (2) a copy of the bank statement showing the withdrawal from the donor's personal account. See HUD Handbook 4155.1, REV-5, ¶2-10(C); Mortgagee Letter 00-28. As stated in the Report, the borrower received a $2,315 gift to cover the earnest money deposit and the funds needed to close this loan **(Exhibit B-6)** from his non-purchasing spouse. To evidence the gift, MCMC obtained a gift letter in the amount of $2,815 from the borrower's wife, [redacted] **(Exhibit I-1)**, a copy of the non-purchasing spouse's bank account with TCF Bank demonstrating she had sufficient funds to provide the gift **(Exhibit I-2)**, and withdrawal slips demonstrating her withdrawals of the funds needed to close **(Exhibit I-3)**.

Notwithstanding this documentation, the Report asserts that the source of the $3,000 the donor used to open the bank account should be documented, as the borrower and his wife shared the account. Although the borrower inadvertently listed the TCF Bank account on his initial loan application, the bank account statement evidenced that the account was in the name of Ms. [redacted] and was not shared by the borrower and the non-purchasing spouse **(Exhibit I-2)**. While HUD guidelines require lenders to document the source of gift funds to the borrower, FHA requirements expressly state that "[a]s a rule, we are not concerned with how the donor obtains the gift funds provided they are not derived in any manner from a party to the sales transaction." HUD Handbook 4155.1 REV-5, ¶ 2-10(C). Here, the donor's funds came from a $3,000 deposit on May 2, 2007 that she used to open the TCF Bank account. This deposit was made almost sixty days before the borrower signed the sales contract on June 28, 2007 **(Exhibit I-4)** or completed the initial loan application on July 2, 2007 **(Exhibit I-5)**. These documents evidence that, at the time the donor deposited the funds into her account, the borrower did not know who the interested parties to the sales transaction would be. Thus, there was no reason to believe that the donor derived the funds used as a gift from an impermissible source. For these reasons, MCMC properly evidenced the source of the borrower's funds to close from the donor, and did not further document the source of the funds to the donor. MCMC maintains that it adhered to FHA requirements in documenting the gift funds in the [redacted] loan and, as a result, this assertion should be removed from the final Report.

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6. Credit History Analysis

In three loans, the Report takes issue with the Company's evaluation of the borrowers' creditworthiness. Specifically, this sub-finding asserts that the borrowers' credit histories involved collections, judgments, and/or delinquent accounts.

MCMC respects the importance of analyzing a borrower's credit performance and examining his or her attitude towards credit obligations. It is MCMC's policy and practice, with respect to every FHA applicant, to scrutinize the applicant's credit record and reasonably determine the potential borrower's creditworthiness. Given the potential risks not only to the Department, but to the Company, of making a poor credit decision, the Company's management endeavors to monitor underwriting performance and provide ongoing training to employees on the issue of credit analysis.

That said, we note that HUD delegated to FHA lenders the responsibility for analyzing a borrower's credit and determining an individual's creditworthiness. See HUD Handbook 4155.1 REV-5, ¶ 2-3. While HUD has established specific guidelines, credit analysis remains largely subjective. For example, where derogatory credit items are present, lenders have discretion to consider the borrower's unique circumstances and determine whether financing is appropriate. As discussed above, the Department has recognized that underwriting is more of an art than a science and requires the careful weighing of the circumstances in each individual case. Thus, it is MCMC's policy to carefully scrutinize a borrower's credit history to obtain any documentation or explanation necessary to assess a borrower's credit risk. See Mortgagee Letters 00-24 and 95-07; see also HUD Handbook 4155.1 REV-5, ¶ 2-3. While two underwriters may make different decisions about a borrower's credit in the same case, both underwriters may have complied with FHA requirements and made reasonable underwriting decisions. MCMC takes its underwriting responsibility seriously and would never knowingly approve a loan to an unqualified borrower.

In several of the cases cited in the Report, MCMC complied with FHA guidelines by examining the borrowers' overall pattern of credit behavior and reasonably determining that the borrowers qualified for FHA financing. The Company properly considered each borrower's previous housing obligations, recent and/or undisclosed debts, collections, judgments, and bankruptcies, and MCMC underwriters reasonably determined that past derogatory items did not reflect a current disregard for financial obligations. The loan files contain required documentation and MCMC prudently exercised the discretion granted to it by the FHA. As discussed below, the borrowers in these cases generally were hard-working individuals who took responsibility for their financial obligations. As a result, MCMC adhered to FHA requirements by reasonably determining that the borrowers were creditworthy and qualified for FHA loans. We address a representative sample of the cited loans below.

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Comment 9

a. [redacted] – FHA Case No. 261-9230184

In this case, the Report asserts that the credit report referenced two open collection accounts; however, the loan file did not document the lender's reasons for not considering the collection accounts.

MCMC respectfully disagrees with the assertion that the Company did not consider the collection accounts in its analysis of the borrower's creditworthiness in this case. As discussed above, with regard to analyzing a potential borrower's credit, MCMC understands and appreciates that it must obtain a written explanation from the borrower regarding all delinquent inquiries shown on a credit report obtained prior to closing. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3(B). The Report acknowledges that, while the lender must consider all open collection accounts, such accounts need not be satisfied prior to closing. See id. at ¶ 2-3(C). In this case, the credit report reflected that both open collection accounts were medical in nature **(Exhibit J-1)**. The borrower provided an explanation letter indicating that these accounts were accumulated as a result of his lack of health insurance and unexpected medical issues that arose during that time **(Exhibit J-2)**. This explanation evidences that medical issues, rather than a disregard for credit obligations, caused the borrower's past delinquencies. Moreover, the credit report evidenced that the borrower had chosen not to incur any traditional debt, evidencing his conservative use of credit **(Exhibit J-1)**. Finally, the VORs indicated that the borrower consistently made timely rental payments **(Exhibit J-3)**, which demonstrated his prioritization of housing payments. The underwriter properly considered all aspects of the borrower's credit profile, including the circumstances underlying the referenced collection accounts, in analyzing the borrower's creditworthiness. As the derogatory accounts were medical in nature, and as the remainder of the borrower's credit history evidenced a conservative use of credit and timely payments on his housing obligation, the underwriter reasonably determined that the borrower was an acceptable credit risk. For this reason, we believe that administrative action is inappropriate and request that this recommendation be removed from the Report.

Comment 10

b. [redacted] – FHA Case No. 262-1653481

In the [redacted] loan, the Report alleges that the Company did not adequately evaluate the borrower's credit history or obtain strong compensating factors to support loan approval, as the borrower's credit report referenced only one current installment account, recent collection accounts for utilities, and contained only two alternative credit reference letters.

With regard to the borrower's credit history, as you know, HUD guidelines expressly state that "[n]either the lack of credit history nor the borrower's decision not to

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use credit may be used as a basis for rejecting the loan application. ... For those borrowers, and for those who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider." See HUD Handbook 4155.1 REV-5, ¶ 2-3. In this case, as the credit report referenced several collection accounts **(Exhibit K-1)**, the underwriter obtained an explanation from the borrower regarding these items **(Exhibit K-2)**, and evidence of her satisfaction of these obligations **(Exhibit K-3)**. The borrower's explanation evidenced that several of these accounts had resulted from unexpected medical expenses or misunderstandings between the borrower and her creditors **(Exhibit K-2)**, rather than a disregard for credit obligations. Moreover, the credit report evidenced the borrower's conservative use of traditional credit, as she had only one automobile loan with a seven-month history of current payments **(Exhibit K-1)**. As the credit report reflected only one traditional credit account, the underwriter conditioned loan approval on the receipt of three alternative credit references. As indicated above, the underwriter has the discretion to waive such conditions, provided the loan documentation otherwise meets FHA guidelines. In this instance, the borrower provided two alternative credit sources, evidencing timely payments of her child care costs **(Exhibit K-4)** and, with two minor exceptions based on the change in due date, her utility payments **(Exhibit K-5)**. Based on the underwriter's analysis of the borrower's overall credit history and alternative credit references, the underwriter reasonably determined that the borrower took her credit obligations seriously and had established a sufficient credit record to qualify for the FHA-insured loan at issue.

In addition to the explanation letters and alternative credit references, and contrary to the Report's allegation, the loan file also documented significant compensating factors that justified loan approval in this case. As discussed above, the loan file contained a VOR from her current landlord evidencing an excellent payment history for the past nine months **(Exhibit G-3)**. Moreover, the borrower's housing payment in fact decreased from $636 to $432 **(Exhibits G-1, G-3)**, which the underwriter reasonably deemed to be a significant factor that would help compensate against the slightly above-average back-end ratio. The borrower also had good job stability **(Exhibit G-1)**, and the loan file evidenced that the borrower was employed as a certified nurse aid **(Exhibit G-4)**, with the potential for increased earnings. See HUD Handbook 4155.1 REV-5, ¶ 2-13(I). The MCAW also demonstrated that the borrower had approximately $1,000 in cash reserves after closing, which would have covered at least two mortgage payments **(Exhibit G-1)**. HUD guidelines state that cash reserves compensate against higher-than-average debt ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(G). Finally, the subject property appraised for $56,000, which was more than $10,000 over the sales price **(Exhibit G-1)**.

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In summary, the underwriter in the [redacted] loan evaluated the totality of the borrower's circumstances and, based on the credit references and compensating factors present in this case, reasonably determined that the borrower qualified for FHA financing in compliance with HUD guidelines. Therefore, administrative action is unwarranted, and we request that this allegation be removed from the final Report.

7. Rent Verification

Comment 11

Finally, in the [redacted] loan, **FHA Case No. 262-1625921**, the Report asserts that the borrower's rental history was not properly verified, as the loan file did not contain copies of cancelled checks for the borrower's last twelve mortgage payments.

MCMC respectfully disagrees that such documentation was required in this case. With regard to verification of a borrower's past rental payments, HUD guidelines require that the lender determine a borrower's payment history "through either the credit report, verification of rent directly from the landlord (with no identity-of-interest with the borrower) or verification of mortgage directly from the mortgage servicer, or through canceled checks covering the most recent 12-month period." HUD Handbook 4155.1 REV-5, ¶ 2-3 (emphasis added); see also id. ¶ 3-1(J). In this case, while the underwriter initially conditioned for cancelled rental checks, the loan file contained a signed VOR from the borrower's landlord evidencing that the borrower had made timely rental payments from February of 2004 through July of 2006 **(Exhibit L)**, which covered the two years prior to loan closing on July 14, 2006 **(Exhibit C-1)**. MCMC adhered to HUD requirements to document the borrower's rental history, and any waiver of the underwriting condition regarding cancelled rent checks conformed to FHA guidelines. Administrative action would therefore be unwarranted in this case. The Company requests that this assertion be removed from the final Report.

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

Comment 12

1. MCMC Exercised Due Diligence in Underwriting the Loans at Issue

In addition to the underwriting deficiencies discussed above, the Report asserts that, in the seven loans at issue, the underwriter's certification on page 3 of the Addendum to the Uniform Residential Loan Application ("URLA"), Form HUD-92900-A ("Addendum") was incorrect, as the underwriter certified to using due diligence in underwriting these cases but did not do so. We understand that this allegation is predicated on the OIG's determination that these seven cases contained underwriting deficiencies. The Report alleges that these underlying oversights demonstrate that the underwriter did not exercise due diligence in examining the loan file and, as a result, the

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certification on the Addendum in these cases was incorrectly signed. The Report recommends in connection with these allegations that HUD's Associate General Counsel for Program Enforcement determine the legal sufficiency of and, if sufficient, pursue remedies under the PFCRA for the inaccurate certifications in these cases. As discussed in detail above, MCMC takes exception to the allegations that these loans contained underlying origination deficiencies, as well as the inflammatory recommendation to impose PFCRA penalties made in connection with this finding.

HUD is authorized to impose civil penalties under PFCRA against persons who "make, submit, or present, or cause to be made, submitted, or presented, false, fictitious, or fraudulent claims or written statements to Federal authorities or to their agents." 24 C.F.R. § 28.1. The Report suggests that, because the OIG identified underwriting deficiencies in these seven cases, the underwriters' certifications that due diligence was used in underwriting these loans are inaccurate. As demonstrated in the above discussion, however, in several of the seven cases cited, MCMC substantially complied with HUD requirements and the underwriter made a reasonable decision to approve the loan after exercising due diligence in examining each of the files at issue. For these reasons, MCMC disagrees with the recommendation of any penalty in connection with these loans, let alone the harsh sanction of PFCRA penalties recommended in the Report.

Additionally, the Report does not allege, and there is no evidence to suggest, that MCMC or its employees intended to circumvent HUD underwriting guidelines in these cases. Rather, the certifications in these seven cases were executed by the underwriters after diligent review of the loan files in which these individuals made every effort to comply with FHA requirements. The certifications in these cases were executed in the belief that the borrowers qualified for FHA financing, which in fact they did in each case, rather than in an attempt to mislead the Department. The Report does not allege that MCMC or its underwriters knowingly misrepresented facts to the Department or intentionally provided false information in the cases at issue. Before imposing penalties on FHA-approved lenders, HUD weighs a number of factors. While intentional violations or a disregard for HUD requirements can lead to severe sanction, such as PFCRA penalties, HUD traditionally imposes less severe consequences for deficiencies caused by unintentional error. Additionally, MCMC maintains that the borrowers in the cited cases qualified for FHA financing. At worst, certain of these loans contained minor errors that did not affect the insurability of the loans. As indicated above, MCMC believes that the final report should omit recommendations of administrative action in connection with many of these cases, making the recommendation of PFCRA penalties all the more severe under these circumstances.

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We also note that, rather than cite new allegations, the PFCRA recommendation appears to be an attempt to pile on the allegations made against MCMC's underwriting practices in this Report. Typically, OIG audit reports allege certain deficiencies in a company's FHA operations, and the company is given an opportunity to address the materiality and accuracy of the allegations. By also adding an incorrect certification allegation to these underwriting assertions, the OIG has created a situation where every misunderstanding of FHA requirements or oversight of a detail or document in a FHA loan could give rise to allegations of a false certification claim. Considering the sensationalizing of the "Operation Watchdog" probe, and the devastating effects this matter has and will continue to have on the targeted lenders, such actions will create a chilling effect on lenders who want to participate in the FHA Program. Enforcement actions are meant to reinforce HUD's rules and regulations, rather than discourage broad participation in FHA lending. For the sake of the Program, therefore, we believe the OIG should reconsider its approach to alleging false certifications and focus on the compliance with FHA rules and regulations.

2. **The PFCRA Allegations Constitute a Recommendation to HUD, Rather than a Final Action By the Department**

As noted above, the Report merely recommends that the Department determine the legal sufficiency of pursuing PFCRA remedies in the cited cases. Upon receiving the final report, the Department will have an opportunity to independently examine the review findings and make an independent determination of whether such penalties are appropriate in these seven cases. As discussed at length earlier in this response, MCMC disagrees that the Report's assertions warrant administrative action or PFCRA remedies. HUD may also disagree with the Report's assertions and decide not to pursue PFCRA penalties in this instance.

In addition, while the review process is still ongoing at the time the OIG issues its "final" report, the Report and the OIG's recommendations typically are made public on the OIG website. As a result, a lender's investors and peers are able to access the preliminary recommendations of the OIG before a final assessment as to their merit can be made by the Department. These entities often misinterpret the OIG's recommendations to be final actions by the Department. Under these circumstances, making these preliminary recommendations public and including inflammatory allegation that HUD pursue PFCRA remedies with the suggestion that the loans identified involve misrepresentations will have a material, adverse effect on the Company's business. This would be especially detrimental in this circumstance, as the public nature of the "Operation Watchdog" probe has already resulted in the loss of investors and customers to the point where MCMC has been forced to wind down its operations.

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If the OIG's goal is to present the reader with a full and accurate disclosure of this review and its implications to the Company, the Report should include the following disclosure on the first page in bold, capitalized lettering:

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

Such a disclosure would more accurately convey the status of the OIG's "final" report to the Company's investors, customers, and the public.

III. **CONCLUSION**

MCMC takes the matters raised in the draft Report seriously. Because FHA lending has comprised a significant portion of MCMC's overall business operations throughout its existence, 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. Although the publication of the Department's scrutiny of the Company in the press release announcing the "Operation Watchdog" probe has effectively put the Company out of business, MCMC nevertheless has conducted a thorough review of the issues identified in the Report. As discussed above, MCMC's review indicated that the Report's findings are, for the most part, at variance with the facts, do not constitute violations of HUD/FHA requirements on the part of MCMC, or do not affect the underlying loans' insurability. The Company substantially complied with FHA underwriting requirements in several of the loans identified in the Report and made loans to qualified FHA borrowers. Accordingly, we respectfully request that the OIG revise the allegations cited in the Report based on the information and documentation provided in this response and remove allegations for which MCMC has demonstrated its compliance with HUD requirements.

Finally, MCMC believes that the recommendations involving PFCRA penalties are unwarranted, as they suggest an intent to circumvent HUD requirements when the OIG knows full well that no such intention existed in these cases. MCMC values its relationship with the Department and did not, in any manner, seek to misrepresent any information to HUD. MCMC believes that the various remedies available to HUD, short of the severe sanctions under PFCRA, are commensurate to resolve any deficiency identified in the Report. We believe, and we hope the OIG will agree, that this response

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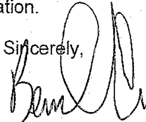
and accompanying exhibits demonstrate that including these recommendations in the Report is unnecessary, inappropriate, and will further damage MCMC's reputation, which has already suffered as a result of the public nature of the "Operation Watchdog" probe. We respectfully request that the OIG revise its recommendations to fit the facts of this case.

If you have any additional questions, or if you need additional information, please do not hesitate to contact our Washington counsel, Phillip Schulman, at (202) 778-9027.

Thank you for your kind consideration.

Sincerely,



Bernard Cason
President

cc: Heath Wolfe, Regional Inspector General for Audit, Region V

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

OIG's Evaluation of Lender Comments

Comment 1 We agree that there is no specific HUD requirement that requires a lender to document reasons for a borrower's pay raise or why such a pay raise will continue. We also agree and specifically cited in our discussion draft memorandum report that HUD does not impose a minimum length of time a borrower must have held a position to be eligible for FHA financing. However, HUD does require lenders to verify employment for the previous 2 years in order to analyze income stability. Specifically, to analyze and document the probability of continued employment, HUD requires lenders to examine the borrower's past employment record, qualifications for the position, previous training and education, and the employer's confirmation of continued employment.

In this case, the borrower did not show stable employment for approximately 15 of the 24-month period preceding the loan closing. Based on tax returns and other supporting documentation in Mac-Clair's loan file, employment prior to the borrower's current job was sporadic and both the number and duration of periods of unemployment were not determinable.

Comment 2 The borrower served as a teaching assistant for construction trades at a vocational school. Teaching construction trades as an assistant is <u>not</u> the same line of work as being self employed, owning and operating a construction business. As stated in our review, if the two occupations were not considered related, self employment income of less than 2 years would not have been considered in the mortgage approval process. Further, while the loan application stated that the borrower had been self-employed for 1 year, there was no documentation in the loan file to establish the date that he started working in his own business. According to the verification of employment from the vocational school, the borrower's employment ended on September 2, 2005, less than 1 year prior to the loan closing. While the borrower may have been working on his own prior to this date, the actual start date was not documented by Mac-Clair.

Comment 3 While Mac-Clair's underwriter has discretion to waive and/or clear underwriting conditions, the loan file did not indicate that the payoff condition had been waived. Further, Mac-Clair did not provide evidence of the payoff of the debt with its comments. The underwriter had required the borrower to provide proof of payoff of a credit card bill of $376 before loan closing.

Comment 4 The borrower's automobile loan was reduced to nine payments remaining only through a gift from his parents. Given that the borrower would have no liquid assets remaining after loan closing, the $300 monthly payment would affect his ability to make the mortgage payment.

Mac-Clair stated that its underwriter used a very conservative calculation of the borrower's income, an average over 18.75 months. It contended that using only the borrower's documented 2005 monthly earnings of $2,443, and including the

$300 debt in the calculation, the qualifying ratios would have been acceptable. We disagree with Mac-Clair. Using only the borrower's 2005 wage income to support an acceptable debt-to-income ratio would not be appropriate given the discrepancies in income from 2004 to 2006. While the borrower earned $29,326 in wages for 2005, he had earned only $14,072 in 2004. Further, he was unemployed for almost the first 5 months of 2006 and had only earned $5,800 as of July 21, 2006.

Comment 5 Mac-Clair stated in its response that an oversight regarding exclusion of the $320 monthly payment was a harmless error. It further stated that the borrower had earned an average of $170 per month in overtime income. It asserted that if both the overtime income and the monthly payment were considered, the ratios would be acceptable. We disagree with Mac-Clair. Although the verification of employment showed that the borrower had earned $1,564 in 2006 overtime income as of October 2, 2006, the verification did not indicate whether the overtime was expected to continue. The verification also did not show that the borrower earned any overtime in 2005. Over a 24-month period, the average amount of overtime earned was $65 per month. This amount of additional monthly income would still result in an excessive total fixed payment-to-income ratio of 50.16 percent.

Comment 6 HUD Handbook 4155.1, REV-5, paragraph 2-13, specifies the compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's guidelines. One compensating factor is the potential for increased earnings, as indicated by job training or education in the borrower's profession. Mac-Clair stated that the borrower's employment as a certified nurse aid required continuing education that leads to the potential for increased earnings. However, there was no evidence provided by Mac-Clair to show that the continuing education was actually required or received, and that it could lead to increased earnings.

Another compensating factor is at least 3 months worth of cash reserves after loan closing. In this instance, the mortgage credit analysis worksheet supported only 2 months of cash reserves. Also, neither a reduction in monthly housing expense nor an appraised value exceeding the sales price of the property are HUD-accepted compensating factors.

Comment 7 Based on Mac-Clair's comments and additional documentation regarding the borrower's assets for FHA loan 262-1625921, we removed it as a material deficiency.

Comment 8 The TCF bank account is shown as an asset of the borrower on both the initial and final loan applications. Further, the initial loan application stated that the source of the borrower's downpayment was a checking account and the final loan application showed the source as a checking/savings account. Although the transaction history showed the account to be only in the name of the borrower's

spouse, the fact that the borrower listed the same bank account as an asset should have been questioned by Mac-Clair's underwriter.

Mac-Clair also cited in its comments that $3,000 was deposited into the donor spouse's bank account on May 2, 2006, or almost 60 days before the borrower signed the sales contract. However, the borrower's credit report showed numerous credit inquiries starting in May 2006 that the borrower stated were related to his search for a mortgage lender. Therefore, given that the deposit was made at the same time that the borrower was purchasing a home, Mac-Clair should have ensured that the funds were not provided by an unacceptable source, like a party to the sales transaction.

Comment 9 We agree and specifically cited in our discussion draft memorandum report that HUD does not require collection accounts to be satisfied prior to closing. However, in this instance, the borrower's credit report showed that the medical account was opened only 5 months before the loan closing and the entire amount of the original debt was delinquent. While we recognize that unexpected medical costs can create financial hardship, the fact that no payment was made on the debt shortly before applying for a home mortgage could question a borrower's creditworthiness.

Comment 10 As stated in our discussion draft memorandum report, Mac-Clair's underwriter conditioned loan approval on the receipt of three alternative credit references covering 12 months with no late payments. Because only two credit references were provided of which one covered only 7 months, the condition was not met. Further, there was no evidence that the closing condition was waived.

See comment 6.

Comment 11 While Mac-Clair's underwriter has discretion to waive and/or clear underwriting conditions, the loan file did not indicate that the condition to provide cancelled rent checks had been waived.

Comment 12 Mac-Clair believes that our recommendations for remedies under the Program Fraud Civil Remedies Act and administrative action are not appropriate. We did not change our recommendations, because these recommendations are appropriate based on the issues cited in the memorandum. Violations of FHA rules are subject to civil and administrative action.