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MEMORANDUM FOR: Vicki B. Bott, Deputy Assistant Secretary, Single Family, HU

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

Tanya E Schulze

FROM: Tanya E. Schulze, Regional Inspector General for Audit, 9DGA

SUBJECT: American Sterling Bank, Sugar Creek, MO, Did Not Properly Underwrite a Selection of FHA Loans

INTRODUCTION

We reviewed 12 Federal Housing Administration (FHA) loans that American Sterling Bank (American) underwrote as an FHA direct endorsement lender. Our review objective was to determine whether American underwrote the 12 loans in accordance with FHA requirements. This review is part of Operation Watchdog, an Office of Inspector General (OIG) initiative to review the underwriting of 15 direct endorsement lenders at the suggestion of the FHA Commissioner. The Commissioner expressed concerns 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 American on July 16, 2010, and received its response on July 27, 2010. American stated that it was unable to respond because it did not have the loan files available. It will have an additional opportunity to respond and provide documentation during the audit resolution process. The complete text of the lender's response, along with our evaluation of that response, can be found in appendix C of this memorandum report.

SCOPE AND METHODOLOGY

American is 1 of 15 direct endorsers 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 claim status. We selected loans for American that defaulted within the first 30 months and were (1) not streamlined refinanced and (2) for manually underwritten loans, associated with an underwriter (usually an individual) with a high number of claims.

BACKGROUND

American was a supervised direct endorsement lender based in Sugar Creek, MO. FHA approved American as a direct endorser in September 1983. American was seized by the Federal Deposit Insurance Corporation on April 17, 2009, and purchased by Metcalf Bank of Lee's Summit, MO. FHA's mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to approve mortgages for otherwise creditworthy borrowers that might not be able to meet conventional underwriting requirements by protecting the lender against default. The direct endorsement program simplifies the process for obtaining FHA mortgage insurance by allowing lenders to underwrite and close the mortgage loan without prior HUD review or approval. Lenders are responsible for complying with all applicable HUD regulations and are required to evaluate the borrower's ability and willingness to repay the mortgage debt. Lenders are protected against default by FHA's Mutual Mortgage Insurance Fund, which is sustained by borrower premiums.

The goal of Operation Watchdog is to determine why there is such a high rate of defaults and claims. We selected up to 20 loans in claim status from 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. American endorsed 3,665 loans valued at $706.4 million and submitted 60 claims worth $10.5 million.

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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 of more than 200 percent as a warning sign of a lender's performance.

Our objective was to determine whether the selected loans were properly underwritten and if not, whether the underwriting reflected systemic problems. Eighteen American loans fit our selection criteria, but we were only able to locate files for 12 of the loans.

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 consider the internal controls or information systems controls of American, consider the results of previous audits, or communicate with American'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 poorly performing lenders that led to a high rate of defaults and claims against the FHA insurance fund. To meet our objective, it was not necessary to fully comply with the standards, nor did our approach negatively affect our review results.

RESULTS OF REVIEW

American did not properly underwrite 9 of the 12 loans reviewed because its underwriters did not follow FHA's requirements. As a result, FHA's insurance fund suffered actual losses totaling $369,555 for eight loans and an estimated potential loss of $122,684 for one loan,[3] totaling $492,239, as shown in the following table.

FHA/loan number	Closing date	Number of payments before first default	Original mortgage amount	Actual loss to HUD	Estimated loss to HUD
023-2459219	05/30/07	2	$206,755		$122,684 [3]
431-4366963	03/03/08	4	240,230	57,598	
461-4204295	12/31/07	5	146,160	81,154	
491-8898498	11/29/06	11	85,325	48,371	
491-8972325	05/22/07	10	60,627	35,367	
492-7731763	12/05/06	5	51,601	7,761	
492-7737924	12/29/06	1	115,192	47,982	
492-7755169	02/16/07	1	126,514	66,925	
492-7807135	04/30/07	6	107,069	24,397	
Totals			$1,139,473	$369,555	$122,684

[3] We estimated the loss to HUD for this loan because the foreclosed-upon properties had not been sold by HUD. The estimated amount is 60 percent of the unpaid principal balance of the loan, based on the 60 percent loss severity rate published in the fiscal year 2009 actuarial review of the FHA Mutual Mortgage Fund.

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

Area of noncompliance	*Number of loans*
Income	4
Liabilities	2
Excessive ratios	3
Assets	2
Gift funds	4
Credit report	5
Verification of rent	1

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

Income

American 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. American 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 491-8898498, American did not obtain verification of employment from the borrower's employer to determine whether the employment or overtime income was expected to continue.

For loan number 492-7807135, American did not obtain an explanation for the year and a half gap in the borrower's employment between October 21, 2004, and April 3, 2006 (the loan closed on April 30, 2007). The lender is required to verify the borrower's employment for the most recent 2 full years and must explain any gaps in employment spanning 1 month or more. American obtained a verbal verification of employment for the borrower's current employer. However, it did not confirm the borrower's current salary, the probability of continued employment, or the average hours per week. Therefore, the $4,049 in monthly income used by the lender to approve the loan could not be relied upon.

Liabilities

American did not properly assess the borrowers' financial obligations for two loans. HUD requires lenders to consider recurring obligations in qualifying borrowers.

For example, for loan number 023-2459219, the liabilities listed on the loan application included Sunterra Financial, showing a monthly payment of $212 (in brackets) and an unpaid balance of $13,219. The $212 payment was not included in the total monthly payments of $123 shown in the loan application, but the unpaid balance was included in the total liabilities of $20,198. We traced this Sunterra account to the credit report in the file, which showed that the account was opened in September 2006 in the amount of $13,365 with a 10-year term and the category of the account was “real estate/conventional loan.”

For loan number 492-7807135, American did not adequately evaluate the borrowers’ liabilities. The lender underreported the recurring expenses by $128. Two accounts were shown in the loan application with payments of $0 and $91, but the credit report showed the two accounts with payments of $106 and $113 ($219 total). The $128 ($219 - $91) difference increased the borrowers’ total liabilities to $1,059 (see the Excessive Debt Ratio section for the impact of this increase).

Excessive Ratios

American improperly approved three loans for which the borrowers’ ratios exceeded FHA’s guidelines without identifying strong compensating factors. Effective April 13, 2005, the fixed payment-to-income and debt-to-income ratios were increased from 29 and 41 percent to 31 and 43 percent, respectively. If either or both ratios are exceeded on a manually underwritten mortgage, the lender is required to describe the compensating factors used to justify the mortgage approval (see appendix B for detailed requirements).

For example, for loan number 491-8898498, the underwriter did not provide adequate compensating factors to justify approving the loan. The underwriter calculated the mortgage payment-to-income ratio at 34.5 percent, which exceeded HUD’s allowable ratio of 31 percent. The underwriter’s compensating factor stated minimum increase in housing expense. However, the borrower’s rent was $640, and the proposed mortgage payment was $856.54, for an increase of $216.54 (34 percent). We do not consider a 34 percent increase in housing expense to be a minimal increase and do not consider this a sufficient compensating factor.

For loan number 492-7807135, the underwriter did not accurately calculate the qualifying ratios. The underwriter understated both the mortgage payment and the recurring expenses by a total of $377. While the underwriter calculated the total fixed payment-to-income ratio at 41.23 percent, recalculating with the correct payments changes the ratio to 50.5 percent, which exceeds HUD’s guideline of 43 percent. The underwriter did not provide compensating factors.

Assets

American did not properly document the source of the borrower’s funds to close for two loans. HUD requires the lender to verify and document the borrower’s investment in the property.

For loan number 023-2459219, American did not provide documentation supporting the source of the borrower’s funds on deposit. The borrower reported two bank accounts with balances of $100 and $4,700 on his loan application, and a verification of deposit from each bank was in the loan file. The verification of deposit from the first bank showed a balance of $4,226 instead of $100, with the average balance over the past 2 months of only $63. The verification of deposit from the other bank had a balance of $5,272 and a 2-month average balance of only $470. American did not explain the source of the large recent deposits.

Gift Funds

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

For example, for loan number 023-2459219, a gift letter from a downpayment assistance donor stated that the lender had determined that the borrower needed a gift of $12,925 to purchase the home and the funds would be transferred to the settlement/closing agent. However, there was no evidence in the loan file supporting the gift donor's transfer of funds.

Credit Report

American did not properly evaluate the borrowers' credit histories for five 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 491-8972325, the underwriter did not obtain an explanation for the six delinquent collection accounts totaling $5,803 and seven inquiries in the credit report within the past 2 years. The borrower did not provide an explanation. Further, the credit report showed seven inquiries within 90 days of closing, but no explanation was provided by the borrower.

For loan number 492-7737924, the underwriter did not obtain an adequate explanation for the 19 delinquent collection and charge-off accounts in the credit report totaling $7,385. The borrower provided one general explanation for all of his past credit issues. The loan file did not include an explanation that addressed payments of outstanding collections as identified as a condition to close by the underwriter.

Verification of Rent

American did not properly verify the borrower's rental history for loan number 023-2459219. The underwriter improperly relied on a verification of rent that was faxed from the realtor's office. The verification of rent evidences the payment history of the borrower's housing obligations and holds significant importance in evaluating credit. The verification of rent page in the FHA file had a fax header stating "Nations Investments," and it appeared that the landlord's name had been whited out. HUD does not allow lenders to accept or use documents relating to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties.

Incorrect Underwriter's Certifications Submitted to HUD

We reviewed the certifications for the nine loans with material underwriting deficiencies for accuracy, which were comprised of six manually underwritten loans and three automated underwritten loans. American's direct endorsement underwriters incorrectly certified that due diligence was used in manually underwriting the six loans and incorrectly certified to the integrity of the data supplied that were used to determine the quality of the three loans with the automated underwriting. 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. When underwriting a loan using an automated system, HUD requires a direct endorsement lender to certify to the integrity of the data supplied and used to determine the quality of the 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 to recompense such agencies for losses resulting from such claims and statements; to permit administrative proceedings to be brought against persons who make, present, or submit such claims and statements; and 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 American and/or its principals for incorrectly certifying to the integrity of the data or that due diligence was exercised during the underwriting of nine loans that resulted in losses to HUD totaling $492,239, which could result in affirmative civil enforcement action of approximately $1,051,978.[4]

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

1B. Take appropriate administrative action against American 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	$492,239

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 and estimated loss HUD incurred or will incur when it sells the affected properties.

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

APPENDIXES

Appendix A

SUMMARY OF MATERIAL UNDERWRITING DEFICIENCIES

FHA case number	Unsupported income or questionable employment history	Underreported liabilities	Excessive debt-to-income ratio	Unsupported assets	Insufficient gift documentation	Significant credit-related deficiencies or no credit	Incomplete verification of rent history
023-2459219	X	X		X	X		X
431-4366963	X						
461-4204295					X		
491-8898498	X		X	X		X	
491-8972325						X	
492-7731763					X		
492-7737924					X	X	
492-7755169			X			X	
492-7807135	X	X	X			X	

Appendix B

LOANS WITH MATERIAL UNDERWRITING DEFICIENCIES

Loan number: 023-2459219

Mortgage amount: $206,755

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: 05/30/07

Status as of April 30, 2010: Claim

Payments before first default reported: Two

Loss to HUD: $122,684

Summary:

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

Income:

American improperly relied on income documents that were faxed from the realtor's office. The verification of employment, pay stubs, and Internal Revenue Service (IRS) forms W-2 in the FHA file for the borrower's employer were on pages with a fax header stating "Nations Investments." The HUD-1 settlement statement showed a sales/brokers commission of $9,450 paid at the settlement of the FHA loan to Nations Investments Corp.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 3-1, states that lenders may not accept or use documents relating to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties (e.g., real estate agents, builders, sellers) or by using their equipment. The lender is accountable for determining the authenticity of verification forms and documents by examining information included in a document's headers and footers.

Liabilities:

The liabilities listed on the loan application included Sunterra Financial, showing a monthly payment of $212 (in brackets) and an unpaid balance of $13,219. The $212 payment was not included in the total monthly payments of $123 shown in the loan application, but the unpaid balance was included in the total liabilities of $20,198. We traced this Sunterra account to the credit report in the file, which showed that the account was opened in September 2006 in the amount of $13,365 with a 10-year term, and the category of the account was “real estate/conventional loan.”

Although the Sunterra loan appeared to be a real estate loan, the borrower stated in the declarations section of the loan application that he had not had an ownership interest in property in the past 3 years.

Review of the mortgage credit analysis worksheet showed that American did not include the $212 payment in the monthly liabilities, which would have a minor impact on the total fixed payment-to-income ratio.

American did not explain the purpose of the Sunterra debt or why the $212 monthly payment was shown on the loan application but not included in the total monthly liabilities on the loan application and mortgage credit analysis worksheet.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that the lender must determine the purpose of any recent debts, as the indebtedness may have been incurred to obtain part of the required cash investment on the property being purchased. Similarly, the borrower must provide a satisfactory explanation for any significant debt that is shown on the credit report but not listed on the loan application.

Assets:

American did not provide documentation supporting the source of the borrower’s funds on deposit. The borrower reported two bank accounts with balances of $100 and $4,700 on his loan application, and a verification of deposit from each bank was in the loan file. The verification of deposit from the first bank showed a balance of $4,226 instead of $100, with the average balance over the past 2months of only $63. The verification of deposit from the other bank had a balance of $5,272 and a 2-month average balance of only $470. American did not explain the source of the large recent deposits.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10, states that all funds for the borrower’s investment in the property must be verified and documented. Paragraph 2-10B states that a verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account, the lender must obtain a credible explanation of the source of those funds.

Gift Funds:

American did not document the transfer of gift funds from the nonprofit donor to the settlement agent. A gift letter was documented, but the actual transfer by check, wire transfer, or other method was not documented to ensure that the funds used to close came from an acceptable source.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10, 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.

Verification of Rent:

American improperly relied on a verification of rent that was faxed from the realtor's office. The verification of rent evidences the payment history of the borrower's housing obligations and holds significant importance in evaluating credit. The verification of rent page in the FHA file had a fax header stating "Nations Investments," and it appeared that the landlord's name had been whited out. As stated in the Income section above, HUD/FHA does not allow lenders to accept or use documents relating to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties.

Loan number: 431-4366963

Mortgage amount: $240,230

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: 03/03/08

Status as of April 30, 2010: Claim

Payments before first default reported: Four

Loss to HUD: $57,598

Summary:

We found a material underwriting deficiency relating to the borrower's gift funds. This loan was processed through the automated underwriting system, Fannie Mae's Government Underwriting Service, using the FHA TOTAL Scorecard. American did not meet one of the approval conditions required by the system.

Gift:

American did not document and retain a copy of the transfer of gift funds from the nonprofit donor to the settlement agent. A gift letter was documented, but the actual transfer by check, wire transfer, or other method was not documented to ensure that the funds used to close came from an acceptable source.

HUD/FHA Requirements:

Approval condition number 30 in the automated underwriting system stated that the underwriter must document and retain a copy of the transfer of gift funds and confirm that those funds came from an acceptable source.

HUD Handbook 4155.1, REV-5, paragraph 2-10, 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.

Loan number: 461-4204295

Mortgage amount: $146,160

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: 12/31/07

Status as of April 30, 2010: Claim

Payments before first default reported: Five

Loss to HUD: $81,154

Summary:

We found material underwriting deficiencies relating to the borrower's income. This loan was processed through the automated underwriting system, Fannie Mae's Government Underwriting Service, using the FHA TOTAL Scorecard. American did not meet the income approval conditions required by the system.

Income:

American did not obtain adequate income documentation from the borrower and verification of employment from the employer. The underwriter did not take into account the lack of pertinent income documents in the file, such as pay stubs, when analyzing monthly income. The underwriter did not obtain pay stubs covering the most recent 1 full month's earning period.

According to the loan application, the borrower worked at Executive DeSign Group for 3 years as a construction manager. The only pay stub in the file covered a 1-week period from October 13 to 19, 2007, and it did not include the borrower's Social Security number, hours worked, or rate of pay. Based on this pay stub alone, we could not determine how the borrower's base pay of $3,732 was calculated on the mortgage credit analysis worksheet and uniform residential loan application. Therefore, we took the average of the borrower's pay for the last 2 years and 10.5 months based on the IRS forms W-2 and one pay stub in the file and arrived at the average pay of $2,996, which is $736 less than the amount reported on the uniform residential loan application and mortgage credit analysis worksheet.

The underwriter obtained the verification of employment via telephone, but it did not contain adequate information to determine the borrower's length of employment, rate of pay, or probability of continued employment. It only stated that the processor spoke with an employee who verified that the borrower was an active employee.

HUD/FHA Requirements:

Approval condition number 21 in the automated underwriting system states that a borrower's income must be supported by the most recent year-to-date pay stub documenting 1 full month's earnings and written and verbal verification of employment.

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 3 years of the mortgage loan.

Loan number: 491-8898498

Mortgage amount: $85,325

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: 11/29/06

Status as of April 30, 2010: Claim

Payments before first default reported: 11

Loss to HUD: $48,371

Summary:

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

Income:

We could not determine that the borrower's income was stable or could reasonably be expected to continue through at least the first 3 years of the mortgage loan. American did not obtain verification of employment from the employer that showed overtime income information and the probability of continued employment. Also, the underwriter did not justify and document the reason the income was used for qualifying purposes.

The underwriter averaged 2006 gross income from the latest pay stub (8 months) in the file with the same employer's 2005 IRS form W-2 (the borrower worked there the last 4 months of 2005). Comparing the two sequential pay stubs from this employer showed varying hours and earnings for several earnings categories, including: regular hours, extra regular, overtime, nightshift, and star bonus. The year-to-date total for regular and extra regular earnings on the latest pay stub only amounted to $11,992 (62 percent) of the $19,418 total earnings.

The underwriter stated as qualifying factors that the borrower "works varied shifts at higher rates and overtime" but had no confirmation that this would continue.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-2, states that lenders must examine the employer's confirmation of continued employment to analyze and document the probability of continued employment. The income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first 3 years of the mortgage loan. Both overtime and bonus income may be used to qualify if the borrower has received such income for the past 2 years and it is likely to continue. The lender must develop an average of bonus or overtime income for the past 2 years, and the employment verification must not state that such income is unlikely to continue. Periods of less than 2 years may be acceptable provided the lender justifies and documents the reason for using the income for qualifying purposes.

An earnings trend also must be established and documented for overtime and bonus income. If either type shows a continual decline, the lender must provide a sound rationalization in writing for including the income for borrower qualifying. If bonus income varies significantly from year to year, a period of more than 2 years must be used in calculating the average income.

Excessive Debt Ratio:

The borrower's mortgage payment-to-income ratio exceeded HUD's allowable ratio of 31 percent. The ratio reported on the mortgage credit analysis worksheet was 34.47 percent. As a compensating factor, American's underwriter stated minimal housing increase.

The verification of rent reported the borrower's rent payment as $640 for the past 10 months. The proposed mortgage payment was $856.54, for an increase of $216.54 (34 percent). We do not consider a 34 percent increase in rent to be a minimal increase and do not consider this a sufficient compensating factor.

The credit report documented the borrower's satisfactory rent payment history for the current and prior landlords (December 2005 through November 2006 and February 2004 through December 2005).

HUD/FHA Requirements:

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

HUD Handbook 4155.1, REV-5, paragraph 2-13A, states that compensating factors include when there is only a minimal increase in the borrower's housing expense.

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

Assets:

American did not properly verify and document the source of funds used for the borrower's $500 downpayment and closing costs. According to the HUD-1 settlement statement, the settlement date was November 29, 2006, and the cash due from the borrower was $1,735.65. There was no documentation in the loan file to show the borrower's source of these funds. The loan application listed $887 in a Compass Bank checking account and $1,790 in savings for downpayment, for a total of $2,677. The loan file included a verification of deposit, dated November 2, 2006, and a printout of the borrower's bank statement, dated November 27, 2006. The verification of deposit confirmed that borrower had a balance of $887.39 in her bank account, which she opened on April 26, 2004. Her average balance for the previous 2 months was $329.99. According to the printed bank statement, the borrower's ending balance was $1,263.17, with a handwritten note stating, "+ $1,000-11/27/06," that was allegedly from a boyfriend. A copy of the transaction receipt to support the $1,000 deposit was on file; however, it did not provide information about the source of funds or clearly show that the funds were deposited into the borrower's account.

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

HUD Handbook 4155.1, REV-5, paragraph 2-10, states that all funds for the borrower's investment in the property must be verified and documented. Paragraph 2-10B states that a verification of deposit, along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account, the lender must obtain a credible explanation of the source of those funds.

<u>Credit</u>:

American did not adequately evaluate the borrower's credit history. It did not document the reason(s) for not considering collections when approving this loan.

The borrower had five derogatory accounts with a past-due amount totaling $218 and an unpaid balance of $2,537. The borrower provided an explanation letter addressing the collection accounts. American did not document an analysis of the credit history to determine whether the collections were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower. American did not identify sufficient compensating factors to justify accepting the borrower's derogatory credit history.

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

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that when delinquent accounts are revealed, the lender must document its analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including disputes with creditors. While minor derogatory information occurring 2 or more years in the past does not require explanation, major indications of derogatory credit–including judgments, collections, and other recent credit problems–require sufficient written explanation from the borrower. The lender must document its reasons for approving a mortgage when the borrower has collection accounts or judgments.

Paragraph 2-3 also states that 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.

Loan number: 491-8972325

Mortgage amount: $60,627

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: 05/22/07

Status as of April 30, 2010: Claim

Payments before first default reported: 10

Loss to HUD: $35,367

Summary:

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

Credit:

American did not adequately evaluate the borrower's credit history. It did not document the reason(s) for not considering collections accounts, nor did it document the borrower's explanation for the collection accounts and inquiries in the credit report. In addition, American did not identify strong compensating factors to justify accepting the borrower's derogatory credit history.

The credit report showed that the borrower had seven collection accounts totaling $5,861 that had gone into collection within the past 2 years. American did not document a borrower explanation for the collections. It did not document an analysis of the credit history to determine whether the collections were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

American did not document borrower explanations for seven credit inquiries made within 90 days of the credit report date.

American did not identify strong compensating factors to justify accepting the borrower's derogatory credit history. The compensating factors identified by American are discussed below:

- Job stability: This is not a HUD-acceptable compensating factor.
- Cash reserves: This is a HUD-acceptable compensating factor. The cash reserve of $4,148 is greater than $1,764 (three times the mortgage payment of $588). However, the borrower chose to save money instead of paying past debts.

- Minimal use of credit: This is a HUD-acceptable compensating factor. However, the borrower's derogatory credit history did not support this factor.
- Borrower demonstrates ability to save: This is a HUD-acceptable compensating factor. The borrower had saved $3,920 in a 401K; however, the borrower had not paid past debts in collection totaling $5,861.

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

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that when delinquent accounts are revealed, the lender must document its analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including disputes with creditors. While minor derogatory information occurring 2 or more years in the past does not require explanation, major indications of derogatory credit–including judgments, collections, and other recent credit problems–require sufficient written explanation from the borrower. The lender must document its reasons for approving a mortgage when the borrower has collection accounts or judgments.

Paragraph 2-3 also states that 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.

The lender must determine the purpose of any recent debts, as the indebtedness may have been incurred to obtain part of the required cash investment on the property being purchased. Similarly, the borrower must provide a satisfactory explanation for any significant debt that is shown on the credit report but not listed on the loan application. The borrower must explain in writing all inquiries shown on the credit report in the last 90 days.

HUD discusses the compensating factors that may be used to justify approval of mortgage loans in the Borrower Qualifying section of HUD Handbook 4155.1, REV-5, paragraph 2-13.

Loan number: 492-7731763

Mortgage amount: $51,601

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: 12/05/06

Status as of April 30, 2010: Claim

Payments before first default reported: Five

Loss to HUD: $30,536

Summary:

We found material underwriting deficiencies relating to the borrower's gift funds. This loan was processed through the automated underwriting system, Fannie Mae's Government Underwriting Service, using the FHA TOTAL Scorecard. American did not meet one of the approval conditions required by the system.

Gift:

American did not document the transfer of $1,713 in gift funds from the nonprofit donor, Genesis Gift Funds, to the settlement agent. A gift letter was documented, but the actual transfer by check, wire transfer, or other method was not documented to ensure that the funds used to close came from an acceptable source.

HUD/FHA Requirements:

Approval condition number 1N in the automated underwriting system states that the underwriter must document the transfer of gift funds according to FHA requirements.

HUD Handbook 4155.1, REV-5, paragraph 2-10, 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. When the transfer occurs at closing, the lender remains responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source.

Loan number: 492-7737924

Mortgage amount: $115,192

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: 12/29/06

Status as of April 30, 2010: Claim

Payments before first default reported: One

Loss to HUD: $47,982

Summary:

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

Credit:

American did not adequately evaluate the borrower's credit history. It did not document the reason(s) for not considering the 19 collections and charge-off accounts, nor did it identify strong compensating factors to justify accepting the borrower's derogatory credit history.

The underwriter did not obtain an explanation for the collection accounts in the credit report. The credit report showed that the borrower had 19 collection and charge-off accounts with a total past-due balance of $7,385. American did not document an analysis of the credit history to determine whether the collections were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower. American did not document compensating factors to justify accepting the borrower's collection and charge-off accounts.

The borrower provided one general explanation for all of his past credit issues. The loan file did not include an explanation that addressed payments of outstanding collections, which was identified as a condition to close by the underwriter.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that when delinquent accounts are revealed, the lender must document its analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including disputes with creditors. While minor derogatory information occurring 2 or more years in the past does not require explanation, major indications of derogatory credit–

including judgments, collections, and other recent credit problems–require sufficient written explanation from the borrower. The lender must document its reasons for approving a mortgage when the borrower has collection accounts or judgments.

Paragraph 2-3 also states that 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.

Gift Funds:

American did not document the transfer of gift funds from the nonprofit donor to the settlement agent. A gift letter was documented, but the actual transfer by check, wire transfer, or other method was not documented to ensure that the funds used to close came from an acceptable source.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10, 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.

Loan number: 492-7755169

Mortgage amount: $126,514

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: 02/16/07

Status as of April 30, 2010: Claim

Payments before first default reported: One

Loss to HUD: $66,925

Summary:

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

Excessive Debt Ratio:

American improperly used an excessive qualifying ratio when approving this loan. It calculated a mortgage payment-to-income ratio of 40.5 percent, which is higher than HUD's guideline of 31 percent. American did not identify strong compensating factors to justify the high qualifying ratio when approving this loan (see the Credit section below).

HUD Requirements:

Mortgagee Letter 2005-16, dated April 13, 2005, increased the payment-to-income and debt-to-income ratios 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

Credit:

American did not adequately evaluate the borrower's credit history. It did not document the reason(s) for not considering the collection and charge-off accounts, nor did it identify strong compensating factors to justify accepting the borrower's derogatory credit history when approving this loan.

The credit report showed that the borrower had six collection accounts and two charge-off accounts with a balance due of $4,781. American did not document an analysis of the credit history to determine whether the collections were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

American did not document additional evidence to support the borrower's explanation that the medical collections should have been taken care of through medical insurance and that five accounts did not belong to the borrower.

The compensating factors identified by American are discussed below:

- First-time home-buyer tax advantage: This is not a HUD-acceptable compensating factor.
- Conservative credit user: This is a HUD-acceptable compensating factor. However, the borrower's derogatory credit history did not support this factor.
- Satisfactory alternative credit: This is not a HUD-acceptable compensating factor.

HUD Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that when delinquent accounts are revealed, the lender must document its analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including disputes with creditors. While minor derogatory information occurring 2 or more years in the past does not require explanation, major indications of derogatory credit–including judgments, collections, and other recent credit problems–require sufficient written explanation from the borrower. The lender must document its reasons for approving a mortgage when the borrower has collection accounts or judgments.

Paragraph 2-3 also states that 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 2-13, lists compensating factors that may be used to justify approval of mortgage loans with ratios exceeding FHA benchmark guidelines. Underwriters must record in the "remarks" section of the form HUD-92900 (mortgage credit analysis worksheet) the compensating factor(s) used to support loan approval. A compensating factor used to justify mortgage approval must be supported by documentation.

Loan number: 492-7807135

Mortgage amount: $107,069

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: 04/30/07

Status as of April 30, 2010: Claim

Payments before first default reported: Six

Loss to HUD: $24,397

Summary:

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

Income:

American did not adequately evaluate the borrower's income. It did not document the borrower's employment for the 2-year period before loan closing and did not document an explanation for the year and a half gap in the borrower's employment. The borrower had worked for the current employer since April 3, 2006, and the loan closed on April 30, 2007. Before that, the borrower worked for another employer from March 15 to October 20, 2004. American did not document a borrower explanation for the employment gap between October 21, 2004, and April 3, 2006.

In addition, American did not adequately verify the borrower's current employment or whether it was likely to continue. The verbal verification of employment in the loan file did not confirm the borrower's current salary, that continued employment was likely, or the average hours per week. Consequently, the $4,049 monthly income used by the lender to approve the loan may not have been accurate or likely to continue for 3 years.

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 3 years of the mortgage loan.

Liabilities:

American did not adequately evaluate the borrowers' liabilities. The lender underreported the recurring expenses by $128. Two accounts were shown in the loan application with payments of $0 and $91, but the credit report showed the two accounts with payments of $106 and $113 ($219 total). The $128 ($219 - $91) difference increased the borrowers' total liabilities to $1,059 (see the Excessive Debt Ratio section for the impact of this increase).

HUD Requirements:

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

Excessive Debt Ratios:

American did not accurately calculate the qualifying ratios. It understated both the mortgage payment and the recurring expenses by a total of $377. The correct mortgage payment was $987 instead of the $738 used by American. As discussed in the Liabilities section above, the recurring expenses should have been $1,059 instead of $931.

	Original	**Revised**	**Difference**
Total mortgage payment:	$738	$987	$249
Recurring expenses:	$931	$1,059	$128
Total fixed payment:	**$1,669**	**$2,046**	**$377**

American calculated the total fixed payment-to-income ratio at 41.23 percent or $1,669 divided by $4,049 of monthly income. The revised total fixed payment-to-income ratio is calculated at 50.5 percent or $2,046 divided by $4,049 of monthly income. The 50.5 percent ratio exceeds HUD's guideline of 43 percent.

American did not provide compensating factors.

HUD Requirements:

Mortgagee Letter 2005-16, dated April 13, 2005, increased the payment-to-income and debt-to-income ratios 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.

Credit:

American did not adequately evaluate the borrower's credit history. The underwriter did not obtain an explanation for the eight inquiries that were made within the last 90 days as shown on the credit report.

HUD Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that the lender must determine the purpose of any recent debts, as the indebtedness may have been incurred to obtain part of the required cash investment on the property being purchased. Similarly, the borrower must provide a satisfactory explanation for any significant debt that is shown on the credit report but not listed on the loan application. The borrower must explain in writing all inquiries shown on the credit report in the last 90 days.

APPENDIX C

LENDER COMMENTS AND OIG's EVALUATION

Ref to OIG Evaluation **Lender Comments**

LAWRENCE K. DODGE
28202 Cabot Road, Suite 640
Laguna Niguel, CA 92677

July 27, 2010

Ms. Tanya E. Schulze
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General Region IX
611 West Sixth Street, Suite 1160
Los Angeles, California 90017-3101

RE: Audit Report American Sterling Bank

Dear Ms. Schulze:

We are in receipt of your draft report dated July 16, 2010. As stated in your cover letter American Sterling Bank ceased operation on April 17, 2009 as result of the bank being placed under receivership of the Federal Deposit Insurance Corporation (FDIC).

Comment 1

As a result of the receivership, all financial records of American Sterling Bank were taken over by the FDIC leaving us with no records to refer to in making a response to the specifics in your review of the twelve loans sited in your report.

We do not know to what extent you received information pertaining to the loans covered by your review. Operationally, we imaged the loans files, which were then destroyed sixty days after being imaged. There were a few instances where files were maintained in hard copy at our offsite storage facility at Iron Mountain. Without our knowledge of what type of file you reviewed, it is impossible for us to respond adequately to your findings.

In addition, if the loan files reviewed were from images, we do not know if you were supplied the full file or only that section which might have been sent to the investor. Our standard procedure for imaging files was to image what we referred to the as the "right side" of the file containing those documents which the investor required for purchase. In addition we imaged what we referred to as the "left side" of the file which contained the underwriter's notes and work papers. We are unable to determine if you received both the right side and left side of the loan files you reviewed. The "left side" of the file might or might not have answers to some of the questions raised in the findings of your report.

If you would send us copies of the file material you reviewed, we may be able to check the few hardcopy files available to us to determine if some of the information necessary to create a more complete response is available.

Respectfully,

Lawrence K. Dodge

OIG's Evaluation of Lender Comments

Comment 1 The lender was unable to respond to the draft report because it did not have copies of the loan files as a result of its being placed under receivership of the Federal Deposit Insurance Corporation. The lender will have additional time to evaluate the loans with HUD during the audit resolution process.