Issue Date
October 25, 2010

Audit Report Number
2011-FW-1002

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

//signed//

FROM: Gerald R. Kirkland
Regional Inspector General for Audit, Fort Worth Region, 6AGA

SUBJECT: Gold Financial Services, Inc., San Antonio, TX, Did Not Follow HUD/FHA Requirements in Underwriting Two Loans and Originated a Third in Violation of Its Own Internal Controls

HIGHLIGHTS

What We Audited and Why

We performed an audit of Gold Financial Services, Inc. (Gold Financial), a Federal Housing Administration (FHA) direct endorsement lender and a branch of AmericaHomeKey, Inc., in San Antonio, TX. We selected Gold Financial for audit because its default rate was almost 10 percent for the audit period while the average default rate in the San Antonio area was 2.2 percent. Our objective was to determine whether Gold Financial complied with U. S. Department of Housing and Urban Development (HUD) and FHA loan origination requirements for loans endorsed between January 1, 2008, and December 31, 2009.

What We Found

Gold Financial did not follow HUD/FHA underwriting requirements in two of seven loan originations reviewed. Gold Financial's underwriter did not require two borrowers to explain recent poor credit. As a result, Gold Financial originated two ineligible loans that resulted in a loss to HUD of $71,259 and an increased risk to the FHA insurance fund of $86,885.

Gold Financial originated a third loan that did not violate HUD/FHA underwriting requirements, but did violate its own internal controls concerning borrowers with poor credit. Specifically, the underwriter did not require the borrower to have three months reserves in accordance with Gold Financial's closing instructions.

What We Recommend

We recommend that the Deputy Assistant Secretary for Single Family Housing require Gold Financial to (1) indemnify HUD for one ineligible loan with an unpaid principal balance of $144,808, thereby putting an estimated $86,885 to better use, and (2) reimburse the FHA mortgage insurance fund $71,259 for losses incurred on one loan.

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

Auditee's Response

We provided our discussion draft report to Gold Financial on September 9, 2010, and held the exit conference on September 20, 2010. We requested a written response by September 24, 2010. Gold Financial generally disagreed with the finding and provided its response on September 23, 2010. The complete text of its response, along with our evaluation of that response, can be found in appendix B of this report.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVE

Gold Financial Services, Inc. (Gold Financial), is a branch of AmericaHomeKey, Inc. (AmericaHomeKey), and is located at 2943 Mossrock in San Antonio, TX. AmericaHomeKey is a nonsupervised direct endorsement lender, approved by the U. S. Department of Housing and Urban Development (HUD) to originate Federal Housing Administration (FHA) approved mortgage loans on April 25, 2001.

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. FHA's mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to approve mortgages for otherwise creditworthy borrowers and projects that might not be able to meet conventional underwriting requirements by protecting the lender against default.

From January 1, 2008, to December 31, 2009, Gold Financial underwrote 2,204 FHA loans with a total origination value of $271,832,906. During the same period, 212 of the loans (nearly 10 percent)[1] with a total origination value of $24,360,725 defaulted, and 33 of the 212 loans (more than 15 percent) with a total origination value of $3,487,200 defaulted without the borrowers making any payments.

As Gold Financial's parent company, AmericaHomeKey established the internal control system that Gold Financial was to follow when originating, underwriting, and closing FHA loans. Since our review indicated weaknesses in the internal control system, we will conduct an audit of AmericaHomeKey.

Our objective was to determine whether Gold Financial followed HUD and FHA loan origination requirements for loans endorsed between January 1, 2008, and December 31, 2009.

[1] In comparison, the average default rate for all FHA loans in San Antonio, TX, was 2.2 percent.

RESULTS OF AUDIT

Finding: Gold Financial Did Not Comply With HUD/FHA Requirements in Underwriting Two Loans and Originated a Third in Violation of Its Own Internal Controls

Gold Financial did not comply with HUD/FHA requirements in underwriting two of seven loans reviewed, and did not comply with its own internal controls in underwriting a third loan. This noncompliance occurred because Gold Financial's underwriter failed to exercise due diligence in underwriting the loans. Gold Financial's underwriter approved loans for two borrowers that did not provide required explanations for recent poor credit in violation of HUD/FHA requirements. As a result, Gold Financial placed the FHA insurance fund at increased risk for one loan with an estimated future loss of more than $86,000 and lost more than $71,000 on the sale of one property. Gold Financial also violated its internal controls when it underwrote a loan after its underwriter determined the borrower did not have sufficient required reserves.

Gold Financial originated two FHA loans with original loan values totaling $248,835 that violated FHA's requirements because the borrowers had unexplained recent derogatory credit. HUD paid claims totaling $107,125 on one of the two loans (loan number 495-7786023) that violated FHA requirements, foreclosed, and lost $71,259 on the property sale. HUD can expect estimated losses of $86,885 for a second loan (loan number 495-7829555) that violated FHA requirements.

Two Loans with Unexplained Recent Derogatory Credit

According to HUD regulations[2] and its own processing instructions,[3] Gold Financial was supposed to obtain explanations for recent derogatory credit, such as judgments, collections, and other credit problems. HUD requires that the borrower's explanation make sense and be consistent with other credit information. Further, the underwriter must document compensating factors to justify approval when the borrower's credit history reflects continuous slow payments, judgments, and delinquent accounts.

Despite the requirements, Gold Financial's underwriter failed to exercise due diligence by not obtaining explanations or providing adequate justification for approving two loans despite poor credit. For example, the underwriter said he missed an auto repossession during the credit review for one of the loans.

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2 HUD Handbook 4155.1, REV-5. Mortgage Credit Analysis for Mortgage Insurance, paragraph 2-13

3 AmericaHomeKey, Inc., Processing Module, page 22, Credit Explanations

As a result, Gold Financial's underwriter originated two ineligible FHA loans: loan number 495-7786023 for $99,922 and loan number 495-7829555 for $148,913. HUD foreclosed and paid claims totaling $107,125 for loan number 495-7786023 and lost $71,259 on the property sale.

As of July 31, 2010, HUD had paid claims totaling $164,052 for loan number 495-7829555. HUD foreclosed on the loan and listed the property for sale. The FHA insurance fund is estimated to lose $86,885[4] for the loan unless Gold Financial indemnifies HUD.

One Borrower Did Not Have Sufficient Reserves

According to Gold Financial's internal controls (closing instructions) for one loan for a borrower with a poor credit history, the underwriter was supposed to verify that the borrower would have 3 months of cash reserves after the loan closing. However, the underwriter did not verify that the borrower for FHA loan number 495-7775673 had the required cash reserves. The borrower's bank balance was overdrawn before closing, and after a payroll deposit, the bank balance was less than half of the required reserves.

HUD regulations require that a borrower with recent poor credit have strong compensating factors[5]. The borrower had compensating factors, but the underwriter noted in the closing instructions that the borrower needed the cash reserves after closing due to poor credit. Therefore, Gold Financial did not violate HUD regulations in this case but violated its own internal controls by originating the loan without complying with the closing instructions.

As a result, Gold Financial approved the loan for $162,450. As of July 31, 2010, the unpaid loan balance was $158,352; however, HUD had foreclosed on the loan and listed the property for sale. HUD paid claims totaling $177,598 for the property, and the FHA insurance fund is estimated to lose $95,011 on the property sale.

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4 According to the actuarial review of the FHA Mutual Mortgage Insurance Fund for fiscal year 2009, FHA's average loss experience is about 60 percent of the unpaid principal balance upon sale of a mortgaged property. The unpaid balance for FHA loan 495-7829555 was $144,808 on July 31, 2010 and 60 percent of the unpaid balance is $86,885.

5 HUD Handbook 4155.1 Rev 5, Mortgage Credit Analysis for Mortgage Insurance on One- to Four-Unit Mortgage Loans, paragraph 2-3

Conclusion

Gold Financial’s underwriter did not comply with HUD regulations and Gold Financial’s internal instructions in originating three of seven loans reviewed. As a result, Gold Financial placed the FHA insurance fund at risk for two loans with original mortgage amounts totaling $248,835 that violated HUD/FHA regulations. HUD had paid claims totaling $271,177 for the two properties as of July 31, 2010, and lost $71,259 on the sale of one property. The FHA insurance fund could lose an estimated $86,885 on the sale of the other property which has been listed for sale.

Gold Financial also violated its own internal controls when it originated a third loan without ensuring that the loan complied with its closing instructions. As a result, Gold Financial originated a third loan in which HUD foreclosed and paid claims totaling $177,598 for the property. The FHA insurance fund is expected to lose an estimated $95,000 on the sale of this property.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing require Gold Financial to

1A. Indemnify HUD for one insured loan (number 495-7829555), with unpaid principal balance of $144,808, thereby putting an estimated $86,885 to better use based on the FHA insurance fund average loss rate of 60 percent of the unpaid principal balance.

1B. Reimburse the FHA insurance fund $71,259 for losses incurred on loan number 495-7786023.

SCOPE AND METHODOLOGY

To accomplish our objective, we

- Reviewed applicable HUD regulations, requirements, mortgagee letters, and HUD Quality Assurance Division reports;
- Reviewed reports and information on HUD's Neighborhood Watch[6] and Single Family Data Warehouse;[7]
- Reviewed Gold Financial's and AmericaHomeKey's files, ledgers, policies, procedures, and independent audit reports; and
- Conducted interviews with applicable HUD staff, Gold Financial staff, AmericaHomeKey staff, and borrowers.

Using HUD's Neighborhood Watch system, we determined which FHA lenders originated the most defaulted loans in the San Antonio, TX area. We selected the lender with the most defaulted loans that was not already under Office of Inspector General (OIG) review. We obtained a download of defaulted loans with six or fewer payments originated by the lender and endorsed from January 1, 2008, to December 31, 2009. We determined that Gold Financial, a branch of AmericaHomeKey, originated 2,204 loans, 212 (nearly 10 percent) of which later defaulted. We further determined that 33 (more than 15 percent) of the 212 loans defaulted without the borrowers making any payments. We selected a random nonstatistical sample of seven loans with original loan values totaling $880,352 and reviewed the loan documents to determine whether a pattern of defaults existed. We used a nonstatistical random sample because we were determining what types of errors might exist and did not intend to project the test results on the population of loans. We included four random zero-payment loans and three random loans with between one and six payments before default.

We did not evaluate the reliability of HUD's Neighborhood Watch system because we used the data for background purposes only.

We performed our fieldwork between January 25 and June 15, 2010, at Gold Financial's office and our office in San Antonio, TX.

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

6 Neighborhood Watch refers to a Web-based software application that displays loan performance data for lenders and appraisers using FHA-insured single-family loan information. The system is designed to highlight exceptions so that potential problems are readily identifiable.

7 Single Family Data Warehouse is a large and extensive collection of database tables organized and dedicated to support the analysis, verification, and publication of single-family housing data. It consists of database tables structured to provide HUD users easy and efficient access to single-family housing case-level data on properties and associated loans, insurance, claims, defaults, and demographics.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

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

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Policies and procedures intended to ensure that FHA insured loans are properly originated, underwritten, and closed.
- Safeguarding FHA insured mortgages from high-risk exposure.
- Policies and procedures intended to ensure that the quality control program is an effective tool in reducing underwriting errors and noncompliance.

We assessed the relevant controls identified above.

A deficiency in internal controls exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

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

Gold Financial did not have effective controls in place to ensure that the underwriters complied with HUD regulations and the organization’s internal instructions in originating, underwriting, and closing FHA loans (finding).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A		$86,885
1B	$71,259	

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.

2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified.

Implementation of our recommendation to require Gold Financial to indemnify HUD for the loan that was not originated in accordance with HUD/FHA requirements will reduce FHA's risk of loss to the FHA insurance fund. The amount above reflects that, upon the sale of the mortgaged property, FHA's average loss experience is about 60 percent of the unpaid principal balance, based upon statistics provided by HUD (see footnote 4).

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

September 23, 2010

VIA FEDERAL EXPRESS

Mr. Gerald R. Kirkland
Regional Inspector General for Audit
U.S. Department of Housing
and Urban Development
Office of the Inspector General
Region 6AGA
Fritz G. Lanham Federal Building
819 Taylor Street, Suite 13A09
Fort Worth, TX 76102-6195

RE: AmericaHomeKey, Inc.
HUD OIG Draft Audit Report

Dear Mr. Kirkland:

AmericaHomeKey, Inc. ("AHK" or "Company") is in receipt of the Draft Audit Report ("Report") 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 a Company branch office conducted between January and June 2010. The audit covers seven loans originated from the Company's 00201 branch office and endorsed by HUD during the period January 1, 2008 through December 31, 2009. AHK's 00201 branch office is located in San Antonio, Texas and operates under the "doing business as" name of Gold Financial.

The Report states that its objective was to determine whether Gold Financial complied with HUD requirements in the origination of Federal Housing Administration ("FHA") insured loans. The Report contains one finding, alleging underwriting deficiencies in three cases related to cash reserves and borrower creditworthiness. Based on this finding, the Report recommends that HUD require AHK to: (1) indemnify the Department in connection with two loans; (2) reimburse HUD for losses incurred on one loan; and (3) implement effective internal controls to ensure that its underwriters comply with HUD regulations and internal policies and procedures regarding FHA loans.

The OIG provided AHK with an opportunity to submit written comments for inclusion in the final report. This response summarizes AHK's history and operations, and addresses the individual findings in the Report. We appreciate this opportunity to

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comment on the OIG's findings and recommendations. That said, we understand that final audit reports routinely include auditors' comments about the audited lender's written response, but the company is not provided an opportunity to respond to these additional comments. Often, these comments include substantive allegations or statements that were not a part of the draft audit report provided to the company. To the extent that the OIG makes such additional substantive comments in this instance, we respectfully request an opportunity to respond to these additional statements to ensure that a full picture of the audited issues is presented in the final report.

I. BACKGROUND

AHK received approval as a Direct Endorsement mortgagee in April of 2001. Headquartered in Dallas, Texas, AHK operates in several states through over 40 FHA-approved branch offices and employs approximately 1,000 individuals. AHK retains and services certain loans in its portfolio and sells all remaining loans that it originates into the secondary market on a servicing-released basis. Its primary investors include Bank of America and Wells Fargo. It is an authorized agent for 21 principals and acts as principal for 11 authorized agents. The Company enjoys excellent relationships with both consumers and its investors, and AHK's employees consistently strive to produce high quality loans in compliance with HUD/FHA standards.

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

We believe it is important to note that the Company has made significant changes to its FHA-insured loan program to improve its underwriting quality and overall loan performance. For instance, AHK retained new personnel whose sole purpose is to train Company employees on applicable guidelines and systems to ensure continuity and quality in underwriting. The Company also established an Underwriting Helpdesk where AHK underwriters and processors can ask questions and access current resources to make informed and accurate decisions, and all underwriters undergo mandatory underwriting product training. AHK's management also generates weekly "Points to Ponder" to remind the Company's production team of important updates, and

Mr. Gerald R. Kirkland
September 23, 2010
Page 3

all new Company underwriters must submit their loan files to a second underwriting review until management is comfortable that underwriters are familiar with all systems and properly follow agency and investor guidelines. In addition, AHK thoroughly reviews all quality control reports and holds semi-monthly team meetings with underwriters and underwriting management to review any underwriting trends and changes. To the extent the Company identifies patterns in underwriting, AHK often sponsors specific training sessions to address these trends and ensure Company personnel are up-to-date on all origination requirements. Finally, Company underwriters have easy access to a variety of matrixes and product descriptions through AHK's website, which serve as useful reminders of applicable policies and procedures.

The Company has also strengthened its underwriting guidelines over the past year. For example, AHK has developed certain computer "stops" that require specific information to be collected to move forward in the system and assist the Company in identifying underwriting trends. Moreover, AHK has implemented several policies and procedural changes to mitigate risk trends in the Company's loan portfolios, including: (1) minimum FICO scores; and (2) verbal Verifications of Employment within three days of funding to ensure borrowers are still gainfully employed, to name a few. AHK also discontinued originations on manufactured housing in February 2009. These changes have greatly improved the quality and performance of the Company's FHA-insured loan portfolio.

II. RESPONSE TO THE FINDING

Comment 1

The Report contains one finding, in which it alleges that AHK did not originate three loans in accordance with HUD requirements. Upon receipt of the draft Report, AHK conducted a thorough review of the findings and loan files, as well as examined applicable HUD/FHA guidelines and internal Company procedures at the time these loans were originated, in an effort to provide pertinent information and documentation with this response. Our review indicated that 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 AHK's compliance with HUD/FHA requirements and adherence to prudent lending standards. Below we reply to the individual matters raised in the Report, evidence our adherence to FHA requirements in connection with the findings and several cited loans, and set forth our opposition to the manner in which the recommendations are presented in the Report.

Mr. Gerald R. Kirkland
September 23, 2010
Page 4

Comment 2

A. GOLD FINANCIAL IS NOT A SEPARATE HUD-APPROVED ENTITY

As indicated above, the OIG reviewed seven loans originated by AHK's branch office located at 2943 Mossrock in San Antonio, Texas. While this branch location operates under the "doing business as" name of Gold Financial, the Report incorrectly characterizes AHK and Gold Financial as two separate FHA entities.

Notably, the Report refers to "Gold Financial Services, Inc." as a FHA direct endorsement lender and division of AHK on pages one and eight. In addition, although page four of the Report accurately describes Gold Financial as a branch of the Company, this section goes on to state that "both AmericaHomeKey and Gold Financial are nonsupervised direct endorsement lenders. The U.S. Department of Housing and Urban Development approved AmericaHomeKey and Gold Financial to originate Federal Housing Administration-approved mortgage loans on April 25, 2001 and on December 12, 2007, respectively." In actuality, AHK is the FHA-approved direct endorsement lender that received approval on April 25, 2001, and Gold Financial received its approval to operate as a traditional branch of the Company on December 12, 2007. Attached as **Exhibit A** is a copy of the Company's Neighborhood Watch data, which depicts this mortgagee-branch relationship. While we do not object to the Report's reference to AHK's 00201 branch as Gold Financial, we respectfully request the OIG to correct all misrepresentations of the corporate relationship between AHK and its branch office in the final report.

B. AHK COMPLIED WITH HUD'S UNDERWRITING GUIDELINES

The Report asserts that the Company did not originate three of the seven loans reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) cash reserves; and (2) the underwriter's credit analysis. We address each of these individual allegations in turn below.

1. <u>Cash Reserves</u>

Comment 3

In one loan, the [redacted] **(FHA Case No. 495-7775673)** case, the Report asserts that according to both HUD regulations and the Company's closing instructions, AHK's underwriter was supposed to verify that the borrower would have three months of cash reserves after the loan closing. However, the Report claims the underwriter did not verify that the borrower had the required cash reserves despite having poor credit.

Contrary to the allegations in this case, AHK is unaware of any requirement in FHA guidelines that a lender require a borrower with derogatory credit items to have three months of cash reserves after closing. Rather, to the extent that a borrower's debt-to-income ratios exceed HUD's thresholds of 31% and 43%, the Department permits a mortgagee to approve FHA financing where significant compensating factors justify loan approval. See HUD Handbook 4155.1, REV-5, ¶¶2-12. 2-13; Mortgagee Letter 2005-16.[1] One such compensating factor is the fact that a borrower has "substantial documented cash reserves (at least three months' worth) after closing." See HUD Handbook 4155.1, REV-5, ¶ 2-13(G). Thus, if the borrower's debt-to-income ratios exceed 31% on the front end and 43% on the back end, and a lender can verify and document three months of cash reserves in a borrower's bank account, these cash reserves justify a lender's approval of the FHA loan. Moreover, FHA guidelines further require compensating factors if a borrower's credit history reflects continuous slow payments and delinquent accounts. See HUD Handbook 4155.1, REV-5, ¶2-3. Again, while three months of cash reserves may be a compensating factor in this circumstance, the absence of three months of cash reserves is, in no way, a reason to deny FHA financing to an otherwise qualified borrower. As HUD's guidelines identify nine other compensating factors that justify the approval of a loan, even a borrower with zero dollars in cash reserves and derogatory credit items could qualify for an FHA-insured loan.

Here, the Mortgage Credit Analysis Worksheet ("MCAW") reflects the borrower's qualifying ratios as 31% and 42%, which did not exceed HUD's qualifying thresholds **(Exhibit B-1)**. Thus, the underwriter in this case was not required to verify and document compensating factors as a result of the borrower's debt-to-income ratios. Moreover, despite derogatory credit items on the borrower's credit report, the underwriter obtained thorough written credit statements from the borrower to explain these accounts, many of which occurred more than two years prior to closing **(Exhibit B-2)**. The loan file also documented significant compensating factors as dictated by FHA guidelines to justify approval of the loan, including the borrower's current minimal use of credit **(Exhibit B-1)**, the fact that the borrower owned the land that was the subject of the mortgage **(Exhibit B-3)**, and the borrower's ability to accumulate savings based on regular transfers from the borrower's account **(Exhibit B-4)**. See HUD Handbook 4155.1, REV-5, ¶2-13. Just because the underwriter made notations on his internal underwriting documents (not Company closing instructions) to require the borrower to maintain cash reserves **(Exhibit B-5)**, this requirement was not according to FHA guidelines or AHK policies and procedures. Again, nothing in HUD's guidelines or the Company's underwriting procedures required the borrower in this case to maintain three months of cash reserves after closing. Rather, the loan file documented other compensating factors, and the fact that the borrower maintained $3,257.89 in cash

[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 loans cited in the Report were originated and closed. We therefore rely on the prior Handbook, 4155.1 REV-5, and accompanying Mortgagee Letters throughout this response.

reserves prior to closing was yet another positive indicator of the borrower's ability to repay the loan **(Exhibit B-4)**.

The Company, therefore, strongly objects to the Report's statement that "Gold Financial's internal controls system failed to detect or protect the loan origination when its underwriter violated HUD's and its own requirements and originated the loan for $162,450." No HUD or Company guidelines were violated in this case, and including this language in the Report is inequitable, inflammatory, and contrary to the Department's guidelines in such matters. As the underwriter otherwise reasonably determined the borrower to be eligible for FHA financing, AHK respectfully requests that the allegations in this case, the indemnification recommendation, and the quoted statement above be removed from the OIG's final report.

2. <u>Credit Analysis</u>

In two loans, the Report takes issue with the Company's evaluation of the borrowers' creditworthiness. Specifically, the Report generally asserts that the underwriter was supposed to obtain explanations for recent derogatory credit, such as judgments, collections, and other credit problems, that make sense and are consistent with other credit information. The Report also claims that the underwriter must document compensating factors to justify approval when the borrower's credit history reflects continuous slow payments, judgments, and delinquent accounts. The Report alleges that the underwriter did not exercise due diligence when he did not obtain explanations or provide adequate justification for approving the [redacted] and the [redacted] loans.

AHK respects the importance of analyzing a borrower's credit performance and examining his or her attitude towards credit obligations. It is AHK'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 being said, we note that HUD delegated to FHA lenders the responsibility for analyzing a borrower's credit and determining an individual's creditworthiness. <u>See</u> 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. 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 AHK'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. In this case, the underwriter responsible for the two loans at issue has over thirty years of experience as a direct endorsement underwriter. AHK takes its underwriting responsibility seriously and would never knowingly approve a loan to an unqualified borrower.

In the cases cited in the Report, AHK 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, and judgments, and the Company's underwriter reasonably determined that past derogatory items did not reflect a current disregard for financial obligations. The loan files contain required documentation and AHK 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, AHK adhered to FHA requirements by reasonably determining that the borrowers were creditworthy and qualified for FHA loans. We address the Report's general allegations in the two cases below.

a. [redacted] - FHA Case No. 495-7786023

First, in the [redacted] case, the Report claims this loan was ineligible for FHA financing because the underwriter did not obtain explanations for derogatory credit items or provide adequate justification for approving the loan. The Report also states that the underwriter said he missed an automobile repossession during the credit review, although the Report does not identify whether this allegation applies in the [redacted] or the [redacted] case. Nevertheless, for the reasons set forth below, AHK respectfully disagrees with these findings.

As stated above, AHK requires all underwriters to carefully scrutinize a borrower's credit history and to obtain any documentation or explanations necessary to assess a borrower's credit risk. See HUD Handbook 4155.1 REV-5, ¶ 2-3. As you know, when analyzing the borrower's credit record, FHA guidelines provide that "a period of financial difficulty in the past does not necessarily make the risk unacceptable if the borrower has maintained a good payment record for a considerable time period since the difficulty." Id. Moreover, when delinquent accounts are present, a lender must determine whether the late payments were due to a disregard for, or an inability to manage, financial obligations, or to factors beyond the control of the borrower. Id. If a borrower's credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, AHK understands and appreciates that compensating factors are necessary to approve the loan. See HUD Handbook 4155.1, REV-5, ¶ 2-3.

Given these requirements, AHK properly analyzed the borrower's credit and made a prudent decision to approve the borrower for FHA financing. While the borrower's credit report reflected a handful of derogatory accounts and collections, these accounts, with one exception, occurred in March-May 2005, July 2002, July 2003, December 2003, February 2002, and July 2005 **(Exhibit C-1)**. With a closing date in May 2008, this derogatory information was more than three years old, and FHA guidelines do not require an explanation for minor derogatory credit that occurred two or more years in the past. See HUD Handbook 4155.1, REV-5, ¶2-3. The underwriter, therefore, was justified in assigning little weight to the accounts.

Moreover, in accordance with FHA guidelines, the underwriter obtained a written credit explanation from the borrower, where he sufficiently detailed the medical difficulties experienced by his wife and child that caused the borrower to fall behind on certain credit obligations **(Exhibit C-2)**. Furthermore, despite those family circumstances, the borrower had reestablished his credit with eleven on-time payments for a current automobile loan, which was the borrower's only recurring installment debt **(Exhibit C-1)**. Collectively, this documentation demonstrated that the borrower's past credit issues resulted from circumstances beyond the borrower's control and not a disregard for his financial obligations. The borrower's qualifying ratios also equaled 18.9% and 37.2% **(Exhibit C-3)**, which were well below HUD's thresholds, and the borrower's explained that income from a non-purchasing spouse, which was not used to qualify the borrower in this case, was available to assist in making mortgage payments **(Exhibit C-2)**. FHA guidelines explicitly recognize that a borrower's receipt of compensation or income not reflected in effective income is a significant compensating factor. See HUD Handbook 4155.1, REV-5, ¶2-13(E). Thus, when considering the old dates on the borrower's accounts, his re-established credit, the reasons for credit difficulties as explained by the borrower, and the compensating factors in this case, AHK's underwriter properly obtained an explanation from the borrower and reasonably determined the borrower to be creditworthy.

Finally, with regard to the Report's claim that the underwriter stated he missed the automobile repossession, we understand that, during the course of the OIG's review, the OIG auditor provided our underwriter with a single page from a credit report and asked about the automobile repossession without any opportunity to review the circumstances in this case. As FHA guidelines recognize that an underwriter must review a borrower's entire credit history to gage whether a borrower poses a credit risk, the Company is not surprised that the underwriter suggested he may have missed this account when shown an incomplete credit report from a loan that had closed more than two years ago. However, even if the underwriter did not consider this account in the [redacted] case, which we believe unlikely, an automobile repossession occurred in July 2003, which was nearly five years prior to loan closing. This account had little bearing on the borrower's credit risk in 2008. Again, given the borrower's circumstances, which he explained in writing, the underwriter prudently approved Mr. [redacted] for FHA financing. We, therefore, respectfully request that the allegations in this case, as well as the request for reimbursement, be removed from the final audit report.

b. [redacted] - FHA Case No. 495-7829555

Second, in this case, the Report alleges that AHK should not have approved the borrower for FHA financing because the underwriter did not obtain explanations for derogatory credit items. The Report also states that the underwriter said he missed an automobile repossession during the credit review, although it is unclear whether this allegation applies in the [redacted] or the [redacted] case. Contrary to these allegations and despite the items of negative credit on the borrower's credit report, the underwriter properly analyzed the borrower's credit, obtained the necessary credit explanations, and reasonably determined the borrower to be creditworthy.

Notably, in accordance with FHA guidelines, the underwriter obtained several written statements from the borrowers to explain derogatory accounts and collection items appearing on the borrowers' credit report **(Exhibit D-1)**. For instance, the borrower explained that he was unaware of the Luby's and Diamond Shamrock accounts and was taking action to resolve these accounts **(Exhibit D-2)**. The co-borrower also explained that her Discover Card account went into collection during a time when she was out of work on bed rest, and the Time Warner cable account became late due to a payment error compounded by growing medical expenses **(Exhibit D-3)**. As a further example, the borrowers explained that all student loan accounts appearing on the credit report were current and in deferment; any late payments reported here were made in error **(Exhibit D-4)**.

Fourteen of these accounts also occurred more than two years prior to the loan's closing on March 17, 2008, and a majority of the borrower's collections were medical accounts **(Exhibit D-1)**. As noted above, the borrower explained that she had been out of work and on bed rest during a pregnancy and that her son required treatment for asthma **(Exhibit D-3)**. As medical care and the associated costs are unexpected and beyond a borrower's control, it was reasonable for the underwriter to assign little weight to such accounts in determining the borrower's credit risk. Thus, based on the explanations above, as well as seven other credit explanation letters in the loan file **(Exhibit D-5)**, and the age and medical nature of many of the accounts, the underwriter reasonably determined that the borrowers' explanations were sufficient, that many of the accounts resulted from circumstances beyond the borrower's control, and that other older accounts had little bearing on the borrower's current creditworthiness.

The borrowers also had re-established their credit with nearly two years of timely payments made to Drive Time Auto on two accounts **(Exhibit D-1)**. FHA guidelines explicitly provide that "a period of financial difficulty in the past does not necessarily make the risk unacceptable if the borrower has maintained a good payment record for a considerable time period since the difficulty." HUD Handbook 4155.1, REV-5, ¶ 2-3. Here, the borrowers had demonstrated an ability to manage their current financial obligations, which was a positive indicator of the borrowers' ability to repay the mortgage loan. The loan file also documented strong compensating factors to justify approval of the loan. <u>Notably, given the borrowers' current conservative attitude towards the use of credit, the borrowers' qualifying ratios equaled 17.9% and 33.0% **(Exhibit D-6)**, which were well below HUD's thresholds for approval</u>. The underwriter also noted in the "Remarks" section of the MCAW that the borrowers maintained cash reserves **(Exhibit D-6)**, which HUD guidelines recognize as a significant compensating factor, and the borrowers enjoyed excellent job stability with over three years of employment as an Emergency Medical Technician and child care provider **(Exhibit D-7)**. While AHK appreciates that HUD guidelines require job stability, lenders are required to document a borrower's employment for only two years prior to closing. <u>See</u> HUD Handbook 4155.1 REV-5,¶ 2-6. Based on these guidelines, a longer employment history with the same employer demonstrates job stability above and beyond what is required by the Department's guidelines and compensates for past derogatory credit items. Thus, given the borrowers' commitment to re-establishing their credit and the excellent compensating factors documented in the loan file, we believe the underwriter made a prudent decision to approve this loan.

Finally, with regard to the Report's claim that the underwriter stated he missed the automobile repossession, again we understand that, during the course of the OIG's review, the underwriter was shown a single page from a credit report and asked about the automobile repossession without any opportunity to review the circumstances in this case. As FHA guidelines recognize that an underwriter must review a borrower's entire credit history to gage whether a borrower poses a credit risk, the Company is not surprised that the underwriter suggested he may have missed this account when shown an incomplete credit report from a loan that had closed more than two years ago. However, assuming the Report attributes this allegation to the [redacted] loan, even if the underwriter did not consider this account, we believe the automobile repossession had little effect on the underwriter's view of the borrowers' re-established credit history and compensating factors in this case. Again, given the borrowers' circumstances, which they thoroughly explained in writing, the underwriter prudently approved this loan. We, Comment 4

Comment 5

therefore, respectfully request that the allegations in this case, as well as the request for indemnification, be removed from the final audit report.

In summary, AHK maintains that it complied with HUD guidelines in analyzing the borrowers' overall credit profile in the [redacted] and [redacted] loans, and the underwriter reasonably determined that the borrowers had taken responsibility for their obligations and demonstrated an acceptable credit risk. The Company also reminds the OIG to consider the nature of the market in 2008 when the loans at issue were originated. Today's mortgage market is vastly different, and the standards for credit have tightened considerably. Every settlement service provider – and even HUD – operated differently in 2008, and it would be unreasonable for these cases to be viewed strictly through the lens of today's market. As AHK's underwriter properly obtained credit explanations and otherwise reasonably considered the borrowers to be creditworthy based on HUD's guidelines in place in 2008, these loans were eligible for FHA financing. We, therefore, request the OIG to remove inflammatory statements from the final audit report that "Gold Financial's internal control system did not detect or prevent the faulty loan originations."

3. Recommendations

In addition to opposing the individual allegations contained in the Report, AHK disagrees with certain aspects of the recommendations made in connection with the loans referenced. As you know, the Report recommends, among other things, that the Department require the Company to indemnify HUD for potential losses of $182,000 in connection with two loans referenced. To derive these estimated losses, the Report indicates that it included 60% of the unpaid principal balance in these cases. According to Appendix A, this multiplier was selected based on information provided by HUD showing that its losses on sales average 60% of the unpaid principal balance.

AHK would not take issue with the OIG's inclusion of the Department's actual losses in connection with loans for which claims have been made. The Company does, however, take strong exception to inclusion of the $182,000 in estimated losses in the two cited loans. First, we note that the $182,000 figure does not represent a payment that the Report recommends AHK pay to HUD, but rather reflects a mere estimate of the losses the Department could incur if these two loans result in additional claims to HUD. The Report merely recommends that HUD request indemnification, but any amounts paid to HUD in connection with any indemnifications will be determined based on the actual losses to HUD upon resolution of the claim made to the Department, rather than the estimates included in this document. To date, HUD has not incurred any loss in connection with these cases, and it is not possible to determine whether the Department will ever incur losses in these cases. In fact, there is no guarantee the

Department will sustain monetary loss, as HUD may be able to recoup the claim amount in the sale of the underlying property.

Notwithstanding these facts, the Report suggests that the Department will experience losses in the amount of 60% of the unpaid principal balance of each one of these loans, and lists the financial risk to the Department, which it defines as "funds to be put to better use," as $181,896. This calculation assumes that both of the cited loans will go into foreclosure and result in a claim to HUD. Such an assumption would be supportable if 100% of the loans that enter default resulted in claims to HUD; however, that percentage is significantly lower. Thus, there is no reason to believe that the two loans at issue will result in a claim or financial loss to the Department. Based on these facts, absent evidence that the two cited loans will result in an actual claim to the Department, the potential loss figure is inflated and does not paint an accurate picture of the risks associated with this matter. It appears that inclusion of such an inflammatory figure in the final report serves only as an attempt to justify the costs of the audit of this Company, rather than portray the precise amount of the potential losses that HUD may incur in connection with these loans.

Second, as noted above, this arbitrary monetary figure is included with a mere recommendation to the Department to require the Company to indemnify it in connection with certain loans. Upon receiving the final report, the Department will have an opportunity to independently review the audit findings and make an independent determination of whether indemnification is warranted in any of these cases. As discussed at length earlier in this response, AHK disagrees that the findings set forth in the Report warrant indemnification. HUD may also disagree with the Report's assertions and decide not to pursue indemnification in some or all of the cited cases. Notwithstanding the fact that these findings are preliminary, the OIG's recommendations assume that HUD will accept each allegation and pursue indemnification in each case.

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

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

The above discussion demonstrates that the estimated loss figure is unrepresentative of the Department's actual loss risk in connection with two of the loans cited in the draft Report. Inclusion of this overstated figure in the Report unfairly represents the loss exposure to HUD, and ultimately the Company, as a result of this audit. Therefore, AHK strongly opposes the inclusion of this figure in the final report and requests that it be removed or amended to portray a more accurate picture of the potential losses in the FHA loans cited in the Report. As the recommendation regarding these loans is that the Company indemnify HUD, the Report should merely state this recommendation without including estimated losses that are difficult, if not impossible, to predict accurately in these loans. At the very least, if the final report continues to include the average claim loss paid for these two loans as the potential financial risk to HUD and the Company, the Report should also clarify the percentage of defaulted loans that result in a claim to HUD and include the potential losses based on this significantly reduced number of loans. This figure would present readers with a more accurate and fair picture of the financial risks associated with the loans identified in the Report.

Comment 6

Finally, it is important to emphasize that alleged deficiencies in three FHA-insured loans hardly suggest that AHK's internal policies and control yielded "faulty" loans. AHK's 00201 branch office originated 2,204 loans during the two-year period covered by the OIG's review, and three loans, or 0.1% of these total originations, in no way provides a basis for the OIG to draw reasonable conclusions about the Company's policies and procedures and internal controls. This is particularly the case when the Report's allegations involve subjective determinations about a borrower's qualifications, which HUD has specifically entrusted to individual underwriters. As discussed in detail herein, each of the borrowers in the three loans at issue qualified for FHA financing, and the underwriter complied with HUD requirements and Company policies and procedures in approving these loans. We, therefore, see no basis for the Report's claim that "Gold Financial did not have effective controls in place to ensure that the underwriters complied with HUD regulations and the organization's internal instructions in originating,

Mr. Gerald R. Kirkland
September 23, 2010
Page 14

underwriting, and closing FHA loans." This conclusion should be removed from the final audit report.

III. CONCLUSION

AHK takes the matters raised in the draft Report seriously. Because FHA lending comprises a significant portion of AHK's overall business operations, the Company is committed to educating and training its employees on issues regarding FHA compliance and to assuring their adherence to HUD's rules and regulations. As discussed above, AHK substantially complied with FHA underwriting requirements and made loans to qualified FHA borrowers. AHK's thorough review of the findings set forth in the Report indicated that many of the findings are at variance with the facts, do not constitute violations of HUD/FHA requirements on the part of AHK, or do not affect the underlying loans' insurability. AHK at no time misrepresented information it submitted to the Department. Moreover, since the loans cited in the Report were originated, the Company has continued to enhance its underwriting practices.

We believe that this response and accompanying exhibits demonstrate that the Report's recommendations in connection with the cited loans are unwarranted. We respectfully request that the OIG revise its recommendations to fit the facts of this case and remove allegations from the Report in those instances in which AHK has demonstrated its compliance with HUD requirements.

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

Thank you for your kind consideration.

Sincerely,

Lane Terrell
President and Chief Executive Officer

Attachments

cc: Phillip L. Schulman, Esq.

OIG Evaluation of Auditee Comments

Comment 1 The auditee generally disagreed with the findings. We considered the auditee's comments and revised the report as appropriate.

Comment 2 The auditee clarified the relationship between Gold Financial and AmericaHomeKey – We revised the report as appropriate.

Comment 3 The auditee asserted that FHA loan 495-7775673 complied with HUD requirements and did not violate Gold Financial's internal controls. After discussions with HUD's Quality Assurance Division, we agree that the loan origination may not have violated HUD regulations, and we reduced estimated losses from $181,896 for two loans to $86,885 for a single loan. However, we maintain that Gold Financial violated its internal controls when it originated the loan. We revised the report as appropriate.

Comment 4 The auditee asserted that it complied with HUD guidelines in analyzing the borrowers' overall credit profiles when it underwrote FHA loan 495-7786023 and FHA loan 495-7829555 and summarized its assertion at Comment 4 (see page 22 of the report, first full paragraph). We disagree with the assertion because the underwriter clearly did not consider both borrowers' recent poor credit when it originated the loans. The borrower of loan 495-7786023 had two repossessions with the last occurring 17 months before the loan closed. The borrower on loan 495-7829555 also had two repossessions with the last occurring 11 months before the loan closed. FHA requires that when a borrower has major derogatory credit within the last 2 years, the borrower must provide a sufficient written explanation and strong compensating factors, neither of which were in the loan file[8]. We did not revise the report.

Comment 5 The auditee disputed including estimated losses in the report because they are estimates and because it believes that it complied with HUD guidelines in originating the loans. The estimated losses are based on the average loss severity rate from the *Actuarial Review of the FHA Mutual Mortgage Fund for Fiscal Year 2009* provided by HUD. Estimated losses are based on actuarial data and HUD will determine the appropriate actions to take regarding the findings during the management decision process. As stated in Comment 3, we reduced estimated losses for one loan and revised the report as appropriate.

Comment 6 The auditee disputed that the loans were any reflection on AmericaHomeKey's internal policies and procedures. We disagree because AmericaHomeKey's internal policies and procedures allowed the faulty loans to be underwritten. We did not revise the report.

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[8] HUD Handbook 4155.1, Rev 5, paragraph 2-3 states "…major indications of derogatory credit – including judgments, collections, and any other recent credit problems – require sufficient written explanation from the borrower."