Issue Date	September 23, 2011
Audit Report Number	2011-FW-1016

TO: Deborah Holston
Acting Deputy Assistant Secretary for Single Family Housing, HU

Craig T. Clemmensen
Director, Departmental Enforcement Center, CACB

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

SUBJECT: AmericaHomeKey, Inc., Dallas, TX, Did Not Follow HUD-FHA Loan Requirements in Underwriting 13 of 20 Manufactured Home Loans

HIGHLIGHTS

What We Audited and Why

We audited AmericaHomeKey, Inc., a Federal Housing Administration (FHA) direct endorsement lender in Dallas, TX. We selected AmericaHomeKey for audit because during our review of Gold Financial Services (2011-FW-1002), an AmericaHomeKey branch office, we identified three loans originated by one of its underwriters that contained underwriting and valuation deficiencies. Our objective was to determine whether AmericaHomeKey originated manufactured home loans in accordance with U. S. Department of Housing and Urban Development (HUD) and FHA requirements for loans with beginning amortization dates between March 1, 2008, and February 28, 2010.

What We Found

AmericaHomeKey did not follow HUD-FHA underwriting requirements in 13 of 20 loan originations reviewed. This deficiency occurred because its quality control procedures were not adequate to consistently identify and correct underwriting deficiencies. As a result, AmericaHomeKey originated more than $1.7 million in ineligible loans that resulted in losses to FHA's Mutual Mortgage Insurance Fund totaling $538,132 and increased the risk to the insurance fund by more than $680,000.

What We Recommend

We recommend that the Acting Deputy Assistant Secretary for Single Family Housing require AmericaHomeKey to (1) indemnify HUD for the eight ineligible FHA loans with an estimated potential loss of more than $680,000,[1] (2) support or repay the FHA insurance fund $23,803 for claims paid as of July 31, 2011, or the current total amount of claims paid for four insured loans, (3) reimburse the FHA insurance fund $514,329 for actual losses incurred on five insured loans and (4) improve its quality control procedures to ensure that it consistently identifies and corrects underwriting deficiencies in a timely manner. We also recommend that HUD refer AmericaHomeKey to the Mortgagee Review Board for consideration of administrative actions against the lender for not having a compliant quality control program in place and take appropriate administrative actions against the underwriter responsible for the 13 questioned loans. We further recommend that the Director, Departmental Enforcement Center take appropriate administrative sanctions, including possible debarment or other remedies, against the underwriter responsible for the 13 questioned loans.

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 to AmericaHomeKey on August 1, 2011, and held the exit conference on August 23, 2011. We requested a written response by August 18, 2011. AmericaHomeKey disagreed with our conclusions and provided voluminous documentation to support its position. We reviewed the documentation and made changes to the report where appropriate. Our final conclusions regarding the 13 questioned loans remain unchanged.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report. The exhibits referred to in the auditee's response are available upon request.

[1] The amount is based on the estimated percentage of loss of 59 percent that HUD would incur when the FHA property is foreclosed upon and resold as supported by the HUD Single Family Acquired Asset Management System's case management profit and loss by acquisition as of September 2010.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVE

AmericaHomeKey, Inc. is located at 3838 Oak Lawn, Suite 1050, Dallas, TX. AmericaHomeKey is a nonsupervised direct endorsement lender, which was 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 simplified 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.[2]

According to HUD's Neighborhood Watch system,[3] AmericaHomeKey originated 2,870 loans in 2008 with an original mortgage amount of more than $485 million. HUD did not pay any claims in 2008 for loans originated by AmericaHomeKey. However, beginning in January 2009, its loan volume, delinquencies, and HUD claims increased significantly. From January 1, 2009, through February 28, 2011, AmericaHomeKey originated 13,838 loans with an original mortgage amount of more than $2 billion. During calendar years 2009 and 2010, HUD paid claims totaling more than $5.2 million for 47 loans. During the same 2-year period, AmericaHomeKey's default rate was 4.20 percent compared to an average default rate for all FHA loans in the United States of 2.83 percent.

During a previous audit of Gold Financial Services, an AmericaHomeKey branch office located in San Antonio, TX, we identified three loans with underwriting deficiencies that were underwritten by the same underwriter. The underwriter was employed by AmericaHomeKey from December 2007 through February 2009. Using HUD's Neighborhood Watch system, we determined that this particular underwriter originated 39 manufactured home loans[4] totaling $5.2 million during her employment at AmericaHomeKey. Of the 39 loans, 20 loans totaling $2.7 million defaulted in 20 payments or fewer. As a result, we opened this audit of AmericaHomeKey.

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2 HUD defines a default as the inability to make timely mortgage payments or otherwise comply with mortgage terms. A loan is considered in default when no payment has been made 30 days after the due date. Once a loan is in default, the lender can exercise legal rights defined in the contract to begin foreclosure proceedings.

3 Neighborhood Watch is Web-based software that displays loan performance data for FHA-insured single-family loan information. The system is designed to highlight exceptions so that potential problems are readily identifiable.

4 AmericaHomeKey ceased underwriting manufactured home loans in January 2009.

Our objective was to determine whether AmericaHomeKey originated manufactured home loans in accordance with HUD and FHA requirements for loans with beginning amortization dates between March 1, 2008, and February 28, 2010**.**

RESULTS OF AUDIT

Finding: AmericaHomeKey Did Not Comply With HUD-FHA Requirements in Underwriting 13 of 20 Manufactured Home Loans

AmericaHomeKey did not follow HUD-FHA requirements for 13 of 20 loans reviewed.[5] This condition occurred because its quality control procedures were not adequate to consistently identify and correct underwriting deficiencies in a timely manner. As a result, AmericaHomeKey originated 13 ineligible loans with mortgages totaling more than $1.7 million. The ineligible loans resulted in $514,329 in losses to FHA's insurance fund and $23,803 in claim payments. Further, the loans increased the insurance fund's risk by more than $680,000 in additional estimated losses.

AmericaHomeKey Did Not Follow HUD-FHA Requirements

All FHA lenders must follow all applicable statutes, regulations, and HUD's written instructions, including program handbooks and mortgagee letters. Specifically, lenders must follow HUD Handbook 4155.1, REV-5, "Mortgage Credit Analysis for Mortgage Insurance on One-to Four-Unit Mortgage Loans," when underwriting FHA loans. The lender is responsible for eliciting a complete picture of the borrower's financial situation, source of funds for the transaction, and intended use of the property. Its decision to approve the loan must be documented, supported, and verifiable.

AmericaHomeKey did not follow HUD requirements when originating and underwriting 13 of 20 manufactured home loans reviewed. Specifically, it did not adequately document compensating factors, adequately evaluate the borrower's creditworthiness, correctly calculate income, or document the transfer of gift funds. Further, AmericaHomeKey (1) did not ensure that one loan closed in accordance with the loan's approval terms and (2) did not verify the previous housing obligation payment history for two loans reviewed. Additionally, AmericaHomeKey inappropriately used documents obtained from the seller.

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5 Appendix C is a schedule of indemnification and repayment amounts.

A single AmericaHomeKey underwriter approved the 13 loans with multiple deficiencies as outlined in the following table.

Summary of underwriting deficiencies

FHA case number	Compensating factor deficiencies	Questionable creditworthiness	Income deficiencies	Questionable documents	Questionable gift funds	Miscellaneous errors
495-7838607	x		x	x	x	
495-7871535		x		x		
421-4407985	x					
492-8043749	x			x		
491-9300557		x				x
422-2858487		x	x			
491-9144966	x	x				
221-4024471	x	x	x			x
011-5918674	x	x				
492-8004302	x		x			
091-4395020	x	x			x	
281-3386718	x					
421-4340956					x	x
Totals	9	7	4	3	3	3

We included case narratives describing the underwriting deficiencies for each loan in appendix D.

AmericaHomeKey Did Not Adequately Document Compensating Factors

For 9 of the 20 loans reviewed, the borrowers' qualifying ratios exceeded FHA established limits, and AmericaHomeKey did not document compensating factors as required. Qualifying ratios are used to determine whether borrowers can reasonably be expected to meet the expenses involved with home ownership and still provide for their families. FHA requires the lender to compute two ratios: (1) mortgage payment expense to effective income and (2) total fixed payment to effective income.[6] The first ratio considers the total mortgage payment to the borrower's income, while the second ratio considers all of the borrower's debts, including the mortgage payment, to the borrower's income. The qualifying ratios generally should not exceed 31 and 43 percent, respectively, without acceptable compensating factors.[7] When a borrower's qualifying ratios exceed FHA-established limits, FHA requires the underwriter to support loan approval with compensating factors and support the factors with documentation.[8] For four of the nine loans, the underwriter listed acceptable compensating factors[9] on the mortgage credit analysis worksheet but did not include documentation in the loan files to support that the compensating

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6 HUD Handbook 4155.1, REV-5, paragraph 2-12
7 Mortgagee Letter 2005-16
8 HUD Handbook 4155.1, REV-5, paragraph 2-13
9 HUD Handbook 4155.1, REV-5, paragraph 2-13, identifies FHA's compensating factors that are acceptable to justify loan approval when qualifying ratios exceed the FHA limits.

factors existed. The underwriter did not list acceptable compensating factors on the mortgage credit analysis worksheet for the remaining five loans.

AmericaHomeKey Did Not Adequately Evaluate Creditworthiness

AmericaHomeKey did not adequately evaluate the borrower's creditworthiness for 7 of the 20 loans reviewed. Past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions. 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. Major indications of derogatory credit, including judgments, collections, and other recent credit problems, require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file. Further, the lender must document reasons for approving a mortgage when the borrower has collection accounts or judgments.[10] FHA also requires the lender to include the debts of nonpurchasing spouses when the borrower resides in a community property State or if the property being insured is located in a community property State.[11]

Four of the seven loans had written explanations that were inconsistent with other credit information in the files. A fifth loan file did not contain a written explanation for derogatory credit. The sixth loan file contained a written explanation that, when analyzed against the credit history, showed a poor attitude toward credit obligations. There was no documentation in the loan file to show the underwriter's reasons for approving this mortgage. Finally, the seventh loan was for a property in a community property State and did not contain all of the necessary information to determine qualifying ratios because it did not include the nonpurchasing spouse's credit report.

[10] HUD Handbook 4155.1, REV-5, paragraph 2-3
[11] HUD Handbook 4155.1, REV-5, paragraph 2-2D

AmericaHomeKey Did Not Correctly Calculate Income or Verify Income Stability

AmericaHomeKey did not correctly calculate income for 3 of the 20 loans reviewed. Also, it did not verify income stability for a fourth loan.

FHA requires the lender to analyze the borrower's income to determine whether it can reasonably be expected to continue through at least the first 3 years of the mortgage loan. Lenders are allowed to include overtime income in the effective income calculation 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 the income for the past 2 years.[12] In two loans, the underwriter used an average income calculated from a period of less than 2 years.

In the third loan, the borrower had been employed at his commission-earning job for only 3 months before closing. The underwriter included the commission in the effective income calculation. However, commissions earned for less than 1 year are not allowed to be considered in the effective income calculation.[13]

AmericaHomeKey did not verify income stability for a fourth loan. FHA requires the lender to verify the borrower's employment for the most recent 2 full years and to explain gaps in employment spanning 1 month or more.[14] The underwriter obtained employment verification for only 1 year. The underwriter also verified other income from 5 years before the loan application, but the information was not current or relevant.

AmericaHomeKey Did Not Document Gift Fund Transfers

FHA requires the lender to document the transfer of gift funds from the donor to the borrower.[15] AmericaHomeKey did not document the transfer of gift funds for 2 of 20 loans reviewed. For another loan, the lender only documented $7,525, when the borrower received $8,200 in gift funds.

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[12] HUD Handbook 4155.1, REV-5, paragraph 2-7 and 2-7A
[13] HUD Handbook 4155.1, REV-5, paragraph 2-7D
[14] HUD Handbook 4155.1, REV-5, paragraph 2-6
[15] HUD Handbook 4155.1, REV-5, paragraph 2-10C

AmericaHomeKey Underwrote Loans With Other Significant Errors

AmericaHomeKey did not ensure that one loan closed in accordance with the loan's approval terms. Further, it did not verify the previous housing obligation payment history for 2 of the 20 loans reviewed.

Loan Did Not Close in Accordance With Approval Terms

AmericaHomeKey did not ensure that one loan closed in accordance with the loan approval terms. A person other than the borrower signed the mortgage security instrument for this loan. There was no evidence in the loan file that the lender reviewed this person's income, creditworthiness, assets, etc. FHA requires the loan to close in the same manner in which it was underwritten and approved. FHA may withhold endorsement of the loan if there are additional signatures on the security instruments or mortgage note of individuals not reviewed during mortgage credit analysis. [16]

Previous Housing Obligation Payment History Not Verified

AmericaHomeKey did not verify the previous housing obligation payment history for 2 of the 20 loans reviewed. FHA requires the lender to determine the borrower's housing obligation payment history through the credit report, verification of rent, verification of mortgage, or review of canceled checks covering the most recent 12-month period.[17] Neither of the loan files contained documentation to show that the underwriter verified the borrower's previous housing obligation payment history.

AmericaHomeKey Used Documents Obtained From the Seller

AmericaHomeKey should have rejected some documents that passed through the seller to the mortgage company for 3 of 20 loans reviewed. FHA prohibits lenders from accepting or using documents related to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties (real estate agents, builders, sellers) or by using their equipment.[18] For all three loans cited, the underwriter accepted income and credit documents that were faxed from the seller.

[16] HUD Handbook 4155.2, paragraph 6A2f
[17] HUD Handbook 4155.1, REV-5, paragraph 2-3A
[18] HUD Handbook 4155.1, paragraph 3-1

AmericaHomeKey's Quality Control Was Not Effective

All 20 loans reviewed were approved by the same underwriter. Of the 13 questioned loans, 9 required quality control reviews because they defaulted within the first 6 payments.[19] We requested copies of the quality control reviews for six of the nine questioned loans that defaulted within the first six payments, but AmericaHomeKey only provided documents for two of the reviews. Neither of the two reviews was completed in a timely manner,[20] and no findings or patterns of deficiencies were reported to HUD as required.[21] In addition, AmericaHomeKey did not provide evidence that it took corrective action in response to the two quality control reviews. FHA requires a lender's senior management to take prompt action to deal appropriately with any material findings in a quality control report. The final report or an addendum must identify actions being taken, the timetable for their completion, and planned follow-up activities.[22] Further, since AmericaHomeKey did not provide the other four quality control reviews requested, we could not determine whether it performed the reviews in accordance with requirements or whether it had performed the reviews at all.

Because AmericaHomeKey's quality control plan was ineffective, it did not identify patterns of deficient underwriting and did not perform quality control reviews in a timely manner. Further, it did not take prompt action to deal appropriately with quality control report findings.

Conclusion

AmericaHomeKey did not comply with HUD and FHA requirements in underwriting 13 of 20 manufactured home loans reviewed because its quality control procedures were not adequate to consistently identify and correct underwriting deficiencies in a timely manner. As a result, AmericaHomeKey originated more than $1.7 million in ineligible loans that resulted in losses to FHA's insurance fund totaling $538,132 and increased the risk to the insurance fund by more than $680,000.

[19] HUD Handbook 4060.1, REV-2, "FHA Title II Mortgagee Approval Handbook," paragraph 7-6D

[20] One review was completed 14 months after the first default, and the other review was completed 12 months after the first default.

[21] Mortgagee Letter 2005-26

[22] HUD Handbook 4060.1, REV-2, paragraph 7-3I

Recommendations

We recommend that the Acting Deputy Assistant Secretary of Single Family Housing require AmericaHomeKey to

1A. Indemnify HUD for four insured loans[23] with unpaid principal balances of $582,795, thereby putting an estimated $343,848 to better use based on the FHA insurance fund average loss rate of 59 percent of the unpaid principal balances.

1B. Indemnify HUD for four insured loans[24] with unpaid principal balances of $576,052, thereby putting an estimated $339,870 to better use where HUD paid claims but the properties had not been conveyed.

1C. Support or repay the FHA insurance fund $23,803 for claims paid as of July 31, 2011, or the current total amount of claims paid, on four insured loans (see footnote 24). If HUD has taken title to the properties or sold the properties, rather than seeking repayment of the claims paid, the amount to be repaid should be adjusted to the amount of the actual losses to FHA. If the properties are subsequently conveyed to HUD and sold, the loss amounts should be adjusted to reflect any amounts repaid pursuant to this recommendation.

1D. Reimburse the FHA insurance fund $514,329 for actual losses incurred on five insured loans.[25]

1E. Take actions to ensure that its quality control procedures are adequate to consistently identify and correct underwriting deficiencies in a timely manner.

We also recommend that the Acting Deputy Assistant Secretary

1F. Refer AmericaHomeKey to the Mortgagee Review Board for consideration of administrative actions for failure to implement a quality control program in compliance with HUD requirements, resulting in $538,132 in losses and claims and increased risk for future losses to the insurance fund.

We further recommend that the Director, Departmental Enforcement Center

1G. Take appropriate administrative sanctions, including possible debarment or other remedies, against the underwriter responsible for the 13 questioned loans.

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[23] FHA case numbers 422-2858487, 221-4024471, 011-5918674, and 421-4340956
[24] FHA case numbers 495-7838607, 421-4407985, 091-4395020, and 281-3386718
[25] FHA case numbers 495-7871535, 492-8043749, 491-9300557, 491-9144966, and 492-8004302

SCOPE AND METHODOLOGY

To accomplish our objective, we

- Reviewed applicable HUD regulations, requirements, and mortgagee letters;
- Reviewed reports and information on HUD's Neighborhood Watch and Single Family Data Warehouse systems;
- Reviewed AmericaHomeKey's written quality control plan;
- Analyzed AmericaHomeKey's quality control review reports for two loans;
- Reviewed AmericaHomeKey's loan files, policies, procedures, and independent audit reports; and
- Conducted interviews with applicable HUD staff, AmericaHomeKey staff, local county appraisal districts, the Texas comptroller, and borrowers.

During a previous audit of Gold Financial Services, an AmericaHomeKey branch office located in San Antonio, TX, we identified three loans with underwriting problems that were underwritten by the same AmericaHomeKey underwriter and were all for manufactured homes. Using HUD's Neighborhood Watch system, we determined the manufactured homes originated by that underwriter and selected all of the defaulted loans (20) for review. We used a nonrepresentative sample because we wanted to identify underwriting deficiencies on only the loans that defaulted and did not intend to project the test results on the population of loans. We did not evaluate the reliability of HUD's Neighborhood Watch system because we used the data for background purposes only.

Our original objective was to determine whether AmericaHomeKey originated and valued manufactured home loans in accordance with HUD and FHA loan requirements for defaulted loans endorsed between January 1, 2008, and December 31, 2009. Our valuation approach was to compare county appraisal district valuations with FHA appraised values. However, after we discussed appraisal objectives with the local county appraisal districts and the Texas comptroller, we found that the county valuations would not suit our objective without considerable effort to validate the values with actual sales. As a result, we modified our objective to determining whether AmericaHomeKey originated manufactured home loans in accordance with HUD and FHA requirements for loans with beginning amortization dates between March 1, 2008, and February 28, 2010.

We performed our fieldwork between August 4, 2010, and May 18, 2011, at our office in San Antonio, TX. AmericaHomeKey provided copies of its loan origination files.

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

INTERNAL CONTROLS

Internal control is 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 Deficiency

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

- AmericaHomeKey did not implement an effective quality control program to quickly identify poor underwriting and correct identified deficiencies (finding).

FOLLOW-UP ON PRIOR AUDITS

Audit Report 2011-FW-1002

On October 25, 2010, we issued audit report number 2011-FW-1002, Gold Financial Services, Inc., San Antonio, TX, Did Not Follow HUD Requirements in Originating Three Loans. That audit was of Gold Financial Services, Inc., a branch of AmericaHomeKey. We found that Gold Financial did not require two borrowers to explain recent poor credit and violated its own internal controls on a third loan concerning borrowers with poor credit when it did not require the borrowers to have 3 months reserves in accordance with Gold Financial's closing instructions. The report contained the following recommendations:

- Indemnify HUD for one insured loan (number 495-7829555) with an 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.

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

The recommendations in the prior audit report remain open pending completion of actions. We noted similar findings in this audit as listed below.

- AmericaHomeKey approved loans with questionable borrower creditworthiness.
- AmericaHomeKey approved loans without documenting that adequate cash reserves were available.

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A			$343,848
1B			339,870
1C		$23,803	
1D	$514,329		
Totals	$514,329	$23,803	$683,718

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/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. Implementation of our recommendation to require AmericaHomeKey to indemnify HUD for the nine loans that were not originated in accordance with HUD-FHA requirements will reduce FHA's risk of loss to the insurance fund. The amount reflects that, upon the sale of the mortgaged property, FHA's average loss experience is about 59 percent of the unpaid principal balance. The 59 percent loss rate is based on HUD's Single Family Acquired Asset Management System's Case Management Profit and Loss by Acquisition computation for Fiscal Year 2010 based on actual sales.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

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August 17, 2011

VIA FEDERAL EXPRESS

Mr. Gerald R. Kirkland
Regional Inspector General for Audit - Region VI
U.S. Department of Housing and Urban Development
Office of the Inspector General
819 Taylor Street, Suite 13A09
Fort Worth, TX 76102

RE: AmericanHomeKey, Inc.
HUD OIG Draft Audit Report

Dear Mr. Kirkland:

K&L Gates LLP represents AmericaHomeKey, Inc. ("AHK") in connection with the above-referenced matter. AHK is in receipt of the draft audit report ("Report"), dated August 1, 2011, from the U.S. Department of Housing and Urban Development ("HUD") Office of Inspector General ("OIG"). Enclosed please find AHK's written reply to the Report, with supporting documentation. As demonstrated in the enclosed reply and corresponding exhibits, AHK maintains that the company generally adhered to HUD requirements and guidelines in connection with both the underwriting of the files cited in the Report and implementation of its Quality Control program. For these reasons, AHK believes that many of the Report's allegations are unwarranted and should be removed from the final report. After the Report is finalized, we would appreciate it if the OIG would provide us with a copy of the final version. If you have any questions, please contact me at (202) 778-9027 or Emily Booth at (202) 778-9112.

Thank you for your kind consideration.

Sincerely,

Phillip L. Schulman

cc: Lane Terrell, President and CEO, AHK
Emily J. Booth, Esq., K&L Gates, LLP

AMERICAHOMEKEY INC
Where America Comes Home

August 16, 2011

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 VI
819 Taylor Street
Suite 13A09
Fort Worth, TX 76102

RE: AmericaHomeKey, Inc.
HUD OIG Draft Audit Report

AmericaHomeKey, Inc. ("AHK" or "Company") is in receipt of the Draft Audit Report ("Report"), dated August 1, 2011, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of Inspector General ("OIG"). The Report is based on a review of the Company conducted between August 4, 2010 and May 18, 2011. The audit covers 20 loans originated by the Company with beginning amortization dates between March 1, 2008 and February 28, 2010.[1]

The Report states that its objective was to determine whether AHK complied with HUD requirements in the origination of Federal Housing Administration ("FHA") insured manufactured home loans. The Report contains one finding, alleging underwriting deficiencies in 13 cases and stating concerns with the effectiveness of the Company's Quality Control reviews. Based on this finding, the Report recommends that HUD require AHK to indemnify the Department in connection with nine loans, including reimbursement to HUD for full and partial claims that HUD paid on seven loans and actual losses incurred on two loans, as well as take action to ensure the Company's Quality Control procedures are adequate to identify and correct underwriting deficiencies in a timely manner.

[1] AHK ceased underwriting manufactured home loans in January 2009. Thus, the 20 loans reviewed by the OIG were all originated in 2008.

At the outset, AHK would like to emphasize and reassure the OIG that AHK has ample controls in place to ensure compliance with FHA requirements and, in fact, the Company has substantially complied with such requirements and other applicable rules and regulations since its inception. AHK consistently has had robust Quality Control measures in place, including fraud detection and prevention measures, adequately supervised its employees on a day-to-day basis, and acted in good faith with respect to all matters raised in the Report. At no time did AHK knowingly act contrary to FHA requirements and the Company has continuously strived to act in full compliance with applicable rules and regulations.

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 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 that the lender 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 lender. 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 60 FHA-approved branch offices and employs over 500 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 16 principals and acts as principal for 14 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. It strives to comply with applicable rules and regulations and is committed to educating and training employees on FHA compliance matters. In addition, AHK is dedicated to customer service. It aims to make the lending process as simple as possible for borrowers and works closely with each individual applicant to ensure that he or she receives the type of financing that best fits his or her needs. Throughout its existence, AHK has endeavored to provide dependable and professional service and repeatedly has demonstrated its commitment to borrowers and allegiance to the FHA program.

Here, it is important to note that an individual whom AHK no longer employs underwrote all of the loans cited in the Report. Moreover, the Company has made significant changes to its FHA-insured loan program to improve its underwriting quality and overall loan performance. In addition to the fact that AHK ceased underwriting manufactured home loans in January 2009, 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 may ask questions and access current resources to make informed and accurate decisions, and all underwriters undergo mandatory underwriting product training. AHK's management generates weekly "Points to Ponder" to remind the Company's production team of important updates, and 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.

AHK also has strengthened its underwriting guidelines over the past few years. 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 couple. These changes have greatly improved the quality and performance of the Company's FHA-insured loan portfolio. In fact, the Report acknowledges that only 47 loans out of a total of 13,838 loans originated by the Company in 2009 and 2010 resulted in claims, which is a mere 0.3% of AHK's total originations.

II. <u>RESPONSE TO THE FINDING</u>

The Report contains one finding, including several sub-findings, in which it alleges that AHK did not originate 13 manufactured home loans in accordance with HUD requirements and did not ensure that its Quality Control procedures were effective in identifying and correcting underwriting deficiencies. Upon receipt of the draft Report,

Comment 34

Comment 34

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. Its 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 AHK recognizes 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 general compliance with HUD/FHA requirements and adherence to prudent lending standards. Below we reply to the individual matters raised in the Report, evidence our adherence to FHA requirements in connection with the findings and several cited loans, and set forth our opposition to the manner in which the recommendations are presented in the Report.

A. AHK COMPLIED WITH HUD's UNDERWRITING GUIDELINES

The Report asserts in several sub-findings that the Company did not originate and underwrite 13 loans in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) documenting compensating factors; (2) evaluating creditworthiness; (3) income calculation/documentation; (4) documentation of gift funds; (5) document transmittal from third parties; and (6) other miscellaneous issues. We address each of these individual allegations in turn below.

1. Compensating Factors

In 10 cases, the Report asserts that the borrowers exceeded HUD's recommended debt-to-income ratios without valid compensating factors documented in the "Remarks" section of the Mortgage Credit Analysis Worksheet ("MCAW") and the loan file.

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

Furthermore, the Department expressly permits a mortgagee to approve FHA financing to a borrower with qualifying ratios that exceed the benchmark guidelines of

31% and 43% where significant compensating factors justify loan approval. See, e.g., HUD Handbook 4155.1, REV-5, ¶¶ 2-12, 2-13; Mortgagee Letter 2005-16.[2] The Department has professed that the "FHA does not set an arbitrary percent by which ratios may be exceeded but rather FHA relies on the underwriter to judge the overall merits of the loan application and to determine what compensating factors apply and the extent to which those factors justify exceeding the ratios." Mortgagee Letter 00-24 (emphasis added). Thus, where a potential borrower's qualifying ratios are high, an underwriter has to consider all relevant circumstances and exercise discretion in deciding whether to approve or reject a loan. This discretion is particularly important when the same loans underwritten manually could be submitted through an automated underwriting system and receive approval with much higher qualifying ratios. With different standards for varying types of underwriting, the Department must rely on underwriters to analyze a borrower's financial circumstances and take into account all relevant factors, including the range of acceptable levels in qualifying ratios.

It is AHK's policy and practice to consider carefully each borrower's circumstances and document significant compensating factors in the "Remarks" section of the MCAW and in the file in compliance with HUD guidelines. This policy has been in place since the Company's inception, and AHK management regularly reminds its employees of the importance of ensuring that debt-to-income ratios in excess of HUD's guidelines are justified by significant compensating factors. Contrary to the allegations in this sub-finding, when the borrowers' qualifying ratios exceeded 31% and 43% in the cases cited in the Report, AHK identified significant compensating factors permitted by HUD to justify loan approval, obtained the necessary documentation to support these factors, and included the documentation in the loan file and/or noted the factors in the "Remarks" section of the MCAW. We address the allegations raised in each of the 10 cited loans below.

a. [redacted] FHA Case No. 495-7838607

In this case, the Report asserts that the file did not document adequate factors to compensate for the borrower's back-end ratio of 46%, which exceeded HUD's benchmark guideline. Contrary to this allegation, AHK noted valid compensating factors that were sufficient to justify loan approval in the Remarks section of the MCAW and that were supported by loan file documentation.

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

Comment 1

Comment 2

The underwriter's comments in the Remarks section of the MCAW **(Exhibit A-1)** note that the borrower had "good reserves" and "not a lot of debt," both of which were allowable compensating factors. With respect to reserves, FHA guidelines provide that at least three months' worth of cash reserves after closing may be considered a compensating factor to justify approval of mortgage loans with ratios exceeding 31% and 43%. See HUD Handbook 4155.1, REV-5, ¶ 2-13(G). As the Report notes, the underwriter documented cash reserves in this case totaling $7,054 on the MCAW, which satisfies the three-month reserve requirement for use as a compensating factor. The Report alleges, however, that the borrower only had assets of $1,555 per the borrower's Verification of Deposit ("VOD") **(Exhibit A-2)**. That is not the case. In addition to the $1,555 reflected on the VOD, the borrower maintained $9,774.84 in an Employee Stock Ownership Plan **(Exhibit A-3)**, which provided the borrower with the option of cashing-out by taking a taxable distribution of all or part of the fund. With the assets documented on the VOD and the Employee Stock Ownership Plan, the loan file demonstrates the borrower had ample cash reserves to serve as a compensating factor.

Moreover, the underwriter also identified "not a lot of debt" on the MCAW as a compensating factor. While the Report suggests that a low level of debt is not listed as a compensating factor by HUD, AHK notes the HUD Handbook provision expressly providing that a borrower's "ability to accumulate savings" and "conservative attitude toward the use of credit" are significant compensating factors. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C). Here, the borrower's low monthly obligations reflected on the MCAW **(Exhibit A-1)** and supported by the credit history in the loan file **(Exhibit A-4)** demonstrate the borrower's conservative attitude towards the use of credit, and the borrower's substantial cash reserves discussed above demonstrate the ability to accumulate savings.

For the foregoing reasons, the borrower's significant cash reserves and minimal debt, both of which were noted on the MCAW and documented in the file, constituted sufficient compensating factors expressly permitted by HUD to offset the slightly higher-than-average back-end ratio in this case. AHK further notes that the borrower's housing expenses were increasing by only $168.96 **(Exhibit A-1)**, and the borrower had a stellar rental history **(Exhibit A-5)**; therefore, there was only a minimal increase in housing expense, which constitutes another significant compensating factor that would justify loan approval. See HUD Handbook 4155.1 REV-5, ¶ 2-13(F). The borrower qualified for FHA financing and indemnification is not warranted. Thus, we respectfully request that this finding be removed from the final report.

b. [redacted] FHA Case No. 421-4407985

In this case, the Report asserts that the borrower's qualifying ratios exceeded HUD's benchmark guidelines and the compensating factors listed in the Remarks section of the MCAW, which included the borrower's 1.5 months of cash reserves, a paid off judgment, and a low level of debt, were not valid compensating factors.

The borrower's qualifying ratios in this case were 33.73% and 37.06% **(Exhibit B-1)**. As the back-end ratio was significantly lower than the benchmark of 41%, the Report questions the front-end ratio of 33.73%, which slightly exceeded the 31% benchmark. Contrary to the allegation in the Report, however, the loan file documented significant compensating factors expressly permitted by HUD that justified approval of the borrower for FHA financing. As stated in the Report, the underwriter noted the borrower's payment of a judgment, low debt, and 1.5 months of cash reserves in the Remarks section of the MCAW **(Exhibit B-1)**. The borrower's credit documentation in the file evidenced only $167 in recurring monthly expenses and satisfaction of the judgment **(Exhibit B-2)**, and the borrower's checking account, as evidenced on the VOD, supported the $1,889.77 in cash reserves listed on the MCAW **(Exhibit B-3)**. The low monthly obligations reflected the borrower's conservative attitude towards the use of credit, and the $1,889.77 in savings reflected the borrower's ability to accumulate savings, both of which the Department has provided constitute significant compensating factors that justify loan approval when a borrower's qualifying ratios exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C)

Comment 3

What's more, as previously noted, the borrower's back-end ratio was well within the benchmark guideline in this case. While the front-end ratio was 32.72% - 1.72% above the 31% benchmark – HUD guidelines provided that, "for borrowers with limited recurring expense, greater latitude is permissible on this ratio than on the total fixed payment ratio" of 43%. See HUD Handbook 4155.1 REV-5, ¶ 2-12(A). Again, the borrower had limited recurring expenses of only $167 per month, and the front-end ratio was only 32.72%.

Contrary to the allegation in the Report, significant compensating factors expressly permitted by HUD and documented in the file justified approval for FHA financing in the [redacted] loan. The underwriter reasonably determined that these valid compensating factors offset the higher front-end ratio in this case and properly noted the factors in the Remarks section of the MCAW and documented them in the file. The Company complied with HUD guidelines in this case and, as a result, we respectfully submit that this finding should be removed from the final report.

c. [redacted] FHA Case No. 492-8043749

In this case, the Report asserts that the file did not document adequate factors to compensate for the borrower's qualifying debt-to-income ratios of 38% and 47%, which exceeded HUD's benchmark guidelines. Contrary to this allegation, AHK recorded valid compensating factors that were sufficient to justify loan approval on the MCAW and that were supported by loan file documentation.

Mr. Gerald R. Kirkland
August 16, 2011
Page 8

Comment 4

First, the MCAW notes that the borrower had $2,500 in cash reserves and had a low level of debt **(Exhibit C-1)**, which was just shy of the $2,758.92 that constituted three months' worth of reserves. Moreover, the borrower's credit reports evidenced only $214 in recurring monthly expenses **(Exhibit C-2)**. The low monthly obligations reflected the borrower's conservative attitude towards the use of credit, and the nearly three months worth of cash reserves reflected the borrower's ability to accumulate savings, both of which the Department has provided constitute significant compensating factors that justify loan approval when a borrower's qualifying ratios exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C)

Comment 5

Additionally, the underwriter noted on the MCAW that the borrower's overtime pay was used as a compensating factor **(Exhibit C-1)**. While overtime income must be "likely to continue" in order to be used as effective income, there is no such requirement to document the likelihood that overtime income will continue in order to use such income as a compensating factor; in order to qualify as a compensating factor, the loan file must simply document that the borrower receives "compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage." Compare HUD Handbook 4155.1 REV-5, ¶ 2-7(A) with HUD Handbook 4155.1 REV-5, ¶ 2-13(E). Here, the overtime income was reflected on the borrower's pay stubs **(Exhibit C-3)** and therefore was sufficiently documented in the loan file to be used as a compensating factor.

Significant compensating factors expressly permitted by HUD and documented in the file justified approval for FHA financing in the [redacted] case. The underwriter reasonably determined that valid compensating factors offset the higher ratios in this case and properly noted these factors in the Remarks section of the MCAW and documented them in the file. The Company complied with HUD guidelines in this case and, as a result, we respectfully submit that this finding should be removed from the final report.

d. [redacted] FHA Case No. 491-9144966

In this case, the Report asserts that the file did not document adequate factors to compensate for the borrower's qualifying debt-to-income ratios of 33% and 45%, which exceeded HUD's benchmark guidelines. Contrary to this allegation, AHK recorded valid compensating factors that were sufficient to justify loan approval on the MCAW and that were supported by loan file documentation.

Comment 6

Specifically, the MCAW notes that the borrower had one month in cash reserves and had a low level of debt **(Exhibit D-1)**. The borrower's credit documentation evidenced only $441 in recurring monthly expenses **(Exhibit D-2)**, and the borrower's VOD supports the $1,141 in cash reserves noted on the MCAW **(Exhibit D-3)**. The low monthly obligations reflected the borrower's conservative attitude towards the use of credit, and the cash reserves reflected the borrower's ability to accumulate savings. As discussed above, HUD has provided that both of these facts constitute significant compensating factors that justify loan approval when a borrower's qualifying ratios exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C).

Contrary to the allegation in the Report, the underwriter reasonably determined that valid compensating factors offset the higher ratios in this case and properly noted these factors in the Remarks section of the MCAW and documented them in the file. AHK complied with HUD guidelines in this case and, as a result, this finding should be removed from the final report.

e. [redacted] FHA Case No. 221-4024471

In this case, the Report asserts that the file did not document adequate factors to compensate for the borrower's qualifying debt-to-income ratios of 36% and 45%, which exceeded HUD's benchmark guidelines. Contrary to this allegation, AHK recorded valid compensating factors that were sufficient to justify loan approval on the MCAW and that were supported by loan file documentation.

Comment 7

The MCAW notes that the borrower had cash reserves and had a low level of debt **(Exhibit E-1)**.[3] The borrower's credit documentation evidenced only $199 in recurring monthly expenses **(Exhibit E-2)**, and the borrower's bank statements evidenced $2,200 in cash reserves **(Exhibit E-3)**, which was just $97.04 shy of three months worth of reserves. The low monthly obligations reflected the borrower's conservative attitude towards the use of credit, and the cash reserves reflected the borrower's ability to accumulate savings. Again, HUD has provided that both of these facts constitute significant compensating factors that justify loan approval when a borrower's qualifying ratios exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C).

Contrary to the allegation in the Report, the underwriter reasonably determined that valid compensating factors offset the higher ratios in this case and properly noted these factors in the Remarks section of the MCAW and documented them in the file. AHK complied with HUD guidelines in this case and, as a result, this finding should be removed from the final report.

[3] While the Report claims that the MCAW states the borrower has 8 months of cash reserves, please note that the underwriter indicated on the MCAW that the borrower has "3" months of cash reserves – not "8" – and lists an amount of $2,199.50 on Line 12L.

Mr. Gerald R. Kirkland
August 16, 2011
Page 10

f. [redacted] FHA Case No. 011-5918674

In this case, the Report asserts that the file did not document adequate factors to compensate for the borrowers' debt-to-income ratio of 32%, which exceeded HUD's benchmark guideline of 31%.

The borrowers' qualifying ratios in this case were 32% and 39.5% **(Exhibit F-1).** As the back-end ratio was lower than the benchmark of 41%, the Report questions the front-end ratio of 32%, which slightly exceeded the 31% benchmark. Contrary to the allegations in the Report, however, AHK documented significant compensating factors to justify loan approval in this case. As noted in the Remarks section of the MCAW, the borrowers had one month in cash reserves and had a low level of debt **(Exhibit F-1).** The borrowers' credit documentation evidenced only $249 in recurring monthly expenses **(Exhibit F-2),** and the borrowers' bank statements support the $1,475.40 in cash reserves listed on the MCAW **(Exhibit F-3)**. The low monthly obligations reflected the borrowers' conservative attitude towards the use of credit, and the cash reserves reflected the borrowers' ability to accumulate savings. Again, HUD has provided that both of these facts constitute significant compensating factors that justify loan approval when a borrower's qualifying ratios exceed the benchmark guidelines. <u>See</u> HUD Handbook 4155.1 REV-5, ¶ 2-13(C).

Comment 8

What's more, as previously noted, the borrowers' back-end ratio was within the benchmark guideline in this case. While the front-end ratio was 32% - 1% above the 31% benchmark – HUD guidelines provided that, "for borrowers with limited recurring expense, greater latitude is permissible on this ratio than on the total fixed payment ratio" of 43%. <u>See</u> HUD Handbook 4155.1 REV-5, ¶ 2-12(A). Again, the borrowers here had limited recurring expenses of only $249 per month, and the front-end ratio was only 32%.

Contrary to the allegation in the Report, significant compensating factors expressly permitted by HUD and documented in the file justified approval for FHA financing in the [redacted] loan. The underwriter reasonably determined that these valid compensating factors offset the higher front-end ratio in this case and properly noted the factors in the Remarks section of the MCAW and documented them in the file. The Company complied with HUD guidelines in this case and, as a result, we respectfully submit that this finding should be removed from the final report.

g. [redacted] FHA Case No. 492-8004302

In this case, the Report asserts that the file did not document adequate factors to compensate for the borrowers' qualifying debt-to-income ratios of 33% and 44%, which exceeded HUD's benchmark guidelines. Contrary to this allegation, AHK recorded valid

Comment 9

Comment 10

compensating factors that were sufficient to justify loan approval on the MCAW and that were supported by loan file documentation.

Specifically, the MCAW notes that the borrowers had two months in cash reserves and had a low level of debt **(Exhibit G-1)**. Moreover, the borrowers' credit documentation evidenced only $359 in recurring monthly expenses **(Exhibit G-2)**. The low monthly obligations reflected the borrowers' conservative attitude towards the use of credit, and the cash reserves reflected the borrowers' ability to accumulate savings. As discussed above, HUD has provided that both of these facts constitute significant compensating factors that justify loan approval when borrowers' qualifying ratios exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C).

Contrary to the allegation in the Report, the underwriter reasonably determined that valid compensating factors offset the higher ratios in this case and properly noted these factors in the Remarks section of the MCAW and documented them in the file. AHK complied with HUD guidelines in this case and we therefore respectfully submit that this finding should be removed from the final report.

h. [redacted] FHA Case No. 091-4395020

In this case, the Report asserts that the file did not document adequate factors to compensate for the borrower's qualifying debt-to-income ratios of 36% and 48%, which exceeded HUD's benchmark guidelines. Contrary to this allegation, AHK recorded valid compensating factors that were sufficient to justify loan approval on the MCAW and that were supported by loan file documentation.

The MCAW notes that the borrower had three months' cash reserves and had a low level of debt **(Exhibit H-1)**. The Report acknowledges that the three months' reserves constitute a sufficient compensating factor to justify loan approval in this case, but suggests that the reserves were not documented in the file. Although AHK is unable to locate the borrower's asset documentation at this time to demonstrate the cash reserves, such documentation would have been obtained at the time of loan approval. Notably, as stated in the Report, this loan closed in May 2008, over three years ago. An originating lender, however, must retain the entire case file pertaining to loan origination for only two years after endorsement. See prior HUD Handbook 4000.2 REV-3, ¶ 5-8. The fact that AHK no longer can locate the requested documentation does not mean it was not contained in the original loan file, and it was the Company's policy and procedure to obtain such items. Furthermore, the file documented minimal recurring expenses of only $398 per month, as reflected in the borrower's credit documentation **(Exhibit H-2)**. The low monthly obligations reflected the borrower's conservative attitude towards the use of credit, which HUD has acknowledged is a significant compensating factor that justifies loan approval when a borrower's qualifying ratios exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C).

Mr. Gerald R. Kirkland
August 16, 2011
Page 12

Thus, even without considering the borrower's significant cash reserves, the borrower still qualified for FHA financing in this case.

The underwriter reasonably determined that valid compensating factors offset the higher ratios in this case and properly noted these factors in the Remarks section of the MCAW. The Company complied with HUD guidelines in connection with this loan and we therefore respectfully submit that this finding should be removed from the final report.

Comment 11

i. [redacted] FHA Case No. 281-3386715

In this case, the Report asserts that the file did not document adequate factors to compensate for the borrower's qualifying debt-to-income ratios of 34% and 45%, which exceeded HUD's benchmark guidelines. Contrary to this allegation, AHK recorded valid compensating factors that were sufficient to justify loan approval on the MCAW and that were supported by loan file documentation.

Comment 12

The underwriter noted on the MCAW that the borrower had two months in cash reserves and had a low level of debt **(Exhibit I-1)**. The borrowers' credit documentation evidenced only $368 in recurring monthly expenses **(Exhibit I-2)**, and the borrower's bank statements supported the $2,075.10 in cash reserves listed on the MCAW **(Exhibit I-3)**. The low monthly obligations reflected the borrower's conservative attitude towards the use of credit, and the cash reserves reflected the borrower's ability to accumulate savings. Again, according to HUD, both of these facts constitute significant compensating factors that justify loan approval when borrowers' qualifying ratios exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C).

The foregoing compensating factors justified approval for FHA financing in the [redacted] loan. The underwriter reasonably determined that valid compensating factors offset the higher ratios in this case and properly noted these factors in the Remarks section of the MCAW and documented them in the file. AHK complied with HUD guidelines in this case and, as a result, this finding should be removed from the final report.

j. [redacted] FHA Case No. 421-4340956

In this case, the Report asserts that the file did not document adequate factors to compensate for the borrower's qualifying debt-to-income ratios of 34% and 42%, which exceeded HUD's benchmark guidelines.

The borrowers' qualifying ratios in this case were 34.31% and 41.6% **(Exhibit J-1)**. While the back-end ratio was well within the 43% benchmark, the front-end ratio exceeded the 31% benchmark by 3.31%. The underwriter, however, documented

Comment 13

sufficient compensating factors to justify loan approval. As stated in the Report, the underwriter noted that the borrower had one month of cash reserves and a low level of debt. The cash reserves, evidenced by the borrower's asset documentation **(Exhibit J-2)**, reflected his ability to accumulate savings, and the low level of debt totaling only $246 per month, as evidenced by the borrower's credit documentation **(Exhibit J-3)**, demonstrated a conservative attitude towards the use of credit. HUD has provided that both of these facts constitute significant compensating factors that justify loan approval when a borrower's qualifying ratios exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C).

What's more, as previously noted, the borrower's back-end ratio was within HUD's benchmark guideline. While the front-end ratio was 34.31%, HUD guidelines provided that, "for borrowers with limited recurring expense, greater latitude is permissible on this ratio than on the total fixed payment ratio" of 43%. See HUD Handbook 4155.1 REV-5, ¶ 2-12(A). Again, the borrower here had limited recurring expenses of only $246 per month.

Contrary to the allegation in the Report, significant compensating factors expressly permitted by HUD and documented in the file justified approval for FHA financing in the [redacted] loan. The underwriter reasonably determined that these valid compensating factors offset the higher front-end ratio in this case and properly noted the factors in the Remarks section of the MCAW and documented them in the file. The Company complied with HUD guidelines in this case and, as a result, we respectfully submit that this finding should be removed from the final report.

2. Credit Analysis

In seven cases, the Report questions AHK's evaluation of the borrowers' creditworthiness. 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. See HUD Handbook 4155.1 REV-5, ¶ 2-3. While HUD has established specific guidelines, credit analysis remains largely subjective. For example, where derogatory credit items are present, lenders have discretion to consider the borrower's unique circumstances and determine whether financing is appropriate. As discussed above, the Department has recognized that underwriting is more of an art than a science and requires the careful weighing of the circumstances in each individual case. Thus, it is 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. AHK takes its underwriting responsibility seriously and never knowingly would 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 for each of the loans below.

a. [redacted] FHA Case No. 495-7871535

In this case, the Report asserts that the release letters for the two active tax liens shown on the borrowers' credit reports were faxed from the seller **(Exhibit K-1)**. Additionally, the Report asserts that there were no written explanations in the loan file to explain the tax liens.

With respect to the tax lien release letters, AHK understands and appreciates that "[l]enders 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." HUD Handbook 4155.1 REV-5, ¶ 3-1; see also HUD Handbook 4000.2 REV-3, ¶ 3-5. It is the Company's policy and practice to obtain credit documents directly from the providers of these documents and to ensure that faxed documentation is accurate and complete. While the Company does not dispute that the tax lien releases were faxed from the builder's fax machine in this case, please note that this occurrence was isolated and against Company policy. It likely occurred as a result of the borrowers' use of the builder's fax machine as a convenience to transmit these documents to the Company, and it does not reflect a pattern or practice at AHK. Moreover, there is no reason to question the authenticity of the releases in this case. The release of liens is a matter of public record and the tax lien releases in this case could easily be verified through the

Mr. Gerald R. Kirkland
August 16, 2011
Page 15

county recorder's office. In fact, AHK's policy is to reverify the release of liens through a county website prior to loan approval, which would have occurred in this case. Nevertheless, AHK has reminded its employees of the importance of examining every document used to qualify borrowers to ensure that it comes directly from either the provider of the document or the borrowers, and does not pass through the hands of an interested third party.

Comment 14

With respect to any borrower explanation of the tax liens, AHK understands and appreciates HUD's requirement for sufficient written explanation from the borrowers for any major indications of derogatory credit, including judgments, collections, and any other recent credit problems. See HUD Handbook 4155.1 REV-5, ¶ 2-3. It is AHK's policy and practice to obtain such documentation. The Company recognizes, however, that a letter of explanation for the tax liens was not included in the loan file in this case. While the exclusion is an anomaly and does not reflect AHK policy, please note that issues surrounding the [redacted] loan have already been resolved by AHK and HUD pursuant to an indemnification agreement dated December 3, 2010 **(Exhibit K-2)**. AHK therefore requests removal of this loan from the final report.

b. [redacted] FHA Case No. 491-9300557

Comment 15

In this case, the Report asserts that the credit documentation for the nonpurchasing spouse was not included in the loan file for purposes of credit analysis. AHK understands and appreciates FHA's requirement to obtain a credit report for the nonpurchasing spouse when the borrower resides or the property is located in a community property state, like Texas. See HUD Handbook 4155.1 REV-5, ¶ 2-2D. It is AHK's policy and practice to obtain credit reports for nonpurchasing spouses in all such states in order to determine the borrower's debt-to-income ratio. In the [redacted] case, however, the Company has been unable to locate the nonpurchasing spouse's credit report to date. The file closed in September 2008, nearly three years ago, and it is possible that the file is no longer complete. Nevertheless, there is no reason to believe that the non-purchasing spouse's credit report reflected liabilities that did not also appear on the borrower's credit report, a copy of which is contained in the file **(Exhibit L-1)**.

c. [redacted] FHA Case No. 422-2858487

In this case, the Report asserts that the borrower's credit report showed several charged off accounts and late payment histories. While the loan file contains a letter of explanation stating the borrower was unemployed for several months, the Report alleges that the letter of explanation did not explain the entire period of poor credit.

When there are major indications of derogatory credit in a file, FHA guidelines "require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file." HUD Handbook 4155.1 REV-5, ¶ 2-3. HUD has not issued any guidance concerning the level of specificity required in a letter of explanation, and it is within the underwriter's discretion to determine whether explanations of derogatory credit are "sufficient" and whether they "make sense" and are "consistent with other credit information in the file." Here, the borrower's credit report reflected derogatory credit items with most accounts becoming past due in 2006, 2007 and 2008 **(Exhibit M-1)**, and the borrower's Uniform Residential Loan Application ("URLA") noted gaps in employment in early 2006 and early 2008 **(Exhibit M-2)**. The underwriter obtained a written explanation from the borrower in which the borrower indicated that he had been unemployed for several months, causing the delinquent accounts **(Exhibit M-3)**. When a borrower faces

Comment 16

periods of unemployment, even those that are short in duration, it is reasonable to assume that the after-effects of a loss of income would have more than a short-term impact on the borrower's ability to pay his own accounts going forward as such expenditures could deplete savings accounts, lower credit scores, and cause an increase in interest rates when newer accounts are opened. The underwriter determined that the borrower's explanation made sense and was not inconsistent with other file documentation. The required documents therefore were obtained and the loan approval decision was permissible.

d. [redacted] FHA Case No. 491-9144966

In this case, the Report asserts that the borrower's credit report showed several accounts with chargeoffs and that the written explanation stated all of the derogatory credit was old and that the borrower was using an agency to clean up her credit. It alleges, however, that there was no documentation from a credit counseling agency in the file.

As previously noted, when there are major indications of derogatory credit, a lender is required to obtain a written explanation from the borrower that makes sense and is consistent with other credit information in the file. <u>See</u> HUD Handbook 4155.1 REV-5, ¶ 2-3. HUD has not issued any guidance concerning the level of specificity required in a letter of explanation, and, while it is AHK's policy to obtain documentation to support a borrower's letter of explanation, the published guides do not require such documentation (only that the information be consistent with anything else in the file). Here, the borrower furnished a letter of explanation indicating that she was using an

Comment 17

agency to assist her with credit clearance issues **(Exhibit D-4)**, and the credit report supports that some of the delinquent accounts were in dispute **(Exhibit D-2)**. In addition, it is clear from the loan file that the underwriter followed up with the borrower on the issue via the telephone in order to obtain a more complete credit explanation **(Exhibit D-5)**. Nothing in the file contradicted the borrower's explanation of work with a credit counseling agency Thus, the underwriter determined that the information provided was sufficient and made sense. The underwriter's determination was permissible, and the underwriter was justified in qualifying the borrower based on this explanation. AHK complied with published HUD guidelines in this case and we therefore respectfully submit that this finding should be removed from the final report.

e. [redacted] FHA Case No. 221-4024471

In this case, the Report asserts that the borrower's credit report showed several accounts were charged off **(Exhibit E-2)** and that the borrower provided an explanation indicating that she had been ill and paid the accounts in full **(Exhibit E-4)**, but that there was no documentation in the loan file to show that the accounts had been paid.

Comment 18

It is AHK's policy and procedure to verify that accounts have been charged off during the credit analysis process and to obtain a copy of the documentation evidencing such chargeoffs. We note that the loan was processed over three years ago and, given the FHA requirement to retain loan origination files for only two years (HUD Handbook 4000.2 REV-3, ¶ 5-8), AHK has been unable to locate this documentation. Nevertheless, there is no evidence to suggest that the accounts were not paid off as disclosed by the borrower in the letter of explanation. In general, the borrower's accounts showed a conservative attitude toward credit, with the borrower's credit history evidencing only $199 in recurring monthly expenses **(Exhibit E-2)**, and the borrower's bank statements evidencing $2,200 in cash reserves **(Exhibit E-3)**.

f. [redacted] FHA Case No. 011-5918674

In this case, the Report asserts that the borrowers' credit report showed several accounts in collection or charged off. It notes the letter of explanation stating that one of the borrower's complications during pregnancy contributed to the derogatory credit, but alleges that there was no evidence in the file to show the borrowers' attempted to pay delinquent accounts once she returned to health. The Report alleges that the borrowers' failure to pay the accounts illustrated a poor attitude towards credit obligations and that there was no documentation in the file showing the lender's reasons for approving the mortgage.

AHK disagrees with the characterization of the borrowers in the Report, and the Company complied with FHA requirements in this case. In compliance with FHA's requirement that a lender obtain written explanation from the borrower for major indications of derogatory credit that makes sense and is consistent with other file documents, see HUD Handbook 4155.1 REV-5, ¶ 2-3, the underwriter obtained a letter of explanation from the borrower describing the reasons for her previous poor credit **(Exhibit F-4)**. The borrower explained that she had suffered pregnancy complications that resulted in a temporary inability to work. Moreover, contrary to the suggestion in the Report, the file evidenced that the borrowers took their financial obligations

Comment 19

seriously, sought to restore good credit, and in fact was settling accounts as possible. To this end, the loan file includes updated documentation showing that the borrowers satisfied some of the delinquent accounts and demonstrating that the co-borrower's credit situation improved when her health improved and she retained higher paying employment **(Exhibit F-5)**. In addition, the Verification of Rent ("VOR") reflected that the borrowers had been making their housing payments on time with no late payments in nearly three years **(Exhibit F-6)**. Significantly, according to HUD, an applicant's payment on previous housing expenses is at the top of the credit hierarchy; "[t]he payment history of the borrower's housing obligations holds significant importance in evaluating credit." HUD Handbook 4155.1 REV-5, ¶ 2-3. The borrower's perfect rental history therefore was of paramount importance in this case.

In determining whether to approve financing here, the underwriter considered the totality of the circumstances. The fact that the borrower had a reasonable explanation for past derogatory credit (i.e., pregnancy complications) that made sense and was consistent with other file documentation, coupled with her efforts to obtain higher paying employment and satisfy existing obligations where possible and a stellar three-year rental history, led to the reasonable conclusion that the period of financial difficulty in the past was not reflective of the borrower's overall attitude towards credit obligations. The underwriter made a reasonable and allowable financing decision in this case.

g. [redacted] FHA Case No. 091-4395020

In this case, the Report asserts that the borrower's credit report showed several accounts that were charged off and that the written explanation stated that the derogatory credit stemmed from the borrower's divorce. The Report states, however, that the borrower was divorced in 2001 and that, because the derogatory credit occurred after 2001, the borrower's credit difficulties could not have occurred because of the divorce.

Comment 20

AHK takes exception to the finding in this case. First, note that four of the accounts on the credit report (including one charge off) were opened or had their last activity in 2001, when the borrower divorced his ex-wife **(Exhibit H-2)**. Moreover, the borrower's letter of explanation **(Exhibit H-3)** states that, because the borrower was forced to pay some of his ex-wife's accounts, he was unable to pay all of his own obligations (not limited to obligations arising prior to the divorce). It is reasonable to assume that the after-effects of paying his ex-wife's accounts after a divorce would have more than a short-term impact on the borrower's ability to pay his own accounts going forward as such expenditures could deplete savings accounts, lower credit scores, and cause an increase in interest rates when newer accounts are opened. HUD guidelines require only that, in the underwriter's discretion, explanations of derogatory credit are sufficient written explanations that "make sense" and are "consistent with other credit information in the file." HUD Handbook 4155.1 REV-5, ¶ 2-3. In this case, the letter of

Mr. Gerald R. Kirkland
August 16, 2011
Page 19

explanation was consistent and supported by the other credit information in the loan file, and therefore the underwriter was justified in qualifying the borrower based on this explanation.

3. Income Calculation

In four cases, the draft Report asserts that the Company did not properly assess the borrowers' income. AHK respectfully disagrees with the allegations in several of the cases included in this sub-finding.

a. [redacted] FHA Case No. 495-7838607

In this case, the Report asserts that the underwriter overstated the borrower's monthly income by $437 by erroneously including the borrower's overtime income. That is not the case.

Comment 21

FHA guidelines provide that overtime income may be used to qualify the borrower if the lender uses an average and the employment verification does not state it is unlikely to continue. See HUD Handbook 4155.1 REV-5, ¶ 2-7(A). Here, the overtime income appeared on the borrower's pay stubs **(Exhibit A-6)**, the Verification of Employment ("VOE") was silent with respect to overtime (i.e., it did not state it was unlikely to continue) **(Exhibit A-7)**, and the 2007 W-2 forms **(Exhibit A-8)** confirmed that the borrower continuously had been receiving overtime pay given that the total income exceeded the borrower's base earnings on the pay stubs. The processor's note on the VOE indicates that the borrower's increase in income was due to a merger that occurred in 2007, which merger is documented in the loan file **(Exhibit A-7)**. While the amount in overtime was not continuous over the full two-year period, HUD's guidelines note that "periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes." HUD Handbook 4155.1 REV-5, ¶ 2-7(A). As the borrower's overtime earnings were steady following the employer's merger, and as the file clearly documented the borrower's receipt of the earnings, the overtime income was acceptable to use as effective income.

Comment 1

Nevertheless, we note that the borrower still would have qualified for FHA financing even without including the overtime income as effective income. Excluding the overtime income from effective income would yield qualifying ratios of 35.46% and 51.68% **(Exhibit A-1)**. As discussed above, however, the file documented significant cash reserves and a conservative attitude toward credit, as well as a minimal increase in housing expenses, all of which constitute significant compensating factors expressly permitted by HUD to justify loan approval when the borrower's qualifying ratios exceed the benchmark guidelines. Additionally, removal of the overtime earnings from effective income would render the overtime earnings additional income not considered in effective income but directly affecting the borrower's ability to repay the mortgage, which would constitute yet another permissible compensating factor to justify loan approval. See HUD Handbook 4155.1 REV-5, ¶ 2-13(E). For these reasons, although the underwriter properly calculated and included the overtime earnings in effective income in this case, the borrower still would have qualified for the loan if the overtime earnings excluded. Thus, this finding should be removed from the final report.

b. [redacted] FHA Case No. 422-2858487

In this case, the Report asserts that the underwriter included commission income in the calculation of ratios when there was no documentation in the file that the borrower had earned a commission income for more than a year. It states that the MCAW and VOE noted the borrower's currently monthly income of $6,000, which included commission income of roughly $1,000 per paycheck, but that HUD guidelines require that commission income be excluded from effective income calculations if earned for less than one year. See HUD Handbook 4155.1 REV-5, ¶ 2-7(D). The Report further states that there is no indication in the loan file that the borrower only recently started to receive commission income and that, while the borrower had only recently started a job with Fennell & Associates as an insurance agent (and pay stubs for this position showed commission income), the borrower maintained a similar position with his previous employer for the two prior years.

During an income analysis, the underwriter must determine whether the borrower's income reasonably can be expected to continue through at least the first three years of the mortgage loan. See HUD Handbook 4155.1 REV-5, ¶ 2-7. Here, the borrower's tax returns **(Exhibit M-4)**, W-2s **(Exhibit M-5)**, and pay stubs **(Exhibit M-6)** demonstrate that the borrower maintained a similar position for the previous two years as an insurance agent, with steadily increasing income, and a 100% probability of continued employment listed on the VOE **(Exhibit M-7)**. The underwriter therefore reasonably determined that the borrower's employment was expected to continue through at least the first three years of the mortgage.

With respect to commission income, FHA guidelines generally require an average over the previous two years based on signed tax returns and the most recent pay stubs, and commissions earned for less than one year may not be included in effective income unless the borrower's salary was changed from salary to commission within a similar position with the same employer or the portion of earnings not attributed to commissions would be sufficient to qualify the borrower for the mortgage. See HUD Handbook 4155.1 REV-5, ¶ 2-7(D). Here, the latter situation applied. Even without the

Comment 22 commission income, the borrower still would have qualified for FHA financing.

As stated in the Report, the commission income totaled $2,000 per month. Without this income, the borrower's qualifying ratios would exceed HUD's qualifying ratios. As reflected on the MCAW **(Exhibit M-8)**, however, the borrower had $5,799 in cash reserves, which demonstrated an ability to accumulate savings –a significant compensating factor under HUD's guidelines. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C). Moreover, removal of the commission income from effective income would render it additional income not included in effective income but directly affecting the borrower's ability to pay the mortgage, which would constitute yet another compensating factor expressly permitted by HUD. See HUD Handbook 4155.1 REV-5, ¶ 2-13(E). Thus, the borrower still would have qualified for the loan.

Ultimately, this loan would have qualified for HUD financing regardless of whether commission income was included in effective income or instead used as one of several significant compensating factors. Indemnification therefore is not appropriate.

c. [redacted] FHA Case No. 221-4024471

In this case, the Report asserts that the underwriter failed to verify the most recent 2 years of income for the borrower.

Comment 23

It is AHK's policy and procedure to verify the stability of borrower income by obtaining bank statements, W-2 forms, and VOE for the current employer and previous two years of employment. In this case, however, the URLA notes that the borrower had been employed for 11 months as a caretaker following an extended leave of absence from the workforce **(Exhibit E-5)**. In addition to the verification for the borrower's current employment, including a VOE, pay stubs, and a W-2 form **(Exhibit E-6)**, the underwriter properly documented the borrower's work history prior to her absence by obtaining a certification of employment and a W-2 Wage and Tax Statement **(Exhibit E-7)**. AHK verified the stability of the borrower's income in this case and we therefore respectfully submit that this finding should be removed from the final report.

d. [redacted] FHA Case No. 492-8004302

In this case, the Report asserts that the underwriter overstated the borrowers' monthly income by $747 by erroneously including the co-borrower's overtime income. That is not the case.

As previously noted, FHA guidelines provide that overtime income may be used to qualify the borrower if the lender uses an average and the employment verification does not state it is unlikely to continue. See HUD Handbook 4155.1 REV-5, ¶ 2-7(A). Here, the overtime income appeared on the co-borrower's pay stubs **(Exhibit G-3)**, the VOE was silent with respect to overtime (i.e., it did not state it was unlikely to continue) **(Exhibit G-4)**, and the 2007 W-2 forms **(Exhibit G-5)** confirmed that the co-borrower continuously had been receiving overtime pay given that the total income exceeded the borrower's base earnings on the pay stubs. Although the income had been received for

Comment 24

Comment 9

Comment 14

less than two years, HUD's guidelines note that "periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes." HUD Handbook 4155.1 REV-5, ¶ 2-7(A). Here, the co-borrower's receipt of overtime had been steady and continuous and there was no reason to believe it would not continue.

Nevertheless, we note that the borrowers still would have qualified for FHA financing even without including the overtime income as effective income. Excluding the overtime income from effective income would yield qualifying ratios of 42.25% and 55.8% **(Exhibit G-1)**. As discussed above, however, the file documented cash reserves, reflecting an ability to accumulate savings, and low debt, reflecting a conservative attitude toward credit, both of which constitute significant compensating factors expressly permitted by HUD to justify loan approval when the borrowers' qualifying ratios exceed the benchmark guidelines. Additionally, removal of the overtime earnings from effective income would render the overtime earnings additional income not considered in effective income but directly affecting the borrower's ability to repay the mortgage, which would constitute yet another permissible compensating factor to justify loan approval. See HUD Handbook 4155.1 REV-5, ¶ 2-13(E). For these reasons, although the underwriter properly calculated and included the overtime earnings in effective income in this case, the borrower still would have qualified for the loan if the overtime earnings excluded. Thus, this finding should be removed from the final report.

4. Document Transmittal from Third Parties

In three cases, the Report asserts that the Company inappropriately accepted documents from the seller, an interested third party. AHK understands and appreciates that "[l]enders 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." HUD Handbook 4155.1 REV-5, ¶ 3-1; see also HUD Handbook 4000.2 REV-3, ¶ 3-5. It is the Company's policy and practice to obtain credit reports and verifications directly from the providers of these documents and to ensure that faxed documentation is accurate and complete. Moreover, with regard to income and deposit documents that would be in the borrower's possession, such as pay stubs, W-2 forms, and bank statements, it is AHK's policy and practice to obtain such documentation directly from the borrower. As discussed in detail below, AHK respectfully disagrees with the assertions in two cases and requests removal of the allegations in all three cases.[4]

[4] As discussed above, FHA Case No. 495-7871535, the [redacted] loan, already has been resolved by AHK and HUD pursuant to an indemnification agreement dated December 3, 2010 **(Exhibit K-2)**. Therefore, we request allegations concerning this loan be removed from the final report.

Mr. Gerald R. Kirkland
August 16, 2011
Page 23

a. [redacted] FHA Case No. 495-7838607

In the [redacted] case, the Report asserts that the borrower's 2006 W-2 form passed through the seller when faxed to the mortgage company.[5]

Comment 25

In this case, the borrower faxed his 2006 W-2 form to AHK from the builder's office. As noted above, it is AHK's policy and practice to obtain such documentation directly from the source, which would have been the borrower in this case, and not from a builder, seller, or any other interested third party. The use of the builder's fax machine in this case was an isolated occurrence that likely resulted from the borrower's use of the builder's fax machine as a convenience to transmit the document to the Company. There is no reason to suspect the integrity of the document. AHK, however, has reminded its employees of the importance of examining credit and employment related documents used to qualify the borrower to ensure they come directly from either the providers of the documents or the borrower and do not pass through the hands of an interested third party.

That said, any deficiency in connection with this matter in the [redacted] file constituted at worst harmless error. Not only is there no reason to suspect the integrity of the document, but, although the borrower faxed the W-2 form from the builder's office, the loan file contained additional documentation verifying the information reflected in the faxed document. Specifically, the loan file contained a telephone employment verification obtained directly by AHK's employee that confirmed the borrower's employment reflected on the W-2 form **(Exhibit A-9)**. The income also was verified and documented in the loan file through the borrower's 2007 W-2 form **(Exhibit A-8)** and recent pay stubs **(Exhibit A-6)**, none of which were faxed from the builder's office. In this case, the borrower, rather than an interested third party, likely faxed the referenced document, both the employment and income information were separately verified verbally and in documents that did not pass through the builder's office, and the borrower qualified for FHA financing. For these reasons, we request that this allegation be removed from the final report.

b. [redacted] FHA Case No. 492-8043749

Comment 25

In the [redacted] case, the Report asserts that the borrower's credit documents passed through the seller when faxed to the mortgage company. Specifically, the loan file shows that the borrower's letters of explanation had been faxed using the builder's fax machine. While the Company has been unable to locate any additional documentation at this time verifying the contents of the letters of explanation, there is no reason to

[5] Note that the W-2 shows that the document was faxed from the builder's office (Clayton Homes) and not the seller's office [redacted].

question the authenticity of the documentation. This isolated instance likely occurred because the borrower used the builder's fax machine as a convenience to transmit these documents to the Company and the letters of explanation are clearly signed by the borrower. Any deficiency in the [redacted] file therefore constituted at worst harmless error and does not affect the integrity of the loan.

5. Gift Funds

In three cases, the Report asserts that the loan files did not contain proper verification of gift funds received by FHA borrowers. In two of these cases, the Report claims that AHK did not document the transfer of gift funds from the donors to the borrowers. The Report questions the Company's verification of the entire amount of gift funds in the third case.

As you know, FHA guidelines require a lender to verify and document the transfer of gift funds used by a borrower. See HUD Handbook 4155.1 REV-5, ¶ 2-10(C). In one loan - [redacted] **FHA Case No. 495-7838607**, the borrower obtained a gift in the form of downpayment assistance. While the Department no longer permits such assistance in FHA-insured loans, see P. Law 110-289, Section 2113, at the time the loans at issue were originated HUD permitted borrowers to obtain gift funds from non-profit entities providing downpayment assistance. Until 2004, Page 2-11 of HUD's Single Family Reference Guide ("Guide") expressly stated that, with respect to gifts provided by a nonprofit or municipality through a downpayment assistance program, "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." For the [redacted] file, the HUD-1 Settlement Statement ("HUD-1") documents the transfer of the funds, and the settlement agent certified to the accuracy of the information reflected on the HUD-1 **(Exhibit N-1)**. It was not until HUD issued Mortgagee Letter 2004-28 that the Department's guidelines expressly required lenders to obtain and keep the documentation of the wire transfer in its mortgage loan application binder in connection with downpayment assistance gift transfers. After issuance of Mortgagee Letter 2004-28, it was AHK's policy and procedure to obtain evidence of the wire transfer of gift funds provided by downpayment assistance companies in all FHA-insured loans involving such assistance. At the time this loan was originated, AHK understands and appreciates that it was required to obtain and retain evidence of the wire transfer of gift funds from the downpayment assistance provider in its loan file. However, we note that
Comment 26
the loan was processed over three years ago and, given the FHA requirement to retain loan origination files for only two years (HUD Handbook 4000.2 REV-3, ¶ 5-8), AHK has been unable to locate the wire transfer evidencing transfer of funds. However, there is no evidence in the file that the downpayment assistance was not received in the matter reported on the HUD-1 and certified to by the title agent.

In the second loan [redacted] FHA Case No. 421-4340956 - the transfer from gift funds was from a relative. With regard to gift funds obtained from a relative, HUD guidelines require a lender to obtain: (1) a gift letter specifying, among other items, the dollar amount given, the donor's name, address, telephone number, and relationship to the borrower, and stating that no repayment is required; (2) a copy of the bank statement showing the withdrawal from the donor's personal account; and (3) evidence that funds have been deposited into a borrower's account before closing or a verification of receipt of the funds from the settlement agent. See HUD Handbook 4155.1, REV-5, ¶2-10(C); Mortgagee Letter 00-28. In the [redacted] case, the borrower received a $3,030 gift to cover the funds needed to close the loan from his father. To evidence the gift, the underwriter obtained a gift letter dated February 8, 2008 in which the borrower's father indicated his intent to provide the $3,030 gift to the borrower at closing in the form of a cashiers check **(Exhibit N-2)**. Bank statements from the donor in the file demonstrate that the donor had more than enough funds in his bank account to provide the gift to the borrower at closing **(Exhibit N-3)**. The HUD-1 documents that the borrower paid $3030.05 at closing and the settlement agents certified to the accuracy of the information reflected on the HUD-1 **(Exhibit N-4)**. It is AHK's policy and procedure to obtain a copy of the donor's bank statement documenting the transfer of funds from the donor's personal account and a verification of the receipt of funds. Again we note that the loan was processed over three years ago and, given the FHA requirement to retain loan origination files for only two years (HUD Handbook 4000.2 REV-3, ¶ 5-8), AHK has been unable to locate this bank statement or a copy of the cashiers check evidencing transfer of funds. Nevertheless, there is no evidence to suggest that the funds were obtained from an impermissible source.

Comment 26

In summary, AHK maintains that the loan file contained sufficient documentation to evidence that the borrowers in both the [redacted] and [redacted] cases received gift funds from permissible sources and that these funds were used to close this loan. While additional gift fund transfer documentation was inadvertently omitted from the loan files in these two isolated cases, any oversight constituted, at worst, harmless error. For these reasons, administrative action would be inappropriate, and we request that these allegations be removed from the final report.

For the third case – [redacted] FHA Case No. 091-4395020, the Report asserts that the HUD-1 shows the borrower received $8,200 in gift funds while the gift funds transfer shows that only $7,525 was transferred **(Exhibit N-5)**. Again, the HUD-1 documents that the full $8,200 was provided at closing and the settlement agents certified to the accuracy of the information reflected on the HUD-1 **(Exhibit N-6)**. Additionally, the gift letter includes a substitution of the $7,525 value for a handwritten value of $8,200 **(Exhibit N-7)**. While AHK recognizes the discrepancy, the attached documentation shows that the donor provided the full $8,200 value and the borrower met their required investment.

Comment 27

Mr. Gerald R. Kirkland
August 16, 2011
Page 26

6. **Miscellaneous Issues**

The Report alleges in four cases that AHK made miscellaneous errors in underwriting the loans and obtaining required documentation. AHK disagrees with the findings in these cases and addresses each file in turn below.

a. [redacted] **FHA Case No. 421-4407985**

In this case, the Report asserts that the lender and underwriter did not document the resolution of the life estate granted in the property deed and that the underwriter did not resolve the difference in square footage of the subject property from the 2,333 square feet listed on the appraisal to the 1,672 square feet listed on the blueprint.

Comment 28

With respect to the life estate, contrary to the suggestion in the Report, AHK resolved the matter. To this end, the underwriter obtained and reviewed a proper title commitment reflecting that the life estate was taken care of and giving the borrower full vesting **(Exhibit B-4).** Moreover, an insured closing letter was provided by the title insurer noting that all appropriate searches and commitments had been completed and reviewed **(Exhibit B-5)**. The underwriter reasonably understood that AHK would have clear title to the property at the time the loan was originated based on this thorough review of title documents and the assurances of the title insurer. As a result, this finding should be removed from the final report.

Comment 28

With respect to the appraisal, the underwriter properly identified the square footage discrepancy during loan processing and took care to resolve the matter. AHK ordered a new appraisal, which was performed and included the corrected square footage (1,672 square feet), as well as comparisons with nearby properties of a similar square footage **(Exhibit B-6)**. This corrected appraisal accurately and adequately supported the value conclusion.

AHK properly resolved the title commitment and appraisal issues prior to closing in this case. The file complied with HUD guidelines and, as a result, this finding should be removed from the final report.

b. [redacted] **FHA Case No. 491-9300557**

In this case, the Report asserts that the borrower did not did not verify the borrower's prior housing obligation payment history through a verification of rent or previous housing payments in the loan file.

In accordance with FHA guidelines, it is AHK's policy and practice to obtain a VOR or verification of mortgage, or evidence of payments through canceled checks covering the most recent 12-month period. See HUD Handbook 4155.1 REV-5, ¶ 2-

Comment 29

3(A). In this case, however, no such documentation was available. As reflected on the URLA and MCAW, the borrower's current rent was $0 per month **(Exhibits L-2 and L-3)**. A written explanation from the borrower indicated that he was living rent-free in a home furnished by his work and previously had paid $500 in rent to his mother every month in cash **(Exhibit L-4)**. As these payments were made in cash, there were no canceled checks. Finally, the borrower's credit report does not provide indication of a recent mortgage or rental payment in the prior two years, which was consistent with the borrower's explanation **(Exhibit L-1)**. While there is no further documentation of prior rental history in the file, there is no indication in the loan file to suggest that the information provided by the borrower on his rental history is inaccurate and there is no reason to question the borrower's integrity. AHK obtained the best available information and documentation and reasonably relied on the borrower's written explanation.

c. [redacted] FHA Case No. 221-4024471

Comment 30

In this case, the Report asserts that a person other than the borrower signed the mortgage note for the loan. HUD guidelines provide that the FHA may withhold endorsement of the loan if there are additional signatures on the security instrument or the mortgage note of individuals not reviewed during the mortgage credit analysis. See HUD Handbook 4155.2 6.A.2.f. However, the only signature on the mortgage note as borrower is that of the borrower [redacted] **(Exhibit E-8)**. The only other signatures appearing on the mortgage note are the notary public, verifying that [redacted] was the person who signed the note, and an AHK employee who signed as a representative of the company and not as a borrower. Moreover, [redacted] credit history was analyzed during the mortgage credit analysis and her credit and income information used to approve the loan **(Exhibits E-1 and E-2)**. The file complied with HUD guidelines and, as a result, this finding should be removed from the final report.

d. [redacted] FHA Case No. 421-4340956

In this case, the Report asserts that the borrower did not verify the borrower's prior housing obligation payment history through a VOR or previous housing payments in the loan file. See HUD Handbook 4155.1 REV-5, ¶ 2-3(A).

Comment 31

As explained above, in accordance with FHA guidelines, it is AHK's policy and practice to obtain a VOR or verification of mortgage, or evidence of payments through canceled checks covering the most recent 12-month period. See HUD Handbook 4155.1 REV-5, ¶ 2-3(A). In this case, however, both the MCAW and URLA report that the borrower lived in the same location for the past two years and list the borrower's rent as $310 a month **(Exhibits J-1 and J-4)**. The address reported on the borrower's credit report matches the address reported on the URLA and the borrower's credit history shows no delinquent payments associated with that address **(Exhibit J-3)**. While there is no further documentation of prior rental history in the file, there is no indication in the loan file to suggest that the information provided by the borrower on his rental history was false.

7. Quality Control

The Report suggests that AHK's Quality Control is not effective. Specifically, based only on two Quality Control reviews examined, the Report alleges that the reviews were not completed in a timely manner, findings or patterns of deficiencies were not identified or reported to HUD, and there was no evidence the Company took corrective action in response to the review findings. AHK disagrees with the Report's assessment. AHK maintains and implements a robust Quality Control program that meets HUD/FHA requirements and effectively monitors FHA compliance, including identification of underwriting and other matters requiring attention. The Company routinely revises and updates its Quality Control procedures as necessary to remain compliant with applicable internal and external requirements and guidelines. It performs timely Quality Control reviews on a monthly basis as required by HUD, rates its findings by level of risk, reports findings to management, and takes corrective action as necessary.

Comment 32

With respect to timing, the Report states that the reviews of two early payment default loans were completed 12 and 14 months after the first default. Contrary to the suggestion in the Report, however, the timing of these reviews complied with FHA requirements. HUD does not specify a timeframe within which Quality Control reviews of early payment defaults must be performed. While AHK agrees that one of the goals underlying a lender's Quality Control program is to ensure swift and appropriate corrective action, AHK performed the referenced reviews as quickly as possible given its other obligations, such as conducting routine Quality Control reviews of other loans on a monthly basis. Given the volume of loans to be reviewed, AHK completed its early payment default reviews in a reasonably timely manner. The Company did not ignore its obligation to review early payment defaults or postpone the reviews indefinitely; rather, it performed the reviews as soon as possible while simultaneously conducting a substantial number of routine Quality Control reviews on a timely basis. Regardless, there is no prescribed time frame for such reviews and thus there is no violation of FHA requirements in connection with this matter. Accordingly, administrative action on this basis is unwarranted and this finding should be removed from the Report.

The Report also alleges that AHK's Quality Control program failed to identify patterns of deficient underwriting. Patterns of deficient underwriting, however, were not detected during AHK's robust Quality Control review process because such patterns did not exist. AHK has refuted most of the alleged underwriting deficiencies contained in the Report. The loans for the most part complied with HUD/FHA requirements and financing was extended to qualified borrowers. Moreover, all of the loans were underwritten by the same underwriter, an individual who no longer works for the

Company. That said, AHK does report Quality Control findings to management and corrective action is taken as necessary. 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. AHK's management generates weekly "Points to Ponder" to remind the Company's production team of important updates and, to the extent the Company identifies patterns in underwriting, it sponsors specific training sessions to address these trends and ensure Company personnel are up-to-date on all origination requirements. If fraud or misrepresentation were identified in a file, AHK promptly would report the matter to HUD as required by FHA guidelines.

Based on a mere review of two Quality Control loan files, the Report gives the misimpression that AHK does not take Quality Control seriously or somehow has failed to implement it meaningful. That is not the case. AHK has taken HUD/FHA requirements, including its Quality Control obligations, seriously since its inception. It consistently has taken care to ensure its employees' compliance with applicable rules and regulations, implemented new policies and procedures as necessary to conform to changes in the industry, and taken prompt corrective actions to address any concerns identified. Not only does the Company work hard to ensure good faith and fair dealings throughout all of its mortgage loan origination and funding activities, but it engages in stringent Quality Control, has implemented specific fraud prevention and detection measures, requires re-verification of data, and outsources loan-level Quality Control reviews to an independent third party.

To this end, the Company conducts product-specific and job-specific training for employees, both on-site and remotely, and it has an Internal Risk Department tasked with conducting loan-level and office-level audits. In addition to engaging in various training and monitoring activities on a regular basis, AHK performs post-closing Quality Control reviews on a minimum of 10% of all loans, as well as reviews of 100% of files originated by new employees during their first 90 days of employment, which the Company contracts out to an independent third party. AHK also runs a "Fraud Guard" (an InterThinx product) on every loan file and requires a minimum Fraud Guard score of 600 to close a loan. In addition, AHK recently made a number of enhancements to its Quality Control and compliance procedures. For example, AHK has purchased a new Loan Operating System – "Encompass 360" by Ellie Mae – to replace the two prior systems used, which were Calyx Point and Del Mar's Data Trac. The version of the system AHK purchased includes the optional feature – "Mavent Compliance System" – which is a robust audit tool that reviews loan files for compliance with federal and state licensing and other requirements. Training for Encompass 360 currently is underway, and the new system should be operational by September 2011.

Mr. Gerald R. Kirkland
August 16, 2011
Page 30

Additionally, as explained above, the Company has made significant changes related specifically to FHA lending in an effort to improve its underwriting quality and overall loan performance. Not only did the Company cease underwriting manufactured home loans in January 2009, but it 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 may ask questions and access current resources to make informed and accurate decisions, and all underwriters undergo mandatory underwriting product training. 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, and 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. Finally, 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, as well as implemented several 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 couple. As previously noted, these changes have greatly improved the quality and performance of the Company's FHA-insured loan portfolio. In fact, the Report acknowledges that only 47 loans out of a total of 13,838 loans originated by the Company in 2009 and 2010 resulted in claims, which is a mere 0.3% of AHK's total originations.

8. Recommendations

In addition to opposing most of 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 $763,349 in connection with nine loans. To derive these estimated losses, the Report indicates that it included 59% 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 59% of the claim paid.

Comment 33

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, which the OIG does for two loans with actual total losses of $175,462. The Company does, however, take strong exception to inclusion of the $763,349 in estimated losses in the nine cited loans. First, we note that the $763,349 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 nine loans ultimately result in claims to HUD. The Report merely recommends that HUD request indemnification, but any amounts paid to HUD in connection with any indemnifications would 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.

Comment 33

Eight of the nine loans at issue remain active. AHK appreciates that these loans may have entered default at some point; however, none of these loans have been foreclosed, terminated, or resulted in conveyance insurance claims to the Department. To date, without a foreclosure and eventual property sale by HUD, the Department has not incurred any actual losses in these cases, and it is not possible to determine whether the Department will ever incur losses in each of the cases. Moreover, in the event that HUD does pay a conveyance claim in any of these loans, there is no guarantee that the Department will sustain monetary loss, as HUD may be able to recoup the claim amount in the sale of the underlying property.

Comment 33

Notwithstanding these facts, the Report suggests that the Department will experience losses in the amount of 59% 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 $763,349. This calculation assumes that <u>every one of the active loans will go into foreclosure and result in a conveyance claim to HUD</u>. 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 any of these loans, let alone all of them, will result in a claim or financial loss to the Department. Based on these facts, absent evidence that the eight active loans will result in an actual claim to the Department, the potential loss figure is greatly inflated and does not paint an accurate picture of the risks associated with this matter. 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.

This is compounded by the fact that the Report separately requests the Company to reimburse HUD for $277,906 in claims paid in connection with seven loans, without any adjustment to this figure by the Department's estimated recovery amount or credence to the fact that HUD may not sustain any losses in these loans. The Report also does not distinguish the fact that $22,928 of the $277,906 represents partial claims paid by the Department in connection with four loans that remain active, which means the partial claim amounts may eventually be paid by the borrowers. Again, the inclusion of this separate request for $277,906 in reimbursements is a gross overstatement of potential losses to the Department in these cases.

Mr. Gerald R. Kirkland
August 16, 2011
Page 32

Furthermore, as noted above, these arbitrary monetary figures are included with a mere recommendation to the Department to require the Company to indemnify or reimburse 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 majority of the findings set forth in the Report warrant indemnification. HUD may also disagree with the Report's assertions and decide not to pursue indemnification or reimbursement 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 or reimbursement in each case.

In addition, while the audit process is still ongoing at the time the OIG issues its "final" report, the Report and the OIG's recommendations are made public on the OIG website. As a result, a lender's investors and peers are able to access the preliminary recommendations of the OIG before a final assessment as to their merit can be made by the Department. These entities often misinterpret the OIG's recommendations to be final actions by the Department, and also frequently misunderstand the potential losses cited to be the actual financial penalties assessed by HUD on the audited FHA lender. Under these circumstances, making these preliminary recommendations public and including an inflammatory potential loss figure that is based on the unsupported assumption that every single loan at issue will result in a claim or actual loss 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.

Comment 33

The above discussion demonstrates that the estimated loss figure and claim figure are unrepresentative of the Department's actual loss risk in connection with 11 loans cited in the draft Report. Inclusion of these overstated figures 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 these figures in the final report and requests that they be removed or amended to portray a more accurate picture of the potential losses in the FHA loans cited in the Report. As one 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 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.

B. AHK PROPERLY INTERPRETED HUD REQUIREMENTS AND DILIGENTLY ORIGINATED FHA LOANS

Finally, the Report repeats allegations from a prior audit from October 25, 2010, without providing any details respecting the Company's thorough response to the allegations in that audit and thereby improperly conflates the findings in the two audits.

As the Report indicates, the prior audit was based on a review of only three loans from Gold Financial Services, Inc., a separate branch of AHK from the one in the current audit. In connection with the prior audit, the OIG requested that AHK indemnify HUD for two loans based on allegations of questionable borrower creditworthiness and failure to document adequate cash reserves. While the Report includes in detail the allegations and findings from that audit, the Report fails to mention that AHK forcefully refuted these allegations. The OIG sent AHK a letter, dated March 7, 2011, detailing the allegations. After a thorough review of the two questioned loan files, AHK responded on May 2, 2011 by stating:

> Based on this stringent review, AHK believes that indemnification would be unwarranted. In these cases, the findings in the Letter are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability.

As reflected on pages 14 to 22 of the final OIG audit report, AHK responded fully to the findings in the cited cases, as well as provided the OIG with a surplus of documentation and evidence to disprove the allegations and refute the premise that AHK in any way has deficient underwriting practices. See OIG Final Audit Report, 2011-FW-1002, available at http://www.hud.gov/offices/oig/reports/files/ig1161002.pdf.

AHK strongly objects to the inclusion of these allegations in the final report. The assertions made in this section of the draft Report merely reiterate allegations already made in the previous audit and to which AHK already responded. Reproducing such allegations devoid of context and without the benefit of AHK's thoughtful response to the

OIG's concerns is inflammatory. Moreover, as previously noted in our May 2, 2011 response to the prior audit, AHK properly interpreted and strictly adhered to HUD guidelines in underwriting the loans at issue. For these reasons, inclusion of the prior allegations here is repetitive, unnecessary, and inflammatory, and the references should be removed from the final report.

III. CONCLUSION

Comment 34

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 ceased making manufactured home loans and continued to enhance its Quality Control and 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
Chief Executive Officer

cc: Phillip L. Schulman, Esq.

Enclosures

OIG Evaluation of Auditee Comments

Comment 1: AmericaHomeKey stated that the borrower maintained $9,775 in an Employee Stock Ownership Plan, which provided the borrower with the option of cashing-out by taking a taxable distribution of all or part of the fund. FHA prohibits lenders from accepting or using documents related to the credit, employment or income of borrowers that are handled by or transmitted from or through interested third parties (real estate agents, builders, sellers) or by using their equipment. The documentation that AmericaHomeKey provided to support this claim was faxed from the builder, and is therefore, not acceptable documentation to support the reserves. In addition, the statement provided is dated 17 months prior to loan closing, and no recent contributions had been made. We concluded that there is no acceptable evidence that the balance existed at the time of underwriting. As a result, we did not remove the issue from the final report.

Comment 2: AmericaHomeKey suggested that the borrower's low monthly obligations demonstrate a conservative attitude toward credit, which is an acceptable compensating factor. However, a review of the credit report that was run prior to loan closing reveals three credit scores ranging between 496 and 594, two collection accounts, and one charge off account within the 2 years prior to closing. The collections and charge off account did not represent a conservative attitude toward credit. Thus, we did not remove the issue from the final audit report. AmericaHomeKey also presented two additional compensating factors, including a minimal increase in housing expense and a stellar rental history. When the qualifying ratios exceed the benchmark guidelines, underwriters must record compensating factors used to support loan approval on the "remarks" section of the Mortgage Credit Analysis Worksheet. These additional compensating factors were not recorded on the Mortgage Credit Analysis Worksheet, and therefore, not used in the lender's decision to approve the loan. Regardless, we believe that the other violations set forth in the finding override the additional compensating factors.

Comment 3: AmericaHomeKey stated the borrower's low monthly debt and significant cash reserves reflected a conservative attitude toward credit and the ability to accumulate savings. The Verification of Deposit shows that the borrower paid $77 per week toward his car payment rather than $77 per month as indicated on the credit report. We analyzed the payments against the balance and determined that the $77 payments per week are more logical in order to pay the balance down. Based on the Verification of Deposit, we calculated the monthly car payment at $308. We reviewed the credit reports provided and including the car payment, calculated monthly debt at $518. With the increased monthly debt, we calculated the ratios at 33 and 46 percent. We changed the final report to reflect the new ratio calculation. Regarding the ability to accumulate savings, the verification of deposit shows a balance of $1,890, and an average balance of $595. This does not illustrate an ability to accumulate savings. FHA requires 3 months of cash reserves when used as a compensating factor. We determined that the borrower needed at least $3,784 to meet the reserve requirement. As a result, we did not remove the issue from the final report.

Comment 4: AmericaHomeKey stated that the borrower had $2,500 in cash reserves, and even though the amount was "just shy" of the required $2,759, the savings still evidenced the ability to save. Neither the loan file nor the written response contained documentation to support the cash reserves. FHA guidelines require documentation to support compensating factors. Further, the borrower took a pay advance of $400 from his employer just 1 month prior to closing, which demonstrated an inability to accumulate savings.

Comment 5: AmericaHomeKey stated that it was not required to show continuance of overtime income since it was not used in the effective income calculation and only used as a compensating factor. The lender also provided copies of three of the borrower's pay statements to show that overtime was earned. When overtime income is used as a compensating factor, the lender must document that the income directly affects the borrower's ability to pay the mortgage. We do not question the overtime income demonstrated in the pay statements provided. However, there was no documentation in the loan file to demonstrate that the additional income will directly affect the borrower's ability to pay the mortgage payment. In fact, the borrower's need to take a pay advance 1 month prior to closing illustrates that the overtime income does <u>not</u> directly affect his ability to pay the mortgage. We question the lender's judgment in this loan because it did not verify the compensating factors used to justify loan approval, and it accepted documents related to the borrower's credit from the seller.

Comment 6: AmericaHomeKey stated that the borrower's low monthly debt and $1,141 in savings illustrated the borrower's conservative attitude toward credit and ability to save. However, the borrower's credit report showed five collection accounts within the past 2 years, which does not demonstrate the ability to save. Additionally, the Verification of Deposit demonstrated an average 2-month balance of only $306. This does not reflect the borrower's ability to accumulate savings. FHA requires 3 months of cash reserves when used as a compensating factor. The borrower needed at least $3,280 to meet this requirement.

Comment 7: AmericaHomeKey stated that the borrower's low monthly debt and $2,200 in cash reserves ($97 less than the required $2,297) illustrated the borrower's conservative attitude toward credit and an ability to save. The borrower's credit report showed two collection accounts within the past 2 years, and the bank statement referred to in AmericaHomeKey's response is a transaction history with only one deposit and no other activity. Further, there is no beginning balance. FHA requires the lender to obtain 3 months of bank statements when verifying funds on deposit. In addition, FHA requires a credible explanation for large increases or new accounts. Based on the transaction history provided, it appears that the borrower opened the account during the same month that the document was printed when the borrower deposited $2,200. There was no explanation for the new account in the loan file. Therefore, the borrower's low monthly debt is negated by the recent collections, and the bank information is insufficient to demonstrate an ability to save.

Comment 8: AmericaHomeKey stated that the borrower's low monthly debt and $1,475 in cash reserves demonstrated a conservative attitude towards the use of credit and an ability to accumulate savings. Further, the front-end ratio was only 1 percent above the benchmark. Borrowers with limited recurring expenses are allowed greater latitude on this ratio. We do not dispute the borrower's low level of recurring expenses. However, the borrower had a collection account as recent as 6 months prior to closing. There was no explanation in the loan file for the collection account. Therefore, we do not agree with AmericaHomeKey's assertion that the borrower demonstrated a conservative attitude toward credit. The bank statements provided show a balance as of April 3, 2008, of $807, including a $6,361 deposit from the Internal

Revenue Service. The borrower did not demonstrate the ability to accumulate savings. Since the compensating factors are refuted, the latitude for the front-ratio was not permissible.

Comment 9: AmericaHomeKey stated that the borrower's low monthly debt of $359 and 2 months of cash reserves demonstrated a conservative attitude towards the use of credit and an ability to accumulate savings. We reviewed the credit report provided and calculated monthly debt totaling $734, including a mortgage payment for a conventional loan. Further, the borrower's credit scores ranged between 523 and 600 and included two charge off accounts and one collection account within the past 2 years. Based on this information, we do not agree with AmericaHomeKey's assertion that the borrower demonstrated a conservative attitude towards credit. AmericaHomeKey did not provide any bank statements to demonstrate the borrower's ability to accumulate savings. The loan file contained a bank statement for one co-borrower for a period of only 1 month with no deposits and charges totaling $520. With only 1 month of bank activity for only one co-borrower, and a decreasing balance, the borrower did not demonstrate an ability to accumulate savings.

Comment 10: AmericaHomeKey stated that since the loan closed over 3 years ago, the fact that it could not locate documentation to support the cash reserves, doesn't mean that the missing documentation wasn't contained in the original loan file. The original loan file contained documentation to show funds on deposit. However, a large deposit totaling $3,000 appeared to be a loan from the borrower's employer that will be paid back with labor or future vacation. Since the $3,000 appears to be a loan, we concluded that AmericaHomeKey did not properly document the cash reserves, and the borrower did not demonstrate an ability to accumulate savings. AmericaHomeKey also indicated that the borrower had minimal recurring expenses totaling $398 per month. We agree that the borrower had minimal revolving debt. However, with such a small monthly obligation, the borrower should have been able to accumulate savings rather than borrow $3,000 from his employer. As a result, we do not agree with AmericaHomeKey's assertion that the borrower demonstrated a conservative attitude towards credit. Further, there is no reason for the asset documentation to be missing when the rest of the loan files in question appear to be intact.

Comment 11: AmericaHomeKey's response addressed FHA loan number 281-3386715. We did not question this loan in the audit report. Based on the narrative in relation to the loan number and documents provided with the written response that included the borrower's name, we concluded that the loan number is a typographical error, and that AmericaHomeKey's response actually addresses FHA loan number 281-3386718.

Comment 12: In its response, AmericaHomeKey stated that the borrower had low monthly obligations and $2,075 in cash reserves, which demonstrated a conservative attitude towards credit and the ability to accumulate savings. We do not dispute the low monthly obligations. However, the borrower's credit scores ranged between 498 and 536. The low credit scores show that the borrower does not have a conservative attitude towards credit. The Verification of Deposit in the loan file showed an average monthly balance of only $470. The bank statements provided in AmericaHomeKey's response support the $2,075 reserves referred to but do not show a beginning balance. Further, the bank statements are questionable because they do not show the name of the bank and were certified by the teller the day before the statement was printed. In addition, the non-purchasing spouse's bank information was provided, which is not relevant in determining whether the borrower demonstrated the ability to accumulate savings. We do not agree with AmericaHomeKey's assertion that the borrower demonstrated an ability to accumulate savings.

Comment 13: AmericaHomeKey stated that the borrower's low monthly obligations totaling $246 and his 1 month's worth of cash reserves illustrated his conservative attitude towards the use of credit and his ability to accumulate savings. We reviewed the documentation and agreed with AmericaHomeKey's assertion. As a result, we removed the issue from the final audit report.

Comment 14: AmericaHomeKey stated that it already signed an indemnification agreement for this loan and requested that the OIG remove the loan from the final report. We reviewed the indemnification agreement provided and determined that there is no documentation to show that AmericaHomeKey has reimbursed HUD for losses incurred. The report recommends reimbursement to HUD for actual losses incurred for this loan. Therefore, we did not change the audit report.

Comment 15: AmericaHomeKey stated that the loan closed in September 2008, and it cannot locate the missing credit report. FHA requires lenders to maintain case binders for at least 2 years after the date of endorsement. This particular loan was endorsed on December 30, 2008. We began our fieldwork on August 4, 2010, well within the 2-year time frame. Without the non-purchasing spouse's credit report, we have no means of verifying that the non-purchasing spouse's debt was included in the calculation of the qualifying ratios.

Comment 16: AmericaHomeKey stated that the borrower was unemployed for several months, which can have more than a short-term impact on the ability to pay debts. Therefore, the written explanation supported the derogatory credit. We reviewed the loan application and determined that the borrower was unemployed for only 3 months between 2006 and 2008 (1 month in 2006, and 2 months in 2008). The credit report shows three collections, including two that became collections while the borrower was employed. In addition, a current account showed several late payments in its payment history. Therefore, we disagree that borrower's short periods of unemployment impacted his ability to pay his debts. We did not change the audit report.

Comment 17: AmericaHomeKey stated that documentation in the loan file supported the borrower's written explanation that she was using an agency to assist with her credit issues and nothing in the loan file contradicted the explanation. However, HUD requires lenders to document that 1 year of the pay-out period has elapsed and the borrower’s payment performance has been satisfactory. In addition, the borrower must receive written permission from the counseling agency to enter into the mortgage. As stated in the audit report, the loan file did not contain any documentation from a credit counseling agency. We amended the audit report to reflect the additional criteria.

Comment 18: AmericaHomeKey is unable to locate documentation to support the borrower's claim that her bad debt had been paid in full but sites that the loan was processed over 3 years ago. FHA requires lenders to maintain case binders for at least 2 years after the date of endorsement. This particular loan was endorsed on December 19, 2008. We began our fieldwork on August 4, 2010, well within the 2-year time frame.

Comment 19: AmericaHomeKey stated that the borrowers took their financial obligations seriously since they satisfied some of the delinquent accounts after recovery from pregnancy complications, retained higher paying employment, and made their housing payments on time for 3 years. We reviewed the borrower's credit report and identified a collection account as recent as 6 months prior to closing. The loan file contained documentation to show that only one delinquent account had been paid. Further, according to the borrower's letter of explanation, her pregnancy complications occurred in 2004 and she retained the higher paying job since 2005 - 3 years prior to this loan's origination. Therefore, we disagree with AmericaHomeKey's assertion that the borrowers took their financial obligations seriously. In addition, when the qualifying ratios exceed the benchmark guidelines, underwriters must record compensating factors used to support loan approval on the "remarks" section of the Mortgage Credit Analysis Worksheet. The borrower's rental history was not recorded on the Mortgage Credit Analysis Worksheet, and therefore, was not used in the lender's decision to approve the loan. Regardless, we believe that the other violations set forth in the finding override the additional compensating factor.

Comment 20: AmericaHomeKey stated that the borrower was unable to pay his own debt obligations as a result of being forced to pay obligations incurred by his ex-wife. Collections and judgments indicate a borrower's regard for credit obligations and must be considered in the creditworthiness analysis. FHA requires sufficient written explanation from the borrower for major indications of derogatory credit. The explanation must make sense and be consistent with other credit information in the file. We disagree with AmericaHomeKey's assertion that the explanation makes sense given that the borrower couldn't afford to pay his debts.

Comment 21: AmericaHomeKey asserts that since the Verification of Employment is silent regarding the continuance of overtime income, there was no indication that overtime would not continue. Further, FHA allows overtime income earned over a period less than 2 years provided the lender justifies and documents in writing the reason for using the income for qualifying purposes. HUD Handbook 4155.1, REV-5, paragraph 2-7(A) states that overtime income may be included in the effective income calculation if the borrower has received such income for the past 2 years and it is likely to continue. Since the Verification of Employment is silent on the issue, the underwriter did not ensure that the overtime was likely to continue. Further, the borrower told the OIG that her hours were cut. In addition, the 2 weeks of pay stubs that were provided show that overtime was present but not consistent in the amount of hours. One week, the borrower earned $439 in overtime. The following week, the borrower earned $98. The inconsistency is further indication that overtime income is not reliable and should have been researched further prior to its inclusion in the effective income calculation. We did not change the audit report.

Comment 22: AmericaHomeKey agreed that commission income should not have been used in the qualifying ratio calculations but contends that without the commission income, the borrower still qualified for the loan because there were acceptable compensating factors for the excessive ratios. AmericaHomeKey stated that the Mortgage Credit Analysis Worksheet shows a compensating factor of an ability to accumulate savings since the borrower had cash reserves totaling $5,799. Regardless, FHA guidelines require documentation to support compensating factors. The bank statement in the loan file was incomplete and showed an ending balance of only $1,682. Therefore, we concluded that since the reserves on the Mortgage Credit Analysis

Worksheet were not supported, the borrower did not have any significant compensating factors to support the excessive ratios.

Comment 23: AmericaHomeKey asserted that the stability of income was verified because the underwriter properly documented the borrower's work history prior to a leave of absence and properly documented current employment. The lender is required to verify the borrower's employment for the most recent 2 full years. The borrower must explain gaps in employment spanning 1 month or more. AmericaHomeKey did not provide an explanation for the "leave of absence." Other income verified in the loan file was from 5 years before the loan application and was not relevant.

Comment 24: AmericaHomeKey contends that overtime income earned for less than 1 year was properly used in the effective income calculation because periods less than 2 years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes. In addition, AmericaHomeKey agreed that without the overtime income inclusion, the qualifying ratios increased to 42 percent and 56 percent. However, the overtime income directly affects the borrower's ability to pay the mortgage, which is a compensating factor. As stated in AmericaHomeKey's response, the lender may use overtime income earned for less than 1 year provided the lender justifies and documents in writing the reason for doing so. However, there is no documented justification from the lender to justify using the overtime income that was earned for less than 1 year. Also, AmericaHomeKey stated that the Verification of Employment is silent regarding the issue of whether the overtime income will continue. As a result, we were unable to determine whether the overtime income will directly affect the borrower's ability to pay the mortgage payment.

Comment 25: AmericaHomeKey stated that while it accepted credit documents from the seller rather than directly from the borrower, there is no reason to suspect the integrity of the documents. Lenders are prohibited from accepting or using documents related to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties (real estate agents, builders, sellers) or by using their equipment. We did not change the audit report.

Comment 26: AmericaHomeKey stated that since the loans in question were processed over 3 years ago, it is unable to locate the wire transfer evidencing the transfer of funds and asserted that there is no evidence in the file that the down payment assistance was not received in the matter reported on the HUD-1. FHA requires the lender to document the transfer of gift funds from the donor to the borrower. Further, there is no reason for the wire documentation to be missing when the rest of the loan files in question appear to be intact.

Comment 27: AmericaHomeKey recognized the discrepancy between the HUD-1 and the wire transfer documentation regarding the amount of gift funds but asserted that since the settlement agents certified to the accuracy of the HUD-1, the gift amount was for the full $8,200 as recorded on the HUD-1. FHA requires the lender to document the transfer of gift funds from the donor to the borrower. Since the entire transfer of the gift funds is not documented, we are unable to determine the actual amount of gift funds actually received, or whether the HUD-1 is accurate.

Comment 28: AmericaHomeKey stated that it did, in fact, resolve the life estate issue and appraisal discrepancies addressed in the draft audit report. We reviewed the documents provided and agree with AmericaHomeKey's statements. As a result, we removed the issues from the final audit report.

Comment 29: AmericaHomeKey agreed that it did not properly verify the borrower's previous housing obligation but contends that it obtained the best documentation available because there were no cancelled checks available since the previous rent was paid to a family member in cash and the current rent was $0 since the housing was provided by the employer. FHA requires the lender to determine the borrower's housing obligation payment history through the credit report, verification of rent directly from the landlord, verification of the mortgage directly from the mortgage servicer, or the review of canceled checks that cover the most recent 12-month period. We did not change the audit report because the lender could have verified the borrower's housing obligation payment history with the employer and the family member.

Comment 30: AmericaHomeKey stated that only the borrower signed the mortgage note. We reviewed the documentation and agreed with the lender. However, an additional person signed the mortgage security instrument. We made the necessary corrections to the audit report.

Comment 31: AmericaHomeKey stated that while there is no verification of prior rental history in the loan file, the Mortgage Credit Analysis Worksheet, Universal Residential Loan Application, and credit report all contain consistent information regarding the borrower's address, and the credit report doesn't show any delinquent payments associated with the address. Regardless, FHA requires the lender to determine the borrower's housing obligation payment history through the credit report, verification of rent, verification of mortgage, or the review of canceled checks that cover the most recent 12 month period.

Comment 32: AmericaHomeKey stated that it maintains and implements a robust quality control program that meets HUD requirements. We disagree because AmericaHomeKey provided only two of the six requested quality control reviews. In addition, of the two quality control reviews performed, AmericaHomeKey did not provide evidence that it took corrective actions in response to the findings, and it did not report the findings to HUD as required.

Comment 33: AmericaHomeKey opposes the OIG's inclusion of funds to be put to better use and its calculation of these funds since the nine loans used in the calculation may not end up actually going into foreclosure. AmericaHomeKey believes that the figure is overstated and unrepresentative of HUD's actual loss risk in connection with the ineligible loans. The 2010 fiscal year to date loss severity rate is 59 percent, supported by the Single Family Acquired Asset Management System's Case Management Profit and Loss by Acquisition, as of September 2010. This rate is the FHA's average loss experience for FY 2010 based on its return on properties sold through its Real Estate Owned Inventory. The OIG and FHA consistently use FHA's most recent fiscal year's loss severity rate as a reasonable basis for calculating the funds to be put to better use.

Comment 34: AmericaHomeKey concluded that it substantially complied with FHA underwriting requirements, and that the issues presented in the finding do not constitute violations of HUD/FHA requirements or affect the loans' insurability. AmericaHomeKey also stated in its written response that HUD has acknowledged that underwriting is more of an art than a science. We disagree with AmericaHomeKey's conclusion. While AmericaHomeKey submitted some documents to successfully remove issues set forth in the draft audit report, the finding still demonstrates that AmericaHomeKey did not substantially comply with FHA requirements. Further, while HUD does acknowledge that underwriting is more of an art than a science, it also expects lenders to use both sound judgment and due diligence in the underwriting of loans to be insured by the FHA. Finally, HUD Handbook 4000.4, REV-1 requires lenders to obtain and verify information with at least the same care that would be exercised if originating a mortgage when the lender would be entirely dependent on the property as security to protect its investment. This audit report clearly demonstrates AmericaHomeKey's lack of sound judgment and due diligence in the underwriting of the 13 questioned loans.

Appendix C

SCHEDULE OF INDEMNIFICATION AND REPAYMENT AMOUNTS

FHA case number	Original mortgage amount	Unpaid mortgage balance	Claims paid as of July 31, 2011[a]	Loss on property sale[b]	Indemnification amount[c]	Loan status as of April 30, 2011
495-7838607	$148,943	$143,193	$1,000		$84,484	Delinquent
495-7871535	$80,353			$67,626		Foreclosed-property sold
421-4407985	$166,881	$163,036	$1,000		$96,191	Delinquent
492-8043749	$101,750			$90,481		Foreclosed-property sold
491-9300557	$136,805			$113,205		Foreclosed-property sold
422-2858487	$226,445	$221,716			$130,812	Reinstated by mortgagor; July payment not paid
491-9144966	$134,883			$121,866		Foreclosed – Property sold
221-4024471	$93,075	$89,842			$53,007	Delinquent
011-5918674	$133,406	$128,555			$75,847	Delinquent
492-8004302	$133,416			$121,151		Foreclosed-property sold
091-4395020	$144,372	$139,041	$15,147		$82,034	Delinquent
281-3386718	$135,867	$130,782	$6,656		$77,161	Reinstated after loss mitigation
421-4340956	$148,667	$142,682			$84,182	Reinstated by mortgagor; June and July 2011 payments not paid
Totals	**$1,784,863**	**$1,158,847**	**$23,803**	**$514,329**	**$683,718**	

a We classified $23,803 in claims paid by HUD as unsupported costs that would be required to be supported or repaid to HUD.

b The loss amount was obtained from HUD personnel.

c We classified $683,718 as funds to be put to better use. This is 59 percent of the $1,158,847 in unpaid principal balances for the eight loans as of July 31, 2011. The 59 percent is the estimated percentage of loss HUD would incur when the FHA property is foreclosed upon and resold as supported by SAM'S Case Management Profit and Loss by Acquisition as of September 2010.

Appendix D

CASE NARRATIVES

Case Narrative—Loan Number 495-7838607

Mortgage amount: $148,943

Date of loan closing: May 8, 2008

Status as of July 31, 2011: 2 months delinquent; $1,000 partial claim paid

Payments before first default reported: Two

Underwriting deficiencies:
The underwriter did not

- Verify compensating factors.
- Calculate income correctly.
- Document gift funds transfer.
- Reject documents passed through the seller to the mortgage company.

Summary:

Verified Compensating Factors Were Not Provided
The borrower's qualifying ratios were 31 and 46 percent, respectively, thus exceeding the limits of 31 and 43 percent.[26] On the mortgage credit analysis worksheet, the underwriter documented that the borrower had good reserves and not a lot of debt. FHA's list of acceptable compensating factors includes at least 3 months of cash reserves after closing. A low level of debt is not listed as a compensating factor.[27] The underwriter documented reserves on the mortgage credit analysis worksheet totaling $7,054. This amount is enough to satisfy the 3 months of reserves requirement. However, FHA guidelines also require documentation to support the compensating factors.[28] The verification of deposit, dated April 6, 2008, showed a balance of only $1,555 and an average balance of $279.

Underwriter Calculated Income Incorrectly
The underwriter overstated the borrower's monthly income by $437. Using the overstated income, the underwriter calculated the borrower's ratios of 31 and 46, respectively. Based on the pay stubs in the loan file, overtime income was present but not consistent. Overtime income may be included in the effective income calculation 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 the income for the past 2 years.[29] The underwriter used 13 months of income instead of the required 24 months.

[26] Mortgage Letter 2005-16
[27] HUD Handbook 4155.1, REV-5, paragraph 2-13
[28] Ibid.
[29] HUD Handbook 4155.1, REV-5, paragraph 2-7.A

Further, there was no documentation in the file to show that overtime income would continue. The underwriter should have excluded the overtime from the ratio calculations, which would have resulted in ratios of 35 and 49 percent. Given the higher ratios, the borrower would not have qualified for the FHA mortgage loan.

Gift Funds Transfer Was Not Documented

The underwriter did not document the transfer of gift funds from the donor to the borrower. FHA requires the lender to document the transfer of gift funds from the donor to the borrower.[30]

Documents Passed Through the Seller to the Mortgage Company

The borrower's Internal Revenue Service Form W-2 passed through the seller to the mortgage company. Lenders are prohibited from accepting or using documents related to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties (real estate agents, builders, sellers) or by using their equipment.[31]

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[30] HUD Handbook 4155.1, REV-5, paragraph 2-10.C

[31] HUD Handbook 4155.1, REV-5, paragraph 3-1

Case Narrative—Loan Number 495-7871535

Mortgage amount: $ 80,353

Date of loan closing: July 16, 2008

Status as of July 31, 2011: Title conveyed to insurer; claims paid totaling $88,151. HUD sold the property on February 18, 2011, for $29,500. The total loss to HUD was $67,626.

Payments before first default reported: Five

Underwriting deficiencies:
The underwriter did not

- Adequately evaluate the borrower's creditworthiness.
- Reject documents handled by the seller and sent to the mortgage company.

Summary:

Borrower's Creditworthiness Was Not Adequately Evaluated
The borrower's credit report showed two active tax liens in California. The loan file contained a release letter for each of the liens. However, they were faxed from the seller. FHA requirements prohibit lenders from accepting or using documents related to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties (real estate agents, builders, sellers) or by using their equipment.[32] The lender should have rejected the letters that were faxed from the seller and obtained the letters directly from the borrowers or from California. FHA also requires sufficient written explanation from the borrower for major indications of derogatory credit. The explanation must make sense and be consistent with other credit information in the file.[33] There was no written explanation in the loan file to explain the tax liens.

Seller Handled Documents That Were Sent to the Mortgage Company
The underwriter allowed documents related to the borrower's credit and income documents to pass through the seller to the mortgage company. Lenders are prohibited from accepting or using documents related to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties (real estate agents, builders, sellers) or by using their equipment.[34]

32 Ibid.
33 HUD Handbook 4155.1, REV-5, paragraph 2-3
34 See footnote 31.

Case Narrative—Loan Number 421-4407985

Mortgage amount: $166,881

Date of loan closing: December 16, 2008

Status as of July 31, 2011: 2 months delinquent; $1,000 partial claim paid

Payments before first default reported: Zero

Underwriting deficiencies:
The underwriter did not

- Provide acceptable compensating factors.

Summary:

Acceptable Compensating Factors Were Not Provided
The underwriter calculated the qualifying ratios as 33 and 37 percent, respectively. Since the borrower's total mortgage payment-to-income ratio of 33 percent exceeded the limit of 31 percent, the underwriter was required to provide acceptable compensating factors.[35] The underwriter documented that the borrower had 1½ half months of reserves, had paid off a judgment, and had a low level of debt. FHA regulations require the lender to obtain supporting documentation from borrowers and document the compensating factor(s) when borrowers exceed qualifying ratios to justify mortgage origination.[36] FHA's list of compensating factors requires at least 3 months of cash reserves after closing. A low level of debt and a paid judgment are not listed as compensating factors.[37] The lender provided additional documentation, after we provided it with the draft audit report, that showed the borrower's monthly debt at $518 instead of the $167 reported on the Mortgage Credit Analysis Worksheet. As a result, we calculated the borrower's qualifying ratios at 34 and 46.

35 See footnote 27.
36 HUD Handbook 4155.1, REV-5, paragraphs 2-12 & 2-13
37 See footnote 27.

Case Narrative—Loan Number 492-8043749

Mortgage amount: $101,750

Date of loan closing: May 8, 2008

Status as of July 31, 2011: Title conveyed to insurer; claims paid totaling $109,399, HUD sold the property on March 11, 2010 for $24,325. The total loss to HUD was $90,481.

Payments before first default reported: Two

Underwriting deficiencies:
The underwriter did not

- Verify compensating factors.
- Reject documents passing through the seller to the mortgage company.

Summary:

Verified Compensating Factors Were Not Provided
The borrower's qualifying ratios of 38 and 47 percent, respectively, exceeded the limits of 31 and 43 percent.[38] On the mortgage credit analysis worksheet, the underwriter documented that the borrower had 3 months of reserves, not a lot of debt, and overtime income that was not used to qualify. The reserves and overtime income are acceptable compensating factors under FHA guidelines. However, FHA guidelines also require documentation to support the compensating factors.[39] The underwriter documented cash reserves totaling $2,500. The required reserves were $2,759. The overtime income that was not used to qualify was not addressed in the verification of employment. Therefore, we were unable to determine whether the overtime income was likely to continue.

The Seller Handled Mortgage Documents That Were Sent to the Mortgage Company
The underwriter allowed documents related to the borrower's credit to pass through the seller to the mortgage company. FHA requirements prohibit lenders from accepting or using documents related to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties (real estate agents, builders, sellers) or by using their equipment.[40]

[38] See footnote 26.
[39] See footnote 27.
[40] See footnote 31.

Case Narrative—Loan Number 491-9300557

Mortgage amount: $136,805

Date of loan closing: September 5, 2008

Status as of July 31, 2011: Title conveyed to insurer; claims paid totaling $145,379. HUD sold the property on June 10, 2010 for $37,500. The total loss to HUD was $113,205.

Payments before first default reported: Two

Underwriting deficiencies:
The underwriter did not

- Adequately evaluate the borrower's creditworthiness.
- Verify previous housing obligation payment history.

Summary:

Borrower's Creditworthiness Was Not Adequately Evaluated
The subject property is located in Texas, a community property State. According to the Form HUD-1, Settlement Statement, the borrower was married. Only one borrower signed the mortgage note, making the borrower's spouse a nonpurchasing spouse. FHA requires the lender to include the debts of nonpurchasing spouses when the borrower resides in a community property State or if the property being insured is located in a community property State.[41] Therefore, the credit for both borrowers should have been analyzed to ensure that the spouse's debt was included in the qualifying ratios. There was no credit documentation in the file for the nonpurchasing spouse.

Previous Housing Obligation Payment History Was Not Verified
The borrower's housing obligation payment history holds significant importance when evaluating credit. The lender must determine the borrower's housing obligation payment history through the credit report, verification of rent directly from the landlord (for landlords with no identity of interest with the borrower), verification of the mortgage directly from the mortgage servicer, or the review of canceled checks covering the most recent 12-month period.[42] The loan file did not contain a verification of rent or previous housing payments.

[41] HUD Handbook 4155.1, REV-5, paragraph 2-2D
[42] HUD Handbook 4155.1, REV-5, paragraph 2-3.A

Case Narrative—Loan Number 422-2858487

Mortgage amount: $226,445

Date of loan closing: July 30, 2008

Status as of July 31, 2011: Reinstated by mortgagor. July payment not paid.

Payments before first default reported: Nine

Underwriting deficiencies:
The underwriter did not

- Calculate income correctly.
- Adequately evaluate the borrower's creditworthiness.

Summary:

Income Was Calculated Incorrectly
The lender calculated monthly income at $6,000 per month. However, the lender incorrectly used commission income in its calculation. According to documents in the loan file, the borrower was employed at his current job for only 3 months before closing. Commissions earned for less than 1 year are not considered effective income.[43] The borrower's prior position was in the same industry, but there was no documentation in the file to show that he earned a commission. The lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation. All information must be verified and documented.[44] As a result, the borrower's commission income could not be used in the effective income calculation. Because the lender included the commission income, it understated the borrower's ratios on the mortgage credit analysis worksheet. The ratios used for loan approval were 30 and 39 percent, respectively. We calculated the borrower's effective income at $4,333 per month ($1,667 less than the lender's calculation) and the ratios at 42 and 54 percent, which exceeded the FHA limits of 31 and43 percent.[45] The lender was required to obtain supporting documentation from borrowers and document the compensating factor(s) when borrowers exceeded qualifying ratios to justify mortgage origination.[46] The underwriter documented 3 months in reserves. However, we did not find any documentation in the loan file to support the claimed reserves.

Borrower's Creditworthiness Was Not Adequately Evaluated
The borrower's credit report showed several accounts that were charged off and late payment histories. Some of these accounts were more than 24 months old. The letter of explanation stated that the borrower was unemployed for several months. This explanation was not consistent with the credit history since the poor credit spanned several years. FHA requires sufficient written explanation from the borrower for major indications of derogatory credit. The explanation must make sense and be consistent with other credit information in the file.[47]

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43 HUD Handbook 4155.1, REV-5, paragraph 2-3D
44 HUD Handbook 4155.1, REV-5, Chapter 3
45 See footnote 26.
46 See footnote 36.
47 See footnote 33.

Case Narrative—Loan Number 491-9144966

Mortgage amount: $134,883

Date of loan closing: March 27, 2008

Status as of July 31, 2011: Title conveyed to insurer; claims paid totaling $150,527. HUD sold the property on September 1, 2011 for $34,000. The total loss to HUD was $121,866.
Payments before first default reported: Three

Underwriting deficiencies:
The underwriter did not

- Provide acceptable compensating factors.
- Adequately evaluate the borrower's creditworthiness.

Summary:

Acceptable Compensating Factors Were Not Provided
The borrower's qualifying ratios of 33 and 45 percent exceeded the limits of 31 and 43 percent.[48] The underwriter documented that the borrower had 1 month of reserves and not a lot of debt as compensating factors. Neither of these items met the requirements of FHA's list of compensating factors. FHA's list of compensating factors requires at least 3 months of cash reserves after closing. A low level of debt is not listed as a compensating factor.[49]

Borrower's Creditworthiness Was Not Adequately Evaluated
The borrower's credit report showed several accounts with charge offs. The written explanation stated that all of the derogatory credit was old and she was using an agency to clean up her credit. However, no documentation from any type of credit counseling agency was in the file. FHA requires the lender to document that 1 year of the pay-out period has elapsed under the plan, and the borrower's payment performance has been satisfactory. In addition, the borrower must receive written permission from the counseling agency to enter into the mortgage transaction.[50]

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[48] See footnote 26.
[49] See footnote 27.
[50] HUD Handbook 4155.1, REV-5, paragraph 2-3F.

Case Narrative—Loan Number 221-4024471

Mortgage amount: $93,075

Date of loan closing: July 11, 2008

Status as of July 31, 2011: 31 months delinquent; first legal action to commence foreclosure

Payments before first default reported: Two

Underwriting deficiencies:
The underwriter did not

- Verify compensating factors.
- Adequately evaluate the borrower's creditworthiness.
- Document stability of income.
- Ensure that the loan closed in compliance with the loan approval requirements.

Summary:

Verified Compensating Factors Were Not Provided
The borrower's qualifying ratios of 36 and 45 percent exceeded the limits of 31and 43 percent.[51] The underwriter documented that the borrower had 3 months of reserves and not a lot of debt. The reserves are acceptable compensating factors under FHA guidelines. However, FHA guidelines also require documentation to support the compensating factors.[52] The underwriter did not provide documentation to support 3 months of reserves.

Borrower's Creditworthiness Was Not Adequately Evaluated
The borrower's credit report showed several accounts that were charged off. The borrower's written explanation stated that she had paid the accounts off and that she had been ill. However, there was no documentation in the loan file to show that the accounts had been paid off. Collections and judgments indicate a borrower's regard for credit obligations and must be considered in the creditworthiness analysis. FHA requires sufficient written explanation from the borrower for major indications of derogatory credit. The explanation must make sense and be consistent with other credit information in the file.[53]

Income Stability Was Not Properly Documented
The lender did not verify the most recent 2 years of income. The lender is required to verify the borrower's employment for the most recent 2 full years. The borrower must explain gaps in employment spanning 1 month or more.[54] Other income verified was from 5 years before the loan application and was not relevant.

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[51] See footnote 26.
[52] See footnote 27.
[53] See footnote 33.
[54] HUD Handbook 4155.1, REV-5, paragraph 2-6

The Loan Did Not Close in Accordance With the Loan Approval Requirements

A person other than the borrower signed the mortgage security instrument for this loan. There was no evidence in the loan file that the lender reviewed this person for income, creditworthiness, assets, etc. FHA requires the loan to close in the same manner in which it was underwritten and approved. FHA may withhold endorsement of the loan if there are additional signatures on the security instruments or mortgage note of individuals not reviewed during mortgage credit analysis.[55]

[55] HUD Handbook 4155.2, paragraph 6.A.2.f

Case Narrative—Loan Number 011-5918674

<u>Mortgage amount</u>: $133,406

<u>Date of loan closing</u>: May 30, 2008

<u>Status as of July 31, 2011</u>: 8 months delinquent, and the borrower had a confirmed bankruptcy plan

<u>Payments before first default reported</u>: Zero

<u>Underwriting deficiencies</u>:
The underwriter did not

- Provide acceptable compensating factors.
- Adequately evaluate the borrower's creditworthiness.

<u>Summary:</u>

Acceptable Compensating Factors Were Not Provided
The borrower's qualifying ratios of 32 and 40 percent exceeded the limits of 31 and 43 percent.[56] The underwriter documented that the borrower had 1 month of reserves and not a lot of debt. Neither of these items met the requirements of FHA's list of compensating factors. FHA's list of compensating factors requires at least 3 months of cash reserves after closing. A low level of debt is not listed as a compensating factor.[57]

Borrower's Creditworthiness Was Not Adequately Evaluated
The borrower's credit report showed several accounts in collection or charged off. The borrower's written explanation stated that complications during pregnancy contributed to the derogatory credit. However, there was no evidence in the file to show that the borrower attempted to pay the delinquent accounts (except for one payoff letter of a $450 debt) once the pregnancy ended and health was restored. The borrower's failure to pay the derogatory accounts illustrated a poor attitude toward credit obligations. Collections and judgments indicate a borrower's regard for credit obligations and must be considered in the creditworthiness analysis. FHA requires sufficient written explanation from the borrower for major indications of derogatory credit. The explanation must make sense and be consistent with other credit information in the file. Further, the lender must document reasons for approving a mortgage when the borrower has collection accounts or judgments.[58] We did not find documentation in the loan file showing the lender's reasons for approving the mortgage.

[56] See footnote 26.
[57] See footnote 27.
[58] See footnote 33.

Case Narrative—Loan Number 492-8004302

Mortgage amount: $133,416

Date of loan closing: April 2, 2008

Status as of July 31, 2011: Title conveyed to insurer; claims paid totaling $141,213. HUD sold the property on June 25, 2010 for $24,402. The total loss to HUD was $121,151.
Payments before first default reported: 11

Underwriting deficiencies:
The underwriter did not
- Provide acceptable compensating factors.
- Calculate income correctly.

Summary:

Acceptable Compensating Factors Were Not Provided
The borrower's qualifying ratios of 33 and 44 percent exceeded the limits of 31 and 43 percent.[59] The underwriter documented that the borrower had 2 months of reserves and not a lot of debt as a compensating factor. Neither of these items met the requirements of FHA's list of compensating factors. FHA's list of compensating factors requires at least 3 months of cash reserves after closing. A low level of debt is not listed as a compensating factor.[60]

Underwriter Calculated Income Incorrectly
The underwriter overstated the borrower's monthly income by $747 per month. Using the overstated income, the underwriter calculated the borrower's qualifying ratios as 33 and 44 percent, respectively. Overtime income may be included in the effective income calculation 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 the income for the past 2 years.[61] There was no documentation in the file to indicate that the overtime income would continue. Regardless, the underwriter used 13.72 months of income instead of the required 24 months. The underwriter should have excluded the overtime from the ratio calculations, which would have resulted in ratios of 42 and 56 percent. Given the higher ratios, the borrower would not have qualified for the FHA mortgage loan.

[59] See footnote 26.
[60] See footnote 27.
[61] See footnote 29.

Case Narrative—Loan Number 091-4395020

Mortgage amount: $144,372

Date of loan closing: May 22, 2008

Status as of July 31, 2011: 16 months delinquent; first legal action to commence foreclosure. Claim paid totaling $15,147.

Payments before first default reported: 11

Underwriting deficiencies:
The underwriter did not

- Verify compensating factors.
- Adequately evaluate the borrower's creditworthiness.
- Document gift funds transfer.

Summary:

Verified Compensating Factors Were Not Provided
The borrower's qualifying ratios of 36 and 48 percent exceeded the limits of 31 and 43 percent.[62] The underwriter documented that the borrower had 3 months of reserves and not a lot of debt. The reserves are acceptable compensating factors under FHA guidelines. However, FHA guidelines also require documentation to support the compensating factors.[63] The underwriter did not provide documentation to support 3 months of reserves.

Borrower's Creditworthiness Was Not Adequately Evaluated
The borrower's credit report showed several accounts that were charged off. The borrower's written explanation stated that his derogatory credit was the result of a divorce. We searched public records and found that the borrower divorced in 2001 and married his current wife in 2006. Most of the derogatory credit occurred after the divorce. Collections and judgments indicate a borrower's regard for credit obligations and must be considered in the creditworthiness analysis. FHA requires sufficient written explanation from the borrower for major indications of derogatory credit. The explanation must make sense and be consistent with other credit information in the file.[64]

Gift Funds Transfer Was Not Documented
The Form HUD-1 showed that the borrower received $8,200 in gift funds. However, the gift funds transfer showed that only $7,525 was transferred. The underwriter did not document the transfer of the remaining $675 in gift funds. FHA requires the lender to document the transfer of gift funds from the donor to the borrower.[65]

[62] See footnote 26.
[63] See footnote 27.
[64] See footnote 33.
[65] See footnote 30.

Case Narrative— Loan Number 281-3386718

Mortgage amount: $135,867

Date of loan closing: April 1, 2008

Status as of July 31, 2011: Reinstated after loss mitigation. Claims paid totaling $6,656.

Payments before first default reported: Two

Underwriting deficiencies:
The underwriter did not

- Provide acceptable compensating factors.

Summary:

Acceptable Compensating Factors Were Not Provided
The borrower's qualifying ratios of 34 and 45 percent exceeded the FHA limits of 31 and 43 percent.[66] The underwriter documented that the borrower had 2 months of reserves and not a lot of debt as compensating factors. Neither of these items met the requirements of FHA's list of compensating factors. FHA's list of compensating factors requires at least 3 months of cash reserves after closing. A low level of debt is not listed as a compensating factor.[67]

66 See footnote 26.
67 See footnote 27.

Case Narrative— Loan Number 421-4340956

Mortgage amount: $148,667

Date of loan closing: February 22, 2008

Status as of July 31, 2011: Reinstated by mortgagor; June and July 2011 payments not paid

Payments before first default reported: Not available

Underwriting deficiencies:
The underwriter did not

-
- Verify previous housing obligation payment history.
- Document the transfer of gift funds.

Summary:

Previous Housing Obligation Payment History Was Not Verified
FHA requires the lender to determine the borrower's housing obligation payment history through the credit report, verification of rent, verification of mortgage, or the review of canceled checks covering the most recent 12-month period.[68] The borrower's loan application documented that he was renting for the 2 years before closing the mortgage. We did not find a verification of rent or previous housing payments in the loan file to show that the lender verified the borrower's housing obligation payment history.

Gift Funds Transfer Was Not Documented by Lender
The loan file contained a gift letter for $3,030 from a relative. The Form HUD-1 showed that the borrower paid $3,030 at closing. However, the loan file did not contain documentation to show the transfer of the gift funds from the donor to the borrower. FHA requires the lender to document the transfer of the funds from the donor to the borrower.[69]

[68] See footnote 42.
[69] See footnote 30.