| Issue Date |
| --- |
| March 19, 2010 |
| Audit Report Number |
| 2010-LA-1009 |

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

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: DHI Mortgage Company, LTD's Scottsdale, AZ, Branches Did Not Follow FHA-Insured Loan Underwriting Requirements

# HIGHLIGHTS

## What We Audited and Why

We audited Federal Housing Administration (FHA)-insured loan processes at two DHI Mortgage Company, LTD (DHI Mortgage), branches in Scottsdale, AZ, to determine whether DHI Mortgage originated, approved, and closed FHA-insured single-family loans in accordance with U.S. Department of Housing and Urban Development (HUD) requirements. We recently conducted an audit of DHI Mortgage's Tucson and Scottsdale branches and identified significant underwriting deficiencies and improper restrictive addenda/liens to the purchase contracts. Based on the results of our prior audit, we chose to audit the remaining two DHI Mortgage Scottsdale branches.

## What We Found

DHI Mortgage did not follow HUD requirements for originating, approving, or closing FHA-insured loans. Specifically, all 20 of the loans reviewed contained underwriting deficiencies, and 12 of these had significant deficiencies that impacted the insurability of the loan. The significant underwriting deficiencies included improper calculation of income, inadequate documentation of income, inadequate determination of credit and/or debt, and inadequate compensating factors when the debt-to-income ratio exceeded

HUD's benchmark ratio. We also reviewed all of the loans in our audit period that were either "new construction" or "new condo" to determine whether improper restrictive covenants were recorded against the FHA-insured properties. We identified eight loans that had prohibited restrictive addenda to the purchase contracts.

## What We Recommend

We recommend that the Deputy Assistant Secretary for Single Family Housing require DHI Mortgage to (1) indemnify HUD for more than $2.5 million for loans that did not meet FHA insurance requirements and (2) reimburse HUD $265,420 for the amount of claims and associated fees paid on loans that did not meet FHA insurance requirements.

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

## Auditee's Response

We provided a discussion draft report to DHI Mortgage on February 5, 2010, and held an exit conference on February 23, 2010. DHI Mortgage provided written comments on March 3, 2010. They generally disagreed with our findings.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

# TABLE OF CONTENTS


Background and Objective 4

Results of Audit

Finding 1: DHI Mortgage Failed To Underwrite FHA-Insured Loans in Accordance With HUD-FHA Requirements 5

Finding 2: DHI Mortgage Did Not Prevent Restrictive Covenants That Violated HUD-FHA Requirements 9

Scope and Methodology 12

Internal Controls 14

Follow-up on Prior Audits 15

Appendixes

A. Schedule of Questioned Costs and Funds To Be Put to Better Use 17
   A-1 Loan Details for Significant Underwriting Deficiencies
   A-2 Loans Details for Schedule A To Purchase Contracts

B. Auditee Comments and OIG's Evaluation 20
C. Criteria 49
D. Narrative Loan Summaries for Significant Underwriting Deficiencies 56

# BACKGROUND AND OBJECTIVE

DHI Mortgage Company, LTD (DHI Mortgage), is a nonsupervised lender[1] approved June 8, 1981, to originate Federal Housing Administration (FHA) loans. DHI Mortgage originates loans under the lender insurance program.[2] The company is a wholly owned subsidiary of D.R. Horton, Inc., a national residential homebuilder, and an affiliate of DHI Title Company (DHI Title), another wholly owned subsidiary of D.R. Horton, Inc. DHI Mortgage headquarters is at 12357 Riata Trace Parkway, Suite C-150, Austin, TX, and the company has branches in 20 States. DHI Mortgage provides mortgage financing services principally to purchasers of D.R. Horton, Inc., homes.

DHI Mortgage has 36 FHA-approved active branch offices.[3] Between fiscal years 2007 and 2009, DHI Mortgage originated 17,993 FHA-insured loans totaling more than $3.2 billion.

We selected the remaining two DHI Mortgage Scottsdale, AZ, branches (FHA numbers 0542400095 and 0542400696) for review because our previous audit of its Tucson and other Scottsdale branches (Report 2009-LA-1018, issued September 10, 2009) identified 24 FHA-insured loans that had significant underwriting deficiencies and 205 FHA-insured loans that had improper restrictive addenda/liens to the purchase contracts. Some of the personnel responsible for originating, approving, and closing loans at the branch offices in our previous audit were also involved with the two remaining Scottsdale branches. The two DHI Mortgage Scottsdale branches originated 1,897 FHA-insured loans totaling more than $344 million during our audit period.[4]

FHA, created by Congress in 1934, is the largest mortgage insurer in the world. The cost of FHA mortgage insurance is paid by the homeowners, and the mortgage insurance fund is used to operate the program. The mortgage insurance fund pays claims to lenders in the event of a homeowner default. Between October 1, 2008, and September 30, 2009, FHA insured more than 1.8 million single-family mortgages totaling more than $328 billion, or 68 percent of the single-family insured mortgage market—up from 39 percent the previous year.[5]

Our objective was to determine whether DHI Mortgage FHA branch numbers 0542400095 and 0545200696 originated, approved, and closed FHA-insured loans in accordance with U.S. Department of Housing and Urban Development (HUD)-FHA regulations and requirements.

---

[1] A nonsupervised lender is a HUD-FHA-approved lending institution that has as its principal activity the lending or investment of funds in real estate mortgages and is not a supervised lender, loan correspondent, governmental institution, government-sponsored enterprise, or public or State housing agency and has not applied for approval for the limited purpose of being an investing lender.

[2] The U.S. Department of Housing and Urban Development's (HUD) lender insurance program allows lenders to self-insure FHA loans and submit only those case binders (paper or electronic) required for review by HUD. HUD reviews approximately 6 percent of insured loans.

[3] According to Neighborhood Watch, as of December 28, 2009.

[4] The audit period included FHA-insured loans with beginning amortization dates between June 1, 2007, and May 31, 2009.

[5] HUD monthly report to the FHA Commissioner: FHA Portfolio Analysis Data as of September 2009.

# RESULTS OF AUDIT

## Finding 1: DHI Mortgage Failed To Underwrite FHA-Insured Loans in Accordance With HUD-FHA Requirements

DHI Mortgage did not follow HUD requirements for underwriting FHA-insured loans. Specifically, all 20 loans reviewed contained underwriting deficiencies, and 12 of these had significant deficiencies that impacted the insurability of the loan. This noncompliance occurred because the lender failed to exercise due diligence in underwriting these loans. As a result, for loans that did not meet FHA insurance requirements the FHA portfolio was exposed to increased insurance risk for $1,186,300 in unpaid mortgage balances and incurred losses of $265,420.

### Twelve Loan Files Contained Significant Underwriting Deficiencies

The loan file review of 20 FHA-insured loans identified 12 with significant underwriting deficiencies that included improper calculation of income, inadequate documentation of income, inadequate determination of credit and/or debt, and inadequate compensating factors when the debt-to-income ratio exceeded HUD's benchmark ratio. DHI Mortgage did not underwrite the 12 loans as required by HUD Handbook 4155.1, REV-5, chapter 3, which states that "the lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation, source of funds for the transactions, and the intended use of the property. All information must be verified and documented." The 12 loans, which totaled more than $1.7 million in unpaid mortgage balances, were approved based on many factors that included reported monthly income, debt obligations, assets, and/or compensating factors. However, DHI Mortgage closed many of the loans based on inadequate determination and evaluation of these factors.

- Income – The significant deficiencies included improperly calculated income; inadequate documentation of income as required by Mortgagee Letter 2004-47; and lack of documentation to support the use of overtime income as required by HUD Handbook 4155.1, REV-5, paragraph 2-7A.

  For example, for FHA loan number 023-2692048, the lender included the borrower's overtime hours in the overtime calculation as well as the base income calculation. As a result, a portion of the overtime income was doubled, and the borrower's monthly income was overstated by $425.

- Credit – The significant deficiencies included the lender's failure to obtain a credit report for a nonpurchasing spouse as required by HUD Handbook 4155.1, REV-5, paragraph 2-2D; exclusion of debts from the qualifying ratios; failure to adjust rental property mortgage payments that were scheduled to increase due to

interest rate resets; failure to document compensating factors and that the borrowers reestablished good credit after bankruptcy as required by HUD Handbook 4155.1, REV-5, paragraph 2-3; and failure to provide proof of satisfied judgments before closing as required by HUD Handbook 4155.1, REV-5, paragraph 2-11.

For example, for FHA loan number 023-2575560, the lender excluded two liabilities for the borrower and coborrower in the total fixed payment-to-income ratio as required by the Fannie Mae Underwriting Findings and HUD Handbook 4155.1, REV-5, paragraph 2-11A. The borrower's pay stub revealed a deduction for "Levy-Fed" of $100 per month, and the coborrower's pay stub revealed a deduction for "Company Store" of $599 per month. The borrower's and co-borrower's liabilities and debts were understated by $699.

- Assets – The significant deficiency regarded the lender's failure to document the transfer of gift funds to the borrower as required by HUD Handbook 4155.1, REV-5, paragraph 2-10C.

  For FHA loan number 023-2866499, the borrower had a downpayment of $19,132 that was derived from a $20,000 gift received from his spouse. At closing, the funds were wired from the borrower's checking account; however, the loan file contained neither a withdrawal document showing that the withdrawal was from the donor's account nor the home buyer's deposit slip or bank statement that showed the deposit.

- Compensating factors – The significant deficiencies regarded the lender's failure to document adequate and eligible compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16.

  For example, for FHA loan number 023-2836293, the borrower's mortgage payment-to-income and total fixed payment-to-income ratios exceeded HUD's benchmark ratios by 16.83 and 6.14 percent, respectively. The only allowable compensating factor listed by the lender was that the borrower had "reserves for 3 months." However, this compensating factor was not eligible because the borrower's reserves were $423 less than the amount required.

The table below lists the 20 FHA loan numbers reviewed and the deficient areas associated with each loan. The table also identifies the 12 loans for which we concluded that the underwriting was significantly deficient and, therefore, warranted indemnification. Appendix D provides underwriting details for each FHA loan considered to have significant underwriting deficiencies.

| FHA loan number | Underwriting deficiencies | | | | Significant underwriting deficiencies |
|---|---|---|---|---|---|
| | Income | Credit | Assets | Compensating factors | |
| 023-2501805 | ✓ | ✓ | | | |
| 023-2510944 | | | ✓ | | |
| 023-2516629 | ✓ | | ✓ | | |
| 023-2546830 | | ✓ | | | ✓ |
| 023-2575560 | ✓ | ✓ | | | ✓ |
| 023-2577611 | ✓ | | | ✓ | ✓ |
| 023-2577634 | | ✓ | ✓ | | ✓ |
| 023-2610061 | ✓ | | | | ✓ |
| 023-2685082 | | ✓ | ✓ | ✓ | |
| 023-2692048 | ✓ | ✓ | | | ✓ |
| 023-2704044 | | | | ✓ | ✓ |
| 023-2709195 | | | ✓ | ✓ | ✓ |
| 023-2715893 | ✓ | | | | |
| 023-2728194 | ✓ | ✓ | | | ✓ |
| 023-2836048 | ✓ | | ✓ | ✓ | |
| 023-2836293 | ✓ | ✓ | | ✓ | ✓ |
| 023-2866499 | | | ✓ | ✓ | ✓ |
| 023-2880511 | | ✓ | ✓ | | ✓ |
| 023-2913632 | ✓ | ✓ | | | |
| 023-3125199 | ✓ | | | | |
| | **12** | **10** | **8** | **7** | **12** |

## The Remaining Eight Loan Files Also Contained Underwriting Deficiencies

The remaining eight loans reviewed also contained underwriting deficiencies that were in violation of HUD-FHA requirements; however, they were not deemed significant enough to impact the insurability of the loan. Examples of these technical underwriting deficiencies include loan files that did not contain the verification of deposit as required by HUD Handbook 4155.1, REV-5, paragraph 3-1F; compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16; verification of employment for 2 years as required by HUD Handbook, paragraph 2-6; explanation of collection accounts on the credit report as required by HUD Handbook, 4155.1, REV-5, paragraph 2-3C; and explanation of credit inquiries that were within 90 days of the completed credit report as required by HUD Handbook 4155.1, REV-5, paragraph 2-3B. In these cases, either the technical underwriting deficiency was not significant enough to impact the insurability of the loan, or the loan would be eligible based on other factors

even if the underwriter had properly adjusted for the deficient items. The table above identifies the loans that contained technical underwriting deficiencies.

## Lack of Due Diligence Increased Risk of Loss to the FHA Insurance Fund

The foreword in HUD Handbook 4155.1, REV-5, states, "This [underwriting] decision must be predicated on sound underwriting principles consistent with the guidelines, rules, and regulations described throughout this Handbook and must be supported by sufficient documentation." Because DHI Mortgage did not follow HUD-FHA requirements when underwriting, it inappropriately approved 12 loans that had significant underwriting deficiencies. The lender did not exercise both sound judgment and due diligence when it submitted these loans for FHA insurance. As a result, the FHA insurance fund was at increased risk for losses on seven[6] loans with significant underwriting deficiencies. Regarding the other three loans with significant underwriting deficiencies, the FHA insurance fund has already realized losses. The losses resulted when the properties that secured these three loans were sold and the insurance claims and other expenses incurred by HUD exceeded the sales proceeds.

## Conclusion

DHI Mortgage's failure to follow HUD-FHA regulations and requirements placed the FHA insurance fund at additional risk for losses. There were 10 loans that did not meet the requirements for FHA insurance. Seven of these loans had a total unpaid mortgage balance of $1,186,300 with an estimated loss to HUD of $711,781[7]. The remaining three loans had an actual loss to HUD of $265,420. (see appendix A-1).

## Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing

1A. Require DHI Mortgage to indemnify HUD against losses for the seven FHA-insured loans with significant underwriting deficiencies in the amount of $1,186,300. The estimated loss to HUD is $711,781.

1B. Require DHI Mortgage to reimburse HUD for the $265,420 in losses resulting from the amount of claims and associated expenses paid on three loans with significant underwriting deficiencies.

---

[6] After the start of the audit, two loans (023-2610061 and 023-2692048) were indemnified by request from the lender.

[7] This amount was calculated based on 60 percent of the unpaid mortgage balances (according to Neighborhood Watch as of December 21, 2009). The 60 percent indemnification rate was the average loss on FHA-insured foreclosed properties based on the FHA Annual Management Report for Fiscal Year 2009.

## Finding 2: DHI Mortgage Did Not Prevent Restrictive Covenants That Violated HUD-FHA Requirements

DHI Mortgage did not ensure that unallowable restrictive covenants were not filed against eight FHA-insured properties. The restrictive covenants precluded the borrowers from rental or resale of their property for 1 year and provided for the seller to recoup $40,000 in liquidated damages if the borrower violated the restrictive covenants. DHI Mortgage allowed the restrictive covenants, generally referred to as a schedule A to purchase contract, because officials believed it would discourage investors from purchasing their affiliate's (the seller's) properties. Because the FHA insurance program requires free assumability with no restrictions, the FHA insurance portfolio had secured more than $1.3 million in unpaid mortgage balances for six loans[8] that did not meet this FHA insurance requirement.

### Restrictive Covenants Were Applied to Eight FHA-Insured Loans

A review of the applicable county recorder's records revealed liens on eight FHA-insured properties These liens, called schedule A to purchase contacts, restricted the new owner(s) from resale or rental of the property during the first year of ownership. The execution of these contracts with the purchase agreements violated the regulations governing HUD's FHA-insured mortgage program, which prohibit restrictive covenants and second liens. As illustrated in the excerpt below, the contracts stated that the "Owner hereby grants to Seller a lien against the Property (the 'Lien') to secure Owner's obligations hereunder. Seller may promptly initiate proceedings to foreclose the Lien if Owner defaults in its obligation to pay Seller liquidated damages in the amount of $40,000 on the date that Owner or any of its successors or assigns conveys during the Restricted Period any rights, title, or interest in the Property without Seller's written consent."

Schedule A to purchase contract corresponding to FHA loan number 023-2470369

> 1.1 RESTRICTION ON RESALE OR RENTAL OF PROPERTY. Owner, for itself, its successors, and its assigns, hereby declares and agrees that it shall not sell, convey, lease, rent or otherwise transfer its rights, title or interest in the Property during the period beginning as of even date herewith and expiring one(1) year from close of escrow (the "Restriction Period"), without the prior written consent of Seller, which consent may be withheld in Seller's sole discretion. Authorized Investment residences/loans will be allowed to rent out said property within the year but can not display a "for rent" sign.

[8] After the start of the audit, two loans (023-2470369 and 023-2488642) were terminated.

1.2 LIQUIDATED DAMAGES. Owner acknowledges and agrees that if Owner breaches its obligation under Section 1.1 above, the damages sustained by Seller shall be difficult to calculate with any precision. Accordingly, if Owner or any of its successors or assigns sells, conveys, leases, rents or otherwise transfers during the Restriction Period any rights, title or interest in the Property without Seller's written consent, Owner shall pay to Seller as liquidated damages the sum of $40,000.00.

2.1 GRANT OF LIEN TO SELLER. Owner hereby grants to Seller a lien against the Property (the "Lien") to secure Owner's obligations hereunder. Seller may promptly initiate proceedings to foreclose the Lien if Owner defaults in its obligation to pay Seller liquidated damages in the amount of $40,000.00 on the date that Owner or any of its successors or assigns conveys during the Restriction Period any rights, title or interest in the Property without Seller's written consent. Owner agrees that all of Seller's reasonable costs and expenses of foreclosure, including reasonable attorney's fees and interest at the rate of 15% per annum from the date of said default, shall become additional indebtedness owed by Owner to Seller that is secured by this Lien. Owner hereby waives any homestead exemption or other exemption now or hereafter existing or enacted under either Arizona or federal law. No transfer of any rights, title or interest in the Property shall relieve Owner from the personal obligation to pay liquidated damages, together with interest, costs and reasonable attorneys' fees, pursuant to this Covenant; provided, however, that Owner's obligations under this Covenant shall not extend to any breach of this Covenant by Owner's successor(s) in title.

Unofficial Document

DHI Mortgage was apparently aware that this practice was not allowed for FHA-insured mortgages because there were instances in which the occupancy/investment disclosure addendum to the purchase contract contained the following exclusion from the restrictive covenant when the buyer purchased the property using FHA financing.

Addendum to purchase contract corresponding to FHA loan number 023-2929894

12. **COVENANT RESTRICTING RESALE OR RENTAL OF PROPERTY**. The following covenant shall apply to any Buyer other than a Buyer that purchases the Property using FHA or VA financing:

However, despite the exclusion clause number 12 to the schedule A to purchase, the contract was executed and recorded in eight instances.

Appendix A-2 contains the FHA loan numbers for which we found a schedule A to purchase contract. The schedule A to purchase contracts made the loans ineligible for FHA insurance because the contract addenda included prohibited liens against FHA-insured property as well as restrictive covenants that prevented the borrower from rental or resale of the FHA-insured property, which violated 24 CFR (Code of Federal Regulations) 203.32 and 203.41, respectively. The regulations at 24 CFR 203.32 state that after the mortgage offered for insurance has been recorded, the mortgaged property will be free and clear of all liens other than such mortgage. The regulations at 24 CFR 203.41(b) state that an FHA-insured "mortgage shall not be eligible for insurance if the mortgaged property is subject to legal restrictions on conveyance" (see appendix C).[9]

[9] The exception to free assumability is at 24 CFR 203.41(c) "Exception for eligible governmental or nonprofit programs."

## DHI Mortgage Officials Used the Covenants to Discourage Investment Purchasers

DHI Mortgage officials stated that the schedule A to purchase contracts was a common practice designed to address a significant problem experienced by D.R. Horton, Inc., – Dietz-Crane (D.R. Horton) and other homebuilders when home prices were rapidly escalating. In many cases, a buyer who claimed to be purchasing a home for his or her residence was actually an investor seeking to purchase and then quickly sell the home at a profit. D.R. Horton did not consider this flipping practice to be consistent with the goal of building sustainable communities at a reasonable price. Officials stated that the "Schedule A was not designed to prohibit or provide for liquid damages in connection with the bona fide purchase and resale of a home by the owner-occupant. Schedule A simply provides that a home may not be resold within one year of the purchase from D.R. Horton without D.R. Horton's consent."

## Conclusion

The schedule A to purchase contract put additional unnecessary risk on the FHA-insured loans by restricting the borrower's ability to rent or sell a property during the first year of the loan and by giving sole discretion to the former seller to grant a waiver of the restrictions. By restricting the borrower's ability to rent or sell the property during the first year of the loan, distressed homeowners were unable to freely sell or rent their property in an attempt to relieve the financial burden. Therefore, the six loans with a total unpaid mortgage balance of more than $1.3 million did not meet the requirements for FHA insurance because they violated 24 CFR 203.32 and 203.41. The estimated loss to HUD associated with these loans is $789,984[10] (see appendix A-2).

## Recommendation

We recommend that the Deputy Assistant Secretary for Single Family Housing require DHI Mortgage to

2A. Indemnify HUD against losses for the six FHA-insured loans with unallowable covenants and prohibited liens in the amount of $1,316,641. The estimated loss to HUD is $789,984.

[10] This amount was calculated based on 60 percent of the unpaid mortgage balances or the actual loss to HUD when known (according to Neighborhood Watch as of December 21, 2009).

# SCOPE AND METHODOLOGY

Our audit period covered loans with beginning amortization dates from June 1, 2007, to May 31, 2009. During this period, DHI Mortgage FHA branch numbers 0542400095 and 0545200696 originated 1,897 FHA-insured mortgages, with a total mortgage balance of more than $344 million. We conducted our fieldwork at DHI Mortgage's Scottsdale, AZ, branch office between July and December 2009.

We reviewed underwriting documentation in the lender/FHA loan files for 20 FHA-insured loans[11] selected nonstatistically based on the existence of loan defaults and claims. We used HUD's online information system for FHA-insured loans to identify all FHA-insured loans from DHI Mortgage branch numbers 054200095 and 0545200696 with beginning amortization dates between June 1, 2007, and May 31, 2009. There were 1,897 FHA-insured loans for the selected branch numbers and period. We then selected loans that (1) had an FHA insurance status of claim and/or (2) were more than 6 months in default and had less than four mortgage payments made before the first 90-day default was reported. This methodology resulted in a sample of 17 FHA-insured loans. We also included three FHA-insured loans that were referred to the Homeownership Center[12] by the lender.

We also reviewed 786 FHA-insured loans in our audit scope that HUD's information system indicated were either "new condo" or "new construction." We reviewed the applicable county recorder's Web site for all 786 of the loans to determine whether improper restrictive covenants were recorded against the FHA-insured properties. We found recorded covenants for eight properties (approximately 1 percent of the loans reviewed). Because the percentage of loans with recorded covenants was much lower than we found during our prior audit of DHI Mortgage branches in Scottsdale and Tucson (see Follow-up on Prior Audits), we then randomly selected 45 of the 786 loans and requested the title files to review for restrictive covenants that were either not recorded or had been recorded under an identifier other than the property address. We also reviewed the title files for the eight loans already identified with recorded restrictive covenants and for the 20 loans selected for the underwriting review sample. Therefore, we reviewed title files for a total of 73 FHA-insured loans (45 plus 8 plus 20) to determine whether there were improper restrictive covenants in the file.

To accomplish our objective, we

- Reviewed HUD regulations and reference materials related to single-family requirements;
- Reviewed DHI Mortgage's loan files;
- Reviewed 73 title files to determine whether there were improper restrictive covenants in the file;
- Interviewed appropriate DHI Mortgage staff; and

[11] These loans were all purchase mortgages.
[12] There are four Homeownership Center's located across the country that are responsible for administering all single-family activities in their respective jurisdictions.

- Interviewed borrowers, when available, associated with the 20 FHA loans in our underwriting review.

We used the source documents in the loan case file to determine borrower income, employment history, and debt. For the loans underwritten by an automated underwriting system, we reviewed the FHA loan file to determine whether it contained the documentation to support the integrity and accuracy of the data used by the automated underwriting system to recommend approval of the loan. For the manually underwritten loans, we reviewed the loan documents to determine whether they supported the underwriting decision and complied with HUD Handbook 4155.1, REV-5, Mortgage Credit Analysis.[13]

We classified the underwriting deficiencies as either technical or significant. The technical underwriting deficiencies were minor underwriting deficiencies that, even if corrected, would not result in a significant increase in mortgage risk. We did not recommend indemnification or reimbursement for loans that only contained technical underwriting deficiencies.

We used data maintained by HUD in its information systems for FHA loans (Neighborhood Watch) to obtain the unpaid mortgage balances and the actual losses to HUD for each of the loans (as of December 21, 2009). HUD paid claims on three of the loans that we determined had significant underwriting deficiencies; however, the properties were still in HUD's inventory or the sale information was not available (see appendix A-1). We requested that HUD indemnify against losses for these loans because the total loss to HUD has not been realized.

We also used data maintained by HUD in its information systems for FHA loans to obtain background information and to select our sample of loans for testing. We did not rely on the data to reach our conclusions; therefore, we did not assess the reliability of the data.

We did not perform a lender quality control review because it was completed and reported during the prior audit of DHI Mortgage (see Follow-up on Prior Audits).

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.

[13] A manually underwritten loan must comply with HUD Handbook 4155.1. HUD's Mortgagee Letter 2004-47 explains that mortgage loans scored as accepted or approved through FHA's TOTAL Mortgagee Scorecard are granted a number of credit policy revisions and documentation relief from the instructions in HUD Handbook 4155.1. However, the lenders must still comply with outstanding eligibility requirements and ensure the integrity and accuracy of the data used to render a decision.

# INTERNAL CONTROLS

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

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

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

## Relevant Internal 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 (approved), and closed.

We assessed the relevant controls identified above.

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

## Significant Weaknesses

Based on our review, we believe that the following items are significant weaknesses:

- DHI Mortgage did not have effective controls in place to ensure that FHA-insured loans were underwritten in accordance with HUD requirements, exposing the FHA insurance fund to unnecessary risk (see findings 1 and 2).

- DHI Mortgage did not have effective controls in place to ensure that FHA-insured loans closed in accordance with HUD requirements, exposing the FHA-insurance fund to unnecessary risk (see finding 2).

# FOLLOW-UP ON PRIOR AUDITS

**DHI Mortgage Company, LTD's Scottsdale and Tucson Branches Did Not Always Follow FHA-Insured Loan Underwriting and Quality Control Requirements, HUD OIG Report 2009-LA-1018**

HUD Office of Inspector General issued an audit report on two DHI Mortgage branch offices (Report 2009-LA-1018) on September 10, 2009. The audit found that DHI Mortgage's Scottsdale branch (FHA number 0542400332, now closed) and Tucson branch (FHA number 0542400180) did not follow HUD requirements for originating, approving, or closing FHA-insured loans. Specifically, the audit identified 205 loans with prohibited restrictive addenda to the purchase contracts and 24 loans with significant underwriting deficiencies. In addition, the audit noted that DHI Mortgage's quality control processes had weaknesses, including failure to determine that 19 loans were not eligible for FHA insurance because the loan officer had been debarred from participation in FHA-insured loan transactions. As of March 2010, HUD generally agreed with the following recommendations addressed to the Assistant Secretary for Housing-Federal Housing Commissioner:

1A. Indemnify HUD against losses for the 205 FHA-insured loans with unallowable covenants and prohibited liens in the amount of $36,157,343. The projected loss to HUD is $15,256,783.

1B. Discontinue the use of unallowable covenants and prohibited liens with FHA-insured loans and refrain executing these documents or filing them with the county recorder's office.

1C. Develop and implement verification procedures to ensure that the unallowable restrictive covenant and the prohibited liens are not executed and/or filed with the county recorder's office for FHA-insured loans.

2A. Indemnify HUD against losses for the 24 FHA-insured loans with significant underwriting deficiencies in the amount of $4,114,822. The projected loss to HUD is $942,818.

2B. Refund the $15,749 in overinsurance generated from financing the loan discount into the FHA-insured loan by (1) reimbursing HUD in the amount of the loan discount for any claim paid on the loan; (2) paying down any amount of arrears, penalties, or fees owed on the loan due to delinquency; and then, if applicable, (3) applying the remaining amount of the loan discount against the principal amount owed on the FHA-insured loan.

3A. Indemnify HUD against losses for the 19 FHA-insured loans originated by a debarred employee in the amount of $3,477,875. The projected loss to HUD is $168,773.

3B. Revise and implement policies and procedures to reflect HUD requirements for updating FHA branch office changes and to ensure that offices do not employ or have a contract with individuals who are under debarment, suspension, or a limited denial of participation.

3C. Fully implement its quality control plan related to FHA-insured loan reviews and FHA branch office reviews.

3D. Discontinue or develop and implement procedures regarding officials working for DHI Mortgage and DHI Title to ensure that a clear and effective separation exists between the two entities and that borrowers know at all times exactly with which entity they are doing business.

3E. Discontinue the compensation to underwriters in the form of commissions, in appearance and in fact.

# APPENDIXES

## Appendix A

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

| Recommendation number | Ineligible 1/ | Funds to be put to better use 2/ |
|---|---|---|
| 1A | | $711,781 |
| 1B | $265,420 | |
| 2A | | $789,984 |
| Totals | $265,420 | $1,501,765 |

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General 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. If HUD implements our recommendations to indemnify loans that were not originated in accordance with FHA requirements, it will reduce FHA's risk of loss to the insurance fund. The amount above reflects HUD's calculation that FHA loses an average of about 60 percent of the unpaid mortgage balance when it sells a foreclosed property.

See the appendixes in this section for further explanation of costs.

# Appendix A-1

## LOAN DETAILS FOR SIGNIFICANT UNDERWRITING DEFICIENCIES

The table below contains the actual, if known, and estimated losses to HUD corresponding to the loans recommended for indemnification under finding 1.

| FHA loan number | Unpaid mortgage balance | Claim paid[14] | Actual loss to HUD[15] | Estimated loss to HUD (60%)[16] |
|---|---|---|---|---|
| 023-2546830 | $128,660 | $137,879 | | $77,196 |
| 023-2575560 | 161,577 | | $55,902 | |
| 023-2577611 | 134,220 | | 81,153 | |
| 023-2577634 | 253,997 | | 128,365 | |
| 023-2610061[17] | – | – | – | – |
| 023-2692048[17] | – | – | – | – |
| 023-2704044 | 173,946 | | | 104,368 |
| 023-2709195 | 149,270 | 156,640 | | 89,562 |
| 023-2728194 | 154,684 | 167,477 | | 92,810 |
| 023-2836293 | 159,866 | | | 95,920 |
| 023-2866499 | 220,761 | 237,886 | | 132,457 |
| 023-2880511 | 199,113 | | | 119,468 |
| **Totals** | **$1,736,094** | **$699,882** | **$265,420** | **$711,781** |

[14] Property conveyed to insurer (HUD) and no sale had been completed or the sale information was not available.
[15] Preforeclosure sale had been completed or property conveyed to insurer (HUD) and sale had been completed.
[16] Amounts were calculated based on 60 percent of the unpaid mortgage balances.
[17] After the start of the audit, these loans were indemnified by request from the lender.

# Appendix A-2

## LOAN DETAILS FOR SCHEDULE A TO PURCHASE CONTRACTS

The table below contains the unpaid mortgage balance and estimated loss to HUD corresponding to the loans recommended for indemnification under finding 2 resulting from FHA-insured loans with schedule A to purchase contracts.

| FHA loan number | Unpaid mortgage balance | Estimated loss to HUD (60%) |
|---|---|---|
| 023-2469200 | $203,897 | $122,338 |
| 023-2470369[18] | – | – |
| 023-2471335 | 218,622 | 131,173 |
| 023-2471568 | 219,416 | 131,650 |
| 023-2478701 | 208,952 | 125,371 |
| 023-2488642[18] | – | – |
| 023-2495541 | 238,467 | 143,080 |
| 023-2497089 | 227,287 | 136,372 |
| **Totals** | **$1,316,641** | **$789,984** |

[18] After the start of the audit, these loans were terminated.

# Appendix B

## AUDITEE COMMENTS AND OIG'S EVALUATION

**Ref to OIG Evaluation** **Auditee Comments**

DHI MORTGAGE

a D·R·HORTON company

America's Builder

VIA E-MAIL AND FEDERAL EXPRESS

March 2, 2010

U.S. Department of Housing and Urban Development
Office of Inspector General – Region IX
Attn: Ms. Joan S. Hobbs
611 West Sixth Street, Suite 1160
Los Angeles, California 90017

Re: DHI Mortgage Branch 0542400095
DHI Mortgage Branch 0542400696
Audit Period: Loans with amortization dates from June 1, 2007 – May 31, 2009

Dear Ms. Hobbs:

This letter serves as the response of DHI Mortgage Company, LTD's ("DHIM" or "Company") to your letter dated February 5, 2010, and the Draft Report containing the findings of the completed audit of the DHIM branch offices referenced above that was conducted by the Office of Inspector General ("OIG").

We want to reiterate at the outset that DHIM is committed to adherence to all state and federal laws, and with all HUD established guidelines, as well as maintaining a high standard of best practices, internal policies and procedures. DHIM and its affiliates are also committed to developing strong sustainable communities and to providing lending opportunities that support the American dream of homeownership now and for years to come. As you know from the Draft Report, these two commitments can, in some instances, lead to a conflict, as was the case with respect to the restrictive covenant. As addressed in the prior audit response reviewing the same subject manner and as restated clearly below, that covenant -- which was prepared and instituted by the builder/seller and designed to prevent property flipping -- was not valid or enforceable by the builder in connection with an FHA insured loan. However, in spite of its invalidity, the covenant was inadvertently recorded in a minimal number of instances without the knowledge or approval of DHIM. While DHIM concedes that the recording of the restrictive covenant violated FHA regulations, as explained below, the purpose of the covenant (to protect homeowners from

CONFIDENTIAL/RESTRICTED USE

the devastating effects of property flipping by investors), the unenforceability of the covenant, the lack of knowledge by DHIM, and the lack of any injury to HUD, are all factors that warrant a remedy other than the indemnification demanded in the Draft Report. With respect to all of the findings of the Draft Report, DHIM responds as follows:

**EXAMINATION FINDINGS**

**Finding #1:** ***DHI Mortgage Failed to Underwrite FHA-Insured Loans in Accordance with HUD-FHA Requirements.***

In March 2008, HUD conducted a routine exam of DHIM's offices where it identified certain underwriting deficiencies. Please note that many of the deficiencies that are cited in the OIG Draft Report pre-dated the corrective actions that DHIM took in response to the March 2008 HUD audit; therefore, the issues in the Draft Report have already been addressed. Specifically, DHIM conducted additional reviews of the underwriting quality and provided specialized and detailed training and counseling on the issues identified in the HUD audit. DHIM also made several staffing changes in the Southwest Underwriting Center when it became evident that there were concerns of not meeting DHIM's standard of quality after DHIM provided the extensive training and counseling.

While we feel confident that the Company has provided thorough training with the underwriters on any issues cited after the date these loans were underwritten, DHIM will be preparing and conducting additional training with its underwriting department to review the findings of this report and HUD's guidelines surrounding the items noted during the audit. In addition to the training that was provided in 2008, DHIM discovered through its QC audits that the finding regarding material inquires was not being addressed. This issue was addressed and corrected with the underwriting department in January of 2009. Training pursuant to the receipt of the HUD OIG Audit report dated September 10, 2009 has also occurred. Our managers are diligent with providing on-going training with our underwriting team and will continue to do so in areas where opportunities for improvement present themselves.

In further response to Finding #1, Addendum 1 hereto contains DHIM's loan-by-loan response to each of the alleged underwriting deficiencies set forth in the Draft Report.

**Finding #2:** ***DHI Mortgage Allowed Restrictive Covenants That Violated HUD-FHA Requirements.***

**Comment 1**

DHIM acknowledges that, without its knowledge or approval, a covenant which purports to restrict the resale or rental of property (hereinafter "Schedule A") was recorded in connection with eight FHA insured properties. As addressed in the response to the HUD OIG Audit report dated August 24, 2009, DHIM vehemently disagrees with the implication that it had knowledge of the actual recording of Schedule A in connection with any FHA insured properties. The

contractual agreement from which Schedule A originated clearly and expressly contains language excluding its use in connection with FHA and VA financing.

**Comment 2**

The first sentence of the OIG's finding states that "DHI Mortgage did not ensure that unallowable restrictive covenants were not filed against eight FHA-insured properties." It is the responsibility of DHI Mortgage to close loans pursuant to appropriate lending practices, including FHA regulations. The terms of the transaction as outlined in the purchase contract and lenders instructions were followed through the recording of the FHA insured lien. As previously stated, the Schedule A was recorded without the knowledge of DHIM and after the FHA insured lien was recorded, representing the close of the transaction with DHIM. The finding further provides that: "DHI Mortgage allowed the restrictive covenants … because officials believed it would discourage investors from purchasing their affiliate's (the seller's) properties." We respectfully disagree with these statements as they are inaccurate and unsupported by the evidence. Specifically, DHIM approved the loans based on FHA accepted underwriting guidelines and without consideration of any such restrictive covenant. Based on prior reviews it appears that the builder regularly had the document executed prior to having knowledge of the type of financing the borrower would select. It is also significant that at the time of the origination of these particular loans, the majority of DHIM's origination activity was conventional financing. In addition, none of DHIM's Lenders Instructions to the settlement agent included reference to the recording of Schedule A. Further, as previously noted, the exclusionary language in the Occupancy/Investment Disclosure, which was provided to all of the borrowers, renders the Schedule A irrelevant and unenforceable in connection with FHA transactions.

While the finding implies that DHIM had knowledge of the use of the restrictive covenant for FHA/VA loans, in fact, the evidence indicates the contrary; that is, DHIM did not find this an acceptable practice for FHA/VA loans. The OIG Draft Report reinforces this fact when indicating in the finding that "DHI Mortgage was apparently aware that this practice was not allowed for FHA-insured mortgages because there were instances in which the occupancy/investment disclosure addendum to the purchase contract contained the following exclusion from the restrictive covenant when the buyer purchased the property using FHA financing." Draft Report page 10.

**Comment 3**

While DHIM did not endorse the use of the Schedule A, it also takes issue with the OIG's implication that there was harm to any homebuyers as a result of the use of the restrictive covenant. The covenant was used during a time of unprecedented growth in the homebuilding industry. During that period, it was discovered that real estate investors were falsely representing themselves as owner-occupant homebuyers, only to close on the purchase of the property and then quickly flip the property thereafter to a new buyer or rent it out as an investment property. As the OIG is well aware, the practice of property flipping and speculation was a leading contributing factor to the sudden artificial inflation and subsequent severe deterioration of property values which ultimately led to the housing bubble and economic conditions of today throughout our nation. Borrowers representing themselves as owner-

occupants with the secretive and subversive intention of renting or flipping the property were perpetrating mortgage fraud. This, in conjunction with the detrimental long term effects on the newly developing community, is what obviously motivated the builder/seller to seek solutions that were specifically designed to put a stop to this practice.

**Comment 4**

DHIM also notes that borrowers who obtained financing through a conventional loan where the Schedule A was permissible and, indeed, appropriate for the reasons discussed above, still retained the opportunity to sell the subject property as long as the sale was pursuant to a number of any normally occurring life events. The following excerpt from the Schedule A demonstrates this fact:

a. A transfer resulting from the death of Owner.
b. A transfer by Owner where the spouse of Owner becomes the only co-owner with Owner of the Property;
c. A transfer by Owner into a revocable inter vivos trust in which Owner is a beneficiary;
d. A transfer resulting from the decree of dissolution of marriage or legal separation or from a property settlement agreement incident to such decree;
e. The transfer, conveyance, pledge, assignment, or other hypothecation of the Property to secure the performance of an obligation, which transfer, conveyance, pledge, assignment or hypothecation will be released or reconveyed upon the completion of such performance; and
f. The transfer by Owner where (1) at the time of transfer Owner is occupying the Property as Owner's place of residence and (2) the transfer is necessary to facilitate Owner's relocation of his place of residence in order to accommodate a job transfer required by Owner's employer or to accommodate a change in employment location greater than twenty-five miles.

**Comment 5**

With the clear understanding that the Schedule A did not apply to FHA loans, DHIM proceeded to transact business accordingly. The recording of the Schedule A in connection with FHA insured properties appears to have occurred through miscommunications between the Settlement Agent and the builder/seller. The intention of the Schedule A, being rooted in the deterrence of investors from perpetrating mortgage fraud and unrelated to restricting *bona fide* homeowners in any capacity, specifically FHA insured homeowners, is further evidenced by the fact that the Schedule A has never been enforced against any FHA insured borrower.

**Comment 6**

The Draft Report suggests that DHIM should indemnify HUD against losses for the six FHA-insured loans with the Schedule A as they "…put additional unnecessary risk on the FHA-insured loans…." As the Schedule A was not applicable to these transactions, it was unenforceable as a matter of law, and was done without the knowledge or approval of DHIM; indemnification is neither appropriate nor warranted. Additionally, of the of the eight loans originally identified, two had already been terminated without payment of the alleged Schedule "A" restriction which further reinforces that there is no "risk" to the insurance fund.

DHIM has conducted training with both the Builder and Title affiliates with respect to the restrictions on the use of unallowable covenants and prohibited liens in connection with FHA loans. In addition, DHIM enhanced its standard closing instructions. Previously, the wording on the instructions to the settlement agent read: "No second lien shall be placed on the property without prior approval." While the Company believed that this instruction should have alerted the settlement agents to contact DHIM prior to the recording of any restrictive covenants, DHIM changed the instructions to the settlement agent to read: "No second liens, or restrictive covenants, are to be placed on the property without prior approval by DHIM." This is now capitalized and in bold text.

In conclusion, DHIM appreciates the opportunity to submit this Response to the Draft Report and it hopes that the OIG will modify its Draft Report accordingly. We believe that there is no question but that it was, and remains, the intent of DHIM to comply fully and completely with all standards set forth by HUD and all applicable state and federal laws. We will be happy to provide you with additional information, or to discuss the information in this Response, at your convenience.

Sincerely,

Jennifer Hedgepeth
Vice President/National Operations Manager
DHI Mortgage Company, LTD

Enclosures

CONFIDENTIAL/RESTRICTED USE

ADDENDUM TO DHIM'S RESPONSE TO AUDIT FINDING #1

**023-2546830**
We are seeking indemnification of this loan based on the lender's failure to properly evaluate the borrower's credit.

**OIG Finding**

**Credit**
Both the borrower and coborrower had Chapter 7 bankruptcies that were discharged in 2003 and 2001, respectively. While a Chapter 7 bankruptcy does not disqualify a borrower from obtaining an FHA-insured mortgage if at least 2 years has elapsed, HUD Handbook 4155.1, REV-5, paragraph 2-3E, states that the borrower must have reestablished good credit or chosen not to incur new credit obligations and the borrower also must have demonstrated a documented ability to responsibly manage his or her financial affairs. The borrowers did not reestablish good credit and did not demonstrate the ability to responsibly manage their affairs as evidenced by the multiple collection accounts on their credit report that were originally reported in 2005 through 2007, after the bankruptcies were discharged. The loan file contained two letters from vendors stating that the borrowers were current on their payments; however, these letters did not sufficiently show that the borrowers had reestablished good credit, nor did they demonstrate the borrowers' ability to responsibly manage their financial affairs.

In addition, HUD Handbook 4155.1, REV-5, paragraph 2-3, states that if a borrower's credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan. The lenders used compensating factors such as "borrowers have had extraordinary medical bills which is causing the FICO (credit score) to be low" to justify approving the loan; however, none of the compensating factors were allowed by HUD Handbook 4155.1, REV-5, paragraph 2-13.

**DHIM Response**

**Comment 7**

**Credit**
Disagree. Although both the borrower and the co-borrower had previous bankruptcies in 2003 and 2001, in the years following the bankruptcies both borrowers showed a hesitancy to utilize traditional credit. The only traditional credit reporting on their credit report after the 2003 bankruptcy is an auto loan from Bashas Associates Credit Union which was paid on time for 63 months until it was paid off in May 2006. The only other accounts listed on the credit report after the bankruptcy are medical collections related to the accident in which our borrower was a victim of a hit and run accident. The medical collections were well explained in the file and did not represent a disregard for credit by the borrowers. Due to the lack of traditional credit history since the 2003 bankruptcy, the underwriter relied on a strong rental history going back four years with no late payments and two non-traditional credit references which covered two years and seven years

respectively in addition to the auto loan from Bashas Associates Credit Union. The OIG has referenced the HUD Handbook 4155.1, REV-5, paragraph 2-3 with regards to credit history. This does not apply to this borrower. This borrower did not show a disregard for credit while having sufficient income. The one account the borrower had which was the auto loan from Bashas Associates Credit Union was paid on time for over five years. The medical collections were not a disregard for credit. The borrowers' clearly felt that the insurance company was arranging payment with the hospital for all medical bills and therefore they were unaware that any action on their part was required. In summary, the underwriter determined that the strong rental history, the auto loan history, and the two non-traditional credit references were stronger indications of the borrowers' credit history than the medical collections. That decision by the underwriter was the basis of the loan approval.

**023-2575560**

We are seeking indemnification of this loan based on the revised total fixed payment-to income ratio, which reflects the allowable qualifying income and liabilities as calculated by OIG in accordance with HUD-FHA requirements. After revision, the ratio increased from 44.63 to 60.83 percent, which far exceeds HUD's total fixed payment-to-income benchmark ratio of 43 percent as stated in Mortgagee Letter 2005-16. The lender did not document compensating factors that could have justified the excessive ratio.

**OIG Finding**

**Income**

The lender calculated the borrower's income based on 40 hours per week; however, the borrower's pay stubs only supported an average of 36.8 hours per week. As a result, the lender overstated the borrower's income by $243.36 per month.

**DHIM Response**

**Income**

Agree. The paystubs in the file show 32 hours some weeks and 40 hours in other weeks. An explanation should have been obtained for the weeks that showed less than 40 hours.

**OIG Finding**

**Credit**

Both the borrower and the coborrower had payments withheld from their pay checks that were not considered by the lender and the automated underwriting system as required by the Fannie Mae Underwriting Findings and HUD Handbook 4155.1, REV-5, paragraph 2-11A. The Fannie Mae Underwriting Findings, item 19, states that when a debt or obligation is revealed during the loan process that was not listed on the loan application and/or credit report, the lender must verify the actual monthly payment amount and resubmit the loan with the liability if it is greater than $100. per month. HUD Handbook 4155.1, REV-5, paragraph 2-11A, states that in computing the debt-to-income ratios, the

lender must include the monthly housing expense and all additional recurring charges extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payments during the months immediately after loan closing. The borrower's pay stub revealed a deduction for "Levy – Fed" of $100.01 per month, and the coborrower's pay stub revealed a deduction for "Company Store" of $599.14 per month. These liabilities were not included on either the loan application or the credit report, and the loan file did not contain documentation showing that these debts would last less than 10 months. As a result, the borrowers' recurring expenses were understated by $699.15.

Additionally, the indication that the borrower had a Federal levy deducted from his wages requires further consideration by the lender. A Federal levy is usually only enacted after an obligor has neglected or refused to pay a Federal debt, indicating that the debt was delinquent. HUD Handbook 4155.1, REV-5, paragraph 2-5B, states that if a borrower is presently delinquent on any Federal debt or has a lien, including taxes, placed against his property for a debt owed to the United States, the borrower is not eligible until the delinquent account is brought current, paid, or otherwise satisfied or a satisfactory repayment plan is made.

**DHIM Response**

**Credit**
Agree. The borrowers' income was not supported based on the debts listed on their paystubs. DHIM should have requested and explanation and considered these debts in the qualifying ratios.

**023-2577611**
We are seeking indemnification of this loan based on the revised mortgage payment-to income and total fixed payment-to-income ratios, which reflect the allowable qualifying income as calculated by OIG in accordance with HUD-FHA requirements, and based on the lender's failure to document adequate compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines. After revision, the ratios were increased from 37.07 and 47.70 to 39.25 and 50.51 percent, respectively, which far exceeded HUD's benchmark ratios of 31 and 43 percent as stated in Mortgagee Letter 2005-16.

**OIG Finding**

**Income**
The lender calculated the borrower's monthly income based on the $36,000 annual income stated on the verification of employment. However, the loan file contained the borrower's contract, which stated that the annual income for the year was $34,000. The amount in the contract was also supported by the borrower's pay stubs. As a result, the borrower's monthly income was overstated by $166.67.

**DHIM Response**

**Comment 8**

**Income**
Disagree. The paystub in the file shows the borrower was paid $1,545.45 semi-monthly which supports a base monthly salary of $3,090.90. The year-to-date base pay on the paystub shows $10,768.15. The employment contract began on July 15, 2007 so a 3.5 month average is $3,076.57 per month. In addition, the borrower received additional pay listed under Proposition 301 which is an incentive program passed by Arizona voters. This pay was not included in qualifying due to a lack of two year history but the borrower had already received $1,000. during the school year. The teaching contract discrepancy should have been questioned but the borrower's pay on the paystubs does support the income used in qualifying.

**OIG Finding**

**Compensating Factors**
The lender did not list eligible compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16. Mortgagee Letter 2005-16 states that if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, lists compensating factors that underwriters must record in the remarks section of the HUD 92900-WS/HUD 92900-PUR used to support loan approval. The loan was manually approved by the lender with mortgage payment-to-income and total fixed payment-to-income ratios that exceeded HUD's benchmark ratios by 6.07 and 4.70 percent, respectively. The lender used "borrower will have 2 months reserves after closing" and "good employment history with very good prospects for future earnings" as compensating factors. One of FHA's eligible compensating factors is that the borrower has at least 3 months of cash reserves after closing, not 2 months. Also the lender did not document training or education in the borrower's profession to support future earnings as required.

**DHIM Response**

**Comment 9**

**Compensating Factors**
Disagree. The borrower had additional income that was verified but was not used in qualifying. The borrower received income listed under Prop 301 on her paystubs. She had received $1,000. year-to-date through 3.5 months which is an average of $285.71 per month. The underwriter did not list this as one of the compensating factors on the MCAW to support the approval.

**Comment 10**

**OIG Finding**

**Credit**
The loan file did not contain an explanation for the three collection accounts on the borrower's credit report as required by HUD Handbook 4155.1, REV-5, paragraph 2-3C.

**DHIM Response**

**Credit**
Disagree. The three collection accounts listed on the borrower's credit report were all over two years old at the time of approval. The underwriter was able to establish an acceptable credit history for the borrower without explanation of these accounts.

**023-2577634**
We are seeking indemnification of this loan based on the lender's failure to properly determine the borrower's liabilities and assets. This loan was approved by the automated underwriting system with mortgage payment-to-income and total fixed payment-to income ratios of 27.09 and 46.72 percent, respectively.

**OIG Finding**

**Credit**
The lender calculated the net rental income for the borrower's existing rental property but did not take into consideration the scheduled increase in the mortgage payment due to the interest rate reset. The mortgage for the existing rental property had an adjustable rate that was going to reset 5½ months after the close of escrow (November 16, 2007) for the FHA-insured property. The interest only adjustable rate rider for the existing rental property states that the interest rate was 7.70 percent and would change starting on April 1, 2008, and every 6 months thereafter. The new rate would be calculated by adding 6.70 percent to the current index (or LIBOR (London Interbank Offered Rate) index); however, the interest rate at the first change date would not be greater than 10.70 percent or less than 7.70 percent. The LIBOR index at the time of the borrower's application on November 15, 2007, was 4.8324 percent. Therefore, the interest rate for the existing rental property would have increased by 3 percent. An increase of 3 percent would have increased the mortgage payment for the existing rental property by $514.66. The borrower stated that his payments increased by about $200. to $300.

Also the lender did not include the homeowners association fee when calculating the net rental income for the existing rental property. According to the homeowners association management company, the dues were $105.00 per quarter.

**Comment 11**

**DHIM Response**

**Credit**
Disagree. There is no evidence in the file to support OIG's finding. The underwriter would not have known at the time of approval that the borrower's mortgage loan had an adjustable rate mortgage that was due to reset in 5.5 months and it is not required by HUD guidelines for the underwriter to obtain such documentation. The payment used to qualify the borrower was verified on the credit report and it was verified that the payment included property taxes and insurance.

In addition, the underwriter would not have known if the property belonged to an HOA and/or required any monthly HOA dues to be considered. The borrower did not indicate on their application that HOA dues were part of their monthly payment on the property.

**OIG Finding**

**Assets**
The lender did not verify the source of funds that the borrower used for the earnest money deposit when the verification of deposit did not support the borrower's ability to fund the earnest money deposit as required by HUD Handbook 4155.1, REV-5, paragraph 2-10A. The borrower's earnest money deposit was $3,000, while the verification of deposit showed an average monthly balance of only $721. In an interview with the borrower, he stated that he borrowed some of the funds for the earnest money deposit from his parents.

In addition, assets in a retirement account that were used to qualify the borrower did not meet the requirements of the Fannie Mae Underwriting Findings. The lender used 60 percent of the retirement account balance without regard for the amount the borrower had vested, and the lender did not document that the retirement account allowed for withdrawals for conditions other than those related to the borrower's employment or death and that the borrower qualified for withdrawal and/or borrowing.

**DHIM Finding**

**Comment 12**

**Assets**
Disagree. The VOD ("Verification of Deposit") in the file was dated November 13, 2007, which was five months after the earnest money check was written. The average balance on the VOD is for the previous two months. This is not an indication of the money available to the borrower in June when the earnest money check was written. The HUD Handbook 4155.1 requires the underwriter to verify the source of funds for the earnest money deposit if the amount of the earnest money deposit exceeds two percent of the sales price or appears excessive based on the borrower's history of accumulating savings. Per the HUD Handbook, satisfactory documentation includes:

- A copy of the borrower's cancelled check;

- Certification from the deposit-holder acknowledging receipt of funds; OR
- Separate evidence of the source of funds.

DHIM had a copy of the borrower's cancelled check which is one of the items listed above as satisfactory documentation.

DHIM agrees that the underwriter did not obtain evidence of the withdrawal conditions on the borrower's retirement account.

**023-2610061**
We are not seeking indemnification of this loan because it was indemnified on August 14, 2009, by request from the lender. The lender determined that the borrower had been working for a placement agency for only 1 month and had no prior history of working temporary jobs when the loan was approved. The lender also noted that the borrower's last day of employment was the day of closing. We identified an additional significant underwriting deficiency for this loan regarding the borrower's income.

**OIG Finding**

**Income**
The lender did not obtain the borrower's most recent year-to-date pay stub documenting 1 full month's earnings as required by item 23 of the Fannie Mae Underwriting Findings. The lender obtained only one of the borrower's pay stubs, which documented less than 14 days of earnings. Since the borrower's employment start date was April 28, 2008, and the lender noted that the borrower's last day of employment was the day of closing on May 22, 2008, the lender would have known that the borrower was no longer employed if it had delayed closing to obtain a pay stub documenting 1 full month's earnings.

**DHIM Response**

**Income**
Agree. DHIM found the deficiency on this loan during an internal audit and self reported the loan to HUD in April 2009.

**023-2692048**
We are seeking indemnification of this loan based on the revised total fixed payment-to income ratio, which reflects the allowable qualifying income and liabilities as calculated by OIG in accordance with HUD-FHA requirements. After revision, the ratio increased from 48.42 to 60.86 percent, which far exceeded HUD's benchmark ratio of 43 percent as stated in Mortgagee Letter 2005-16. The lender did not document compensating factors that could have justified the excessive ratio.

**OIG Finding**

**Income**
The lender included the borrower's overtime hours in the overtime income calculation as well as the base income calculation. The lender calculated the borrower's overtime income based on the average of the overtime income earned over the past 19.5 months. The lender then calculated the borrower's base income using 47 hours per week instead of 40 hours. As a result, the borrower's monthly income was overstated by $424.67.

In addition, the loan file did not contain the appropriate support to justify the overtime pay used in the ratios to qualify the borrower as required by HUD Handbook 4155.1, REV-5, paragraph 2-7A. The borrower's overtime income was earned for less than 2 years, and the lender did not document in writing the justification for including the borrower's overtime income.

**DHIM Response**

**Comment 13**

**Income**
Agree. DHIM found the deficiency on this loan during an internal audit and self reported the error to HUD. DHIM has indemnified this loan as of September 2009.

**OIG Finding**

**Credit**
The borrower had a payment withheld from his pay check that was not considered by the lender and the automated underwriting system. The Fannie Mae Underwriting Findings, item 19, states that when a debt or obligation is revealed during the loan process that was not listed on the loan application and/or credit report, the lender must verify the actual monthly payment amount and resubmit the loan with the liability if it is greater than per month. The borrower's 2-week pay stub revealed a deduction for "Advance" of $93. This liability was not included on either the loan application or the credit report. As a result, the borrower's recurring expenses were understated by $201.50.

In addition, the credit report contained a civil judgment with an explanation from the loan processor that it contacted the appropriate authority and the civil judgment did not reflect information identifying the borrower. Also the judgment would be removed in December 2008 (which was nine months after the close of escrow). The Fannie Mae Underwriting Findings, item 22, requires evidence of payoff of any outstanding judgments shown on the credit report. HUD Handbook 4155.1, REV-5, paragraph 2-3, also states that courtordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement.

**DHIM Response**

**Credit**
Agree. DHIM found the deficiency on this loan during an internal audit and self reported the error to HUD. DHIM has indemnified this loan as of September 2009.

**023-2704044**
We are seeking indemnification of this loan based on the lender's failure to document adequate compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines.

**OIG Finding**

**Compensating Factors**
The lender did not list eligible compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16. Mortgagee Letter 2005-16 states that if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, lists compensating factors that underwriters must record in the remarks section of the HUD 92900-WS/HUD 92900-PUR used to support loan approval. The loan was manually approved by the lender with mortgage payment-to-income and total fixed payment-to-income ratios that exceeded HUD's benchmark ratios by 13.12 and 9.71 percent, respectively. The only allowable compensating factor listed by the lender was that the borrower had "potential for advancement." This compensating factor was not eligible because, although the borrower anticipated graduating with a bachelor's degree, this graduation was to occur more than two years after the close of escrow. Also, the lender did not show that the education was in the borrower's profession as required.

**DHIM Response**

**Compensating Factors**
Agree. The underwriter did not support HUD approved compensating factors to justify approval of the loan with excessive ratios. DHIM discovered income misrepresentation on this loan during an internal audit and the loan was self reported to HUD in February 2009.

**OIG Finding**

**Credit**
The borrower had student loans on the credit report with a balance of more than $4,000- that may not have been deferred for more than 12 months after mortgage closing. HUD Handbook 4155.1, REV-5, paragraph 2-11C, states that if a debt payment such as a student loan is scheduled to begin within 12 months of the mortgage closing, the lender must include the anticipated monthly obligation in the underwriting analysis, unless the borrower provides written evidence that the debt will be deferred to a period outside of this timeframe. The credit report stated that the payments were deferred but did not

provide a timeframe. The borrower provided a letter stating that the loans were deferred until his anticipated graduation date, which was more than 12 months from the mortgage closing; however, the lender should have obtained evidence from the student loan holder that the loans were deferred more than 12 months from the mortgage closing.

**DHIM Response**

**Credit**

**Comment 14**

Disagree. The underwriter included the monthly payments on all student loans in the qualifying ratios. The monthly payments for the student loans were not listed on the credit report so the underwriter calculated the payments at five percent of the unpaid balance. This is a conservative approach since most student loan payments are much less than five percent of the unpaid balance.

**OIG Finding**

**Assets**

A verification of deposit accompanying the most recent bank statement was not provided as required by HUD Handbook 4155.1, REV-5, paragraph 3-1F.

**DHIM Response**

**Assets**

**Comment 15**

Disagree. The AUS Findings require that the assets be verified by one of the following:

- VOD;
- Most recent bank statements for the previous two months showing the previous months balances; or
- Most recent three months statements

Here is an excerpt from HUD Handbook 4155.1:

***Alternative Documentation.*** *As an alternative to obtaining a VOD, the lender may obtain from the borrower original bank statement(s) covering the most recent three-month period. Provided the bank statement shows the previous month's balance, this requirement is met by obtaining the two most recent, consecutive statements.*

DHIM obtained the most recent three months bank statements to verify assets. Therefore, a VOD was not required.

**023-2709195**

We are seeking indemnification of this loan based on the lender's failure to document adequate compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines.

**OIG Finding**

**Compensating Factors**
The lender did not list eligible compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16. Mortgagee Letter 2005-16 states that if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, lists compensating factors that underwriters must record in the remarks section of the HUD 92900-WS/HUD 92900-PUR used to support loan approval. The loan was manually approved by the lender with mortgage payment-to-income and total fixed payment-to-income ratios that exceeded HUD's benchmark ratios by 13.95 and 5.34 percent, respectively. The only allowable compensating factor listed by the lender was that the borrower had "potential for future earnings." However, this compensating factor was not eligible because it was not supported by job training or education in the borrower's profession as required.

**DHIM Response**

**Compensating Factors**
Agree. DHIM agrees that the underwriter did not list and support approved HUD compensating factors for excessive ratios.

**OIG Finding**

**Assets**
A recent bank statement accompanying the verification of deposit was not provided as required by HUD Handbook 4155.1, REV-5, paragraph 3-1F.

**DHIM Response**

**Assets**
Agree. DHIM should have obtained a recent bank statement to go along with the VOD in order to document the assets properly.

**023-2728194**
We are seeking indemnification of this loan based on the revised mortgage payment-to income and total fixed payment-to-income ratios, which reflect the allowable qualifying income as calculated by OIG in accordance with HUD-FHA requirements. After revision, the ratios were increased from 31.57 and 40.26 percent to 40.05 and 51.07 percent, respectively, which far exceeded HUD's benchmark ratios of 31 and 43 percent as stated in Mortgagee Letter 2005-16. The lender did not document compensating factors that could have justified the excessive ratio.

**OIG Finding**

**Income**
The loan file did not contain the appropriate support to justify the overtime pay used in the ratios to qualify the borrower as required by HUD Handbook 4155.1, REV-5, paragraph 2-7A. The borrower's overtime was in decline, and the lender did not provide a sound rationalization in writing for including the overtime income. The average of the borrower's overtime income was $843.25 and $881.67 per month for 2006 and 2007, respectively. However, as shown in the verification of employment, the overtime income averaged only $383.50 per month for the first 2 months of 2008. Further, the borrower's pay stub in the loan file, dated February 9, 2008, stated that the year-to-date overtime income was $691.67, and the verification of employment stated that as of March 1, 2008, the year-to-date overtime income was $767.00. This documentation showed that in approximately 3 weeks, the borrower earned only $75.33 in overtime income. Therefore, the borrower's overtime income was inappropriately included, resulting in an overstatement of the monthly income by $826.00.

Also, the verification of income stated that the continuation of overtime income was unknown. HUD Handbook 4155.1, REV-5, paragraph 2-7, states that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can be reasonably expected to continue for at least the first 3 years of the mortgage loan. It further states that overtime income may be used if it is likely to continue.

**DHIM Response**

**Income**
Diagree. The borrower's overtime income for 2006 and 2007 was very consistent at $10,119 and $10,580 respectively. Two months of 2008 was not enough history to determine that the overtime income was declining. The borrower could have earned the majority of his overtime during peak periods of the year. A two year average was the most appropriate income calculation. The HUD Handbook allows the use of overtime income unless the employer states that the income is not likely to continue. The underwriter made the determination that the overtime was likely to continue based on the history of receiving the overtime during the past two years.

**Comment 16**

**OIG Finding**

**Credit**
The loan file did not contain an explanation for the two credit report inquiries that were within 90 days of the completed credit report, as required by HUD Handbook 4155.1, REV-5, paragraph 2-3B.

In addition, the borrower had a court-ordered judgment on his credit report that may not have been paid. HUD Handbook 4155.1, REV-5, paragraph 2-3C, requires that courtordered judgments be paid off before the mortgage loan is eligible for FHA

insurance endorsement. Chapter 3 of the handbook also requires that all information be verified and documented. The HUD-1 settlement statement showed a disbursement to the court; however, the check was given to the borrower rather than directly to the court. The lender should have obtained documentation showing that the judgment had been paid.

**DHIM Response**

**Credit**

**Comment 17**

Disagree. The account referenced was a collection account not a court ordered judgment. Collection accounts are not required to be paid off per HUD guidelines. The account was listed to be paid off on the final HUD-1 settlement statement. DHIM expects all debts listed on the HUD-1 to be paid by the title agent and would have no knowledge of the funds being given to the borrower.

DHIM agrees that no explanation was provided for the credit inquiries listed on the credit report.

**023-2836293**

We are seeking indemnification of this loan based on the lender's inability to determine the borrower's liabilities and failure to document adequate compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines.

**OIG Finding**

**Income**

The loan file did not contain the appropriate support to justify the overtime pay used in the ratios to qualify the borrower as required by HUD Handbook 4155.1, REV-5, paragraph 2-7A. The borrower's overtime income was earned for less than 2 years, and the lender did not document in writing the justification for including the borrower's overtime income.

**DHIM Response**

**Income**

Agree. DHIM did not determine the borrower had a two year history of earning overtime income and therefore should not have included the overtime income for qualifying.

**OIG Finding**

**Credit**

The lender did not obtain a credit history report for the borrower's nonpurchasing spouse as required by HUD Handbook 4155.1, REV-5, paragraph 2-2D, which requires a credit report for a nonpurchasing spouse in a community property State such as Arizona. Based on the documentation in the file, specifically the uniform residential loan application, dated June 10, 2008, and the pay stub, dated April 11, 2008, it appeared that the borrower

was married. There was another name listed on the borrower's bank statement. Without obtaining the nonpurchasing spouse's credit report or establishing alternative credit, the lender was unable to determine the coborrower's liabilities.

**DHIM Response**

**Credit**
Agree. DHIM did not obtain a credit report for the non-purchasing spouse as required by HUD guidelines in community property states.

**OIG Finding**

**Compensating Factors**
The lender did not list eligible compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16. Mortgagee Letter 2005-16 states that if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, lists compensating factors that underwriters must record in the remarks section of the HUD 92900-WS/HUD 92900-PUR to support loan approval. The loan was manually approved by the lender with mortgage payment-to-income and total fixed payment-to-income ratios that exceeded HUD's benchmark ratios by 16.83 and 6.14 percent, respectively. The only allowable compensating factor listed by the lender was that the borrower had "reserves for 3 months." However, this was not an eligible compensating factor because the borrower's reserves were $422.72 less than the amount required.

**DHIM Response**

**Compensating Factors**
Agree. DHIM counted gift assets as reserves which was not allowed by HUD guidelines, therefore, the borrower did not have a full three months reserves as required.

**023-2866499**
We are seeking indemnification of this loan based on the lender's failure to document the transfer of gift funds that were used as the borrower's cash investment in the property.

**OIG Finding**

**Assets**
The loan file did not contain the required documentation supporting the transfer of a $20,000 gift from the nonpurchasing spouse. The borrower had a downpayment of $19,132 that was derived from the gift, and at the closing, the funds were wired from the borrower's checking account. However, the loan file contained neither a withdrawal document showing that the withdrawal was from the donor's account nor the home

buyer's deposit slip or bank statement that showed the deposit. HUD Handbook 4155.1, REV-5, paragraph 2-10C, states that all funds for the borrower's investment in the property must be verified and documented. Paragraph 2-10A further states that if the gift funds are in the home buyer's bank account, the lender must document the transfer of the funds from the donor to the home buyer by obtaining a copy of the canceled check or other withdrawal document showing that the withdrawal is from the donor's account. The home buyer's deposit slip and bank statement that show the deposit are also required. The gift funds were not documented as required, and without the gift, the borrower did not have sufficient funds to close1.

**DHIM Response**

**Assets**
Agree. The underwriter conditioned for the gift funds to be wired directly from the gift donor to the title company. However, it appears the gift funds were wired from the borrower's account. This indicates that the borrower had the funds transferred to him from the donor prior to closing and therefore the transfer from the gift donor to the borrower was not properly documented.

**OIG Finding**

**Compensating Factors**
The lender did not list eligible compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16. Mortgagee Letter 2005-16 states that if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, lists compensating factors that underwriters must record on the remarks section of the HUD 92900-WS/HUD 92900-PUR to support loan approval. The loan was manually approved by the lender with mortgage payment-to-income and total fixed payment-to-income ratios that exceeded HUD's benchmark ratios by 10.9 and 2.68 percent, respectively. The only allowable compensating factor listed by the lender was that the borrower was "putting 9% down payment into transaction." However, this compensating factor was not eligible because the handbook requires a 10 percent or more downpayment.

**DHIM Response**

**Compensating Factors**
Agree. The underwriter did not list acceptable HUD approved compensating factors for the excessive ratios. However, the borrower's nine percent down payment is an indication of their commitment to the property as borrower's who make a down payment larger than the minimum required are more likely to repay the mortgage.

**023-2880511**
We are seeking indemnification of this loan based on the lender's failure to properly determine the borrower's liabilities. This loan was approved by the automated underwriting system with mortgage payment-to-income and total fixed payment-to income ratios of 36.95 and 51.88 percent, respectively.

**OIG Finding**

**Assets**
The borrower received an $8,000 gift from his brother; however, the automated underwriting system did not show the funds segregated as gift funds, which may have affected the decision to approve the loan. Also, the loan file did not contain the required documentation supporting the transfer of the gift funds. A deposit slip was in the file; however, there was no canceled check or other withdrawal document showing that the withdrawal was from the donor's account. HUD Handbook 4155.1, REV-5, paragraph 2-10, states that all funds for the borrower's investment in the property must be verified and documented. Paragraph 2-10C further states if the gift funds are in the home buyer's bank account, the lender must document the transfer of the funds from the donor to the home buyer by obtaining a copy of the canceled check or other withdrawal document showing that the withdrawal is from the donor's account. The home buyer's deposit slip and bank statement that show the deposit are also required.

**DHIM Response**

**Assets**
Agree. DHIM obtained a copy of the $8,000 gift check from the donor and a deposit slip showing the funds were deposited into the borrower's account. However, a cancelled check or other withdrawal document should have been obtained from the donor to properly document the gift funds.

**OIG Finding**

**Credit**
The lender calculated the net rental income for the borrower's existing rental property but did not take into consideration the increase in the mortgage payment due to the interest rate reset. The existing rental property had two mortgages, with one having an adjustable rate that reset before the borrower's loan application for the FHA-insured property. The adjustable rate rider for the existing rental property stated that the interest rate was 6.75 percent and would change starting on June 1, 2008, and every 6 months thereafter. The new rate would be calculated by adding 6.50 percent to the current index (or LIBOR index) but the interest rate at the first change date would not be greater than 9.75 percent or less than 6.75 percent. The borrower's loan application was dated June 30, 2008 (after the change date); however, the mortgage payment used in calculating the net rental income did not reflect a change based on the rate reset. The LIBOR index at the time of the change date was 2.8544 percent. Therefore, the interest rate for the existing rental

property would have increased by 2.6044 percent ([6.50 plus 2.8544] minus 6.75). Conservatively, if we assume that the payment was interest only, an increase of 2.6044 percent would have increased the mortgage payment for the existing rental property by approximately $282.

**DHIM Response**

**Credit**

**Comment 18**

Disagree. There is no evidence in the file to support OIG's finding. There is not an interest only adjustable rate rider for the existing rental property nor would the underwriter have requested such a document. The underwriter would not have known at the time of approval that the borrower's present mortgage loan had an adjustable rate mortgage that was due to reset every six months. The monthly payment on the borrower's present mortgage was verified by the credit report and the property taxes and insurance on the property were verified with copies of the property tax statement and insurance policy.

## OIG Evaluation of Auditee Comments

**Comment 1** As stated in our previous audit, we disagree with the auditee's assertion that it lacked knowledge that the restrictive covenants were recorded and therefore had no responsibility to ensure its FHA-insured loans were (1) freely assumable as required under 24 CFR (*Code of Federal Regulations*) 203.41 and (2) free and clear of all other liens as required under 24 CFR 203.32(a). The regulations under 24 CFR 203.32(a) state "a mortgagor must establish that, after the mortgage offered for insurance has been recorded, the mortgaged property will be free and clear of all liens other than such mortgage, and that there will not be outstanding any other unpaid obligations contracted in connection with the mortgage transaction or purchase of the mortgaged property, except obligations that are secured by property or collateral owned by the mortgagor independently of the mortgaged property." Thus, it was DHI Mortgage's responsibility to ensure that the liens, which were included in the restrictive covenant, were not placed against the FHA-insured property. If DHI Mortgage had ensured its FHA loans were free of the improper liens, then it would have been aware that the related properties also had restrictive covenants that violated FHA's free assumability rule.

We agree that the contractual agreement form which the schedule A to purchase contract originated provided exclusionary language for FHA and VA financed loans. Additionally, 24 CFR 203.41(b) explicitly states, "[a] mortgage shall not be eligible for insurance if the mortgaged property is subject to legal restrictions on conveyance." Because the 8 loans discussed under finding 2 of the report were subject to legal restrictions on conveyance, these loans were clearly ineligible for FHA insurance.

**Comment 2** We disagree with the auditee's response that the two statements in finding 2 of the report are inaccurate and unsupported by the evidence. As stated in comment 1, it was DHI Mortgage's responsibility to ensure that the liens, which were included in the restrictive covenant, were not placed against the FHA-insured property. If DHI Mortgage had ensured its FHA loans were free of the improper liens, then it would have been aware that the related properties also had restrictive covenants that violated FHA's free assumability rule. The statements were also based upon the following excerpt from a letter dated June 5, 2009 provided to the OIG by DHI Mortgage's attorney:

> Schedule A to the purchase contract was designed to address a significant problem experienced by D.R. Horton, Inc. – Dietz-Crane (D.R. Horton) and other home builders when home prices were escalating at a rapid rate. In many cases a buyer claiming to be purchasing a home for his or her residence actually was an investor seeking to purchase and then quickly sell the home at a profit. D.R. Horton did not consider the flipping practice to be consistent with the goal of building sustainable communities at reasonable prices.

We acknowledge that DHI Mortgage used the Schedule A to Purchase Contract with the conventional market in mind. However, 24 CFR (*Code of Federal*

*Regulations*) 203.41 was clear that such a restriction on the resale of a property made the mortgage ineligible for FHA insurance.

> 24 CFR 203.41 Free Assumability
>
> (a)(3) Legal restrictions on conveyance means any provision in any legal instrument, law or regulation applicable to the mortgagor or the mortgaged property, including but not limited to a lease, deed, sales contract, declaration of covenants, declaration of condominium, option, right of first refusal, will, or trust agreement, that attempts to cause a conveyance (including a lease) made by the mortgagor to:… (ii) Be the basis of contractual liability of the mortgagor for breach of an agreement not to convey, including rights of first refusal, pre-emptive rights or options related to mortgagor efforts to convey; (iii) Terminate or subject to termination all or a part of the interest held by the mortgagor in the mortgaged property if a conveyance is attempted; (iv) Be subject to the consent of a third party;….
>
> (b) Policy of free assumability with no restrictions. A mortgage shall not be eligible for insurance if the mortgaged property is subject to legal restrictions on conveyance, except as permitted by this part.

The auditee's response notes that, for the audit time period, DHI's loan origination activity was primarily conventional financing. It is OIG's opinion that, because DHI officials were aware that the use of the schedule A was a common practice, they should have taken extra steps to ensure that the covenant was removed once it was determined that a specific loan would be FHA-insured.

**Comment 3** As stated in our previous audit, we disagree with the auditee's implied response that the use of the restrictive covenant could not have harmed the homebuyers because it was used at a time of unprecedented growth in the homebuilding industry. The schedule A to purchase contract, as discussed under finding 2, states the "[s]eller may promptly initiate proceedings to foreclose the Lien if Owner defaults in its obligation to pay Seller liquidated damages in the amount of $40,000 on the date that Owner or any of its successors or assigns conveys during the Restricted Period any rights, title, or interest in the Property without Seller's written consent." The prospect of the $40,000 liability could readily deter a borrower from renting or selling their property if the need arose. The notion expressed in the auditee's response that it is obvious that the FHA-exclusionary language in the original sales contract would likely take precedence over the recorded lien assumes the homebuyer has sophisticated legal knowledge. The previous OIG audit noted an instance where a borrower who experienced financial difficulties after the first four month's mortgage payments believed that she could not attempt to find a renter for the property because of the restrictive covenant. However, after the one-year restriction period expired, the borrower decided that the housing market decline had depressed prices to a point that made

it unlikely she could sell or rent the home for an amount that would cover the mortgage. As a result, the home went into foreclosure.

**Comment 4** This portion of the auditee's response pertains to conventional loans and therefore is not relevant to the finding regarding FHA-insured loans. Moreover, the "life events" presented in the auditee's response as reasons the lien would be released do not include financial difficulties alone.

**Comment 5** See OIG responses to comments 1 and 2.

**Comment 6** See OIG responses to comment 3.

In addition, the auditee's response asserts that, the fact that two loans had already been terminated without payment of the alleged schedule A restriction further reinforces that there is no risk to the insurance fund. We disagree with the auditee's assertion because the termination of these two loans occurred more than 2 years after the loans had closed. Therefore the relevant 1-year period restricting resale or rental of the property had expired. Specifically, FHA loan number 023-2470369 closed on June 14, 2007 and was terminated on December 30, 2009. FHA loan number 023-2488642 closed on July 20, 2007 and was terminated on November 23, 2009.

**Comment 7** We disagree with the auditee's response. As stated in the report, the borrowers did not reestablish good credit and did not demonstrate the ability to responsibly manage their affairs, as required by HUD Handbook 4155, REV-5, paragraph 2-3E, after being discharged from a Chapter 7 bankruptcy. The response from the auditee did not address this issue. The borrowers had multiple collection accounts on their credit report after the bankruptcies were discharged. Even though the collection accounts were medical related and explained by the borrowers, they showed that the borrower's did not reestablish good credit or demonstrate the ability to responsibly manage their affairs.

In addition, we believe that the borrower's credit history (a Chapter 7 bankruptcy in 2001, a Chapter 7 bankruptcy in 2003, and multiple collection accounts) did represent a disregard for credit by the borrowers.

**Comment 8** We disagree with the auditee's response that the paystub in the file supports a base monthly salary of $3,090 and that the year-to-date base pay on the paystub supports a monthly average of $3,076.57. The paystub does show that the borrower was paid $1,545.45 semi-monthly; however, the borrower was a school teacher and the contract with her employer states "The term of this Agreement is for one school year, starting on July 15th, 2007 and ending June 15th, 2008…" Therefore, the borrower's income should have been calculated based on 11 months (July 15, 2007 to June 15, 2008) instead of 12 months. The OIG calculated her annual salary as follows: $1,545.45 multiplied by 22 paychecks (11 months multiplied by 2 paychecks per month) equals $33,999.90. This annual

salary is also supported by the borrower's contract which states "…the School will pay you an annual salary of $34,000 plus any 301 monies that you qualify to receive…" This supports monthly income of $2,833.33 ($33,999.90 divided by 12 months).

In addition, the year-to-date base pay on the paystub does show $10,768.15 and this does represent a 3.5 month average; however, as stated earlier, the borrower's employment contract is for 11 months. Therefore, if using the year-to-date based pay on the paystub, the borrower's annual salary should be calculated as follows: $3,076.57 per month average ($10,768.15 year-to-date divided by 3.5 months) multiplied by 11 months (the length of the contract) equals $33,842.76. This supports monthly income of $2,820.23 ($33,842.76 divided by 12 months).

**Comment 9** We disagree with the auditee's response that implies the borrower received an average of $285.71 per month of additional income that was not used in qualifying and therefore is an adequate compensating factor to support approval of this loan. The borrower's paystub shows that the borrower received year-to-date earnings of $1,000 for Prop 301; however the paystub did not show any current earnings for Prop 301. The file did not contain any documentation that the borrower expected to receive additional Prop 301 earnings for the remainder of her contract. Therefore, we do not agree that the borrower's additional income that was not used in qualifying the borrower is an adequate compensating factor that should be considered in supporting the approval of the loan. HUD Handbook 4155.1, REV-5, paragraph 2-13E states that a compensating factor that may be used to justify approval of mortgage loans is "The borrower receives documented compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and similar public benefits." Additional income of $1,000 per year for Prop 301 did not directly affect the borrower's ability to pay the mortgage when the revised mortgage payment-to-income and total fixed payment-to-income ratios were 39.25 and 50.51 percent, respectively, which far exceed HUD's benchmark ratios

**Comment 10** We disagree with the auditee's response that the three collection accounts did not require an explanation because they were all over two years old at the time of approval. HUD Handbook 4155.1, REV-5, paragraph 2-3 states "While *minor* derogatory information occurring two or more years in the past does not require explanation, *major* indications of derogatory credit – including judgments, collections, and any other credit problems – require sufficient written explanation from the borrower." Therefore, all major indications of derogatory credit, regardless of when they occurred, require sufficient written explanation from the borrower.

**Comment 11** We disagree that the underwriter would not have known at the time of approval that the borrower's mortgage loan for his rental property had an adjustable rate mortgage that was due to reset in 5.5 months and that the rental property belonged to an HOA. HUD Handbook 4155.1, REV-5, chapter 3 states "The lender is

responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation, source of funds for the transactions, and the intended use of the property. All information must be verified and documented." The lender should have asked sufficient questions regarding the payment and any potential changes that could occur to the borrower's rental property. The underwriter also could have obtained information about the borrower's mortgage loan from the appropriate county recorder's office which is public information and easily accessible through the county recorder's Web site.

The lender also should have asked questions regarding the community in which the property was located. The HOA dues could be verified through the HOA's Web site.

**Comment 12** We disagree that the borrower's earnest money deposit was properly verified by only obtaining a copy of the borrower's cancelled check. HUD Handbook 4155.1, REV-5, paragraph 2-10 states "If the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds. Satisfactory documentation includes a copy of the borrower's cancelled check. A certification from the deposit-holder acknowledging receipt of funds and separate evidence of the source of funds is also acceptable. Evidence of source of funds includes a verification of deposit or bank statement showing that at the time the deposit was made the average balance was sufficient to cover the amount of the earnest money deposit." Therefore, the lender is not only required to verify documentation of the deposit amount but also the source of funds. The lender did obtain documentation of the deposit amount through a copy of the borrower's cancelled check; however, the lender did not verify the source of the funds as required.

**Comment 13** We agree that this loan has already been indemnified. We removed the recommendation to seek indemnification for this loan and also changed the language in the report to identify that this loan has already been indemnified.

**Comment 14** We agree that the monthly payment on all student loans were included in the qualifying ratios at five percent of the unpaid balance. We removed this underwriting deficiency from the report; however we did not change our conclusion to seek indemnification for this loan because we did not revise the qualifying ratios based on the student loans. As stated in the report, we are seeking indemnification of this loan based on the lender's failure to document adequate compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines. The loan was manually approved with mortgage payment-to-income and total fixed payment-to-income ratios of 44.13 and 52.71 percent, respectively.

**Comment 15** We agree that a verification of deposit was not required. We removed this underwriting deficiency from the report; however, we did not change our

conclusion to seek indemnification for this loan because the missing verification of deposit was considered to be a technical underwriting deficiency. As stated in the report, we are seeking indemnification of this loan based on the lender's failure to document adequate compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines. The loan was manually approved with mortgage payment-to-income and total fixed payment-to-income ratios of 44.13 and 52.71 percent, respectively.

**Comment 16** We disagree that a two year average of overtime was the most appropriate income calculation. Even though the overtime income for 2006 and 2007 was very consistent, there were several indicators that the overtime was in decline for the current year 2008.

- As stated in the report, the borrower's overtime income averaged only $383.50 per month for the first 2 months of 2008 while the overtime income averaged $843.25 and $881.67 per month for 2006 and 2007, respectively. Further, the borrower's paystub in the file, dated February 9, 2008, stated that the year-to-date overtime was $691.67, and the verification of employment stated that as of March 1, 2008, the year-to-date overtime income was $767. This showed that in approximately 3 weeks, the borrower earned only $75.33 in overtime income.
- The written verification of employment, dated March 11, 2008, states that average number of hours per week was 40.
- The weekly paystub in the file only shows 1.61 hours of overtime for that pay period, which supports the written verification of employment that the borrower only averages about 40 hours per week.

The lender calculated the borrower's overtime to be $826, which was inappropriate. While we acknowledge that the borrower could have earned the majority of his overtime during peak periods of the year, this is information that should have been asked of the borrower by the lender when the overtime appeared to be in decline. This information should have also been documented at the time of approval.

**Comment 17** We agree that the credit report states that the account was a collection account; however, the borrower explained to the lender that the account was for a ticket by the police and the judge fined the borrower late fees and additional court fees. Information that was readily available to the lender from the applicable municipal court's Web site revealed that the account was a judgment. We did not change our conclusion to seek indemnification for this loan because the revised mortgage payment-to-income and total fixed payment-to-income ratios (40.05 percent and 51.07 percent), which reflect the allowable qualifying income as calculated by OIG in accordance with HUD-FHA requirements, far exceeded HUD's benchmark ratios of 31 and 43 percent, respectively.

**Comment 18** We disagree that the underwriter would not have known at the time of approval that the borrower's mortgage loan had an adjustable rate mortgage that was due to

reset every 6 months. HUD Handbook 4155.1, REV-5, chapter 3 states "The lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation, source of funds for the transactions, and the intended use of the property. All information must be verified and documented." The lender should have asked sufficient questions regarding the payment and any potential changes that could occur to the borrower's rental property. The underwriter also could have obtained information about the borrower's mortgage loan from the appropriate county recorder's office which is public information and easily accessible through the county recorder's Web site.

# Appendix C

## CRITERIA

1. HUD Handbook 4155.1, REV-5

- Foreword states, "This Handbook describes the basic mortgage credit underwriting requirements for single family (one to four units) mortgage loans insured under the National Housing Act. For each loan FHA insures, the lender must establish that the borrower has the ability and willingness to repay the mortgage debt. This decision must be predicated on sound underwriting principles consistent with the guidelines, rules, and regulations described throughout this Handbook and must be supported by sufficient documentation…While it is not FHA's intent to insure mortgages that are likely to result in default, regardless of the borrower's equity, lenders may exercise some discretion in the underwriting of home mortgages where the borrower's financial and other circumstances are not specifically addressed by this Handbook. However, lenders are expected to exercise both sound judgment and due diligence in the underwriting of loans to be insured by FHA."

- Paragraph 1-7 states, "The borrower must make a cash investment at least equal to the difference between the sales price and the resulting maximum mortgage amount."

- Paragraph 2-2D states, "Except for the obligations specifically excluded by state law, the debts of the non-purchasing spouse must be included in the borrower's qualifying ratios if the borrower resides in a community property state or the property to be insured is located in a community property state. Although the non-purchasing spouse's credit history is not to be considered a reason for credit denial, a credit report that complies with the requirements of paragraph 2-4 must be obtained for the non-purchasing spouse in order to determine the debt-to-income ratio."

- Paragraph 2-3 states, "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. A borrower who has made payments on previous and current obligations in a timely manner represents reduced risk. Conversely, if the credit history, despite adequate income to support obligations, reflects slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan…While minor derogatory information occurring two or more years in the past does not require explanation, major indications of derogatory credit – including judgments, collections, and any other recent credit problems – require sufficient written explanation from the borrower."

- Paragraph 2-3A states, "The payment history of the borrower's housing obligations hold significant importance in evaluating credit. The lender must determine the borrower's payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity-of-interest with the borrower) or verification of mortgage directly from the mortgage servicer, or through canceled checks covering the most recent 12-month period."

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

- Paragraph 2-3C states, "Court-ordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement…FHA does not require that collection accounts be paid off as a condition of mortgage approval. Collections and judgments indicate a borrower's regard for credit obligations and must be considered in the analysis of creditworthiness with the lender documenting its reasons for approving a mortgage where the borrower has collection accounts or judgments. The borrower must explain in writing all collections and judgments."

- Paragraph 2-3E states, "A Chapter 7 bankruptcy (liquidation) does not disqualify a borrower from obtaining an FHA-insured mortgage if at least two years have elapsed since the date of the discharge of the bankruptcy. Additionally, the borrower must have re-established good credit or chosen not to incur new credit obligations. The borrower also must have demonstrated documented ability to responsibly manage his or her financial affairs."

- Chapter 2, section 2, states, "The anticipated amount of income, and the likelihood of its continuance, must be established to determine a borrower's capacity to repay mortgage debt. Income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue. This section describes acceptable types of income, procedures for calculating effective income, and requirements for establishing income stability."

  Paragraph 2-5B states, "If the borrower, as revealed by public records, credit information, or HUD's Credit Alert Interactive Voice Response System (CAIVRS), is presently delinquent on any Federal debt (e.g., VA-guaranteed mortgage, Title I loan, Federal student loan, Small Business Administration loan, delinquent Federal taxes) or has a lien, including taxes, placed against his or her property for a debt owed to the U.S., the borrower is not eligible until the delinquent account is brought current, paid, otherwise satisfied, or a satisfactory

repayment plan is made between the borrower and the Federal agency owed and is verified in writing."

- Paragraph 2-6 states, "We do not impose a minimum length of time a borrower must have held a position of employment to be eligible. However, the lender must verify the borrower's employment for the most recent two full years."

- Paragraph 2-7 states, "The income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage loan."

- Paragraph 2-7A states, "Both overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of bonus or overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. 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. An earnings trend also must be established and documented for overtime and bonus income. If either type shows a continual decline, the lender must provide a sound rationalization in writing for including the income for borrower qualifying. If bonus income varies significantly from year to year, a period of more than two years must be used in calculating the average income."

- Paragraph 2-7D states, "Commission income must be averaged over the previous two years. The borrower must provide copies of signed tax returns for the last two years, along with the most recent pay stub…Individuals whose commission income shows a decrease from one year to the next require significant compensating factors to allow for loan approval."

- Paragraph 2-7M (2) states, "If a property was acquired since the last income tax filing and is not shown on Schedule E, a current signed lease or other rental agreement must be provided. The gross rental amount must be reduced for vacancies and maintenance by 25 percent (or the percentage developed by the jurisdictional HOC [Homeownership Center]), before subtracting PITI [principal, interest, taxes, and insurance] and any homeowners' association dues, etc., and applying the remainder to income (or recurring debts, if negative)."

- Paragraph 2-10 states, "All funds for the borrower's investment in the property must be verified and documented."

- Paragraph 2-10A states, "If the amount of the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds. Satisfactory documentation includes a copy of the borrower's cancelled check. A certification from the deposit-holder

acknowledging receipt of funds and separate evidence of the source of funds is also acceptable. Evidence of source of funds includes a verification of deposit or bank statement showing that at the time the deposit was made the average balance was sufficient to cover the amount of the earnest money deposit."

- Paragraph 2-10B states, "A verification of deposit (VOD), along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account, or the account was opened recently, the lender must obtain a credible explanation of the source of those funds."

- Paragraph 2-10C states, "An outright gift of the cash investment is acceptable if the donor is the borrower's relative, the borrower's employer or labor union, a charitable organization, a governmental agency or public entity that has a program to provide homeownership assistance to low- and moderate-income families or first-time homebuyers, or a close friend with a clearly defined and documented interest in the borrower…The lender must document the gift funds by obtaining a gift letter, signed by the donor and borrower, that specifies the dollar amount of the gift, states that no repayment is required, shows the donor's name, address, telephone number and states the nature of the donor's relationship to the borrower. In addition, the lender must document the transfer of funds from the donor to the borrower, as follows: 1. If the gift funds are in the homebuyer's bank account, the lender must document the transfer of the funds from the donor to the homebuyer by obtaining a copy of the canceled check or other withdrawal document showing that the withdrawal is from the donor's account. The homebuyer's deposit slip and bank statement that shows the deposit is also required…"

- Paragraph 2-11A states, "The borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other additional recurring charges extending ten months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc. Debts lasting less than ten months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing. The following additional information deals with revolving accounts and alimony payments: 1. If the account shown on the credit report has an outstanding balance, monthly payments for qualifying purposes must be calculated at the greater of 5 percent of the balance or $10 (unless the account shows a specific minimum monthly payment)."

- Paragraph 2-11C states, "If a debt payment, such as a student loan, is scheduled to begin within twelve months of the mortgage loan closing, the lender must include the anticipated monthly obligation in the underwriting analysis, unless the

borrower provides written evidence that the debt will be deferred to a period outside this timeframe."

- Paragraph 2-13 states, "Compensating factors that may be used to justify approval of mortgage loans with ratios exceeding our benchmark guidelines are those listed below. Underwriters must record on the 'remarks' section of the HUD 92900-WS [Mortgage Credit Analysis Worksheet]/HUD 92900-PUR [Mortgage Credit Analysis Worksheet Purchase Money Mortgages] the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation. A. The borrower has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12-24 months. B. The borrower makes a large down payment (ten percent or more) toward the purchase of the property. C. The borrower has demonstrated an ability to accumulate savings and a conservative attitude toward the use of credit. D. Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses. E. The borrower receives documented compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and similar public benefits. F. There is only minimal increase in the borrower's housing expense. G. The borrower has substantial documented cash reserves (at least three months' worth) after closing. In determining if an asset can be included as cash reserves or cash to close, the lender must judge whether or not the asset is liquid or readily convertible to cash and can be done so absent retirement or job termination…H. The borrower has substantial non-taxable income (if no adjustment was made previously in the ratio computations). I. The borrower has a potential for increased earnings, as indicated by job training or education in the borrower's profession. J. The home is being purchased as a result of relocation of the primary wage-earner, and the secondary wage-earner has an established history of employment, is expected to return to work , and reasonable prospects exist for securing employment in a similar occupation in the new area. The underwriter must document the availability of such possible employment."

- Chapter 3 states, "The lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation, source of funds for the transaction, and the intended use of the property. All information must be verified and documented."

- Paragraph 3-1 states, "The application package must contain all documentation supporting the lender's decision to approve the mortgage loan…All documents may be up to 120 days old at the time the loan closes (180 days for new construction) unless this or other applicable HUD instructions specify a different timeframe, or the nature of the document is such that its validity for underwriting purposes is not affected by being older than the number of prescribed days (e.g., divorce decrees, tax returns). Updated, written verifications must be obtained when the age of the documents exceed these limits…The following documents

are generally required for mortgage credit analysis in all transactions except for certain streamline refinances: …E. Verification of Employment (VOE) and the borrower's most recent pay stub are to be provided. 'Most recent' means at the time the initial loan application is made…As an alternative to obtaining a VOE, the lender may obtain the borrower's original pay stub(s) covering the most recent 30-day period, along with original IRS [Internal Revenue Service] W-2 Forms from the previous two years…The lender also must verify by telephone all current employers…F. VOD and most recent bank statements are to be provided. 'Most recent' means at the time the initial loan application is made...As an alternative to obtaining a VOD, the lender may obtain from the borrower original bank statement(s) covering the most recent three-month period. Provided the bank statement shows the previous month's balance, this requirement is met by obtaining the two most recent, consecutive statements…"

2. Mortgage Letter 2004-47 states, "The lender must obtain the single most recent pay stub (showing year-to-date earnings of at least one month) and any one of the following to verify current employment:
    - Written Verification of Employment (VOE)
    - Verbal verification of employment (Lender or service provider must document individual verifying the employment.)
    - Electronic verification acceptable to FHA…

    The lender is required to verify the applicant's employment history for the previous two years. However, direct verification is not required if all of the following conditions are met:
    - The current employer confirms a two-year employment history (this may include a paystub indicating a hiring date)
    - Only base pay is used to qualify (no overtime or bonuses)
    - The borrower signs form IRS 4506 or 8821 for the previous two tax years."

3. Mortgagee Letter 2005-16 states, "for manually underwritten mortgages where the Direct Endorsement (DE) underwriter must make the credit decision, the qualifying ratios are raised to 31% and 43%...As always, if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval."

4. 24 CFR 203.32(a) states, "…a mortgagor must establish that, after the mortgage offered for insurance has been recorded, the mortgaged property will be free and clear of all liens other than such mortgage, and that there will not be outstanding any other unpaid obligations contracted in connection with the mortgage transaction or the purchase of the mortgaged property, except obligations that are secured by property or collateral owned by the mortgagor independently of the mortgaged property."

5. 24 CFR 203.41

    - Paragraph (a)(3) states, "Legal restrictions on conveyance means any provision in any legal instrument, law or regulation applicable to the mortgagor or the

mortgaged property, including but not limited to a lease, deed, sales contract, declaration of covenants, declaration of condominium, option, right of first refusal, will, or trust agreement, that attempts to cause a conveyance (including a lease) made by the mortgagor to: …(ii) Be the basis of contractual liability of the mortgagor for breach of an agreement not to convey, including rights of first refusal, pre-emptive rights or options related to mortgagor efforts to convey; (iii) Terminate or subject to termination all or a part of the interest held by the mortgagor in the mortgaged property if a conveyance is attempted; (iv) Be subject to the consent of a third party…"

- Paragraph (b) states, "A mortgage shall not be eligible for insurance if the mortgaged property is subject to legal restrictions on conveyance, except as permitted by this part."

- Paragraph (c) states, "Legal restrictions on conveyance are acceptable if: (1) The restrictions are part of an eligible governmental or nonprofit program and are permitted by paragraph (d) of this section; and (2) The restrictions will automatically terminate if title to the mortgaged property is transferred by foreclosure or deed-in-lieu of foreclosure, or if the mortgage is assigned to the Secretary."

# Appendix D

## NARRATIVE LOAN SUMMARIES FOR SIGNIFICANT UNDERWRITING DEFICIENCIES

The following narratives provide the details for the significant underwriting deficiencies noted in the table contained in finding 1.

**1. FHA loan number: 023-2546830 Loan status: Claim**
**Requesting indemnification: Yes Default status: Property conveyed to insurer**

We are seeking indemnification of this loan based on the lender's failure to properly evaluate the borrower's credit.

Credit
Both the borrower and coborrower had Chapter 7 bankruptcies that were discharged in 2003 and 2001, respectively. While a Chapter 7 bankruptcy does not disqualify a borrower from obtaining an FHA-insured mortgage if at least 2 years has elapsed, HUD Handbook 4155.1, REV-5, paragraph 2-3E, states that the borrower must have reestablished good credit or chosen not to incur new credit obligations and the borrower also must have demonstrated a documented ability to responsibly manage his or her financial affairs. The borrowers did not reestablish good credit and did not demonstrate the ability to responsibly manage their affairs as evidenced by the multiple collection accounts on their credit report that were originally reported in 2005 through 2007, after the bankruptcies were discharged. The loan file contained two letters from vendors stating that the borrowers were current on their payments; however, these letters did not sufficiently show that the borrowers had reestablished good credit, nor did they demonstrate the borrowers' ability to responsibly manage their financial affairs.

In addition, HUD Handbook 4155.1, REV-5, paragraph 2-3, states that if a borrower's credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan. The lenders used compensating factors such as "borrowers have had extraordinary medical bills which is causing the FICO (credit score) to be low" to justify approving the loan; however, none of the compensating factors were allowed by HUD Handbook 4155.1, REV-5, paragraph 2-13.

**2. FHA loan number: 023-2575560 Loan status: Claim**
**Requesting indemnification: Yes Default status: Preforeclosure sale completed**

We are seeking indemnification of this loan based on the revised total fixed payment-to-income ratio, which reflects the allowable qualifying income and liabilities as calculated by OIG in accordance with HUD-FHA requirements. After revision, the ratio increased from 44.63 to 60.83 percent, which far exceeds HUD's total fixed payment-to-income

benchmark ratio of 43 percent as stated in Mortgagee Letter 2005-16. The lender did not document compensating factors that could have justified the excessive ratio.

Income

The lender calculated the borrower's income based on 40 hours per week; however, the borrower's pay stubs only supported an average of 36.8 hours per week. As a result, the lender overstated the borrower's income by $243.36 per month.

Credit

Both the borrower and the coborrower had payments withheld from their pay checks that were not considered by the lender and the automated underwriting system as required by the Fannie Mae Underwriting Findings and HUD Handbook 4155.1, REV-5, paragraph 2-11A. The Fannie Mae Underwriting Findings, item 19, states that when a debt or obligation is revealed during the loan process that was not listed on the loan application and/or credit report, the lender must verify the actual monthly payment amount and resubmit the loan with the liability if it is greater than $100 per month. HUD Handbook 4155.1, REV-5, paragraph 2-11A, states that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payments during the months immediately after loan closing. The borrower's pay stub revealed a deduction for "Levy – Fed" of $100.01 per month, and the coborrower's pay stub revealed a deduction for "Company Store" of $599.14 per month. These liabilities were not included on either the loan application or the credit report, and the loan file did not contain documentation showing that these debts would last less than 10 months. As a result, the borrowers' recurring expenses were understated by $699.15.

Additionally, the indication that the borrower had a Federal levy deducted from his wages requires further consideration by the lender. A Federal levy is usually only enacted after an obligor has neglected or refused to pay a Federal debt, indicating that the debt was delinquent. HUD Handbook 4155.1, REV-5, paragraph 2-5B, states that if a borrower is presently delinquent on any Federal debt or has a lien, including taxes, placed against his property for a debt owed to the United States, the borrower is not eligible until the delinquent account is brought current, paid, or otherwise satisfied or a satisfactory repayment plan is made.

**3. FHA loan number: 023-2577611 Loan status: Claim**
**Requesting indemnification: Yes Default status: Preforeclosure sale completed**

We are seeking indemnification of this loan based on the revised mortgage payment-to-income and total fixed payment-to-income ratios, which reflect the allowable qualifying income as calculated by OIG in accordance with HUD-FHA requirements, and based on the lender's failure to document adequate compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines. After revision, the ratios were increased from 37.07 and 47.70 to 39.25 and 50.51 percent, respectively, which far exceeded HUD's benchmark ratios of 31 and 43 percent as stated in Mortgagee Letter 2005-16.

Income
The lender calculated the borrower's monthly income based on the $36,000 annual income stated on the verification of employment. However, the loan file contained the borrower's contract, which stated that the annual income for the year was $34,000. The amount in the contract was also supported by the borrower's pay stubs. As a result, the borrower's monthly income was overstated by $166.67.

Compensating Factors
The lender did not list eligible compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16. Mortgagee Letter 2005-16 states that if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, lists compensating factors that underwriters must record in the remarks section of the HUD 92900-WS/HUD 92900-PUR used to support loan approval. The loan was manually approved by the lender with mortgage payment-to-income and total fixed payment-to-income ratios that exceeded HUD's benchmark ratios by 6.07 and 4.70 percent, respectively. The lender used "borrower will have 2 months reserves after closing" and "good employment history with very good prospects for future earnings" as compensating factors. One of FHA's eligible compensating factors is that the borrower has at least 3 months of cash reserves after closing, not 2 months. Also the lender did not document training or education in the borrower's profession to support future earnings as required.

Credit
The loan file did not contain an explanation for the three collection accounts on the borrower's credit report as required by HUD Handbook 4155.1, REV-5, paragraph 2-3C.

**4. FHA loan number: 023-2577634 Loan status: Claim**
**Requesting indemnification: Yes Default status: Preforeclosure sale completed**

We are seeking indemnification of this loan based on the lender's failure to properly determine the borrower's liabilities and assets. This loan was approved by the automated underwriting system with mortgage payment-to-income and total fixed payment-to-income ratios of 27.09 and 46.72 percent, respectively.

Credit
The lender calculated the net rental income for the borrower's existing rental property but did not take into consideration the scheduled increase in the mortgage payment due to the interest rate reset. The mortgage for the existing rental property had an adjustable rate that was going to reset 5½ months after the close of escrow (November 16, 2007) for the FHA-insured property. The interest only adjustable rate rider for the existing rental property states that the interest rate was 7.70 percent and would change starting on April 1, 2008, and every 6 months thereafter. The new rate would be calculated by adding 6.70 percent to the current index (or LIBOR (London Interbank Offered Rate) index); however, the interest rate at the first change date would not be greater than 10.70 percent

or less than 7.70 percent. The LIBOR index at the time of the borrower's application on November 15, 2007, was 4.8324 percent. Therefore, the interest rate for the existing rental property would have increased by 3 percent. An increase of 3 percent would have increased the mortgage payment for the existing rental property by $514.66. The borrower stated that his payments increased by about $200 to $300.

Also the lender did not include the homeowners association fee when calculating the net rental income for the existing rental property. According to the homeowners association management company, the dues were $105.00 per quarter.

Assets

The lender did not verify the source of funds that the borrower used for the earnest money deposit when the verification of deposit did not support the borrower's ability to fund the earnest money deposit as required by HUD Handbook 4155.1, REV-5, paragraph 2-10A. The borrower's earnest money deposit was $3,000, while the verification of deposit showed an average monthly balance of only $721. In an interview with the borrower, he stated that he borrowed some of the funds for the earnest money deposit from his parents.

In addition, assets in a retirement account that were used to qualify the borrower did not meet the requirements of the Fannie Mae Underwriting Findings. The lender used 60 percent of the retirement account balance without regard for the amount the borrower had vested, and the lender did not document that the retirement account allowed for withdrawals for conditions other than those related to the borrower's employment or death and that the borrower qualified for withdrawal and/or borrowing.

**5. FHA loan number: 023-2610061 Loan status: Claim**
**Requesting indemnification: No Default status: Property conveyed to insurer**

We are not seeking indemnification of this loan because it was indemnified on August 14, 2009, by request from the lender. The lender determined that the borrower had been working for a placement agency for only 1 month and had no prior history of working temporary jobs when the loan was approved. The lender also noted that the borrower's last day of employment was the day of closing. We identified an additional significant underwriting deficiency for this loan regarding the borrower's income.

Income

The lender did not obtain the borrower's most recent year-to-date pay stub documenting 1 full month's earnings as required by item 23 of the Fannie Mae Underwriting Findings. The lender obtained only one of the borrower's pay stubs, which documented less than 14 days of earnings. Since the borrower's employment start date was April 28, 2008, and the lender noted that the borrower's last day of employment was the day of closing on May 22, 2008, the lender would have known that the borrower was no longer employed if it had delayed closing to obtain a pay stub documenting 1 full month's earnings.

**6. FHA loan number: 023-2692048 Loan status: Claim**
**Requesting indemnification: No Default status: Property conveyed to insurer**

We are not seeking indemnification of this loan because it was indemnified on December 4, 2009, by request from the lender. Before this loan was indemnified, the OIG was going to seek indemnification based on the revised total fixed payment-to-income ratio, which reflects the allowable qualifying income and liabilities as calculated by OIG in accordance with HUD-FHA requirements. After revision, the ratio increased from 48.42 to 60.86 percent, which far exceeded HUD's benchmark ratio of 43 percent as stated in Mortgagee Letter 2005-16. The lender did not document compensating factors that could have justified the excessive ratio.

Income

The lender included the borrower's overtime hours in the overtime income calculation as well as the base income calculation. The lender calculated the borrower's overtime income based on the average of the overtime income earned over the past 19.5 months. The lender then calculated the borrower's base income using 47 hours per week instead of 40 hours. As a result, the borrower's monthly income was overstated by $424.67.

In addition, the loan file did not contain the appropriate support to justify the overtime pay used in the ratios to qualify the borrower as required by HUD Handbook 4155.1, REV-5, paragraph 2-7A. The borrower's overtime income was earned for less than 2 years, and the lender did not document in writing the justification for including the borrower's overtime income.

Credit

The borrower had a payment withheld from his pay check that was not considered by the lender and the automated underwriting system. The Fannie Mae Underwriting Findings, item 19, states that when a debt or obligation is revealed during the loan process that was not listed on the loan application and/or credit report, the lender must verify the actual monthly payment amount and resubmit the loan with the liability if it is greater than $100 per month. The borrower's 2-week pay stub revealed a deduction for "Advance" of $93. This liability was not included on either the loan application or the credit report. As a result, the borrower's recurring expenses were understated by $201.50.

In addition, the credit report contained a civil judgment with an explanation from the loan processor that it contacted the appropriate authority and the civil judgment did not reflect information identifying the borrower. Also the judgment would be removed in December 2008 (which was 9 months after the close of escrow). The Fannie Mae Underwriting Findings, item 22, requires evidence of payoff of any outstanding judgments shown on the credit report. HUD Handbook 4155.1, REV-5, paragraph 2-3, also states that court-ordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement.

**7. FHA loan number: 023-2704044 Loan status: Active**
**Requesting indemnification: Yes Default status: Special forbearance**

We are seeking indemnification of this loan based on the lender's failure to document adequate compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines.

Compensating Factors
The lender did not list eligible compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16. Mortgagee Letter 2005-16 states that if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, lists compensating factors that underwriters must record in the remarks section of the HUD 92900-WS/HUD 92900-PUR used to support loan approval. The loan was manually approved by the lender with mortgage payment-to-income and total fixed payment-to-income ratios that exceeded HUD's benchmark ratios by 13.12 and 9.71 percent, respectively. The only allowable compensating factor listed by the lender was that the borrower had "potential for advancement." This compensating factor was not eligible because, although the borrower anticipated graduating with a bachelor's degree, this graduation was to occur more than 2 years after the close of escrow. Also, the lender did not show that the education was in the borrower's profession as required.

**8. FHA loan number: 023-2709195 Loan status: Claim**
**Requesting indemnification: Yes Default status: Property conveyed to insurer**

We are seeking indemnification of this loan based on the lender's failure to document adequate compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines.

Compensating Factors
The lender did not list eligible compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16. Mortgagee Letter 2005-16 states that if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, lists compensating factors that underwriters must record in the remarks section of the HUD 92900-WS/HUD 92900-PUR used to support loan approval. The loan was manually approved by the lender with mortgage payment-to-income and total fixed payment-to-income ratios that exceeded HUD's benchmark ratios by 13.95 and 5.34 percent, respectively. The only allowable compensating factor listed by the lender was that the borrower had "potential for future earnings." However, this compensating factor was not eligible because it was not supported by job training or education in the borrower's profession as required.

Assets
A recent bank statement accompanying the verification of deposit was not provided as required by HUD Handbook 4155.1, REV-5, paragraph 3-1F.

**9. FHA loan number: 023-2728194 Loan status: Claim**
**Requesting indemnification: Yes Default status: Property conveyed to insurer**

We are seeking indemnification of this loan based on the revised mortgage payment-to-income and total fixed payment-to-income ratios, which reflect the allowable qualifying income as calculated by OIG in accordance with HUD-FHA requirements. After revision, the ratios were increased from 31.57 and 40.26 percent to 40.05 and 51.07 percent, respectively, which far exceeded HUD's benchmark ratios of 31 and 43 percent as stated in Mortgagee Letter 2005-16. The lender did not document compensating factors that could have justified the excessive ratio.

Income
The loan file did not contain the appropriate support to justify the overtime pay used in the ratios to qualify the borrower as required by HUD Handbook 4155.1, REV-5, paragraph 2-7A. The borrower's overtime was in decline, and the lender did not provide a sound rationalization in writing for including the overtime income. The average of the borrower's overtime income was $843.25 and $881.67 per month for 2006 and 2007, respectively. However, as shown in the verification of employment, the overtime income averaged only $383.50 per month for the first 2 months of 2008. Further, the borrower's pay stub in the loan file, dated February 9, 2008, stated that the year-to-date overtime income was $691.67, and the verification of employment stated that as of March 1, 2008, the year-to-date overtime income was $767. This documentation showed that in approximately 3 weeks, the borrower earned only $75.33 in overtime income. Therefore, the borrower's overtime income was inappropriately included, resulting in an overstatement of the monthly income by $826.

Also, the verification of income stated that the continuation of overtime income was unknown. HUD Handbook 4155.1, REV-5, paragraph 2-7, states that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can be reasonably expected to continue for at least the first 3 years of the mortgage loan. It further states that overtime income may be used if it is likely to continue.

Credit
The loan file did not contain an explanation for the two credit report inquiries that were within 90 days of the completed credit report, as required by HUD Handbook 4155.1, REV-5, paragraph 2-3B.

In addition, the borrower had a court-ordered judgment on his credit report that may not have been paid. HUD Handbook 4155.1, REV-5, paragraph 2-3C, requires that court-ordered judgments be paid off before the mortgage loan is eligible for FHA insurance endorsement. Chapter 3 of the handbook also requires that all information be verified and documented. The HUD-1 settlement statement showed a disbursement to the court;

however, the check was given to the borrower rather than directly to the court. The lender should have obtained documentation showing that the judgment had been paid.

**10. FHA loan number: 023-2836293 Loan status: Active**
**Requesting indemnification: Yes Default status: Special forbearance**

We are seeking indemnification of this loan based on the lender's inability to determine the borrower's liabilities and failure to document adequate compensating factors when the borrower's ratios exceeded HUD's benchmark guidelines.

Income
The loan file did not contain the appropriate support to justify the overtime pay used in the ratios to qualify the borrower as required by HUD Handbook 4155.1, REV-5, paragraph 2-7A. The borrower's overtime income was earned for less than 2 years, and the lender did not document in writing the justification for including the borrower's overtime income.

Credit
The lender did not obtain a credit history report for the borrower's nonpurchasing spouse as required by HUD Handbook 4155.1, REV-5, paragraph 2-2D, which requires a credit report for a nonpurchasing spouse in a community property State such as Arizona. Based on the documentation in the file, specifically the uniform residential loan application, dated June 10, 2008, and the pay stub, dated April 11, 2008, it appeared that the borrower was married. There was another name listed on the borrower's bank statement. Without obtaining the nonpurchasing spouse's credit report or establishing alternative credit, the lender was unable to determine the coborrower's liabilities.

Compensating Factors
The lender did not list eligible compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16. Mortgagee Letter 2005-16 states that if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, lists compensating factors that underwriters must record in the remarks section of the HUD 92900-WS/HUD 92900-PUR to support loan approval. The loan was manually approved by the lender with mortgage payment-to-income and total fixed payment-to-income ratios that exceeded HUD's benchmark ratios by 16.83 and 6.14 percent, respectively. The only allowable compensating factor listed by the lender was that the borrower had "reserves for 3 months." However, this was not an eligible compensating factor because the borrower's reserves were $422.72 less than the amount required.

**11. FHA loan number: 023-2866499 Loan status: Claim**
**Requesting indemnification: Yes Default status: Property conveyed to insurer**

We are seeking indemnification of this loan based on the lender's failure to document the transfer of gift funds that were used as the borrower's cash investment in the property.

Assets
The loan file did not contain the required documentation supporting the transfer of a $20,000 gift from the nonpurchasing spouse. The borrower had a downpayment of $19,132 that was derived from the gift, and at the closing, the funds were wired from the borrower's checking account. However, the loan file contained neither a withdrawal document showing that the withdrawal was from the donor's account nor the home buyer's deposit slip or bank statement that showed the deposit. HUD Handbook 4155.1, REV-5, paragraph 2-10C, states that all funds for the borrower's investment in the property must be verified and documented. Paragraph 2-10A further states that if the gift funds are in the home buyer's bank account, the lender must document the transfer of the funds from the donor to the home buyer by obtaining a copy of the canceled check or other withdrawal document showing that the withdrawal is from the donor's account. The home buyer's deposit slip and bank statement that show the deposit are also required. The gift funds were not documented as required, and without the gift, the borrower did not have sufficient funds to close[19].

Compensating Factors
The lender did not list eligible compensating factors that may be used to justify approval of mortgage loans with ratios exceeding HUD's benchmark guidelines as required by HUD Handbook 4155.1, REV-5, paragraph 2-13, and Mortgagee Letter 2005-16. Mortgagee Letter 2005-16 states that if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, lists compensating factors that underwriters must record on the remarks section of the HUD 92900-WS/HUD 92900-PUR to support loan approval. The loan was manually approved by the lender with mortgage payment-to-income and total fixed payment-to-income ratios that exceeded HUD's benchmark ratios by 10.9 and 2.68 percent, respectively. The only allowable compensating factor listed by the lender was that the borrower was "putting 9% down payment into transaction." However, this compensating factor was not eligible because the handbook requires a 10 percent or more downpayment.

**12. FHA loan number: 023-2880511 Loan status: Active**
**Requesting indemnification: Yes Default status: Delinquent**

We are seeking indemnification of this loan based on the lender's failure to properly determine the borrower's liabilities. This loan was approved by the automated underwriting system with mortgage payment-to-income and total fixed payment-to-income ratios of 36.95 and 51.88 percent, respectively.

[19] HUD Handbook 4155.1, paragraph 1-7, states that the borrower must make a cash investment at least equal to the difference between the sales price and the resulting maximum mortgage amount.

Assets

The borrower received an $8,000 gift from his brother; however, the automated underwriting system did not show the funds segregated as gift funds, which may have affected the decision to approve the loan. Also, the loan file did not contain the required documentation supporting the transfer of the gift funds. A deposit slip was in the file; however, there was no canceled check or other withdrawal document showing that the withdrawal was from the donor's account. HUD Handbook 4155.1, REV-5, paragraph 2-10, states that all funds for the borrower's investment in the property must be verified and documented. Paragraph 2-10C further states if the gift funds are in the home buyer's bank account, the lender must document the transfer of the funds from the donor to the home buyer by obtaining a copy of the canceled check or other withdrawal document showing that the withdrawal is from the donor's account. The home buyer's deposit slip and bank statement that show the deposit are also required.

Credit

The lender calculated the net rental income for the borrower's existing rental property but did not take into consideration the increase in the mortgage payment due to the interest rate reset. The existing rental property had two mortgages, with one having an adjustable rate that reset before the borrower's loan application for the FHA-insured property. The adjustable rate rider for the existing rental property stated that the interest rate was 6.75 percent and would change starting on June 1, 2008, and every 6 months thereafter. The new rate would be calculated by adding 6.50 percent to the current index (or LIBOR index) but the interest rate at the first change date would not be greater than 9.75 percent or less than 6.75 percent. The borrower's loan application was dated June 30, 2008 (after the change date); however, the mortgage payment used in calculating the net rental income did not reflect a change based on the rate reset. The LIBOR index at the time of the change date was 2.8544 percent. Therefore, the interest rate for the existing rental property would have increased by 2.6044 percent ([6.50 plus 2.8544] minus 6.75). Conservatively, if we assume that the payment was interest only, an increase of 2.6044 percent would have increased the mortgage payment for the existing rental property by approximately $282.