Issue Date	January 21, 2010
Audit Report Number	2010-PH-1004

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

//signed//

FROM: John P. Buck, Regional Inspector General for Audit, Philadelphia Region, 3AGA

SUBJECT: Residential Home Funding Corporation, Gaithersburg, MD, Did Not Always Comply With HUD Requirements in Originating FHA-Insured Single-Family Loans

HIGHLIGHTS

What We Audited and Why

We audited Residential Home Funding Corporation, a nonsupervised[1] lender approved to originate Federal Housing Administration (FHA) single-family mortgage loans. Residential Home Funding Corporation has one office located in Gaithersburg, Maryland. We selected Residential Home Funding Corporation because its default rate was significantly higher than the average default rate for the State of Maryland. Our objective was to determine whether Residential Home Funding Corporation complied with U.S. Department of Housing and Urban Development (HUD) regulations, procedures, and instructions in the origination of FHA loans.

What We Found

Residential Home Funding Corporation did not always comply with HUD requirements in its origination of FHA loans. For five loans reviewed, Residential

[1] A nonsupervised lender is an FHA-approved lending institution that has as its principal activity the lending or investing of funds in real estate mortgages.

Home Funding Corporation did not properly verify or support the borrowers' income. These deficiencies stemmed from Residential Home Funding Corporation's misinterpretation of HUD requirements related to verification of employment/income. As a result, the FHA insurance fund was exposed to an unnecessarily increased risk.

What We Recommend

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require Residential Home Funding Corporation to indemnify more than $1.6 million[2] for five loans, which it issued contrary to HUD's loan origination requirements and refer Residential Home Funding Corporation's principals and underwriting staff to HUD's Mortgagee Review Board for administrative sanctions as appropriate.

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 draft report to Residential Home Funding Corporation on December 9, 2009. We discussed the audit results with Residential Home Funding Corporation during the audit and at an exit conference on December 17, 2009. We requested a written response by December 29. Residential Home Funding Corporation provided written comments to our draft report on December 27, 2009. It generally disagreed with our report. The complete text of its response, along with our evaluation of that response, can be found in appendix B of this report.

[2] This amount is the unpaid principal balance. The projected loss to HUD is $997,291 based on HUD's insurance fund average loss rate of 60 percent.

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BACKGROUND AND OBJECTIVE

The U.S. Department of Housing and Urban Development's (HUD) strategic plan states that part of its mission is to increase homeownership, support community development, and increase access to affordable housing free from discrimination.

The National Housing Act, as amended, established the Federal Housing Administration (FHA), an organizational unit within HUD. FHA provides insurance for lenders against loss on single-family home mortgages.

In 1983, HUD implemented the direct endorsement program, which authorized approved lenders to underwrite loans without HUD's prior review and approval. There are two types of approved direct endorsement mortgagees - supervised and nonsupervised. A supervised mortgagee is an FHA-approved financial institution that is a member of the Federal Reserve System or an institution whose accounts are insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration. A nonsupervised lender is an FHA-approved lending institution that has as its principal activity the lending or investing of funds in real estate mortgages. HUD requires lenders to use its Neighborhood Watch system to monitor and evaluate their performance, and has many sanctions available for taking actions against lenders or others who abuse the direct endorsement program.

Residential Home Funding Corporation is a nonsupervised direct endorsement lender for FHA loans and is located in Gaithersburg, MD. This is the only active office for the lender. Residential Home Funding Corporation issued 40 FHA loans valued at $11.6 million between April 2007 and March 2009 that defaulted within the first 2 years. Of the 40 loans, 22 that had not been terminated or refinanced defaulted with 12 payments or fewer. These loans were valued at more than $6.2 million. We reviewed five of the loans valued at approximately $1.7 million.

On September 30, 2009, HUD terminated Residential Home Funding Corporation's FHA loan origination approval agreement for the Washington, DC, jurisdiction because of its relatively high default and claim rate. As stipulated by this termination HUD will no longer insure loans originated in the Washington, DC, jurisdiction by Residential Home Funding Corporation.

Our objective was to determine whether Residential Home Funding Corporation complied with HUD regulations, procedures, and instructions in the origination of FHA-insured single-family loans.

RESULTS OF AUDIT

Finding: Residential Home Funding Corporation Did Not Always Comply With HUD Requirements in the Origination of FHA-Insured Single-Family Loans

Residential Home Funding Corporation did not verify borrowers' income in accordance with HUD requirements for five loans reviewed, originally valued at more than $1.6 million. It could not provide adequate supporting documentation to show that it established that the borrowers had the capacity to repay their mortgage debts. The deficiencies occurred because Residential Home Funding Corporation misinterpreted HUD requirements related to verification of employment/income. As a result, the FHA insurance fund was exposed to an unnecessarily increased risk. Therefore, Residential Home Funding Corporation should indemnify more than $1.6 million[3] for the five defaulted loans.

The Lender Did Not Properly Verify or Support Borrowers' Income

According to HUD requirements,[4] the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt. In this regard, HUD requires[5] the lender to obtain and document verification of employment and the borrower's most recent pay stub. As an alternative to obtaining verification of employment, the lender may obtain the borrower's original pay stub(s) covering the most recent 30-day period, along with original Internal Revenue Service (IRS) W-2 forms from the previous 2 years.

For the five sample loans reviewed, we did not find sufficient evidence to support the borrowers' income. In three cases, Residential Home Funding Corporation used verification of employment forms and the borrowers' paychecks to support the borrowers' income. No pay stubs were provided. In another case, verification of employment forms were provided for the borrower and a coborrower. However, a pay stub was only provided for the coborrower, whose income represented less than half of the total income used to qualify the borrowers for the loan. The borrower's income was only supported by a paycheck. In the remaining case reviewed, verification of employment forms and the borrowers' pay stubs and paychecks were provided as proof of income. The pay stubs did not

[3] See footnote 2.
[4] HUD Handbook 4155.1, REV-5, chapter 2, section 2
[5] HUD Handbook 4155.1, REV-5, section 3.1E

show the year-to-date earnings, only the gross pay and taxes for the pay period. Furthermore, one of the pay stubs did not show the company name and Social Security number for one of the borrowers.

In four of the cases in which paychecks were provided, the checks were handwritten checks from the borrowers' employers. Copies of the back of the checks were not documented or provided; therefore, we could not determine whether the checks had been cashed. Also, for one of the five loans, the employer was the seller of the property being purchased by the borrower. In four of the five cases, the employees' payroll taxes were written in the memo area of the paycheck. There were no W-2 forms, tax returns, or documents requesting tax returns documented in any of the case files.

Residential Home Funding Corporation did not obtain or provide sufficient evidence to validate the borrowers' income and, therefore, failed to demonstrate that it ensured that the borrowers had the capacity to repay their mortgage debts.

The Lender Misinterpreted HUD Requirements

The loan origination deficiencies noted occurred because Residential Home Funding Corporation erroneously believed that paychecks could be substituted for pay stubs in the employment/income verification process. The lender indicated that it accepted paychecks instead of pay stubs because it primarily did business with small business owners. In four of the cases reviewed, the borrowers received gift funds and seller assistance and in two of the cases the borrowers had no prior history of making rent or mortgage payments because they previously lived with relatives. Also, no tax returns were documented in their files. In light of these factors and given the HUD requirements for employment/income verification, Residential Home Funding Corporation should have been more diligent in verifying the borrowers' income to ensure that they had the capacity to repay their mortgage debts.

Conclusion

Residential Home Funding Corporation did not always comply with HUD requirements in its origination of FHA-insured loans. It did not properly verify or support the borrowers' income for the five cases reviewed and, therefore, failed to demonstrate that it determined the borrowers' capacity to meet their mortgage obligations. The deficiencies occurred because Residential Home Funding Corporation misinterpreted HUD requirements related to verification of employment/income. As a result, FHA's insurance fund was exposed to an unnecessarily increased risk. Therefore, Residential Home Funding Corporation should indemnify more than $1.6 million[6] for the five defaulted loans (see appendixes C and D for more detail).

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing

1A. Require Residential Home Funding Corporation to indemnify $1,662,152[7] for five loans, which it issued contrary to HUD requirements.

1B. Refer Residential Home Funding Corporation's principals and underwriting staff to HUD's Mortgagee Review Board for administrative sanctions as appropriate.

[6] See footnote 2.
[7] See footnote 2.

SCOPE AND METHODOLOGY

We performed our on-site audit work between June and August 2009 at Residential Home Funding Corporation's office located at 704 Quince Orchard Road, Gaithersburg, MD. Our review period was from April 2007 through March 2009 but was expanded when necessary to include current data through October 2009.

We queried HUD's Neighborhood Watch system for information on lenders' default rates. HUD's Neighborhood Watch system is a Web-based software application that displays loan performance data for lenders and appraisers by loan types and geographic areas, using FHA-insured single-family loan information. The loan information is displayed for a 2-year origination period and is updated on a monthly basis. HUD requires lenders to use the Neighborhood Watch system to monitor and evaluate their performance.

Based on the Neighborhood Watch query results, we identified and selected Residential Home Funding Corporation located in Gaithersburg, MD, for review because its percentage of defaults by 2 years was 19.61 percent compared with the Maryland State average of 6.79 percent. This is the only active office for the lender.

Residential Home Funding Corporation originated 40 FHA loans, valued at approximately $11.6 million, between April 2007 and March 2009 that defaulted within the first 2 years. After eliminating refinanced loans, terminated loans, and loans with more than 12 payments before default, 22 defaulted loans remained. The 22 loans, valued at more than $6.2 million, defaulted with 12 payments or fewer. We originally selected eight of those loans, valued at approximately $2.7 million, for review; however, due to Residential Home Funding Corporation's indication that the company would probably be dissolved in the near future (due to losing its approval to originate FHA loans), we reduced our sample size to five loans valued at approximately $1.7 million. The original sample selection was based on the eight loans with the highest mortgage amounts. To determine whether Residential Home Funding Corporation complied with HUD regulations, procedures, and instructions in its origination of FHA loans, we performed the following:

- Reviewed applicable HUD handbooks and mortgagee letters,
- Reviewed case files for the five sample loans,
- Examined records and related documents of Residential Home Funding Corporation, and
- Conducted interviews with officials and employees of Residential Home Funding Corporation as well as HUD employees.

In addition, we relied in part on data maintained by HUD in the Neighborhood Watch system. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data adequately reliable for our purposes.

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

INTERNAL CONTROLS

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

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- 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 Control

We determined that the following internal control was relevant to our audit objective:

- Loan origination process – Policies and procedures that management has in place to reasonably ensure that the loan origination process complies with HUD program requirements

We assessed the relevant control identified above.

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

Significant Weakness

Based our review, we believe that the following item is a significant weakness.

- Residential Home Funding Corporation did not operate in accordance with HUD requirements as they relate to loan origination.

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use 1/
1A	$997,291

1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this instance, implementation of our recommendation to indemnify loans that were not originated in accordance with HUD requirements will reduce the risk of loss to the FHA insurance fund. The above amount reflects HUD statistics, which show that FHA, on average, lost 60 percent of the claim paid on each property during 2009 (see appendix C).

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

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December 27, 2009

VIA EMAIL AND EXPRESS MAIL
John P. Buck
Regional Inspector General for Audit, Philadelphia Region, 3AGA
U.S. Department of Housing and Urban Development
Wanamaker Building, Suite 1005
100 Penn Square East
Philadelphia, PA 19107-3390

Re: Residential Home Funding Corporation, Gaithersburg, MD— Response to Department of Housing and Urban Development's ("HUD") Draft Audit Report Office of HUD's Office of Inspector General (the "OIG")

Dear Mr. Buck:

On behalf of our client, the Residential Home Funding Corporation ("RHFC"), we appreciate the opportunity to submit this response to the OIG's draft audit report (the "Draft Report") pertaining to RHFC's compliance with the Federal Housing Administration's (the "FHA") underwriting requirements for the origination of FHA-insured single-family loans.[1]

Comment 1

As an initial matter, RHFC has been a longtime supporter of HUD's mission to increase home ownership, support community development, and increase access to affordable housing to low- and moderate-income populations, particularly protected minority groups. RHFC also values the role of the OIG in providing independent and objective reporting of the integrity, efficiency, and effectiveness of HUD's operations, and believes that audits provide lenders with key insights into how best to improve compliance with HUD and FHA guidelines. To those ends, RHFC has worked cooperatively with the OIG throughout the subject auditing process.

Comment 2

While RHFC recognizes the important function and purpose of the OIG, RHFC respectfully disagrees with the Draft Report's initial conclusions that RHFC was not in compliance with FHA requirements in the origination of FHA-insured loans. To the contrary, RHFC submits that the five loans under audit review complied with the written HUD guidelines in place at the time of their origination and were verbally deemed to be in compliance by HUD operating staff during their own previous audit and compliance review. RHFC thus strongly objects to the Report's proposal to impose sanctions and to require RHFC to indemnify the FHA for losses associated

[1] The factual statements contained in this letter response are those of our client, RHFC, and have been relied upon without independent verification on our part. The legal positions and conclusions set forth herein are made by our firm, Venable LLP, and may be supplemented in future submissions should the matter dictate. However, if requested, senior members of management of RHFC will submit certificates verifying the factual matters set forth herein, including conversations with HUD Regional Office staff to the effect that RHFC's interpretation of the FHA underwriting requirements at issue was correct.

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with the subject loans, and respectfully requests the OIG to reconsider its recommendations before issuing the final audit report.

For purposes of background, RHFC is a full service mortgage company that was incorporated in the State of Maryland on October 25, 2000, and received its FHA Direct Endorsement approval in March of 2001. RHFC believes that all individuals should be given and equal opportunity to own their own home without intentional or unintentional discrimination based upon underwriting procedures employed in the particular circumstance. In fact—and as reflected in its original business plan reviewed and approved by the FHA—RHFC has always aided those in the underserved communities to reach their dream of home ownership and worked to further the government's goal of such increased home ownership. Such borrowers are predominantly minorities, including first generation Americans who work in professions that do not provide the type of income documentation typically accepted for full documentation loans. Whereas other lenders have not served such communities or automatically place them into high-cost, subprime products, RHFC has remained committed to placing borrowers into the more stable FHA programs by adapting its underwriting guidelines in a manner consistent with FHA guidelines.

Comment 3

The Draft Report asserts that RHFC failed to comply with FHA underwriting guidelines by not properly verifying or supporting the income of five Hispanic borrowers. Specifically, the Report states that RHFC misinterpreted FHA guidelines related to verification of employment and income by erroneously believing that the paychecks provided by the Hispanic loan applicants could be a reasonable substitute for "pay stubs." RHFC maintains that the it complied with the HUD guidelines in place at the time of the origination of the subject mortgage loans, and further, asserts that it took reasonable steps not required by HUD guidelines to help ensure the validity of the documents provided by those members of the Hispanic community seeking FHA mortgages—which underwriting approach was approved by operating personnel at HUD. In fact, it was only after HUD operating staff informed RHFC that it was necessary to tighten its underwriting in regard to employment verification that RHFC modified its underwriting process. RHFC thus does not believe that it should not be required to indemnify the FHA for $1.6 million and that imposing sanctions is inappropriate.

Comment 2

1. In Accordance with FHA Guidelines, RHFC Adapted Its Underwriting Requirements in a Manner Consistent to Meet the Special Needs of the Underserved Communities

As noted above, since its inception, RHFC has focused its business plan on providing access to the housing market for underserved communities. RHFC believes that the underserved communities, including many members of the Hispanic community, have traditionally been wary

Comment 3

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of banks for cultural and other reasons, but are no less deserving than others for housing credit. While other lenders have skirted such populations, RHFC has never shied away from seeking flexible ways to provide these individuals with loans in a safe and sound manner consistent with FHA guidelines.

Comment 4

For purposes of this response, it is important at this juncture to point out that the applicable FHA handbook discussed in the Draft Report (the "Handbook") describes acceptable underwriting guidelines, and specifically authorize some degree of flexibility in underwriting:

> 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 or other circumstances are not specifically addressed by this Handbook.[2]

To that end, the Handbook clarifies this grant of discretion by stating:

> We recognize that many low-and moderate-income families rely upon part-time and seasonal income for day-to-day needs. Lenders must not restrict the consideration of such income sources in qualifying these borrowers.[3]

Comment 4

HUD's own mission statement underscores the government's commitment to extending affordable housing in a manner free from discrimination.[4] RHFC shares the government's goal of extending housing to individuals who have a means of verifying their ability to pay and has chosen not to deny persons loans simply because their employers do not provide the kinds of pay stubs typical of large employers. Many of RHFC's borrowers work in professions such as construction, landscaping, and domestic labor where their employers handwrite checks as means of payment. In RHFC's view, to deny loans on such a basis alone would constitute discrimination and would cut off credit to a significant portion of the American population.

Comment 4

Whereas other lenders have simply chosen not to extend services to underserved communities and minorities or have directed such persons to less-sound subprime products, RHFC chose to adapt its underwriting requirements to meet the special needs of its targeted underserved minority communities. Specifically, in addition to obtaining Verification of Employment ("VOE") and obtaining paychecks that constitute pay stubs for underserved populations, RHFC

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2 FHA Handbook 4155.1 Rev-5, at II-3.
3 Handbook at II-39.
4 U.S. Department of Housing and Urban Development, Mission, *available at* http://portal.hud.gov/portal/page/portal/HUD/about/mission.

took extra steps to verify employment (e.g., conducting 411 checks, reviewing business insurance, telephonic verification, etc.).

2. HUD Staff Confirmed the Permissibility of RHFC Underwriting Procedures

Comment 2

RHFC states that the procedures that it followed to underwrite the five loans under review by the OIG complied with the HUD guidelines in effect at the time such loans were originated. RHFC is familiar with Section 3.1E of the Handbook pertaining to Verification of Employment, and relied on those guidelines when developing its underwriting procedures. RHFC interpreted those guidelines as permitting a primary means of verification of employment (*i.e.,* the use of VOEs and most recent pay stubs) or an alternate means of verification (requiring various other documents). RHFC followed the primary means of obtaining verification of employment by requiring completed VOE forms and "pay stubs." With the understanding from the Handbook that an exercise of some discretion was permissible, RHFC accepted paychecks, which generally included notations for such items as gross pay, federal tax, state tax, and Social Security tax. Based on RHFC's experience, such paychecks constituted "pay stubs" from employers without computerized payroll systems.

Comment 5

As evidence that this interpretation is valid, RHFC points out that it utilized this same income documentation methodology under dispute in its initial test cases for Direct Endorsement approval from HUD. Since that time, RHFC was audited three times by FHA and not once did FHA find that accepting the paychecks as pay stubs was invalid, insufficient or impermissible. In fact, two of the five files being cited in the Report were included in the most recent audit conduct directly by the FHA.

Comment 5

Most significantly—and completely contrary to the position in the Draft Report that RHFC "erroneously" interpreted FHA underwriting guidelines, RHFC received verbal confirmation from Regional HUD Office staff that use of such paychecks in the manner described above was permissible. RHFC thus asserts that it accepted paychecks as pay stubs with the knowledge and authorization of HUD.[5]

[5] In RHFC's exit interview on December 17, 2009, a representative of the OIG indicated that it was their experience that HUD Regional Office staff have frequently provided incorrect interpretative advice. Whether or not this conclusion is correct, our client is entitled to reasonably rely upon that advice—particularly since the advice received was consistent with three previous HUD compliance reviews.

Comment 3

Comment 6

Comment 7

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3. RHFC Could not Comply with the OIG's Conclusions without Violating State and Federal Fair Lending Laws.

While we are, of course, aware that the focus of the OIG's audit was limited to compliance with compliance by RHFC with the OIG's views and interpretations of the underwriting requirements set forth in the Handbook, we note to HUD that had RHFC not reasonably adapted its underwriting to accommodate the needs of its Hispanic customers it could easily have been accused of violating the Fair Housing Act and other state and federal fair lending laws.

The five loans audited by the OIG were for Hispanic loan applicants whose work situations did not include—through no fault of their own—the ability to provide pay stubs that would have been found acceptable to the OIG. Rather than unilaterally denying these Hispanic loan applicants home credit, RHFC modified its underwriting to obtain employment verification that reasonably approximated the data contained on "typical" pay stubs—and thereby permitted the subject Hispanic loan applicants to have their applications fairly considered.

We note to HUD that if RHFC had not taken this approach, it could have been accused of violating the Fair Housing Act based upon a disparate impact analysis.[6]

4. RHFC Revised Its Underwriting Guidelines When HUD Staff Informed RHFC That FHA Guidelines Would Be Tightening

When RHFC learned from its HUD Regional Office staff contact that the FHA employment verification guidelines would be tightening in the future, RHFC changed its underwriting procedures. Specifically, during an onsite visit with a senior staff official, RHFC was told that FHA intended to prospectively tighten up its employment and income documentation, and that compliance with the increased requirements would be audited for strict compliance. However, RHFC was also told that its then current employment verification procedures—described herein—were acceptable for loans already originated. Accordingly, RHFC modified its procedures for new loans originated on a go-forward basis.

5. The OIG's Interpretive Position Regarding "Pay Stubs" is Incorrect

The gravamen of the Draft Report is the contention that paychecks are not "pay stubs." Specifically, the Draft Report states that the pay stubs reviewed did not show the year-to-date

6 Though beyond the scope of this response, we note that a lender may incur liability under a disparate impact theory when its underwriting—while racially or ethnically neutral on its face—nevertheless disproportionally adversely impacts a protected group, such as low- and moderate-income Hispanic loan applicants.

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earnings, company name, or Social Security number. Additionally, the Report notes that the loan application files did not include copies of the backs of such checks to prove that they had been cashed. During the December 17, 2009 meeting with the OIG staff to discuss the Draft Report, a representative of the OIG acknowledged that such items are not FHA "requirements" *per se,* but rather, were perhaps the best indication of a borrower's receipt of income. RHFC agrees that had those items been included they would have been helpful in contributing to income verification. However, RHFC also agrees with that such items were not required and therefore not necessary to provide sufficient evidence of the regular receipt of income. Moreover, RHFC maintains that it would have been impractical to require either a minority loan applicant or a lender to obtain copies of the back of the checks after they were cashed because such cashed checks (or a copy of the cashed checks) are returned to the employer rather than to the employee.

6. Conclusions and Recommendations

Comment 2

Comment 6

In light of the facts presented above, RHFC maintains that it reasonably and justifiably relied on HUD guidance—including confirmation from HUD Regional Office staff—that that use of paychecks—in conjunction with completed VOE forms—was a sufficient methodology to verify employment for the category of Hispanic loan applicants at issue. When RHFC received notice from the HUD Regional Office that HUD guidelines regarding employment verification would be tightening up in the future, at that time RHFC modified its underwriting guidelines to comply going forward.

Comment 8

Based upon the foregoing, we respectfully request that the conclusions set forth in the Draft Report be amended to reflect that RHFC reasonably relied upon HUD and FHA guidance in regard to the employment verification procedures it employed, and that the recommendation that RHFC indemnify the FHA be removed. Further, we request that the Draft Report be modified to remove the recommendation that sanctions be considered against RHFC and/or any related person or entity.

* * *

Comment 8

We thank you for your consideration of this important matter, and believe that the factual discussion and analysis set forth herein should be sufficient to resolve the OIG's concerns without further enforcement actions being considered against RHFC.

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Should you or your colleagues believe that an additional meeting or conversation might be beneficial, we can be reached at the contact information above.

Sincerely,

J.T. Lynyak III

Joseph T. Lynyak III
Venable LLP

cc: Barry Filderman, President, RHFC
Sheila Robertson, Chief Operating Officer, RHFC
Mark Lawson, Vice President, RHFC

OIG Evaluation of Auditee Comments

Comment 1 We appreciate the courtesy and cooperation demonstrated by Residential Home Funding Corporation throughout the audit process.

Comment 2 Our audit conclusion is supported by audit work performed in accordance with generally accepted government auditing standards. According to HUD requirements, the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt. Further, HUD expects lenders to exercise sound judgment and due diligence in underwriting FHA loans. As discussed in the report, Residential Home Funding Corporation did not provide sufficient evidence to support the borrowers' income in the cases we reviewed. Based on HUD's written guidelines, Residential Home Funding Corporation should have obtained verifications from the borrowers' employers as well as the borrowers' most recent pay stubs. Residential Home Funding Corporation obtained verifications from the borrowers' employers but in most cases only had handwritten personal checks to fulfill the requirement for the pay stubs. We assessed the paychecks provided and concluded that they did not constitute sufficient evidence of the borrowers' income, and that the support provided as a whole was not sufficient to provide assurance that the borrowers had the capacity to repay their debts. Also, Residential Home Funding Corporation could not provide any evidence to show that HUD confirmed the permissibility of the kind of checks it relied on in place of the required pay stubs.

Comment 3 We agree that all eligible individuals should be given an opportunity to own their home without intentional or unintentional discrimination based on underwriting procedures. However, all prospective borrowers for FHA loans must be carefully evaluated in a manner consistent with HUD guidelines and with prudence to ensure that they will have the ability to repay their mortgage debts. HUD expects lenders to exercise both sound judgment and due diligence in the underwriting of loans to be insured by FHA. The documentation provided for the cases we reviewed was not sufficient to support the borrowers' income and provide assurance that they had the capacity to repay their mortgage debts. As a note, when HUD terminated Residential Home Funding Corporation's FHA loan origination approval agreement for the Washington, DC, jurisdiction because of its relatively high default and claim rate, HUD noted that other lenders serving the same area originated loans to similarly employed borrowers under identical market conditions but maintained acceptable default and claim rates.

Comment 4 We recognize that HUD guidelines award lenders the flexibility to exercise discretion in the underwriting of home mortgages. However, as stated above, HUD also expects lenders to exercise both sound judgment and due diligence. Residential Home Funding Corporation could not provide documentation to show that the personal handwritten checks accepted in lieu of the required pay stubs were cashed by the borrowers. As discussed in the report, in one of the cases, the employer was the seller of the property being purchased by the borrower. Residential Home Funding Corporation stated that it took extra steps to verify the legitimacy of the borrowers' employers. In the same manner, it should have been prudent and taken extra steps to verify the borrowers' income. Based on our assessment of the documentation provided for the cases we reviewed, Residential Home Funding Corporation failed to demonstrate that it ensured that the borrowers had the capacity to repay their mortgage debts.

Comment 5 Our audit conclusions are supported by work performed in accordance with generally accepted government auditing standards, and were discussed with HUD officials. We do not know the scope of FHA's reviews of Residential Home Funding Corporation, and our review was conducted independently, therefore, we cannot comment on the results of other reviews. Also, Residential Home Funding Corporation could not substantiate that HUD authorized it to rely on the checks it accepted in lieu of the required pay stubs. Further, the statement that OIG indicated that Regional Office staff has frequently provided incorrect interpretive advice is incorrect. OIG indicated that the audit results had been discussed with HUD and that the final decision on the audit recommendations would be made by the appropriate HUD headquarters officials.

Comment 6 Residential Home Funding Corporation's efforts to revise its underwriting procedures and impose stronger requirements would be a positive step going forward. However, it should have been prudent and taken extra measures to verify the income of the borrowers in the cases reviewed.

Comment 7 Our position is specifically based on the paychecks that Residential Home Funding Corporation provided as support of the borrowers' income for the specific cases we reviewed. The issue with the particular checks provided is that they did not constitute sufficient evidence of the borrowers' receipt of the income. Although the backs of the paychecks were not required, if furnished, they would have provided some assurance that the borrowers actually received the claimed net pay. Residential Home Funding Corporation contends that it would have been impractical to obtain copies of the backs of the personal checks because they would have been returned to the employers after they were cashed. However, since the employers were generally small businesses, the copies may not have been as impractical to obtain as stated by Residential Home Funding Corporation. While not required, obtaining this information and/or the borrowers' tax information would have provided a little more assurance of the borrowers' receipt of the income. Since Residential Home Funding Corporation appropriately took additional measures to verify the legitimacy of the employers due to the unique circumstances of these cases, it should, in the same manner, have been prudent and taken extra steps to verify the borrowers' receipt of income and their ability to repay their mortgage debts.

Comment 8 The conclusions in the audit report are supported by audit work performed in accordance with generally accepted government auditing standards. Residential

Home Funding Corporation's underwriting should have been based on HUD guidance as well as prudence. The evidence contained in the borrowers' files was not sufficient to provide assurance that the borrowers had the ability to repay their debts. We maintain our position with regards to our conclusion and recommendations.

Appendix C

SCHEDULE OF CASE FILE DISCREPANCIES

Income not properly verified/supported			
Case number	**Mortgage amount**	**Unpaid balance**	**60% loss rate ***
249-5073588	$352,217	$350,623	$210,374
249-5091677	347,256	346,478	207,887
249-5091704	347,256	345,417	207,250
249-5093678	322,452	319,990	191,994
241-7897975	301,405	299,644	179,786
TOTALS	1,670,586	1,662,152	997,291

* This amount was calculated by taking 60 percent of the unpaid principal balance as of October 31, 2009, for the loans. HUD statistics show that FHA, on average, lost 60 percent of the claim paid on each property during 2009.

Appendix D

NARRATIVE CASE PRESENTATIONS

Case number: 249-5073588

Payments before first default reported: Six

Mortgage amount: $352,217

Unpaid principal balance: $350,623

Date of loan closing: May 17, 2007

Claims paid to loan servicer: $381,036

Status: Property conveyed to insurer

Summary:

The lender did not properly verify or support the borrowers' income.

Pertinent Details:

According to HUD Handbook 4155.1, REV-5, chapter 2, section 2, the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt. Chapter 3-1E further states that a verification of employment 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 verification of employment, the lender may obtain the borrower's original pay stub(s) covering the most recent 30-day period, along with original IRS W-2 forms from the previous 2 years.

In this case, there was a borrower and a coborrower. The lender only verified the coborrower's income in accordance with HUD requirements. Request for verification of employment forms were on file for both borrowers, and pay stubs were provided for the coborrower. However, only a handwritten paycheck was provided for the borrower. The coborrower's income represented less than half of the total income used to qualify the borrowers for the loan. The borrower's paycheck does not fulfill the HUD requirement and does not constitute sufficient evidence of income. There were no W-2 forms, tax returns, or documents requesting tax returns in the loan case file.

The borrowers received $10,650 in gift funds from AmeriDream, Inc., and $10,150 in seller assistance closing costs.

Case number: 249-5091677

Payments before first default reported: Two

Mortgage amount: $347,256

Unpaid principal balance: $346,478

Date of loan closing: October 5, 2007

Claim paid to loan servicer: $352,591

Status: Property conveyed to insurer

Summary:

The lender did not properly verify or support the borrower's income.

Pertinent Details:

According to HUD Handbook 4155.1, REV-5, chapter 2, section 2, the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt. Chapter 3-1E further states that a verification of employment 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 verification of employment, the lender may obtain the borrower's original pay stub(s) covering the most recent 30-day period, along with original IRS W-2 forms from the previous 2 years.

The lender only had a request for verification of employment form and copies of the front of handwritten paychecks from two employers in the borrower's file. The borrower's paychecks do not fulfill the HUD requirement and do not constitute sufficient evidence of income. There were no W-2 forms, tax returns, or documents requesting tax returns in the loan case file. In addition, the seller was the borrower's employer. The seller purchased the property for $255,000 16 months before selling it to his employee. The borrower/employee purchased the property for $350,000 from the employer.

The borrower received $10,500 in gift funds from AmeriDream, Inc., and $10,452 in seller assistance closing costs.

Case number: 249-5091704 Status: Repayment

Mortgage amount: $347,256 Payments before first default reported: Three

Date of loan closing: November 30, 2007 Unpaid principal balance: $345,417

Summary:

The lender did not properly verify or support the borrower's income.

Pertinent Details:

According to HUD Handbook 4155.1, REV-5, chapter 2, section 2, the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt. Chapter 3-1E further states that a verification of employment 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 verification of employment, the lender may obtain the borrower's original pay stub(s) covering the most recent 30-day period, along with original IRS W-2 forms from the previous 2 years. The pay stub(s) must show the borrower's name, Social Security number, and year-to-date earnings.

The lender provided verification of employment forms, and the borrowers' pay stubs and paychecks as proof of income. However the pay stubs provided were not sufficient. The pay stubs provided did not show the year-to-date earnings, only the gross pay and taxes for the pay period. Furthermore the coborrower's pay stub did not show the company name and borrower's Social Security number. With the paychecks that were provided, copies of the back of the checks were not documented or provided; therefore, we could not determine whether the checks had been cashed. There were no W-2 forms, tax returns, or documents requesting tax returns in the loan case file.

The borrower received $10,500 in seller assistance closing costs.

Case number: 249-5093678 | Status: First legal action to commence foreclosure

Mortgage amount: $322,452 | Payments before first default reported: Four

Date of loan closing: September 6, 2007 | Unpaid principal balance: $319,990

Summary:

The lender did not properly verify or support the borrower's income.

Pertinent Details:

According to HUD Handbook 4155.1, REV-5, chapter 2, section 2, the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt. Chapter 3-1E further states that a verification of employment 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 verification of employment, the lender may obtain the borrower's original pay stub(s) covering the most recent 30-day period, along with original IRS W-2 forms from the previous 2 years.

The lender only had a request for verification of employment form and a copy of the front of a handwritten paycheck in the borrower's file. The borrower's paycheck does not fulfill the HUD requirement and does not constitute sufficient evidence of income. There were no W-2 forms, tax returns, or documents requesting tax returns in the loan case file.

The borrower received $9,750 in gift funds from AmeriDream, Inc., and $9,750 in seller assistance closing costs.

Case number: 241-7897975 | Status: First legal action to commence foreclosure

Mortgage amount: $301,405 | Payments before first default reported: Seven

Date of loan closing: October 4, 2007 | Unpaid principal balance: $299,644

Summary:

The lender did not properly verify or support the borrower's income.

Pertinent Details:

According to HUD Handbook 4155.1, REV-5, chapter 2, section 2, the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt. Chapter 3-1E further states that a verification of employment 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 verification of employment, the lender may obtain the borrower's original pay stub(s) covering the most recent 30-day period, along with original IRS W-2 forms from the previous 2 years.

The lender only had a request for verification of employment form and a copy of the front of a handwritten paycheck in the borrower's file. The borrower's paycheck does not fulfill the HUD requirement and does not constitute sufficient evidence of income. There were no W-2 forms, tax returns, or documents requesting tax returns in the loan case file.

The borrower received $9,114 in gift funds from the Nehemiah Down Payment Assistance Program and $14,452 in seller assistance closing costs.