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MEMORANDUM NO:
2010-CH-1811

August 4, 2010

MEMORANDUM TO: Vicki Bott, Deputy Assistant Secretary for Single Family, HU
Dane Narode, Associate General Counsel for Program Enforcement, CACC

FROM: Heath Wolfe, Regional Inspector General for Audit, 5AGA

SUBJECT: D & R Mortgage Corporation, Farmington Hills, MI, Did Not Properly Underwrite a Selection of FHA Loans

INTRODUCTION

We reviewed 15 Federal Housing Administration (FHA) loans that D & R Mortgage Corporation (D & R) underwrote as an FHA direct endorsement lender. Our review objective was to determine whether D & R underwrote the 15 loans in accordance with FHA requirements. This review is part of Operation Watchdog, an Office of Inspector General (OIG) initiative to review the underwriting of 15 direct endorsement lenders at the suggestion of the FHA Commissioner. The Commissioner expressed concern regarding the increasing claim rates against the FHA insurance fund for failed loans.

For each recommendation without a management decision, please respond and provide status reports in accordance with U.S. Department of Housing and Urban Development (HUD) Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the review.

We provided our discussion draft memorandum report to D & R during the review. We asked D & R to provide written comments on our discussion draft memorandum report by June 30, 2010. D & R's president provided written comments, dated June 28, 2010. The president disagreed with our findings and recommendations. The complete text of the lender's written response, along with our evaluation of that response, can be found in appendix C of this report, except for 19 exhibits of 307 pages of documentation that was not necessary to understand the lender's comments. We provided HUD's Deputy Assistant Secretary for Single Family Housing and

Associate General Counsel for Program Enforcement with a complete copy of D & R's written comments plus the 307 pages of documentation.

METHODOLOGY AND SCOPE

D & R is 1 of 15 direct endorsement lenders we selected from HUD's publicly available Neighborhood Watch[1] system (system) for a review of underwriting quality. These direct endorsement lenders all had a compare ratio[2] in excess of 200 percent of the national average as listed in the system for loans endorsed between November 1, 2007, and October 31, 2009. We selected loans that had gone into a claims status. We selected loans for D & R that defaulted within the first 30 months and were (1) not streamline refinanced, (2) not electronically underwritten by Fannie Mae or Freddie Mac, and (3) associated with an underwriter (usually an individual) with a high number of claims.

BACKGROUND

D & R is a nonsupervised, direct endorsement lender based in Farmington Hills, MI. FHA approved D & R as a direct endorsement lender in August 1998. FHA's mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to approve mortgages for otherwise creditworthy borrowers that might not be able to meet conventional underwriting requirements by protecting the lender against default. The direct endorsement program simplifies the process for obtaining FHA mortgage insurance by allowing lenders to underwrite and close the mortgage loan without prior HUD review or approval. Lenders are responsible for complying with all applicable HUD regulations and are required to evaluate the borrower's ability and willingness to repay the mortgage debt. Lenders are protected against default by FHA's mutual mortgage insurance fund, which is sustained by borrower premiums.

The goal of Operation Watchdog is to determine why there is such a high rate of defaults and claims. We selected up to 20 loans in claims status from each of the 15 lenders. The 15 lenders selected for our review endorsed 183,278 loans valued at $31.3 billion during the period January 2005 to December 2009. These same lenders also submitted 6,560 FHA insurance claims with an estimated value of $794.3 million from November 2007 through December 2009. During this period, D & R endorsed 6,291 loans valued at $903 million and submitted 225 claims worth $28.1 million.

Our objective was to determine whether the 15 selected loans were properly underwritten and if not, whether the underwriting reflected systemic problems.

We performed our work from January through April 2010. We conducted our work in accordance with generally accepted government auditing standards, except that we did not

[1] Neighborhood Watch is a system that aids HUD/FHA staff in monitoring lenders and FHA programs. This system allows staff to oversee lender origination activities for FHA-insured loans and tracks mortgage defaults and claims.
[2] HUD defines "compare ratio" as a value that reveals the largest discrepancies between the direct endorser's default and claim percentage and the default and claim percentage to which it is being compared. FHA policy establishes a compare ratio over 200 percent as a warning sign of a lender's performance.

consider the internal controls or information systems controls of D & R, consider the results of previous audits, or communicate with D & R's management in advance. We did not follow standards in these areas because our objective was to aid HUD in identifying FHA single-family insurance program risks and patterns of underwriting problems or potential wrongdoing in poor-performing lenders that led to a high rate of defaults and claims against the FHA insurance fund. To meet our objective, it was not necessary to fully comply with the standards, nor did our approach negatively affect our review results.

RESULTS OF REVIEW

D & R did not properly underwrite 9 of the 15 loans reviewed because its underwriters did not follow FHA's requirements. As a result, FHA's insurance fund suffered actual losses of more than $936,000 on the 9 loans, as shown in the following table.

FHA loan number	*Closing date*	*Number of payments before first default*	*Original mortgage amount*	*Actual loss to HUD*
483-3712823	3/29/07	10	$128,950	$55,888
262-1650023	2/12/07	2	156,450	84,648
261-9177201	3/28/07	13	198,400	152,655
483-3758135	9/7/07	14	125,950	62,495
261-9065622	4/27/06	4	168,300	130,123
261-9065826	5/15/06	5	70,400	90,914
261-9205529	6/1/07	16	207,550	111,983
261-8996673	12/6/05	4	92,550	102,633
261-9111473	9/21/06	6	224,700	145,233
	Totals		$1,373,250	$936,572

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

Area of noncompliance	*Frequency*
Excessive ratios	3
Credit history	7
Income	2
Liabilities	3
Assets	1

Excessive Ratios

D & R improperly approved three loans when the borrowers' ratios exceeded FHA's requirement. Effective April 13, 2005, the fixed payment-to-income and debt-to-income ratios were increased from 29 and 41 percent to 31 and 43 percent, respectively. If either or both ratios are exceeded on a manually underwritten mortgage, the lender is required to describe the compensating factors used to justify the mortgage approval (see appendix B for detailed requirements).

For example, for loan number 483-3758135, the fixed payment-to-income ratio was 47.4 percent. D & R's underwriter did not include compensating factors on the mortgage credit analysis

worksheet[3]. The documentation in the loan file also did not support significant compensating factors.

Credit History

D & R did not properly evaluate the borrowers' credit history for seven loans. HUD requires the lender to consider collection accounts in analyzing a borrower's creditworthiness. The lender must explain all collections in writing (see appendix B for detailed requirements).

For example, for loan number 261-9177201, D & R did not obtain sufficient explanations for an unpaid collection account, late payments for a previous mortgage, and judgments that were consistent with other credit information in the borrower's file.

Income

D & R did not properly verify borrowers' income or determine income stability for two loans. HUD does not allow income to be used in calculating a borrower's income ratios if it cannot be verified, is not stable, or will not continue. D & R is required to analyze whether income is reasonably expected to continue through at least the first 3 years of the mortgage loan (see appendix B for detailed requirements).

For example, for loan number 261-9065622, the borrower provided copies of his paycheck stubs. The four stubs had different check numbers and different pay dates; however, the pay periods, year-to-date earnings, and taxes withheld remained the same on each stub. Normally with each paycheck, the year-to-date amounts increase by the value of the current paycheck and deductions. The borrower's loan file contained two additional paychecks which contained year-to-date earnings that were not accurate. For instance, the borrower's weekly income was $950; however, for the paychecks ending February 12 and February 19, 2006, his cumulative year-to-date earnings were $6,650, and $7,600, respectively, which was $950 more than the amount that should have been reflected on the borrower's paystubs. Further, the borrower's verification of employment form indicated he did not work overtime or receive a bonus or commission income.

Liabilities

D & R did not properly assess the borrowers' financial obligations for three loans. HUD requires lenders to consider debts if the amount of the debts affects the borrower's ability to make the mortgage payment during the months immediately after loan closing (see appendix B for detailed requirements).

For example, for loan number 261-8996673, the borrower had entered into a repayment agreement of $75 per month with a collection agency to settle an unpaid collection account. The payments were for 13 months. D & R did not include this information as a liability on the mortgage credit analysis worksheet for calculating the qualifying ratios.

[3] The mortgage credit analysis worksheet is used to analyze and document mortgage approval.

Assets

D & R did not properly verify the source of the borrower's funds to close for loan number 261-9177201. HUD requires the lender to verify and document the borrower's investment in the property (see appendix B for detailed requirements).

Incorrect Underwriter's Certifications Submitted to HUD

We reviewed the certifications for the nine loans with material underwriting deficiencies for accuracy. D & R's direct endorsement underwriters incorrectly certified that due diligence was used in underwriting the nine loans. When underwriting a loan manually, HUD requires a direct endorsement lender to certify that it used due diligence and reviewed all associated documents during the underwriting of a loan.

The Program Fraud Civil Remedies Act of 1986 (231 U.S.C. (United States Code) 3801) provides Federal agencies, which are the victims of false, fictitious, and fraudulent claims and statements, with an administrative remedy to (1) to recompense such agencies for losses resulting from such claims and statements; (2) permit administrative proceedings to be brought against persons who make, present, or submit such claims and statements; and (3) deter the making, presenting, and submitting of such claims and statements in the future.

RECOMMENDATIONS

We recommend that HUD's Associate General Counsel for Program Enforcement

1A. Determine legal sufficiency and if legally sufficient, pursue remedies under the Program Civil Remedies Act against D & R and/or its principals for incorrectly certifying to the integrity of the data or that due diligence was exercised during the underwriting of 9 loans that resulted in losses to HUD totaling $936,572, which could result in affirmative civil enforcement action of approximately $1,940,644[4].

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

1B. Take appropriate administrative action against D & R and/or its principals for the material underwriting deficiencies cited in this report once the affirmative civil enforcement action cited in recommendation 1A is completed.

Schedule of Ineligible Cost 1/

Recommendation number	Amount
1A	$936,572

[4] Double damages plus a $7,500 fine for each of the 9 incorrect certifications.

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations. The amount shown represents the actual loss HUD incurred when it sold the affected properties.

Appendix A

SUMMARY OF MATERIAL UNDERWRITING DEFICIENCIES

FHA loan number	Excessive qualifying ratios	Significant credit related deficiencies	Unsupported income or questionable employment history	Underreported liabilities	Unsupported assets
483-3712823			X	X	
262-1650023		X		X	
261-9177201		X			X
483-3758135	X	X			
261-9065622			X		
261-9065826	X	X			
261-9205529	X	X			
261-8996673		X		X	
261-9111473		X			

Appendix B

LOANS WITH MATERIAL UNDERWRITING DEFICIENCIES

Loan number: 483-3712823

Mortgage amount: $128,950

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: March 29, 2007

Status: Claim

Payments before first default reported: 10

Loss to HUD: $55,888

Summary:

We found material underwriting deficiencies relating to the borrower's income and liabilities.

Income:

D & R used excessive overtime income to approve the loan. Its underwriter used the current verification of employment to calculate the overtime income of $318 per month rather than using the actual overtime earned during the past 2 years. There was no documentation in the loan file to show that the borrower's overtime income was analyzed to determine whether the $318 was stable and would continue. From the Internal Revenue Service Form W-2 statements, and accounting for a change in pay rate in April 2006, we determined that the actual average overtime income for the past 2 years was $204 per month. Using this average for the previous 2-year period would increase borrower's qualifying ratios to an unacceptable level, as shown below in the liabilities section.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, chapter 2, section 2, states that income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue. Paragraph 2-7A states that overtime income may be used to qualify if the borrower has received such income for the past 2 years and it is likely to continue. The lender must develop an average of overtime income for the past 2 years, and the employment verification must not state that such income is unlikely to continue.

Liabilities:

In calculating the borrower's monthly liabilities, D & R's underwriter did not include a monthly installment of $109 that was disclosed on the borrower's credit report. The borrower owed $985, and as of February 21, 2007, nine payments of $109 remained. The underwriter excluded this liability because fewer than 10 payments were left. There was no analysis in the loan file showing that this debt would not affect borrower's ability to make the mortgage payment during the months immediately after loan closing. The borrower had limited assets. According to the borrower's bank statements and the verification of deposit, the lowest balance in the borrower's checking account was $8 on January 22, 2007, and the highest balance was $385 on February 23, 2007.

The proper inclusion of the monthly liability and exclusion of excess overtime income would have disqualified the borrower for the loan. We recomputed the qualifying ratios excluding the excess overtime income and including the monthly installment payment. The revised qualifying ratios, mortgage payment to income and total fixed payment to income, would be 35 and 49 percent, respectively, which exceed HUD's allowable ratios of 31 and 43 percent, respectively.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-11A, states that debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing, especially if the borrower will have limited or no cash assets after loan closing.

HUD Handbook 4155.1, REV-5, paragraph 2-12, states that ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. If the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total of the mortgage payment and all recurring charges exceeds 41 percent of the gross effective income, the loan may be acceptable only if significant compensating factors, as discussed in paragraph 2-13, are documented and are recorded on the mortgage credit analysis worksheet.

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

HUD Handbook 4155.1, REV-5, paragraph 2-13, states that FHA underwriters must record in the remarks section of HUD Form 92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation.

Loan number: 262-1650023

Mortgage amount: $156,450

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: February 12, 2007

Status: Claim

Payments before first default reported: Two

Loss to HUD: $84,648

Summary:

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

Liabilities:

The borrower's pay statement, dated December 8, 2006, showed a garnishment of $95.80 per week for child support. This liability was not reported on the borrower's loan application or on the mortgage credit analysis worksheet. The weekly child support payment computed to a monthly amount of $415.13. Including the child support monthly payment would increase the total fixed payment-to-income ratio from 37.34 to 48.81 percent.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-11A, states that recurring obligations must be considered in qualifying borrowers. The borrower's recurring obligations 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 recurring charges extending 10 months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc.

HUD Handbook 4155.1, REV-5, paragraph 2-12, states that ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. If the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total of the mortgage payment and all recurring charges exceeds 41 percent of the gross effective income, the loan may be acceptable only if significant compensating factors, as discussed in paragraph 2-13, are documented and are recorded on the mortgage credit analysis worksheet.

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

HUD Handbook 4155.1, REV-5, paragraph 2-13, states that FHA underwriters must record in the remarks section of HUD Form 92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation.

Credit:

D & R did not adequately review the borrower's credit history. The borrower had a bankruptcy discharged in March 2003. In the recent credit history after the bankruptcy, the borrower had an unexplained collection account opened in February 2006, two accounts with late payments, and two accounts that were over their limit. There was no verification that the collection account had been paid off, and the loan file did not contain an explanation. The borrower; however, showed payment on one of the over limit revolving credit cards, and he provided an explanation for the late payments. D & R did not document how the borrower reestablished good credit and demonstrated an ability to manage his financial affairs.

HUD/FHA Requirements:

According to HUD Handbook 4155.1, REV-5, paragraph 2-3, 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. If the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan. When delinquent accounts are revealed, the lender must document its analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower. Major indications of derogatory credit-including judgments, collections, and any other recent credit problems-require sufficient written explanations for the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

HUD Handbook 4155.1, REV 5, paragraph 2-3C, states that collections and judgments indicates 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.

HUD Handbook 4155.1, REV-5, paragraph 2-3E, states that a Chapter 7 bankruptcy does not disqualify a borrower from obtaining an FHA-insured mortgage if at least 2 years have elapsed since the date of the discharge of the bankruptcy. Further, the borrower must have either reestablished good credit or chosen not to incur new credit obligations. The borrower also must have demonstrated a documented ability to responsibly manage his or her financial affairs.

Loan number: 261-9177201

Mortgage amount: $198,400

Section of Housing Act: 203(B)

Loan purpose: Purchase

Date of loan closing: March 28, 2007

Status: Claim

Payments before first default reported: 13

Loss to HUD: $152,655

Summary:

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

Assets:

According to the mortgage credit analysis worksheet, the borrower needed $13,898 to close, and the loan file documents showed that the borrower had $15,401 in assets available. However, D & R did not obtain an explanation for the source of these funds. A bank statement showed a balance of $4,145 for the period ending January 24, 2007. A request for verification of deposit, dated February 27, 2007, indicated an account balance of $9,904, and a copy of a teller receipt, dated March 20, 2007, showed an account balance of $15,401.

As shown above, borrower's bank account balance increased by $5,760 between January and February 2007 and again by $5,497 between February and March 2007. Both amounts were large considering that the borrower's gross earnings were $5,819 per month. There were no bank statements to show the dates of deposit or source of these funds. The only document in the loan file was a printout from TurboTax showing a statement that the borrower's Federal income tax return would be $10,243. A copy of the borrower's tax returns was not in the loan file. D & R should have obtained additional documentation or verification to ensure that the borrower did not obtain an undocumented loan, funds from an interested party, or funds from another excludable source.

HUD/FHA Requirements:

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

Credit:

D & R did not adequately review and analyze the borrower's credit history. The borrower's credit history included two judgments, three open collections, and two revolving accounts with late payments in the payment history. The written explanation from the borrower did not explain the two judgments in the credit history. The borrower stated that the credit problems started during 2004, but both judgments were before 2003; one was in 2001, and one was in 2002. The judgment from 2001 was satisfied in July 2004, and the judgment from 2002 was satisfied in June 2003. As required by HUD, D & R should have obtained an explanation for these judgments.

The borrower's explanation stated that the collection accounts were caused by family medical problems, which occurred during 2004. However, the collection accounts occurred in March and December 2005, and the medical collection account was opened in August 2006. The borrower paid two of the collections before closing but not the remaining medical collection for $157. The borrower's explanation stated that he did not pay one of the two non-medical collections for $297 on principle. Refusing to pay a bill or not properly disputing a charge does not demonstrate a responsible attitude toward credit.

Further, the borrower had a number of late payments on the previous mortgage account, including delinquent payments in August and September 2005. The combination of the borrower's unexplained judgments, disregard of a collection account on principle, recent late payments on revolving credit and delinquency on the previous mortgage were indications of derogatory credit. Although the borrower had earned adequate income of more than $190,000 during 2005 and 2006 collectively, he did not satisfy these debts.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-1, states that the purpose of underwriting is to determine a borrower's ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties, and to examine the property offered as security for the loan to determine whether it is sufficient collateral.

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that 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. If the credit history, despite adequate income to support obligations, reflects continuous slow payments and delinquent accounts, strong compensating factors will be necessary to approve the loan. The lender must document its analysis regarding whether the late payments were based on disregard for financial obligations or otherwise. Major indications of derogatory credit-including judgments, collections, and any other recent credit problems-require sufficient written explanations for the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

HUD Handbook 4155.1, REV 5, paragraph 2-3C, states that collections and judgments indicates 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.

Loan number: 483-3758135

Mortgage amount: $125,950

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: September 7, 2007

Status: Claim

Payments before first default reported: 14

Loss to HUD: $62,495

Summary:

We found material underwriting deficiencies relating to the borrower's debt-to-income ratio and credit history.

Excessive Ratio:

The borrower's fixed payment-to-income ratio on the mortgage credit analysis worksheet was 47.4 percent. D & R did not note compensating factors in the loan file. Therefore, the loan should not have been approved.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-12, states that ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. If the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total of the mortgage payment and all recurring charges exceeds 41 percent of the gross effective income, the loan may be acceptable only if significant compensating factors, as discussed in paragraph 2-13, are documented and are recorded on the mortgage credit analysis worksheet.

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

HUD Handbook 4155.1, REV-5, paragraph 2-13, states that FHA underwriters must record in the remarks section of HUD Form 92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation.

Credit:

D & R did not adequately review or analyze the borrower's credit history. The borrower had declared bankruptcy, which was discharged in June 2004, more than 3 years before the loan closed. The borrower did not reestablish good credit, as evidenced by the 22 medical collection accounts which were opened after the bankruptcy. Nine of the accounts were still open, and five of the nine were opened within 1 year of the loan closing.

The borrower explained that his bankruptcy occurred because he cosigned for three car loans at the same time for friends. His friends did not make payments, and he was "stuck" with a tab he could not pay. However, there was no evidence in the loan file that this situation was the cause of the bankruptcy. Further, the borrower did not reestablish good credit or choose not to incur new obligations following the discharge of the bankruptcy. The written explanation also provided by the borrower for the derogatory items on his credit report was not consistent with other documents in the loan file.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-1, states that the purpose of underwriting is to determine a borrower's ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties, and to examine the property offered as security for the loan to determine whether it is sufficient collateral.

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that 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. If the credit history, despite adequate income to support obligations, reflects continuous slow payments and delinquent accounts, strong compensating factors will be necessary to approve the loan. The lender must document its analysis regarding whether the late payments were based on disregard for financial obligations or otherwise. Major indications of derogatory credit-including judgments, collections, and any other recent credit problems-require sufficient written explanations for the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

HUD Handbook 4155.1, REV 5, paragraph 2-3C, states that collections and judgments indicates 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.

HUD Handbook 4155.1, REV-5, paragraph 2-3E, states that a Chapter 7 bankruptcy does not disqualify a borrower from obtaining an FHA-insured mortgage if at least 2 years have elapsed since the date of the discharge of the bankruptcy. Further, the borrower must have either reestablished good credit or chosen not to incur new credit obligations. The borrower also must have demonstrated a documented ability to responsibly manage his or her financial affairs.

Loan number: 261-9065622

Mortgage amount: $168,300

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: April 27, 2006

Status: Claim

Payments before first default reported: Four

Loss to HUD: $130,123

Summary:

We found a material underwriting deficiency relating to the borrower's income.

Income:

D & R did not properly verify the borrower's employment. The documents provided by the borrower appeared to be questionable, and D & R should have required the borrower to provide additional explanation. The borrower's verification of employment for the current job and the previous job were signed by the same person. The borrower's previous employment was with a different employer at a different business entity. Further, the borrower provided copies of his paycheck stubs. The four stubs had different check numbers and different pay dates; however, the pay periods, year-to-date earnings, and taxes withheld remained the same on each stub. Normally with each paycheck, the year-to-date amounts increase by the values of the current paycheck and deductions.

The borrower's loan file contained two additional paychecks which contained year-to-date earnings that were not accurate. For instance, the borrower's weekly income was $950; however, for the paychecks ending February 12 and February 19, 2006, his cumulative year-to-date earnings were $6,650, and $7,600, respectively, which was $950 more than the amount that should have been reflected on the borrower's paystubs. Further, the borrower's verification of employment form indicated he did not work overtime or receive a bonus or commission income.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, chapter 2, section 2, states that income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue.

Loan number: 261-9065826

Mortgage amount: $70,400

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: May 15, 2006

Status: Claim

Payments before first default reported: Five

Loss to HUD: $90,914

Summary:

We found material underwriting deficiencies relating to the mortgage payment-to-income ratio and the borrower's credit history.

Excessive Ratio:

The borrower's mortgage payment-to-income ratio exceeded HUD's allowable ratio of 31 percent by 4.88 percent. The ratio reported on the mortgage credit analysis worksheet was 35.88 percent. As a compensating factor to justify the excessive ratio, D & R's underwriter used the borrower's ability to pay the same mortgage payments as the rental housing expense.

The borrower was residing in the property she purchased. The documentation to support the rental payment included payments of $533 per month for the landlord's (seller) mortgage, which was supported by copies of money order receipts. The underwriter noted on the mortgage credit analysis worksheet that the borrower was also paying property taxes for the landlord of $2,567 per year. As a result, the underwriter determined that the borrower was paying $747 per month for rental expenses, which was still not equal to or greater than the proposed monthly housing expense for the new mortgage of $781 as required by HUD.

To support the payment of property taxes by the borrower, the loan file contained a cancelled check for $2,567, dated February 10, 2006, made payable to the landlord. There was no assurance of whether this check was for the property taxes or some other purpose. According to a tax bill in the loan file, the total property taxes were $2,383. Further, the borrower reported on the loan application, dated May 15, 2006 (the day of loan closing), that the monthly rent was $533 per month. The borrower's initial loan application, dated February 21, 2006, stated that the rent was $530 per month.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-12, states that ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. If the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total of the mortgage payment and all recurring charges exceeds 41 percent of the gross effective income, the loan may be acceptable only if significant compensating factors, as discussed in paragraph 2-13, are documented and are recorded on the mortgage credit analysis worksheet.

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

HUD Handbook 4155.1, REV-5, paragraph 2-13, states that FHA underwriters must record in the remarks section of HUD Form 92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation.

Credit:

D & R's underwriter did not adequately evaluate the borrower's credit history or obtain strong compensating factors to support loan approval. The borrower's credit report disclosed six late payments and collection accounts with past-due balances. The borrower explained that her collection accounts were due to identity theft because her checkbook was stolen in December 2004. The borrower filed a police report on February 16, 2006, just 5 days before she applied for the loan. In the police report, the borrower stated that she had already received a refund for the fraudulent checks. The underwriter should have required the borrower to provide verification from the bank. Further, there was no explanation for the delay of more than 14 months in filing the police report.

D & R required the borrower to pay off the collection accounts, provide additional credit references, and provide a statement showing that she made timely payments for the previous 12 months as a condition to approve the loan. The borrower paid one of the collection accounts using a credit card. According to the credit report, the borrower did not own this credit card. D & R's underwriter should have required the borrower to explain this discrepancy.

The borrower provided three credit references, but they were not provided by an independent source. These references were faxed from the same fax number as that shown on the sales contract. The borrower also provided a letter of credit from DTE Energy that did not identify whether she made on-time payments, only the balance due.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-1, states that the purpose of underwriting is to determine a borrower's ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties, and to examine the property offered as security for the loan to determine whether it is sufficient collateral.

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that 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. If the credit history, despite adequate income to support obligations, reflects continuous slow payments and delinquent accounts, strong compensating factors will be necessary to approve the loan. The lender must document its analysis regarding whether the late payments were based on disregard for financial obligations or otherwise. Major indications of derogatory credit-including judgments, collections, and any other recent credit problems-require sufficient written explanations for the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

HUD Handbook 4155.1, REV 5, paragraph 2-3C, states that collections and judgments indicates 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.

HUD Handbook 4155.1, REV 5, Paragraph 2-3, for those borrowers who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider.

Loan number: 261-9205529

Mortgage Amount: $207,550

Section of Housing Act: 203(b)

Loan Purpose: Purchase

Date of loan closing: June 1, 2007

Status: Claim

Payments before first default reported: 16

Loss to HUD: $111,983

Summary:

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

Excessive Debt Ratio:

D & R improperly approved the loan when the borrower's monthly mortgage payment-to-income ratio exceeded the FHA's qualifying ratio. The ratio calculated by D & R on the mortgage credit analysis worksheet was 34.732 percent, which exceeded the qualifying ratio of 31 percent. D & R did not describe or document compensating factors in the loan file to justify loan approval.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-12, states that ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and otherwise provide for the family. If the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total of the mortgage payment and all recurring charges exceeds 41 percent of the gross effective income, the loan may be acceptable only if significant compensating factors, as discussed in paragraph 2-13, are documented and are recorded on the mortgage credit analysis worksheet.

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

HUD 4155.1, REV-5, paragraph 2-13, states that compensating factors that may be used to justify approval of mortgage loans with ratios exceeding our benchmark guidelines are those listed in the handbook. Underwriters must record in the "remarks" section of the HUD Form

92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation.

Credit:

D & R did not adequately analyze the borrower's credit history. The borrower had declared a bankruptcy that was discharged on February 13, 2006, less than 2 years but more than 1 year from the date of loan closing.

The borrower provided an explanation for his bankruptcy in which he stated that he had medical bills of approximately $100,000 related to an injury and that the injury led to his other debts. His explanation did not agree with the bankruptcy papers or the credit report in the loan file. His bankruptcy papers listed a number of creditors with claims from 1994 through 2005, totaling $61,764. The medical claims accounted for $23,461, and the claims from other creditors accounted for the remaining $38,303. The borrower's explanation was not accurate because the majority of the claims were not medical. Instead, the claims were for utilities, telephone bills, rent, taxes, loans, lawsuits, and credit cards.

The borrower did not exhibit that he could manage his obligations responsibly following the bankruptcy. He was 2 months behind on his January 2007 utility bill and was sent to collections by a different creditor not included in the April 2006 bankruptcy. D & R did not document strong compensating factors to support approval of this loan.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-1, states that the purpose of underwriting is to determine a borrower's ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties, and to examine the property offered as security for the loan to determine whether it is sufficient collateral.

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that 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. If the credit history, despite adequate income to support obligations, reflects continuous slow payments and delinquent accounts, strong compensating factors will be necessary to approve the loan. The lender must document its analysis regarding whether the late payments were based on disregard for financial obligations or otherwise. Major indications of derogatory credit-including judgments, collections, and any other recent credit problems-require sufficient written explanations for the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

HUD Handbook 4155.1, REV 5, paragraph 2-3C, states that collections and judgments indicates 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.

HUD Handbook 4155.1, REV-5, paragraph 2-3E, states that an elapsed period of less than 2 years but not less than 12 months following a Chapter 7 bankruptcy discharge may be acceptable if the borrower can show that the it was caused by extenuating circumstances beyond his control and has since exhibited a documented ability to manage his financial affairs in a responsible manner. Further, the borrower must have reestablished good credit or chosen not to incur new credit obligations. The borrower also must have demonstrated a documented ability to responsibly manage his or her financial affairs.

Loan number: 261-8996673

Mortgage amount: $92,550

Section of Housing Act: 203(b)

Loan Purpose: Purchase

Date of loan Closing: December 6, 2005

Status: Claim

Payments before first default reported: Four

Loss to HUD: $102,633

Summary:

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

Liabilities:

D & R did not include a monthly payment of $75 for a collection account from a previous unpaid rental account. In the loan submission documents, the loan officer noted that the borrower must satisfy the previous unpaid rental. D & R's underwriter documented on the credit report that this account was paid off, but it was not.

The loan file contained a settlement agreement for $2,075 for the unpaid rental account. It consisted of a lump-sum payment of $1,037 and 13 monthly payments of $75. The $75 monthly payment was not included in the calculation of the borrower's qualifying ratios. If D & R had included the $75 monthly payment, the borrower's fixed payment-to-income ratio would have been 44.45 instead of 42.29, exceeding HUD's requirements. Further, D & R did not consider the effect the lump-sum payment would have had on the borrower's ability to make his mortgage payments, considering that the borrower had limited cash.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-11A, states that recurring obligations must be considered in qualifying borrowers. The borrower's recurring obligations include all installment payments all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other recurring charges extending 10 months or more, including payments on installment accounts.

HUD Handbook 4155.1, REV-5, paragraph 2-12, states that ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership and

otherwise provide for the family. If the mortgage payment expense-to-effective income ratio exceeds 29 percent and/or the total of the mortgage payment and all recurring charges exceeds 41 percent of the gross effective income, the loan may be acceptable only if significant compensating factors, as discussed in paragraph 2-13, are documented and are recorded on the mortgage credit analysis worksheet.

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

HUD 4155.1, REV-5, paragraph 2-13, states that compensating factors that may be used to justify approval of mortgage loans with ratios exceeding our benchmark guidelines are those listed in the handbook. Underwriters must record in the "remarks" section of the HUD Form 92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation.

Credit:

D & R did not properly analyze the borrower's credit. The borrower's credit report identified a number of collection accounts and one revolving charge account that were delinquent. The borrower sufficiently explained the collection accounts; however, his explanation for the recent delinquent installment account was inadequate. The borrower explained that he did not make timely payments on his credit card account because he did not always receive a monthly bill. The credit report showed that he was 90 days late three times, 30 days late three times, and 60 days late once.

Since the borrower's credit report identified several derogatory accounts, D & R required him to provide additional credit references to demonstrate a positive 12-month payment history as a condition to close. The borrower provided a statement from his cable provider. However, D & R's underwriter noted that this credit reference was not good because the borrower did not pay his cable bill in a timely manner. The borrower then provided two additional letters of credit, one from an art gallery and the other from a party company. Both of these credit references were faxed from the borrower's place of employment, not directly from independent third parties. In addition, the borrower was unable to provide the lender with a satisfactory rental payment history. His previous landlord had actually reported him to a collection agency for failure to pay his rent. As a condition to close, D & R's underwriter required that the prior housing collection be paid off. The borrower entered into a repayment agreement to settle the collection as discussed in the liabilities section above.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that 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. If the credit history, despite adequate income to support obligations, reflects continuous slow payments and delinquent accounts, strong compensating factors will be

necessary to approve the loan. The lender must document its analysis regarding whether the late payments were based on disregard for financial obligations or otherwise. Major indications of derogatory credit-including judgments, collections, and any other recent credit problems-require sufficient written explanations for the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

HUD Handbook 4155.1, REV 5, paragraph 2-3C, states that collections and judgments indicates 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.

HUD Handbook 4155.1, REV-5, paragraph 3-1, states that the lender may not accept or use documents relating to the credit, employment, or income of borrowers that are handled by or transmitted from or through interested third parties (e.g., real estate agents, builders, sellers) or by using their equipment.

Loan number: 261-9111473

Mortgage amount: $ 224,700

Section of Housing Act: 203(b)

Loan Purpose: Purchase

Date of loan closing: September 21, 2006

Status: Claim

Payments before first default reported: Six

Loss to HUD: $145,233

Summary:

We found a material underwriting deficiency relating to the co-borrower's credit history.

Credit:

D & R did not adequately analyze the co-borrower's credit. The borrower and co-borrower were not related. The borrower would not have qualified for the mortgage without the co-borrower's income

The credit report for the co-borrower identified late payments for credit cards and utility bills and a number of collection accounts. The co-borrower provided explanations, but they were not adequate. For example, one credit card had recent late payments, and the co-borrower explained that his former spouse paid this credit card. However, the co-borrower's credit report indicated that the co-borrower was the sole owner of the account. Further, the account did not have any authorized users.

In another example, the co-borrower's credit report indentified a telephone account with 15 late payments of 90 days that the recent late payment occurred within a month of loan closing. The co-borrower explained that he purchased a telephone for his son and was not aware that his son did not pay the telephone bills. According to the co-borrower's credit report, he was the sole owner of the telephone account. Further, the account did not have any authorized users.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-1, states that the purpose of underwriting is to determine a borrower's ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties, and to examine the property offered as security for the loan to determine whether it is sufficient collateral.

HUD Handbook 4155.1, REV-5, paragraph 2-3, states that 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. If the credit history, despite adequate income to support obligations, reflects continuous slow payments and delinquent accounts, strong compensating factors will be necessary to approve the loan. The lender must document its analysis regarding whether the late payments were based on disregard for financial obligations or otherwise. Major indications of derogatory credit-including judgments, collections, and any other recent credit problems-require sufficient written explanations for the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

HUD Handbook 4155.1, REV 5, paragraph 2-3C, states that collections and judgments indicates 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.

APPENDIX C

LENDER COMMENTS AND OIG's EVALUATION

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June 25, 2010

VIA FEDERAL EXPRESS

Mr. Muhammad Akhtar
Supervisory Forensic Auditor
U.S. Department of Housing
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Office of the Inspector General
Region V
77 West Jackson Boulevard
Suite 2646
Chicago, Illinois 60604

RE: D & R Mortgage Corporation
HUD OIG Draft Memorandum Report

Dear Mr. Akhtar:

D & R Mortgage Corporation ("DRMC" or "Company") is in receipt of the Draft Memorandum Report ("Report"), dated June 14, 2010, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of Inspector General ("OIG"). The Report is based on a review of fifteen Federal Housing Administration ("FHA") insured loans selected as part of HUD and the OIG's "Operation Watchdog" initiative to examine the underwriting of fifteen lenders at the suggestion of the FHA Commissioner. The fifteen loans defaulted within the first 30 months and have since gone into claim status.

The Report states that its objective was to determine whether the Company underwrote the fifteen selected loans in accordance with FHA requirements and, if not, whether the underwriting reflected systemic problems. The Report's "Results of Review" allege that ten of the fifteen loans contained underwriting deficiencies and, in each of these ten cases, the underwriters incorrectly certified that due diligence was used in underwriting the loans. Based on these assertions, the Report recommends that HUD: (1) take appropriate administrative action with regard to the underwriting deficiencies; and (2) in connection with the underwriting certifications, determine the legal sufficiency and, if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act, 31 U.S.C. §§ 3801 et seq. ("PFCRA").

DC-1446195 v1 0308690-00100

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The OIG provided DRMC with an opportunity to submit written comments for inclusion in the final report. This response summarizes DRMC's history and operations and addresses the individual findings cited in the Report. We believe that this response and accompanying exhibits demonstrate that the Report's recommendations in connection with the cited loans are unwarranted. We appreciate this opportunity to comment on the OIG's findings and recommendations. That said, we understand that final reports routinely include auditors' comments about the lender's written response, but that the company is not provided an opportunity to respond to these additional comments. Often, these comments include substantive allegations or statements that were not a part of the draft report provided to the company. To the extent that the OIG makes such additional substantive comments in this instance, we respectfully request an opportunity to respond to these additional statements to ensure that a full picture of the issues is presented in the final Report.

I. BACKGROUND

A. D & R MORTGAGE CORPORATION

DRMC received approval as a non-supervised mortgagee on August 19, 1998, and conducted FHA-insured loan originations until recently, when, as discussed below, it was forced to cease originating loans as a result of the Department's "probe." Headquartered in Farmington Hills, Michigan, DRMC operated through FHA-approved offices in Michigan, North Carolina, Tennessee, and Florida and employed approximately 30 individuals. DRMC sold all loans that it originates into the secondary market on a servicing-released basis, and its primary investors included Wells Fargo Home Mortgage and Bank of America, N.A. At all times during its active operations, DRMC's employees consistently strived to produce high quality loans in compliance with HUD/FHA standards.

In recent months, FHA lending constituted approximately 90% of DRMC's business operations. Because FHA lending represented a substantial portion of DRMC's overall production, the Company has consistently taken its responsibilities under the FHA Program seriously. We have always strived to comply with applicable rules and regulations and are committed to educating and training our employees on issues of FHA compliance. Throughout our existence, we have endeavored to provide dependable and professional service and have repeatedly demonstrated our commitment to borrowers and allegiance to the FHA Program.

We also note that the review covered loans originated between December 6, 2005 and September 7, 2007. As you know, during and immediately following this period, the United States experienced a dramatic financial crisis that resulted in record-

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breaking unemployment, and loan default and foreclosure activity. The state of Michigan, in which DRMC is headquartered, was particularly devastated by the financial crisis and ensuing economic downturn. Our analysis of the loans reviewed in this matter demonstrates that all but one of the borrowers defaulted after making multiple mortgage payments. This payment activity suggests that these borrowers defaulted as a result of unforeseen economic or personal setbacks as a result of this crisis, rather than because of poor origination or underwriting decisions. In fact, loan servicing data for the loans reviewed demonstrates that at least eight of these borrowers reported curtailment of income or illness, which often results in income loss, as the reason for the default.

B. The "Operation Watchdog" Review

As an initial matter, we would like to take this opportunity to point out that this review was not conducted in the typical manner in which the OIG Audit Division performs audits. As acknowledged in the Report, the OIG did not follow its standard procedures of considering the Company's internal or information systems controls or the results of previous audits, and did not communicate with DRMC's management in advance of issuing the Report. Moreover, instead of reviewing a statistically random sample of loans originated by DRMC during the review period, the OIG examined loan files for an adverse sample of 15 loans in which the borrowers had defaulted and the lenders had made a claim to HUD for FHA insurance benefits. Rather than request that the Company provide information and loan files in the cases reviewed, which DRMC would have promptly supplied, the OIG subpoenaed loan file documentation simultaneously from fifteen FHA-approved lenders, including DRMC, in connection with the "Operation Watchdog" probe. While HUD and the OIG expressly stated that there was "no evidence of wrongdoing" on the part of DRMC or the other lenders subjected to this probe **(Exhibit A-2)**, the Department and OIG nevertheless issued a press release announcing the "probe" before reviewing any of the loan files at issue in this matter **(Exhibit A-2)**. Typically, HUD and the OIG refuse to disclose the names of entities subject to ongoing reviews by the Department; however, in this instance, the press release included the names of the fifteen lenders, including DRMC, subject to this particular review **(Exhibit A-2)**.

Although the OIG acknowledged in the press release that it had no evidence of wrongdoing by the Company at that time, by stating that the Department would "aggressively pursue indicators of fraud," the announcement gave the public the impression that the subject lenders had engaged in misconduct or otherwise posed some risk to the FHA Insurance Fund. Given the scrutiny by warehouse lenders and investors of originating lenders in this market, these companies immediately chose to take action against the fifteen lenders subjected to the "probe," rather than wait for the

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results of the Department's review. Consequently, many of the fifteen lenders involved in this matter, including DRMC, lost their investors, warehouse lines, and customer base upon issuance of the press release announcing the review. DRMC is one of several of the subject lenders that have been forced to cease business operations as a result of this review. The Company is in the process of winding down its loan origination business and closing its doors. Nevertheless, DRMC has throughout its existence been committed to complying with HUD requirements and originating quality FHA-insured loans. Therefore, upon receiving the draft Report, we conducted a thorough review of the loan file documentation in light of the issues raised. We address the individual concerns identified in the Report below.

II. RESPONSE TO RESULTS OF REVIEW

As previously noted, the Report alleges noncompliance with HUD requirements in ten loans and recommends action by HUD and the Departmental Enforcement Center regarding these assertions. Based on our review, DRMC strongly objects to both the recommendation for administrative action and PFCRA penalties in the cited loans. Our review indicated that several of the findings in the Report are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability. While we recognize that there is always room for improvement, at no time did the Company intentionally disregard HUD guidelines or knowingly misrepresent information to the Department. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate DRMC's general compliance with HUD/FHA requirements and adherence to prudent lending standards. Below we reply to the individual matters raised in the Report, evidence our adherence to FHA requirements in connection with several cited loans, and set forth our opposition to the to the OIG's recommendations regarding action under PFCRA.

At the outset, we note that, rather than identify fraud or significant infractions of HUD requirements, the majority of the Report's findings identify minor issues or oversights that did not affect the insurability of the loan. For example, in two of the cases in which the Report asserts that the borrower's qualifying ratio exceeded HUD guidelines, the Report references the front-end ratio, rather than the back-end ratio. As discussed in detail below, HUD requirements expressly state that greater latitude is permissible on the borrower's front-end ratio than on the back-end ratio, provided the borrower has limited recurring expenses, as was the case in these two loans. See HUD Handbook 4155.1, REV-5, ¶ 2-12(A). It appears that inclusion of such minor issues in the Report serves only as an attempt to justify the costs of the audit of this Company and the public nature of the "Operation Watchdog" probe that led to this memorandum report. Moreover, as demonstrated below, DRMC properly interpreted and adhered to HUD guidelines in underwriting several of the loans at issue and, in all cases, maintains

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that the borrowers qualified for FHA financing. For these reasons, we believe that most of the Report's allegations are unwarranted and should be removed from the final report.

Comment 1

In addition, we note that, in three of the ten loans at issue in the Report,[1] the Department's Quality Assurance Division ("QAD") previously examined these loans. In one loan, HUD raised no concerns with the loan file documentation. In the remaining two loans, the Department initially raised many of the same issues identified in the Report. After reviewing the Company's responses, however, HUD reconsidered its initial indemnification requests and closed its files in these two cases **(Exhibit B)**. We request that the OIG do the same and remove the allegations HUD has already considered resolved from the final report.

A. DRMC GENERALLY COMPLIED WITH HUD's UNDERWRITING GUIDELINES

In the "Results of the Review" and Appendix B, the Report alleges that DRMC did not underwrite ten of the fifteen FHA loans reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) excessive qualifying ratios; (2) credit history analysis; (3) income verification; (4) assessment of borrower liabilities; and (5) documenting borrower assets. We address each of these individual allegations in turn below.

1. Qualifying Ratios

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

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

[1] These loans are: (1) [redacted] – FHA Case No. 483-3712823; (2) [redacted] – FHA Case No. 483-3758136; and (3) [redacted] – FHA Case No. 261-9205529.

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

It is DRMC's policy to carefully consider each borrower's circumstances and document significant compensating factors in the "Remarks" section of the MCAW in compliance with HUD guidelines. This policy has been in place since the Company's inception, and we regularly remind our employees of the importance of ensuring that debt-to-income ratios in excess of HUD's guidelines are justified by significant compensating factors. Contrary to the allegations in this sub-finding, when compensating factors or other justifications were required, DRMC obtained the necessary documentation to demonstrate these factors, and either included the documentation in the loan file or noted these factors in the "Remarks" section of the MCAW. We address the allegations raised in each of the three cited loans below.

a. [redacted] – FHA Case No. 483-3758135

In the [redacted] loan, the Report alleges that the borrower's fixed payment-to-income ratio of 47.4% exceeded HUD guidelines without adequate compensating factors.

[2] While the Department has issued a new online version of Mortgage Credit Analysis Handbook, 4155.1, the new Handbook became effective for loans originated on or after May 11, 2009, after the loans cited in the Report were originated and closed. We therefore rely on the prior Handbook, 4155.1 REV-5, and accompanying Mortgagee Letters throughout this response.

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Mr. Muhammad Akhtar
June 25, 2010
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Comment 2

As an initial matter, we note that the Company has already addressed this issue in a previous audit of this loan file by the Department's QAD. Based on the Company's response, HUD reconsidered its request for indemnification in this case (**Exhibit B**).

Comment 3

As discussed above, DRMC understands and appreciates that, at the time the [redacted] loan was originated, HUD guidelines provided benchmark ratios for front-end and back-end qualifying ratios of 31% and 43%. See HUD Handbook 4155.1 REV-5, ¶ 2-12; Mortgagee Letter 05-16. Based on these benchmark guidelines, the borrower's front-end qualifying ratio of 28% was within HUD guidelines, and the borrower's back-end ratio of 47.4%, with which the Report takes issue, only slightly exceeded HUD's benchmark guideline (**Exhibit C-1**). In addition, contrary to the assertion in the Report, the loan file evidenced sufficient compensating factors to offset this slightly higher-than-average ratio, which the underwriter reasonably determined justified loan approval in this case. See HUD Handbook 4155.1 REV-5, ¶ 2-13. Importantly, the borrower had strong job stability, as he had been employed in his current position for over five years prior to closing (**Exhibit C-2**). DRMC maintains that the loan file contained evidence of compensating factors that supported loan approval even with a slightly higher-than-average back-end ratio. For these reasons, DRMC believes that administrative action in this case is unwarranted and requests that this allegation be removed from the final report.

b. [redacted] – FHA Case No. 261-9065826

Comment 4

In this case, the Report asserts that the borrower's payment-to-income, or "front-end," ratio of 35.88% exceeded HUD's benchmark guideline of 31% without sufficient compensating factors. Specifically, the Report takes issue with the underwriter's use of the borrower's ability to make the same mortgage payments as the rental housing expense, because the borrower's rental payment was only $533 and, although the loan file documented that the borrower paid the landlord an additional $2,567 to cover taxes on the rental property, which amounted to a total monthly rental payment of $747, this amount was less than the $781 monthly mortgage payment.

Contrary to this allegation, DRMC recorded valid compensating factors that were sufficient to justify loan approval on the MCAW, which were supported by loan file documentation (**Exhibit D-1**). First, as you know, FHA guidelines provide that for borrowers with limited recurring expense, greater latitude is permissible on the borrower's front-end ratio than on the total fixed payment ratio. See HUD Handbook 4155.1, REV-5, ¶ 2-12(A). Thus, as the borrower's back-end ratio of 38.4% was well within HUD guidelines, and the borrower had only $65 in monthly recurring obligations (**Exhibit D-1**), the underwriter was justified in assigning less weight to the front-end ratio.

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Second, the loan file contained documentation demonstrating significant compensating factors in this case. For instance, as acknowledged in the draft Report, the underwriter noted that, in addition to the borrower's base rental payments of $533, which were supported by copies of money order receipts **(Exhibit D-2)**, the loan file evidenced that the borrower also made a payment of $2,567 to her current landlord to cover the property taxes on the property she was renting **(Exhibit D-3)**. The Report, however, takes issue with the fact that the loan application references only the borrower's base rent of $533, and that the loan file does not contain any "assurance" that the payment to her current landlord was for the property taxes and not some other purpose. DRMC respectfully disagrees. As acknowledged in the Report, the loan file also contained a copy of the tax bill for the property, indicating that the taxes were $2,383, a few hundred dollars less than the borrower's payment to the landlord for this purpose. Moreover, the $2,567 check to the landlord stated in the "Memo" line that the funds were to cover "City Taxes for 8254 Fielding" **(Exhibit D-3)**, which further confirmed that these funds were in fact provided to the landlord to cover the property taxes. Based on this information, the underwriter has reasonable assurances that the funds were provided to the landlord to cover property taxes and determined that the borrower's overall monthly rental payment was $533 plus $214, or $747. As this amount was only $34 less than the borrower's monthly mortgage payment, the underwriter reasonably concluded that the currently rental expense was essentially equal to the new mortgage payment, and noted this factor on the MCAW **(Exhibit D-3)**. As you know, HUD guidelines expressly state that a borrower's "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" is a compensating factor. See HUD Handbook 4155.1 REV-5, ¶ 2-13(A).

Comment 5

In addition, although overlooked in the Report, the underwriter also noted that, once the borrower took possession of the rented property, which she was purchasing in this case, the taxes would decrease upon the borrower filing for a homestead exemption **(Exhibit D-1)**. In preparation of this response, DRMC obtained a copy of the Detroit County Public Records, which evidences that the borrower's property taxes in fact decreased as a result of this transaction **(Exhibit D-4)**. This information further supported the underwriter's conclusion that the borrower's rental expense was equal to or less than the monthly mortgage payment. Also, as you know, HUD guidelines expressly consider the following to be a compensating factor: "There is only a minimal increase in the borrower's housing expense." HUD Handbook 4155.1 REV-5, ¶ 2-13(F). Thus, even if one concluded that the $34 difference was not "equal [to] or greater than" the proposed monthly housing expense, this small increase in housing expenses nevertheless constituted a valid compensating factor in this case.

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Comment 6

Moreover, although ignored in the Report, the underwriter also noted on the MCAW that the borrower held a second job that was not used to calculate effective income, but rather was only considered as a compensating factor **(Exhibit D-1)**. Importantly, the loan file contained a Verification of Employment ("VOE"), pay stubs, and W-2 forms evidencing that the borrower had been employed as a restaurant server for over four years prior to closing, and earned additional income through this position **(Exhibit D-5)**. HUD guidelines expressly state that "documented compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage" is a compensating factor. HUD Handbook 4155.1 REV-5, ¶ 2-13(E).

In summary, the above discussion and attached documentation demonstrate that the underwriter identified strong compensating factors that justified loan approval, especially given that the front-end ratio only slightly exceeded HUD's benchmark guidelines and the back-end ratio was well below the Department's 43% threshold. Specifically, contrary to the assertion in the Report, the loan file documented that the borrower's total monthly rental obligation was equal to or greater than the borrower's monthly mortgage payment, especially after the decrease in property taxes based on her homestead exemption. Moreover, the loan file clearly documented that the borrower had additional earnings that were not used to calculate the borrower's effective income. The borrower qualified for FHA financing in this case and, therefore, this allegation should be removed from the final report.

c. [redacted] – FHA Case No. 261-9205529

Comment 7

In this case, the Report asserts that the borrower's front-end ratio of 34.7% exceeded HUD's benchmark threshold of 31%, but the loan file did not document compensating factors to justify loan approval.

As an initial matter, we note that the Department examined this loan in a previous QAD review, and raised no issues with regard to the borrower's qualifying ratios **(Exhibit B)**.

Comment 8

Contrary to this assertion, DRMC recorded valid compensating factors that were sufficient to justify loan approval on the MCAW, which were supported by loan file documentation **(Exhibit E-1)**. First, as discussed above, FHA guidelines provide that, for borrowers with limited recurring expense, greater latitude is permissible on the borrower's front-end ratio than on the total fixed payment ratio. See HUD Handbook 4155.1, REV-5, ¶ 2-12(A). Thus, as the borrower's back-end ratio of 35.4% was well within HUD guidelines, and the borrower had only $40 in monthly recurring obligations **(Exhibit E-1)**, the underwriter was justified in assigning less weight to the front-end ratio. Second, the loan file contained documentation demonstrating significant compensating factors in this case. For example, the loan file documented a stable

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rental history, with only a fourteen percent increase in housing costs as a result of the new mortgage **(Exhibit E-2)**. As discussed above, HUD guidelines recognize that a minimal increase in housing expenses compensates against higher-than-average ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(F). The loan file also documented the borrower's job stability, as he had been employed with his current employer for over one year and in the same line of work for the past three years **(Exhibit E-3)**.

The above discussion demonstrates that loan file documentation supported significant compensating factors in the [redacted] loan, especially given that the borrower's back-end ratio was well within HUD guidelines and the front-end ratio of 34.7% only slightly exceeded HUD's benchmark guideline. We maintain that the Company complied with HUD guidelines in this case and, as a result, this finding should be removed from the final report.

2. Credit History Analysis

In seven loans, the Report takes issue with the Company's evaluation of the borrowers' creditworthiness. Specifically, this sub-finding asserts that the borrowers' credit histories involved collections that were not explained by the borrowers or considered by the underwriter.

DRMC respects the importance of analyzing a borrower's credit performance and examining his or her attitude towards credit obligations. It is DRMC's policy and practice, with respect to every FHA applicant, to scrutinize the applicant's credit record and reasonably determine the potential borrower's creditworthiness. Given the potential risks not only to the Department, but to the Company, of making a poor credit decision, the Company's management has endeavored to monitor underwriting performance and provide ongoing training to employees on the issue of credit analysis.

Comment 9

That said, we note that HUD delegated to FHA lenders the responsibility for analyzing a borrower's credit and determining an individual's creditworthiness. See HUD Handbook 4155.1 REV-5, ¶ 2-3. While HUD has established specific guidelines, credit analysis remains largely subjective. For example, where derogatory credit items are present, lenders have discretion to consider the borrower's unique circumstances and determine whether financing is appropriate. As discussed above, the Department has recognized that underwriting is more of an art than a science and requires the careful weighing of the circumstances in each individual case. Thus, it is DRMC's policy to carefully scrutinize a borrower's credit history to obtain any documentation or explanation necessary to assess a borrower's credit risk. See Mortgagee Letters 00-24 and 95-07; see also HUD Handbook 4155.1 REV-5, ¶ 2-3. While two underwriters may make different decisions about a borrower's credit in the same case, both underwriters may have complied with FHA requirements and made reasonable underwriting

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decisions. DRMC takes its underwriting responsibility seriously and would never knowingly approve a loan to an unqualified borrower.

In all seven of the cases cited in the Report, DRMC complied with FHA guidelines by examining the borrowers' overall pattern of credit behavior and reasonably determining that the borrowers qualified for FHA financing. The Company properly considered each borrower's previous housing obligations, recent and/or undisclosed debts, collections, judgments, and bankruptcies, and DRMC underwriters reasonably determined that past derogatory items did not reflect a current disregard for financial obligations. The loan files contain required documentation and DRMC prudently exercised the discretion granted to it by the FHA. As discussed below, the borrowers in these cases generally were hard-working individuals who took responsibility for their financial obligations. As a result, DRMC adhered to FHA requirements by reasonably determining that the borrowers were creditworthy and qualified for FHA loans. We address each of the cited loans in turn below.

a. [redacted] – FHA Case No. 262-1650023

In the [redacted] loan, the Report asserts that the underwriter did not adequately review the borrower's credit history or document how the borrower had reestablished good credit, as the borrower had an unexplained collection account after a bankruptcy, as well as accounts with late payments and overdrafts.

Comment 10

Contrary to the assertion in the Report, DRMC complied with FHA guidelines in this case by examining the borrower's overall pattern of credit behavior and reasonably determining that the borrower qualified for FHA financing. With regard to the bankruptcy, as acknowledged in the Report, HUD guidelines expressly state that a Chapter 7 bankruptcy 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. See HUD Handbook 4155.1 REV-5, ¶ 2-3(E). As indicated in the Report, the bankruptcy in this case was discharged in March of 2003 **(Exhibit F-1)**, almost four years prior to the loan closing in February of 2007 **(Exhibit F-2)**, and the borrower provided a written explanation regarding his reasons for filing for bankruptcy and his acceptance of responsibility for ensuring the same behavior that led to the bankruptcy did not recur **(Exhibit F-3)**. Based on the time that had elapsed since the bankruptcy, and the borrower's acceptance of responsibility, the underwriter reasonably determined that this derogatory item did not preclude loan approval in this case.

Although the loan file evidenced some additional derogatory items subsequent to the bankruptcy, the borrower provided explanations for most of the items **(Exhibit F-3)**. These explanations demonstrated that the borrower had taken responsibility for the account balances and quickly resolved the issues upon determining that the accounts

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were 30 days late **(Exhibit F-3)**, which the credit report confirmed **(Exhibit F-1)**. While the borrower did not provide an explanation for the collection account, which was opened in 2006, the credit report reflects that this collection was tied to an account dating back to 2003, the time of the borrower's bankruptcy **(Exhibit F-1)**. Thus, it was reasonable for the underwriter to conclude that issues related to this account were tied to the borrower's credit issues at the time of the bankruptcy and that an additional explanation regarding this account was not necessary. In all cases, the borrower took responsibility for his credit obligations and resolved the issues with his creditors. In addition, the loan file evidenced that the borrower had an excellent rental payment history for the past two years **(Exhibits F-1, F-4)**, which evidenced his commitment to timely payment of his housing obligation.

In summary, DRMC maintains that it complied with HUD guidelines in analyzing the borrowers' overall credit profile in the Senter loan and the underwriter reasonably determined that the borrower had taken responsibility for his obligations and demonstrated an acceptable credit risk. Contrary to the assertion in the Report, the underwriter prudently exercised the discretion granted by the FHA. For these reasons, DRMC respectfully requests that the administrative action recommendation in this instance be removed from the final report.

b. [redacted] – FHA Case No. 261-9177201

In this case, the Report asserts that the borrower's credit history included satisfied judgments, open collections, and late payments on a previous mortgage; however, the borrower's explanation did not cover the two judgments and did not adequately resolve the issues underlying the medical collection accounts.

Comment 11

DRMC understands and appreciates that lenders are required to analyze a borrower's past credit record to determine whether past derogatory items resolved from a disregard for, or an inability to manage, financial obligations, or to factors beyond the control of the borrower. See HUD Handbook 4155.1 REV-5, ¶ 2-3. As discussed above, it is DRMC's policy to carefully scrutinize a borrower's credit history and to examine the borrower's overall pattern of credit behavior. See id. Contrary to the Report's suggestion, DRMC complied with this requirement in the [redacted] loan. In this case, while the borrower's credit report reflected two judgments, these items were incurred in 2001 and 2002 **(Exhibit G-1)**, between five and six years before loan closing in March of 2007 **(Exhibit G-2)**, and were satisfied in 2003 and 2004 **(Exhibit G-1)**, between three and four years prior to closing **(Exhibit G-2)**. As the borrower had incurred and satisfied these accounts so many years prior to the loan application, the underwriter reasonably determined that they did not reflect the borrower's current attitude toward credit.

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Comment 12

With regard to the collection accounts and late payments on a previous mortgage, the Company obtained a detailed explanation regarding each of these matters. The letter explained that, in 2004 and 2005, the borrower experienced great financial hardship as a result of complications with the birth of twin children **(Exhibit G-3)**. As a result of the premature birth and death of one twin, and the resulting medical bills and loss of income from the absence from work in caring for the surviving premature twin child, the borrower incurred several of the collection and delinquent accounts reflected on the credit report **(Exhibits G-1, G-3)**. The borrower's letter specifically explains that this extenuating circumstance caused him to become late on the mortgage payments at that time, and that he and his partner sold that property and began renting to save money **(Exhibit G-3)**. This explanation demonstrated that the borrower's past credit problems resulted from unforeseen medical issues outside of the borrower's control, rather than a disregard for his finances. The borrower's explanation letter evidenced that he took responsibility for the obligations he had incurred at that time **(Exhibit G-3)** and had worked to renew his credit before applying for the mortgage loan at issue **(Exhibit G-1)**.

Comment 13

The Report also asserts that one medical collection account opened in August of 2006 did not relate to the borrower's past medical issues and that the borrower had not paid that account "on principle." This is not the case. The borrower's explanation clearly states that the unpaid medical collection with Associated Retinal **(Exhibit G-1)**, relates to a bill from his daughter's doctor that was sent to a previous address by mistake **(Exhibit G-3)**. The borrower indicated that he was working with the insurance company regarding coverage of these expenses and, if the issue was not resolved in 30 days, he would satisfy the outstanding balance **(Exhibit G-3)**. While the borrower's explanation letter does reference a refusal to pay an account, this statement related to a prior bill from Sprint in the amount of $297, which the borrower has since satisfied **(Exhibit G-3)**, as evidenced by the letter in the file from Calvary Portfolio Services **(Exhibit G-4)**. Thus, any concerns regarding the open collection account or the borrower's previously unpaid obligations were addressed in the explanation letter and had been or were in the process of being satisfied at closing.

Comment 14

The above discussion and attached documentation demonstrates that the borrower addressed past credit issues, which were caused by unforeseen medical issues and not a disregard for credit obligations. The loan file demonstrated that, after a period of great hardship, the borrower had taken control of his credit and was committed to honoring financial responsibilities. Moreover, the loan file documented the borrower's excellent rental payment history for 1.5 years prior to closing **(Exhibit G-5)**, which evidenced his commitment to timely payment of housing obligations. The borrower also had excellent job stability, having been employed by the same employer for over ten years **(Exhibit G-6)**, minimal recurrent debt and qualifying ratios well below HUD's

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benchmark guidelines **(Exhibit G-7)**. Based on a review of the totality of the circumstances in this case, including the fact that the borrower had overcome the reasons for past credit issues and demonstrated a commitment to making timely credit and housing payments, the underwriter reasonably determined that the borrower was an acceptable credit risk. DRMC adhered to HUD guidelines in analyzing the borrower's credit history and, thus, we respectfully request that these allegations be removed from the final report.

c. [redacted] – FHA Case No. 483-3758135

In the [redacted] loan, the Report asserts that the borrower did not adequately explain derogatory items on his credit report, including a bankruptcy that had been discharged more than three years before the loan closed and medical collection accounts.

Comment 15

As discussed above, we note that the Company has already addressed these issues in a previous audit of this loan file by the Department's QAD. Based on the Company's response, HUD reconsidered its request for indemnification in this case **(Exhibit B)**. As noted in that response, DRMC understands and appreciates that lenders are required to analyze a borrower's credit record to determine whether past derogatory items resulted from a disregard for, or an inability to manage, financial obligations, or to factors beyond the control of the borrower. See HUD Handbook 4155.1 REV-5, ¶ 2-3. It is DRMC's policy to carefully scrutinize a borrower's credit history and to examine the borrower's overall pattern of credit behavior. See id. Contrary to the Report's suggestion, DRMC maintains that it complied with this requirement in the [redacted] loan.

Comment 16

In this case, while the credit report evidenced a prior bankruptcy and collection accounts, the borrower provided explanations for these delinquent items. These letters explained that, with regard to the bankruptcy, which the Report acknowledges had occurred in 2004 **(Exhibit H-1)**, over three years prior to closing **(Exhibit H-2)**, the borrower had in the past assisted friends in obtaining debt that these individuals could not satisfy, which ultimately affected his credit **(Exhibit H-3)**. Moreover, with regard to the collection accounts, the borrower explained in writing that these accounts reflected medical bills that the borrower had obtained during a period of self-employment when he was uninsured **(Exhibit H-4)**. As these derogatory items were the result of unexpected medical expenses and the borrower's past assistance to others not involved in the current loan transaction, rather than the borrower's disregard for financial obligations, the underwriter reasonably determined that these items did not reflect the borrower's current ability to manage finances. Moreover, the credit report reflected that, with the exception of the medical collection accounts, the borrower was a limited user of credit and was making timely payments on his current and past automobile loan

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obligations for the nineteen months prior to closing **(Exhibit H-1)**. Based on the age of the delinquent accounts and the underlying causes for the original delinquencies, the underwriter reasonably determined that these items did not reflect the borrower's current ability to manage his finances.

In summary, DRMC maintains that it properly analyzed the borrower's credit history in this case and reasonably determined that the borrower presented an acceptable credit risk. Although the loan file indicated past credit issues, the borrower demonstrated that the causes for these items did not result from a disregard for his finances, and that he had taken control of his financial obligations and was a conservative user of credit. For these reasons, DRMC believes that administrative action in this case is unwarranted.

d. [redacted] – FHA Case No. 261-9065826

In this case, the Report takes issue with the underwriter's evaluation of the borrower's credit history, alleging that although the borrower's explanation indicated that her collection accounts resulted from her checkbook being stolen in December of 2004, she did not file a police report until five days before the loan application was taken in February of 2006. The Report also asserts that the borrower used a credit card not belonging to her to satisfy one collection account, and that the credit references were not provided by an independent source.

Comment 17

Here, although the borrower's credit report referenced collection accounts and late payments, the loan file contained considerable documentation to explain the borrower's past derogatory history and demonstrate her commitment to satisfying her financial obligations. With regard to the collection accounts, the credit report reflects that several of these items were incurred and satisfied years before the loan closed on May 15, 2006 **(Exhibits I-1, I-2)**. Moreover, as acknowledged in the Report, the borrower provided an explanation letter indicating that the collection accounts had resulted from identify theft after the borrower's checkbook was stolen **(Exhibit I-3)**, and the loan file contained a police report confirming this explanation **(Exhibit I-4)**. While the Report takes issue with the timing of the police report, the borrower had been unaware that the identify theft was negatively impacting her credit history until she applied for mortgage financing. Upon obtaining a credit report in anticipation of purchasing a home, she discovered the negative impact and, based on the advice of counsel, filed a police report at that time. These circumstances do not alter the fact that the borrower provided a reasonable and documented explanation regarding her past credit issues. Moreover, the underwriter reasonably determined that these issues reflected an extenuating circumstance outside of the borrower's control, rather than a disregard of her credit obligations.

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Additionally, as indicated in the Report, the Company required the borrower to pay off outstanding items reflected on her credit report prior to closing, which she did. **(Exhibits I-1, I-5)**, as well as provide additional credit references **(Exhibits I-6, I-7)**. With regard to the account paid with another's credit card, this account was satisfied by the borrower's mother. As the payment was made by a relative and was not used toward the purchase of the subject property, the underwriter did not document the source of these funds. With regard to the credit references, while two of these references were faxed from the same number as the sales contract, there is no evidence to suggest that these documents were not accurate copies of legitimate references provided by vendors that the borrower used prior to loan closing. In addition, the loan file contained additional credit references evidencing the borrower's excellent payment history that were not faxed to the Company **(Exhibit I-7)**. These references from Z Tel and the borrower's landlord further supported the borrower's timely satisfaction of credit obligations. Even more importantly, the borrower's credit report evidenced her excellent payment history in connection with her student loan account **(Exhibit I-1)**.

Comment 18

Comment 19

The underwriter analyzed all of the loan documentation regarding the borrower's credit profile and made a reasonable determination that the borrower represented an acceptable credit risk. The loan file evidenced that the borrower's past credit problems resulted from circumstances outside of her control and that she had taken responsibility for her credit obligations by paying off her outstanding accounts and making timely payments on her student loan and housing obligations. Moreover, as discussed above, the borrower had an excellent payment history in connection with her current rent, and her housing payment increased only $34 as a result of the mortgage loan **(Exhibits D-2, D-3)**. The borrower also had a second job to assist her in making payments, which the underwriter did not use in calculating the borrower's qualifying ratios **(Exhibit D-5)**.

Comment 20

In summary, the underwriter exercised the discretion delegated by HUD and made a reasonable determination that the borrower in the [redacted] loan qualified for FHA financing. DRMC adhered to HUD guidelines in originating this loan and, as a result, administrative action would be inappropriate. Thus, we request that this finding be removed from the final report.

e. [redacted] – FHA Case No. 261-9205529

In this loan, the Report asserts that the Company did not adequately analyze the borrower's credit history, as the borrower's explanation regarding his bankruptcy stated that he had incurred $100,000 in medical bills related to an injury and the injury had led to other debts; however, the bankruptcy papers listed debts totaling $61,764, only $23,461 of which involved medical debts. The Report also asserts that the borrower

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was behind on a utility bill with a new creditor and that the loan file did not document significant compensating factors.

Comment 21

As an initial matter, we note that the Company has already addressed this issue in a previous audit of this loan file by the Department's QAD. Based on the Company's response, HUD reconsidered its request for indemnification in this case **(Exhibit B)**.

In that response, DRMC demonstrated its compliance with FHA guidelines by examining the borrower's overall pattern of credit behavior and reasonably determining that the borrower qualified for FHA financing. With regard to the bankruptcy, as discussed above, HUD guidelines expressly state that a Chapter 7 bankruptcy between one and two years prior to loan application does not disqualify a borrower from obtaining an FHA-insured mortgage if it was caused by an extenuating circumstance and the borrower has since exhibited an ability to manage his or her financial affairs. See HUD Handbook 4155.1 REV-5, ¶ 2-3(E). As indicated in the Report, the bankruptcy in this case was discharged in February of 2006 **(Exhibit J-1)**, sixteen months prior to the loan closing in June of 2007 **(Exhibit J-2)**, and the borrower provided a written explanation regarding his reasons for filing for bankruptcy **(Exhibit J-3)**.

Comment 22

As acknowledged in the Report, the borrower's bankruptcy resulted from an extenuating circumstance; namely, substantial medical bills that resulted from an unexpected injury and his ensuing inability to pay other debts as a result of the injury **(Exhibit J-3)**. While the borrower's estimate of total medical bills was higher than those reported in his bankruptcy paperwork, this fact alone does not make the borrower's statement regarding his reason for bankruptcy inaccurate. As is often the case when medical injuries and insurance coverage issues arise, individuals make every effort to pay medical bills out of pocket before resorting to bankruptcy. In this case, the borrower could have incurred significant additional medical bills that were satisfied prior to the bankruptcy filing. Nevertheless, in a case such as this borrower who made approximately $60,000 per year, even $23,000 in medical bills would significantly impact the individual's finances, and ultimately his ability to maintain timely payments on other credit accounts. The borrower clearly stated that this was the case in his explanation letter **(Exhibit J-3)**, and the underwriter reasonably accepted this explanation as the reason for the debts discharged in the bankruptcy.

In addition, subsequent to the bankruptcy, the borrower exhibited a conservative use of credit, and had re-established credit and was making timely payments on two revolving credit accounts **(Exhibit J-4)**. Although the loan file evidenced some additional derogatory items subsequent to the bankruptcy, the underwriter determined that these small late payments would not affect the borrower's ability to repay the mortgage, especially given the strong compensating factors in this case. Specifically,

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as discussed above, the loan file documented a stable rental history, with only a fourteen percent increase in housing costs as a result of the new mortgage (**Exhibit E-2**). The loan file also documented the borrower's job stability, as he had been employed with his current employer for over one year and in the same line of work for the past three years (**Exhibit E-3**).

Comment 23

In summary, DRMC maintains that it complied with HUD guidelines in analyzing the borrower's overall credit profile in the [redacted] loan and the underwriter reasonably determined that the borrower had taken responsibility for his obligations after an unforeseen and extenuating circumstance and demonstrated an acceptable credit risk. Contrary to the assertion in the Report, the underwriter prudently exercised the discretion granted by the FHA in approving this borrower for FHA financing. For these reasons, DRMC respectfully requests that the administrative action recommendation in this instance be removed from the final report.

f. [redacted] – FHA Case No. 261-8996673

Here, the Report alleges that the borrower's explanation for a recent delinquent installment account was inadequate and two additional letters of credit from an art gallery and a party company were faxed from the borrower's place of employment, rather than from independent third parties.

Comment 24

Contrary to the allegation in the Report, DRMC adhered to FHA guidelines in analyzing the borrower's credit history and approving this individual for FHA financing. As acknowledged in the Report, although the borrower's credit report evidenced certain derogatory items, the borrower provided detailed letter in which he "sufficiently explained the collection accounts" (**Exhibit K-1**), and the loan file contained evidence that the borrower had satisfied these collection accounts (**Exhibit K-2**). The loan file also contained an explanation letter regarding the late payments on his Capital One account, as well as evidence that the borrower brought the account current prior to closing (**Exhibit K-3**).

Comment 25

Comment 26

As suggested in the Report, the underwriter determined that additional credit references were necessary and requested them in this case. In response, the borrower provided two credit references from [redacted] at a local party store, and from [redacted] at a local art gallery (**Exhibit K-4**). As the underwriter had requested these credit references from the borrower, it was reasonable for the borrower to directly obtain the additional credit references and submit them to DRMC. Nevertheless, as the references had not been provided to the Company directly by the credit references, a DRMC employee contacted both [redacted] and [redacted] to confirm the information contained in these references, and the loan file included a Processor Certification evidencing the validity of these credit references (**Exhibit K-5**). Both references

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Comment 27

covered a twelve-month period and reflected timely monthly payments of $150 and $250 **(Exhibit K-4)**. The loan file also evidenced that the borrower had excellent rental history and had been making timely rental payments for the past twelve months **(Exhibit K-6)**, which evidenced his commitment to meeting his monthly housing obligation.

Comment 28

The underwriter analyzed all of the borrower's credit accounts, explanations, and references and, based on the totality of the circumstances, reasonably determined that this borrower qualified for FHA financing. DRMC therefore maintains that administrative action in this case is unwarranted, and requests that these allegations be removed from the final report.

g. [redacted] – FHA Case No. 261-9111473

In this case, the Report asserts that the Company did not adequately analyze the co-borrower's credit, as the loan file reflected that the co-borrower had: (1) an unsatisfied pending judgment of $1,309 without documentation that worker's compensation would cover the injury; and (2) late payments and collection accounts without adequate explanations regarding the reasons for these derogatory items.

Comment 29

With regard to the judgment, DRMC understands and appreciates that HUD guidelines require that all judgments must be satisfied prior to the loan closing. See HUD Handbook 4155.1 REV-5, ¶ 2-3(C). The Company strictly adhered to this requirement in the [redacted] loan. As indicated in the Report, the co-borrower's credit report evidenced a pending judgment of $1,309 to Stockbridge Area Ambulance, Inc. **(Exhibit L-1)**. Although the co-borrower provided a written explanation indicating that this medical charge had resulted from a work injury and he was pursuing workman's compensation **(Exhibit L-2)**, the Company nevertheless required that this debt be satisfied prior to closing. To that end, the loan file contains an Official Check for $1,384.56 made payable to the Professional Business Bureau, Inc. in satisfaction of the debt **(Exhibit L-3)**. This check was issued on September 16, 2006 **(Exhibit L-3)**, five days prior to closing on September 21, 2006 **(Exhibit L-4)**. This documentation evidences that the Company ensured that the judgment was adequately explained and resolved prior to closing in compliance with HUD guidelines.

Comment 30

With regard to the delinquent credit items, the co-borrower provided a detailed, written explanation for each of these accounts **(Exhibit L-5)**. While the Report suggests that these explanations were inadequate, DRMC respectfully disagrees. The co-borrower in each case provided an accurate explanation of how he had incurred the derogatory credit reference. While several of these explanations indicated that the debts were incurred by others, including his ex-spouse and son, these explanations did not reflect a lack of responsibility for these accounts on the part of the borrower. In fact,

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the loan file documented that the co-borrower satisfied many of the outstanding obligations prior to closing **(Exhibit L-6)**, which evidenced his acceptance of responsibility for these accounts. As the co-borrower had explained and satisfied many of the outstanding accounts prior to closing, the underwriter reasonably determined that the co-borrower, along with the borrower in this case, represented a reasonable credit risk. This conclusion was supported by additional compensating factors that counseled toward loan approval in this case. For example, both borrowers had stable jobs with significant monthly income **(Exhibits L-7, L-8)**, the borrowers' had qualifying ratios well below HUD's benchmark guidelines **(Exhibit L-8)**, and both borrowers had accumulated cash reserves in their 401(k) plans **(Exhibit L-9)**.

Comment 31

In summary, DRMC maintains that it adhered to HUD guidelines in analyzing the co-borrower's credit history, including obtaining evidence that the pending judgment and other derogatory accounts were satisfied prior to closing and that the reasons for the borrowers' past credit issues resulted from reasons unrelated to a disregard for financial obligations. Based on this documentation and the significant compensating factors in this case, the underwriter reasonably determined that the borrowers qualified for the FHA-insured loan at issue. Thus, we respectfully request that this finding, and the recommendation that HUD take administrative action in connection with this loan, be removed from the final report.

3. Income Verification

In three loans, the Report asserts that the Company did not property verify or determine the stability of the borrower's income. DRMC respectfully disagrees with these assertions. We address each case below.

a. [redacted] – FHA Case No. 483-3712823

In this case, the Report asserts that the loan was approved using excessive overtime earnings, as the underwriter used the current VOE to calculate overtime income of $318, rather than using the overtime income the borrower had earned over the past two years, which would have increased the borrower's qualifying ratios to an unacceptable level.

Comment 32

As an initial matter, we note that the Department examined this loan in a previous QAD review, and raised no issues with regard to the loan origination or underwriting **(Exhibit B)**.

With regard to income documentation, DRMC understands and appreciates that a lender must verify the borrower's employment for the most recent two full years and analyze the income to determine whether it can reasonably be expected to continue

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through at least the first three years of the mortgage. See HUD Handbook 4155.1 REV-5, ¶¶ 2-6, 2-7. DRMC complied with these requirements in the [redacted] loan. DRMC obtained a VOE **(Exhibit M-1)**, pay stubs **(Exhibit M-2)**, and W-2 forms **(Exhibit M-3)** evidencing that the borrower had been employed by LoJac Enterprises since September 4, 2003 **(Exhibit M-1)**. See HUD Handbook 4155.1 REV-5, ¶ 3-1(E).

Comment 33

With regard to overtime earnings, DRMC understands and appreciates that HUD guidelines require lenders to develop an average of overtime income for the past two years. See id. ¶ 2-7. The underwriter acknowledged on the MCAW that the overtime income in this case was averaged over the past two years **(Exhibit M-4)**. While the Company appreciates that the $318 reflected on the MCAW likely was based on his current earnings as indicated on the VOE **(Exhibit M-1)**, utilizing an average of the borrower's overtime earnings based on the more conservative earnings totals reflected on the borrower's W-2 forms would not have significantly altered the borrower's qualifying ratios in this case. Specifically, the borrower's 2005 W-2 form indicated that he earned $33,873 that year **(Exhibit M-3)**. The VOE indicated that his base pay rate for 2005 was $15.00, as the borrower received the $0.60 per hour pay raise in April of 2006 **(Exhibit M-1)**. Thus, the borrower's total base pay for 2005 would have been $31,200 ($15 x 40 hours x 52 weeks = $31,200), and his overtime earnings for that year would have been $2,673 ($33,873 in total earnings - $31,200 in base pay = $2,673).

In 2006, the borrower's W-2 form reflected $34,351 in total earnings **(Exhibit M-3)**. Calculating base pay at $15 per hour for the first three months ($15 x 40 x 52/ 12 x 3 = $7,800) and at the $15.60 per hour rate for the remainder of 2006 ($15.60 x 40 x 52/12 x 9 = $24,336) results in total base income for that year of $32,136 ($7,800 + $24,336 = $32,136) **(Exhibit M-1)**. As the borrower earned $34,351 in total income, the file reflected overtime earnings in 2006 of $2,215 ($34,351 - $32,136 = $2,215).

When averaged together, the 2005 and 2006 overtime earnings documented in the file result in $203.66 of average monthly overtime ($2,673 + $2,215/ 24 = $203.66). In addition, the VOE evidenced that the borrower would receive another $0.60 raise in April of 2007, which the loan processor verified **(Exhibit M-1)**. This pay increase resulted in average monthly income of $2,808 ($16.20 x 40 x 52/ 12 = $2,808). When combined with the average monthly overtime earnings from the past two years, the borrower's effective monthly income documented in the loan file was $3,011 ($2,808 + $203 = $3,011), which was only $10 less than the income used to qualify the borrower for FHA financing in this case and would not have altered the borrower's qualifying ratios **(Exhibit M-4)**. As the loan file documented sufficient overtime earnings over the past two years to qualify the borrower for the FHA-insured loan, we believe that the recommendation regarding administrative action in this case is unwarranted and should be removed from the final report.

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b. [redacted] – FHA Case No. 483-3695773

Here, the Report alleges that the stability of the borrower's income was questionable, as the borrower had recently changed jobs and experienced a significant pay increase, and suggests that using an average monthly income from the past two years would have increased the debt-to-income ratios to an unacceptable level.

As discussed above, DRMC understands and appreciates that a lender must verify the borrower's employment for the most recent two full years and analyze the income to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage. See HUD Handbook 4155.1 REV-5, ¶¶ 2-6, 2-7. DRMC complied with these requirements in this case. The loan application indicated that the borrower had recently become employed by ARS, or Accounts Receivable Solutions, LLC **(Exhibit N-1)**. DRMC obtained an employment offer letter **(Exhibit N-2)**, a VOE **(Exhibit N-3)**, and a pay stub **(Exhibit N-4)** to document the borrower's current employment in compliance with HUD requirements. See HUD Handbook 4155.1 REV-5, ¶ 3-1(E).

Comment 34

These documents demonstrated that the borrower had been employed with ARS since November 20, 2006. While the borrower secured this job soon before loan closing, the file clearly documented that the borrower was in fact employed by ARS and was earning $50,000 per year in this new position. The Report takes issue with the fact that the VOE does not include a statement regarding the borrower's annualized salary, and suggests that only the borrower's notation on the pay stub reflects this salary. Contrary to these assertions, the employment offer letter indicates that the borrower will earn a base salary of $50,000 **(Exhibit N-2)**. Moreover, the pay stub, which typically are provided by the borrower who has possession of such documentation, evidences that her weekly earnings were annualized to $50,000. Specifically, the pay stub covered the period from November 12, 2006 through November 25, 2006 **(Exhibit N-4)**. As the borrower began her employment with ARS on November 20, 2006 **(Exhibits N-2, N-3)**, the pay stub reflected only one week's earnings, from November 20, through November 25, 2006. The $961.35 base salary reflected her annualized income of $50,000 ($961.35 x 52 = $49,990.20) **(Exhibit N-4)**. The VOE, employment offer, and pay stubs confirmed that the borrower was in fact employed by ARS and receiving an annual salary of $50,000 at the time the loan closed. Moreover, the employer stated in the VOE that the borrower's likelihood of continued employment was "good" **(Exhibit N-3)**. As these documents clearly evidenced the borrower's current income and likelihood of continuance, the underwriter reasonably used the $4,166 in monthly salary to calculate the borrower's effective income on the MCAW **(Exhibit N-5)**.

With regard to job stability, HUD guidelines expressly state that the Department does not impose a minimum length of time a borrower must have held a position of

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employment to be eligible for FHA financing. See HUD Handbook 4155.1 REV-5, ¶ 2-6. Although the borrower had not been employed at his current position for the two-year period prior to closing, the loan file documented that he had consistently been employed during the past two years, and had begun working for ARS prior to loan closing. Based on the borrower's current income and the employer's express statement that the likelihood of her continued employment was good, the underwriter reasonably determined that the borrower had demonstrated sufficient job stability to warrant loan approval. The underwriter properly used the borrower's current, documented income to calculate the borrower's debt-to-income ratios, and the borrower qualified for FHA financing. DRMC complied with HUD guidelines in documenting and analyzing the borrower's income in this loan and this allegation should be removed from the final Report.

c. [redacted] - FHA Case No. 261-9065622

Finally, in the [redacted] loan, the Report asserts that the underwriter should have questioned the borrower's employment documentation, as: (1) the borrower's VOEs for his current and previous job were signed by the same person; and (2) multiple paycheck stubs for the borrower's current job reflected the same pay periods, year-to-date earnings, and taxes withheld.

Comment 35

The Company understands and appreciates HUD's requirement that an underwriter be aware of irregularities and provide explanations or additional documentation to make a sound underwriting decision. See HUD Handbook 4000.4 REV-1, CHG-2, ¶ 2-4(C)(5); see also HUD Handbook 4155.1 REV-4, CHG-1, ¶ 3-1(L). The Company adhered to these requirements with regard to the borrower's VOEs in this case. The VOE for the borrower's current job with Central Truck Repair was signed by [redacted], the owner **(Exhibit O-1)**. The VOE for the borrower's previous employment with National Truck Services was a verbal verification, which was signed by [redacted] a loan processor employed by DRMC **(Exhibit O-2)**. While [redacted] signature also appears on the VOE for Central Truck Repair, she signed this document on behalf of the Company in Block 3, not in the employer's signature Block 26 **(Exhibit O-1)**. There was nothing questionable about the signatures on the VOEs contained in the loan file. Moreover, DRMC further verified the borrower's current employment by obtaining a verbal VOE, again signed by [redacted] **(Exhibit O-3)**, W-2 forms **(Exhibit O-4)**, and recent pay stubs **(Exhibit O-5)**. The Company verified the borrower's past employment with National Truck Service through the borrower's credit report **(Exhibit O-6)** and 2004 W-2 forms **(Exhibit O-7)**.

With regard to the borrower's pay stubs, the Company acknowledges that four of the borrower's pay stubs for the beginning of 2006 reflected a pay period, year-to-date earnings, and taxes withheld for a December 2005 time period. We acknowledge that

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the underwriter's resolution of this discrepancy should have been documented in the file. That said, we maintain that the underwriter obtained sufficient documentation prior to closing to resolve any concerns regarding this discrepancy. As an initial matter, we note that the employer did not have a computerized payroll system and calculated payroll manually. Thus, it appears that the discrepancies were an oversight on the part of the employer, who carried over the December 2005 information onto the first few checks issued in January of 2006. Such inadvertent errors are not uncommon during manual pay roll calculations by small businesses without computerized systems.

Nevertheless, based on the subsequent information the Company received from the employer regarding the borrower's income and employment history, the underwriter would have had no reason to question a small error in the borrower's January 2006 pay stubs. In addition to the referenced pay stubs, the loan file also included two additional pay stubs for February of 2006, which reflected correct pay periods, year-to-date earnings, and withholding **(Exhibit O-5)**. This more recent documents evidence that the employer identified the errors on the January pay stubs and remedied the payroll calculations to accurately reflect this information on the most recent documents. The loan file also included a written VOE dated April 17, 2006 **(Exhibit O-1)** and a verbal VOE dated April 24, 2006 **(Exhibit O-3)** confirming that the borrower in fact worked for Central Truck Repair and earned weekly income of $950. We also note that Central Truck Repair was a business registered with the State of Michigan From March 31, 2004 through July 15, 2007 **(Exhibit O-8)**. There is no suggestion in the Report or reason to believe that the borrower's employment or income was false and any discrepancies in the January 2006 pay stubs were resolved by file documentation subsequently received by DRMC. For these reasons, we the recommendation regarding administrative action in this case is inappropriate and we request that it be removed from the final report.

4. Assessment of Liabilities

In four loans, the draft Report alleges that the Company did not properly assess each borrower's financial obligations. DRMC respectfully disagrees with the assertions in these cases. We address each of the loans cited in this sub-finding in turn below.

a. [redacted] – FHA Case No. 483-3712823

In this case, the Report asserts that a monthly payment of $109 on an installment loan had less than ten payments remaining; however, as the borrower did not have

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cash assets after closing, this debt should have been included in the calculation of the borrower's qualifying ratios, which would have increased to 33%/47%.[3]

Comment 37

As an initial matter, we note that the Department examined this loan in a previous QAD review, and raised no issues with regard to the loan origination or underwriting **(Exhibit B)**.

Comment 38

As you know, HUD guidelines expressly state that lenders "must include the monthly housing expense and all other additional recurring charges *extending ten months or more*." HUD Handbook 4155.1 REV-5, ¶ 2-11(A) (emphasis in original). In compliance with this requirement, the underwriter excluded the $109 debt, as the borrower had less than ten payments remaining on this obligation after closing. That said, DRMC understands and appreciates that debts lasting less than ten months must be included "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." Id. In this case, while the inclusion of the $109 payment would have increased the borrower's qualifying ratios, the debt would not have affected the borrower's ability to make the mortgage payment. Including the small debt in the borrower's qualifying ratios would have resulted in only a slight increase of the back-end ratio to 47%. The borrower's significant job stability of over six years with his current employer would have offset this increase **(Exhibits M-1, M-2)**. Moreover, we note, and the Report acknowledges, that the borrower in this case made ten payments before becoming delinquent. Thus, this debt was not a factor in the borrower's ability to make his mortgage payment in the months immediately following closing. HUD Handbook 4155.1 REV-5, ¶ 2-11(A).

Comment 39

DRMC maintains that it adhered to FHA guidelines in excluding this debt, as it had less than ten payments remaining and, had the underwriter included the debt, it would not have affected the borrower's qualification for FHA financing. As a result, administrative action is unwarranted and this loan should be removed from the final Report.

b. [redacted] – FHA Case No. 483-3695773

In this loan, the Report asserts that the borrower's qualifying ratios did not include two deferred student loan payments totaling $85 in monthly payments; however the loan file did not include a written explanation from the borrower stating that the loans would be deferred for at least 12 months.

[3] As discussed above, DRMC disagrees with the assertion that a lack of documented overtime income would have further increased the borrower's qualifying ratios in this case.

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DRMC understands and appreciates that, with regard to deferred obligations, 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 time frame. See HUD Handbook 4155.1 REV-5, ¶ 2-11(C). Its is DRMC's policy and procedure to obtain such evidence whenever a borrower's credit report reflects deferred loan payments, as was the case in the [redacted] loan **(Exhibit P-1)**. The Company is confident that the underwriter obtained such written evidence from the borrower with regard to the two student loans identified in the Report, as the underwriter would not have approved the loan without such evidence. That said, DRMC has been unable to locate this documentation and it appears that this document may have been inadvertently omitted from the documents copied into the Company's loan file. We have counseled our employees on the importance of include all documentation in the loan file, and we are certain that any oversight in this regard was isolated and will not recur. We note, however, that HUD guidelines require lenders to retain loan file documentation for a period of two years from the date of insurance endorsement. See HUD Handbook 4000.2 REV-3, ¶ 5-8. The [redacted] loan closed on December 8, 2006, more than three years before this loan file was subpoenaed in January 2010. As the Company was not required to maintain the documents at issue at the time of the OIG's review, it would be fundamentally unfair to recommend administrative action against the Company based on the absence of this information.

In any event, any oversight in connection with the documentation regarding the debts constituted, at worst, harmless error. Even if the underwriter had included the $85 in monthly student loan payments, the borrower's back-end qualifying ratio would have only slightly increased from 42.4% to 44.4%.[4] While this ratio would have slightly exceeded HUD's benchmark guideline of 43%, see HUD Handbook 4155.1 REV-5, ¶ 2-12, the borrower nevertheless would have qualified for FHA financing based on her good credit record **(Exhibit P-2)**. For this reason, we respectfully request that the recommendation for administrative action in this case be removed from the final report.

c. [redacted] – FHA Case No. 262-1650023

In the [redacted] loan, the Report alleges that the borrower's qualifying ratios did not include a $415 expense based on a wage garnishment for child support reflected on the borrower's pay statement, and inclusion of this obligation would increase the back-end ratio from 37.34% to 48.81%.

[4] As discussed above, DRMC disagrees with the assertion that a lack of documented income would have further increased the borrower's qualifying ratios in this case.

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Comment 41

DRMC understands and appreciates that HUD guidelines state that lenders "must include the monthly housing expense and all other additional recurring charges ... including payments on installment accounts." HUD Handbook 4155.1 REV-5, ¶ 2-11(A). It is the Company's policy and practice to include all installment debts evidenced in the loan file in the calculation of a borrower's qualifying ratios. With regard to the child support wage garnishment in this case, had the underwriter been aware of this obligation prior to loan approval, it would have been included in the calculation of the borrower's ratios. The loan file documentation demonstrates, however, that this debt was not disclosed until the borrower was at the closing table. The borrower applied for the loan at issue on January 16, 2007 **(Exhibit Q-1)**. During the underwriting process, the borrower provided DRMC with four pay stubs covering the period from December 9, 2006 through January 5, 2007 **(Exhibit Q-2)**. None of these pay stubs reference the child support wage garnishment **(Exhibit Q-2)**. Thus, when the underwriter approved this loan for FHA financing on February 2, 2007, the Company was unaware of this obligation on the part of the borrower and, therefore, did not include it in the calculation of the borrower's ratios on the MCAW **(Exhibit Q-3)**.

Comment 42

At the closing on February 12, 2007 **(Exhibit F-2)**, the borrower submitted two additional pay stubs covering the pay period from January 20, 2007 to February 2, 2007 to demonstrate his continued employment **(Exhibit Q-4)**. Only these pay stubs reflect the wage garnishment referenced in the Report **(Exhibit Q-4)**. As the underwriter did not has possession of these pay stubs at the time of loan approval – in fact, one of these pay stubs was not even issued until February 9, 2007 **(Exhibit Q-4)**, four days after the underwriter signed the MCAW **(Exhibit Q-3)** – the underwriter could not have included this debt in the qualifying ratios in this case. DRMC therefore maintains that it complied with HUD guidelines in this case by including all known debts in the calculation of the borrower's qualifying ratios. In addition, even if the underwriter had knowledge of the wage garnishment at the time of loan approval, the borrower would nevertheless have qualified for FHA financing. Importantly, while the borrower's back-end ratio would have increased, the loan file demonstrated that the borrower had an excellent rental history for the past two years **(Exhibit F-4)**, which would have been a strong compensating factor to offset the higher ratio. For these reasons, we believe that administrative action would be inappropriate, and ask that this allegation be removed from the final report.

d. [redacted] - FHA Case No. 261-8996673

In this case, the Report asserts that the borrower's qualifying ratios did not include a $75 monthly payment on a previous rental account, and inclusion of this debt would have increased the borrower's back-end ratio from 42.29% to 44.45%.

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As discussed above, DRMC understands and appreciates that HUD guidelines state that lenders "must include the monthly housing expense and all other additional recurring charges ... including payments on installment accounts." HUD Handbook 4155.1 REV-5, ¶ 2-11(A). It is the Company's policy and practice to include all installment debts evidenced in the loan file in the calculation of a borrower's qualifying ratios. In this case, although documented in the loan file, the Company acknowledges that this debt was inadvertently omitted from the qualifying ratio calculation. This oversight was an isolated incident, and the Company has counseled its employees on the importance of documenting and including all borrower liabilities into the consideration of a borrower's qualification for FHA financing.

Nevertheless, any oversight in the [redacted]ase regarding the exclusion of the $75 monthly payment constituted, at worst, harmless error. As noted in the Report, inclusion of this debt would have increased the borrower's back-end ratio to 44.45%, which only slightly exceeds HUD's benchmark guideline of 43%. See HUD Handbook 4155.1 REV-5, ¶ 2-12; Mortgagee Letter 2005-16. Additionally, the loan file evidenced compensating factors that would have offset this slightly higher-than-average ratio. Specifically, as discussed above, the loan file documented an excellent twelve-month rental payment history **(Exhibit K-6)**. The loan file also demonstrated the borrower's stable employment history, as he had been in the same position for over six years prior to closing **(Exhibits R-1, R-2)**. Finally, upon filing for the homestead exemption, the borrower's taxes would decrease from the $159 used to calculate the borrower's qualifying ratios on the MCAW **(Exhibit R-3)**, and result in a final back-end ratio below HUD's 43% threshold. As evidenced by the attached public records, the property taxes did in fact decrease by $36.46 as a result of the homestead exemption **(Exhibit R-4)**. Based on these compensating factors, the borrower would have qualified for the FHA-insured loan if the underwriter had considered the additional $75 debt payment. Therefore, we believe that administrative action would be inappropriate, and ask that this allegation be removed from the final Report.

5. Borrower Assets

Finally, in one loan, [redacted] – **FHA Case No. 261-9177201**, the Report asserts that the loan file did not adequately document the source of the funds used to close the loan. Specifically, the Report alleges that the $15,401 in the borrower's checking account was not verified, even though the loan file contained a TurboTax printout evidencing that the borrower would receive a tax return of $10,243.

DRMC understands and appreciates that FHA lenders must verify large or excessive increases in account funds used to close the loan. See HUD Handbook 4155.1 REV-5, ¶ 2-10(B). It is the Company's policy and procedure to do so in each FHA loan it originates, and DRMC maintains that it did so in this case. As evidenced on

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the HUD-1 Settlement Statement, the borrowers needed $11,944.82 to close the loan on March 28, 2007 **(Exhibit G-2)**. To verify the borrower's assets, the Company obtained a Verification of Deposit ("VOD") and most recent bank statement **(Exhibit S-1)**. As acknowledged in the Report, the co-borrower's checking account, [redacted] reflected verified assets of $9,904 on February 27, 2007 **(Exhibit S-1)**, a month before closing **(Exhibit G-2)**. These assets, which were verified in compliance with HUD guidelines, constituted all but $2,040 of the funds needed to close this loan. In addition, the loan file contained a federal tax return summary, dated March 8, 2007, evidencing that the borrower's $10,183.15 tax refund would be directly deposited into the borrower's checking account [redacted] within 10 to 16 days **(Exhibit S-2)**. Contrary to the suggestion in the Report, this documentation constituted a "credible explanation of the source of funds" in the borrower's checking account as of closing on March 28, 2007, and HUD guidelines did not require the Company to obtain any additional information evidencing the deposit of these funds into the borrower's account. As of March 20, 2007, the borrower's checking account reflected a balance of $15,401 **(Exhibit S-3)**, which was properly verified with the loan file documentation. As of March 28, 2007, the borrower had sufficient funds to close this loan. For this reason, we maintain that administrative action in this case is unwarranted, and request that this finding be removed from the final report.

B. DRMC STRONGLY OPPOSES THE RECOMMENDATION THAT PFCRA PENALTIES ARE APPROPRIATE IN THIS CASE

1. DRMC Exercised Due Diligence in Underwriting the Loans at Issue

In addition to the underwriting deficiencies discussed above, the Report asserts that, in the ten loans at issue, the underwriter's certification on page 3 of the Addendum to the Uniform Residential Loan Application ("URLA"), Form HUD-92900-A ("Addendum") was incorrect, as the underwriter certified to using due diligence in underwriting these cases but did not do so. We understand that this allegation is predicated on the OIG's determination that these ten cases contained underwriting deficiencies. The Report alleges that these underlying oversights demonstrate that the underwriter did not exercise due diligence in examining the loan file and, as a result, the certification on the Addendum in these cases was incorrectly signed. The Report recommends in connection with these allegations that HUD's Associate General Counsel for Program Enforcement determine the legal sufficiency of and, if sufficient, pursue remedies under the PFCRA for the inaccurate certifications in these cases. As discussed in detail above, DRMC takes exception to the allegations that these loans contained underlying origination deficiencies, as well as the inflammatory recommendation to impose PFCRA penalties made in connection with this finding.

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HUD is authorized to impose civil penalties under PFCRA against persons who "make, submit, or present, or cause to be made, submitted, or presented, false, fictitious, or fraudulent claims or written statements to Federal authorities or to their agents." 24 C.F.R. § 28.1. The Report suggests that, because the OIG identified underwriting deficiencies in these ten cases, the underwriters' certifications that due diligence was used in underwriting these loans are inaccurate. As demonstrated in the above discussion, however, in the ten cases cited, DRMC substantially complied with HUD requirements and the underwriter made a reasonable decision to approve the loan after exercising due diligence in examining each of the files at issue. For these reasons, DRMC disagrees with the recommendation of any penalty in connection with these loans, let alone the harsh sanction of PFCRA penalties recommended in the Report.

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Additionally, the Report does not allege, and there is no evidence to suggest, that DRMC or its employees intended to circumvent HUD underwriting guidelines in these cases. Rather, the certifications in these ten cases were executed by the underwriters after diligent review of the loan files in which these individuals made every effort to comply with FHA requirements. The certifications in these cases were executed in the belief that the borrowers qualified for FHA financing, which in fact they did in each case, rather than in an attempt to mislead the Department. The Report does not allege that DRMC or its underwriters knowingly misrepresented facts to the Department or intentionally provided false information in the cases at issue. Before imposing penalties on FHA-approved lenders, HUD weighs a number of factors. While intentional violations or a disregard for HUD requirements can lead to severe sanction, such as PFCRA penalties, HUD traditionally imposes less severe consequences for deficiencies caused by unintentional error. Additionally, DRMC maintains that the borrowers in the cited cases qualified for FHA financing. At worst, certain of these loans contained minor errors that did not affect the insurability of the loans. As indicated above, DRMC believes that the final report should omit recommendations of administrative action in connection with these cases, making the recommendation of PFCRA penalties all the more severe under these circumstances.

We also note that, rather than cite new allegations, the PFCRA recommendation appears to be an attempt to pile on the allegations made against DRMC's underwriting practices in this Report. Typically, OIG audit reports allege certain deficiencies in a company's FHA operations, and the company is given an opportunity to address the materiality and accuracy of the allegations. By also adding an incorrect certification allegation to these underwriting assertions, the OIG has created a situation where every misunderstanding of FHA requirements or oversight of a detail or document in a FHA loan could give rise to allegations of a false certification claim. Considering the sensationalizing of the "Operation Watchdog" probe, and the devastating effects this

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matter has and will continue to have on the targeted lenders, such actions will create a chilling effect on lenders who want to participate in the FHA Program. Enforcement actions are meant to reinforce HUD's rules and regulations, rather than discourage broad participation in FHA lending. For the sake of the Program, therefore, we believe the OIG should reconsider its approach to alleging false certifications and focus on the compliance with FHA rules and regulations.

2. The PFCRA Allegations Constitute a Recommendation to HUD, Rather than a Final Action By the Department

As noted above, the Report merely recommends that the Department determine the legal sufficiency of pursuing PFCRA remedies in the cited cases. Upon receiving the final report, the Department will have an opportunity to independently examine the review findings and make an independent determination of whether such penalties are appropriate in these ten cases. As discussed at length earlier in this response, DRMC disagrees that the Report's assertions warrant administrative action or PFCRA remedies. HUD may also disagree with the Report's assertions and decide not to pursue PFCRA penalties in this instance.

In addition, while the review process is still ongoing at the time the OIG issues its "final" report, the Report and the OIG's recommendations typically are made public on the OIG website. As a result, a lender's investors and peers are able to access the preliminary recommendations of the OIG before a final assessment as to their merit can be made by the Department. These entities often misinterpret the OIG's recommendations to be final actions by the Department. Under these circumstances, making these preliminary recommendations public and including inflammatory allegation that HUD pursue PFCRA remedies with the suggestion that the loans identified involve misrepresentations will have a material, adverse effect on the Company's business. This would be especially detrimental in this circumstance, as the public nature of the "Operation Watchdog" probe has already resulted in the loss of investors and customers to the point where DRMC has been forced to cease loan originations and wind down its operations.

If the OIG's goal is to present the reader with a full and accurate disclosure of this review and its implications to the Company, the Report should include the following disclosure on the first page in bold, capitalized lettering:

THE REPORT FINDINGS REFLECT THE VIEWS OF THE OFFICE OF INSPECTOR GENERAL AND DO NOT CONSTITUTE A FINAL DETERMINATION OF THE MATTERS RAISED HEREIN BY THE U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT. THE FINAL DETERMINATION IN THIS MATTER WILL BE MADE BY THE REPORT'S ADDRESSEE, THE HUD ASSISTANT SECRETARY FOR

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HOUSING – FEDERAL HOUSING COMMISSIONER, WHO WILL ULTIMATELY DECIDE WHETHER TO ACCEPT THE REPORT'S RECOMMENDATIONS IN WHOLE OR IN PART OR REJECT THEM.

Such a disclosure would more accurately convey the status of the OIG's "final" report to the Company's investors, customers, and the public.

III. CONCLUSION

DRMC takes the matters raised in the draft Report seriously. Because FHA lending has comprised a significant portion of DRMC's overall business operations throughout its existence, the Company is committed to educating and training its employees on issues regarding FHA compliance and to assuring their adherence to HUD's rules and regulations. Although the publication of the Department's scrutiny of the Company in the press release announcing the "Operation Watchdog" probe has effectively put the Company out of business, DRMC nevertheless has conducted a thorough review of the issues identified in the Report. As discussed above, DRMC's review indicated that the Report's findings are at variance with the facts, do not constitute violations of HUD/FHA requirements on the part of DRMC, or do not affect the underlying loans' insurability. The Company substantially complied with FHA underwriting requirements in several of the loans identified in the Report and made loans to qualified FHA borrowers. Accordingly, we respectfully request that the OIG revise the allegations cited in the Report based on the information and documentation provided in this response and remove allegations for which DRMC has demonstrated its compliance with HUD requirements.

Finally, DRMC believes that the recommendations involving PFCRA penalties are unwarranted, as they suggest an intent to circumvent HUD requirements when the OIG knows full well that no such intention existed in these cases. DRMC values its relationship with the Department and did not, in any manner, seek to misrepresent any information to HUD. DRMC believes that the various remedies available to HUD, short of the severe sanctions under PFCRA, are commensurate to resolve any deficiency identified in the Report. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate that including these recommendations in the Report is unnecessary, inappropriate, and will further damage DRMC's reputation, which has already suffered as a result of the public nature of the "Operation Watchdog" probe. We respectfully request that the OIG revise its recommendations to fit the facts of this case.

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

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Thank you for your kind consideration.

Sincerely,

David Glass
President

cc: Heath Wolfe, Regional Inspector General for Audit, Region V
Phillip L. Schulman, Esq., K&L Gates LLP

OIG's Evaluation of Lender Comments

Comment 1 D & R did not provide any documentation to support its statement that HUD reviewed loan number 483-3712823. However, whether or not HUD reviewed this loan would not negate the underwriting deficiencies cited for this loan. For loan numbers 483-3758135 and 261-9205529, D & R did not provide the response it provided to HUD and documentation to support that the loans were in compliance with HUD's requirements at the time the loans closed. Further, the results of our review were based upon our independent analysis of the underwriting based on documentation contained in the loan files reviewed.

Comment 2 See comment 1.

Comment 3 We disagree with D & R. For loan number 483-3758135, the borrower's fixed payment to income ratio exceeded HUD's requirements by 4.4 percent. The mortgage credit analysis worksheet in the borrower's loan file did not contain any compensating factors in the remarks section to justify loan approval as required by HUD Handbook 4155.1, REV 5, paragraph 2-13. Further, D & R's assertion that the borrower's strong job stability is a sufficient compensating factor to justify loan approval is not appropriate. Despite adequate income to meet financial obligations and no current housing expense, the borrower's credit report demonstrated he had difficulty meeting his financial obligations. Specifically, the borrower had incurred 5 new collection accounts within 12 months before the loan closed.

The borrower's bank statement dated less than three months before the loan closed identified that the borrower had incurred more than $100 in non-sufficient funds charges. Further, the borrower also indicated in his written explanation that he incurred the collection accounts because he between jobs pursuing a different field of work. This statement contradicts D & R's statement about the borrower's job stability. Therefore, the documents in the file indicated that the borrower already had difficulty meeting his financial obligations at his current wage rate with no housing expense. Thus, the addition of the borrower's mortgage payment increased his fixed monthly payments from $697 to $1,730, which represented an increase of 148 percent.

Comment 4 We disagree with D & R. For loan number 261-9065826, although the underwriter provided compensating factors in the remarks section of the mortgage credit analysis worksheet to justify the borrower's 35.88 percent mortgage payment to income ratio, the compensating factors were not adequately supported by documentation in the borrower's loan file. The borrower's monthly rental amount reflected on the loan application and mortgage credit analysis worksheet was $533. This amount was supported by money order receipts included in the borrower's loan file. Therefore, the borrower's mortgage obligation would result in a $248 increase in the borrower's monthly expenses, which represents a 46.5 percent increase. HUD requires that the borrower demonstrates the ability to pay

housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12 to 24 months, or a minimal increase in the borrower's housing expense.

Further, the borrower's loan file contained a cancelled check for $2,567, dated February 10, 2006, made payable to the landlord, not the City of Detroit. However, there was no documentation in the borrower's loan file to indicate that the landlord used this check or the funds to pay the property taxes. Further, the property tax information sheet contained in the loan file indicated that the property taxes totaled $2,046 and were paid on July 1, 2005, and the next tax payment was due on July 1, 2006. This loan closed on May 15, 2006. Additionally, the amount of the landlord's property taxes did not reconcile with the amount of the borrower's check to the landlord. HUD's Handbook 4155.1 REV 5, paragraph 2-13, states that any compensating factor used to justify mortgage approval must be supported by documentation. Therefore, using the payment of $2,567 to the landlord as one of the compensating factors was not supported.

Comment 5 According to the HUD-1 settlement statement, dated May 15, 2006, in the borrower's loan file, the escrowed amount for the property taxes was $2,046. Public records showed that the property's taxes were reduced during the summer of 2007 due to a homestead tax reduction. Therefore, the borrower would have received the property tax reduction the following year, not during the first year of the mortgage. The borrower defaulted on her mortgage and the home went into foreclosure within the first 12 months of the loan; thus, she did not benefit from the homestead property tax reduction. Therefore, the homestead property tax reduction would not be appropriate to use as a compensating factor since it did not decrease the borrower's housing obligation.

The borrower's monthly rental amount reflected on the loan application and mortgage credit analysis worksheet was $533. This amount was supported by money order receipts included in the borrower's loan file. Therefore, the borrower's housing obligations increased by $248; thus, representing a 46.5 percent increase. Further, the borrower's loan file contained a cancelled check for $2,567, dated February 10, 2006, made payable to the landlord, not the City of Detroit. However, there was no documentation in the loan file to indicate that the landlord used this check to pay the property taxes. Therefore, listing on the mortgage credit analysis worksheet that the borrower's property tax payment would result in the borrower's current housing payment being only $34 less than the proposed mortgage amount was not adequately supported.

Comment 6 Although the borrower worked two jobs, the borrower's bank statements and credit report disclosed the borrower had difficulty managing her financial obligations. For instance, the bank statement, dated January 18, 2006, showed that the borrower had a number of insufficient funds charges and returned checks from November 29, 2005, through January 18, 2006. Further, the borrower's

credit report identified a number of prior and recent collection accounts due to unpaid charges as a result of returned checks. HUD Handbook 4155.1, REV-5, paragraph 2-3, states that if the borrower's credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be needed to approve the loan.

Comment 7 See comment 1.

Comment 8 For loan number 251-9205529, the mortgage credit analysis worksheet in the borrower's loan filed did not contain compensating factors notated in the remarks section to justify loan approval in accordance with HUD Handbook 4155.1, REV-5, paragraph 2-13. Further, D & R's assertions the file documented the borrower's stable rental history and his job stability as compensating factors to justify loan approval is not correct. The borrower's current housing expense of $1,700 was not adequately supported. Specifically, D & R did not provide documentation to support that the borrower made 12 to 24 months of rental payments of $1,700. The borrower's loan file contained four copies of cancelled checks of $550 to cover the five month period from June to October 2006 (the check for the month of September was not included in the borrower's loan file) for one residence. Another five cancelled checks of $1,700 to cover the period of November 2006 through March 2007 for another rental residence was in the loan file. The nine cancelled checks represented only nine months of rental payments, instead of the 12 months in accordance with HUD Handbook, 4155.1, REV-5, paragraph 2-3(a). Further, the loan file did not contain a written verification of rent form from the borrower's landlords. Therefore, the D & R did not support the borrower's ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12 to 24 months to use the borrower's rental history as a significant compensating factor.

Further, job stability as a compensating factor to justify loan approval is not appropriate considering the borrower's credit history. Although the borrower's current housing expense was $1,700 and the proposed mortgage was $1,939 (a 14 percent increase), the borrower filed for Chapter 7 bankruptcy, which was discharged less than 2 years before obtaining the loan. However, the borrower did not demonstrate a documented ability to manage his financial affairs in a responsible manner, and D & R did not document that the borrower's current situation indicated that the events that led to the bankruptcy were not likely to recur as required by HUD Handbook 4155.1, REV-5, paragraph 2-3E. Therefore, even though the borrower had stable employment; he did not demonstrate the ability to manage his financial obligations.

Comment 9 According to HUD's requirements, underwriters must exercise due diligence when considering borrowers for mortgage approval. Specifically, a direct endorsement mortgagee shall exercise the same level of care which it would exercise in obtaining and verifying information for a loan in which the mortgagee

would be entirely dependent on the property as security to protect its investment. Further, according to HUD Handbook 4155.1, REV-5, Section 5, underwriting requires careful analysis of the many aspects of the mortgage. Each loan is a separate and unique transaction, and there may be other factors that demonstrate the borrower's ability and willingness to make timely mortgage payments. The lender is responsible for adequately analyzing the probability that the borrower will be able to repay the mortgage obligation in accordance with the terms of the loan. Although HUD allows for judgment, it specifically outlines the danger of layering flexibilities in assessing mortgage insurance risk, simply establishing that a loan transaction meets minimal standards does not necessarily constitute prudent underwriting.

D& R did not document its analysis as to whether the borrower's late payments were based on a disregard for financial obligations, the inability to manage debts, or factors beyond the control of the borrower, including delayed mail deliveries or disputes with creditors as required by HUD Handbook 4155.1, REV-5, paragraph 2-3. Therefore, we could not determine whether D & R properly analyzed the borrowers' overall pattern of credit behavior. Our assessment of the borrower's credit was based on the credit information documented in the loan files, in conjunction with other supporting documentation.

Comment 10 For loan number 262-1650023, the borrower filed for Chapter 7 bankruptcy, which was discharged more than 2 years before obtaining the loan. However, the borrower did not demonstrate a documented ability to manage his financial affairs in a responsible manner, and reestablish good credit or chose not to incur new credit obligations as required by HUD Handbook 4155.1, REV-5, paragraph 2-3E. Specifically, the borrower had recent derogatory accounts on his credit report, including two revolving accounts that were over the borrower's spending limit and three accounts with recent late payments. Further, the borrower did not provide explanations for all the derogatory accounts, including collections, identified on his credit report. The borrower only explained the two derogatory revolving accounts; however, in his written explanation for the late payments, the borrower stated that he sent his payments in late but he did not think that the late payments would affect his credit.

Further, one of the borrower's collection accounts was opened in 2006. However, the bankruptcy document in the borrower's loan file did not list this collection or its original credit account as one of the creditors. Therefore, we concluded that this collection account was not included in the borrower's Chapter 7 bankruptcy filing. The borrower's income documents indicated that the borrower was earning adequate income to meet his financial obligations as they come due. We acknowledge that the borrower's residential mortgage credit report identified that the borrower had no late rental payments. However, the borrower's stated rent was $590 and his proposed mortgage would be $1,259, a 113 percent increase. Therefore, although the borrower paid his rental obligations in a timely manner,

his credit report indicated he had difficulties meeting other financial obligations, as previously mentioned.

Comment 11 For loan number 261-9177201, although the borrower's judgments were satisfied, he did not explain the judgments in writing as required by HUD Handbook 4155.1, REV-5, paragraph 2-3C. In the borrower's written explanations he contends that his credit problems did not start until 2003. However, his credit report identified two judgments that were incurred in 2001 and 2002. Therefore, the borrower's explanation was not consistent with other documentation in the loan file. Further, the borrower had two recent collection accounts for telephone carriers and one medical collection.

Comment 12 Although the borrower's written explanation letter in the loan file stated that the borrower incurred financial hardships in 2003, as previously mentioned, the judgments occurred in 2001 and 2002. In addition, the borrower's credit report identified a collection account that opened in 2003, a number of charge-off accounts in 2000 and 2001, and a number of accounts with late payments from 2000 to 2003. All of these derogatory accounts were incurred before the borrower's documented financial hardship. In 2005, the borrower's credit report showed collection accounts opened in 2005 and 2006, and recent late payment on two accounts within the past six months of the loan's closing. However, the borrower's income as reflected on his 2005 and 2006 W-2's exceeded $190,000 collectively. Therefore, the borrower's credit deficiencies occurred from 2000 to 2007. This loan closed in March 2007.

Comment 13 Our discussion draft report did not assert that the borrower's medical collection account did not relate to the borrower's past medical issues. Rather, it stated that the borrower had three collection accounts, one of which was for medical. However, we clarified in our report to show that the borrower's statement regarding his refusal to pay on principle actually referred to one of the two non-medical collection accounts. The report's mention of the borrower's credit, in particular the borrower's collection accounts, excluding the one medical collection; and recent late payments on his revolving accounts showed that the borrower neglected to meet his financial obligations. Although the borrower provided written explanations for four of the derogatory items on his credit, the borrower did not explain the reasons for recent late payments on two revolving accounts and two past judgments.

Comment 14 We agree that the documentation in the borrower's file showed that the borrower paid his rental obligations when due. However, the borrower had a prior mortgage that showed he was 30-days late 21 times, 60-days late 6 times, and 90-days delinquent 1 time. According to the borrower, the home was sold in October 2005. According to the mortgage credit analysis worksheet in the borrower's loan file, the borrower's rental expense was $1,038 and the proposed mortgage payment was $1,902, which would be an increase of 83 percent. Although the borrower had enough income to satisfactorily make the mortgage payments, his

credit report identified a number of collections, judgments, and recently delinquent revolving accounts in which the borrower did not sufficiently explain as required by HUD Handbook 4155.1, REV-5, paragraph 2-3C (see comments 11, 12 and 13).

Comment 15 See comments 1 and 9.

Comment 16 For loan number 483-3758135, the borrower's written explanations were not consistent with other documentation in the borrower's loan file. For instance, the borrower stated that he incurred medical collections due to being self-employed with no health insurance at the time the medical bills were incurred. However, the documentation in the borrower's loan file showed that the borrower had been working at his current place of employment since March 2002, whereas according to the borrower's credit report, his medical collection accounts were opened from 2002 through 2006.

Further, the borrower stated that he filed for bankruptcy because he cosigned for three car loans at the same time for friends. However, his friends did not make the car payments. The borrower's credit report only identified that one of the borrower's three car loans were included in the borrower's bankruptcy filing. Additionally, for this one car loan, the credit report showed that the borrower was the primary owner. The second car loan was not included in the borrower's bankruptcy filing; however, the borrower was listed as the sole owner. This car loan identified a number of late payments. The remaining car loan identified the borrower as a joint owner and this account was not derogatory. Further, the borrower's credit report identified a recently obtained "recreation loan" four months prior to closing on the mortgage that was over the credit limit. Even though the borrower's credit report indicated that he only opened two credit accounts since his bankruptcy, the recreational and automobile loans, the borrower's combined balance for these accounts exceeded $20,000 as of the date of the credit report. Therefore, he did not choose to incur new obligations or re-established good credit as required by HUD Handbook 4155.1, REV-5, paragraph 2-3E.

Comment 17 For loan number 261-9065826, the borrower's credit report identified 15 accounts. Of the 15 accounts, 13 were collections or charged-off accounts and were opened from August 2001 through October 2005. Seven of the 13 derogatory accounts were paid in full or settled for less than the original balance. The borrower provided written explanations for the derogatory accounts identified on her credit report. However, the explanations were not consistent with the credit information contained in the borrower's loan file. For instance, according to the borrower's explanation letter, her collection and delinquent accounts were incurred because in 2004 she was a victim of identity theft.

The borrower's loan file contained a copy of a police report, dated February 16, 2006, five days before she applied for the mortgage. According to the police

report, the borrower reported that the identity theft happened between January 1, 1992, and February 16, 2006. Further, the borrower indicated on the police report that she notified the bank regarding the fraudulent charges and had received a refund. However, as of February 22, 2006, the borrower's credit report disclosed that the collection accounts that the borrower identified as being related to the identity theft still remained as unpaid collections. According to HUD's Handbook 4155.1 REV 5, paragraph 2-3, the borrower's explanation must make sense and be consistent with other credit information in the file.

Comment 18 We acknowledge that D & R's underwriter required the borrower to pay off outstanding items reflected on her credit report before the loan closed. The collection agency provided information to our office indicating that the credit card the borrower used to pay off one of her collection accounts belonged to the landlord (the seller). According to D & R, the credit card used to pay the borrower's collection belonged to her mother. However, it did not provide additional information supporting that the credit card belonged to the borrower's mother. According to HUD Handbook 4155.1, REV 5, paragraph 2-10C, the payment of consumer debt by third parties is an inducement to purchase. When someone other than a family member has paid off debts, the funds used to pay off the debt must be treated as an inducement purchase and the sales price must be reduced by a dollar-for-dollar amount in calculating the maximum insurable mortgage.

Comment 19 As indicated in the discussion draft memorandum report, the loan file contained two credit references that were not provided directly by the creditors. The fax number contained on the credit references was the same as the borrower's sales contract. According HUD Handbook 4155.1, REV-5, paragraph 3-1, lenders may not accept or use documents relating to the credit, employment, or income of borrowers that are handled by or transmitted from or through interest third parties, or by using their equipment. Further, one of the two credit reference letters indicated that the borrower was not the account holder, but was paying on the account. However, when we contacted the creditor, we were informed that the company would not know who made the monthly payments. Further, according to HUD Handbook 4155.1 REV 5, paragraph 2-3, for those borrowers who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider. However, the borrower used traditional credit as evidenced by her credit report. Therefore, the use of alternative credit references to support the approval for this loan was not appropriate.

D & R contends that the borrower provided an additional credit reference from Z Tel Company and the borrower's landlord evidencing the borrower had an excellent payment history. We disagree with D & R. The borrower's loan file contained a credit reference letter from Z Tel Company and her current landlord, which was the seller. HUD Handbook 4155.1, REV-5, paragraph 2-3, states the

lender must determine the borrower's payment history of housing obligations through either the credit report or a verification of rent directly from the landlord (with no identify-of-interest with the borrower). The borrower's two credit reference letters were more than three years old from the date of the borrower's loan application. According to HUD Handbook 4155.1, REV-5, paragraph 3-1, all documents may be up to 120 days old at the time the loan closed, unless this or other applicable HUD instructions specify a different time frames or the nature of the documents is such that its validity for underwriting purpose is not affected by being older than the number of prescribed days. Additionally, the letter from Z Tel Company did not contain a payment history.

Comment 20 See comments 5, 6, 17, 18, and 19.

Comment 21 See comment 1.

Comment 22 For loan number 261-9205529, according to the borrower's bankruptcy petition in the loan file, the borrower's bankruptcy was discharged in February 2006 and the mortgage loan closed on June 1, 2007; which means less than 2 years had elapsed. According to the borrower's written explanations, he petitioned for bankruptcy in September 2005 due to medical bills totaling nearly $100,000 from being injured in a car accident, but he did not state when the accident occurred. The borrower's explanations stated that as a result of his medical bills, he was unable to meet his other financial obligations. However, the borrower's statement was not consistent with other information from the loan file. Specifically, a copy of the borrower's filed bankruptcy petition and discharge in the loan file included debts and collections dating back to 1994 and only approximately $20,000 of the $60,000 total was for medical bills.

HUD Handbook 4155.1, REV-5, paragraph 2-3E, states that after a Chapter 7 bankruptcy/ liquidation, an elapsed period of less than two years, but not less than 12 months may be acceptable if the borrower can show that the bankruptcy was caused by extenuating circumstances beyond his control and has since exhibited a documented ability to manage his financial affairs in a responsible manner. Since the borrower's explanation letter did not indicate when the borrower's car accident occurred and the range of the borrower debts included items from 1994 through 2005, the borrower did not show he filed for bankruptcy due to extenuating circumstances. Further, after the borrower's bankruptcy was discharged, the borrower had two recently opened revolving accounts with no late payments; however, his credit report also identified that he had one recent 60 day late payment on an installment account. The borrower's bank transaction inquiry document identified that the borrower incurred $330 of insufficient funds charges during February and March 2007 collectively.

Comment 23 See comment 8.

Comment 24 For loan number 261-8996673, the borrower provided explanations for collection accounts that were not adequately supported and consistent with the information contained in the borrower's loan file. For instance, the borrower stated that the Sprint cellular telephone account belonged to his former spouse. However, the borrower's credit report indicated that he was the sole owner of the account. Further, D & R conditioned on the borrower's loan submission documents that the borrower must satisfy his previous unpaid rental obligation that was listed on his credit report and D & R wrote on the credit report that the rental collection account was paid off. The borrower explained that he was going to make one lump sum payment of $1,037 as soon as possible and monthly installment payments of $75 until the collection was satisfied. According to a letter of agreement between the creditor and the borrower, the borrower agreed to pay one lump sum payment of $ 1,037 by September 30, 2005, and $75 per month thereafter until the collection for the borrower's prior housing obligation was satisfied.

However, at the time loan closed on December 6, 2005, there was no supporting documentation in the borrower's loan file to show that the borrower made any payments to his creditor as agreed. When we contacted the collection agency, we were informed that the borrower never made any payments. HUD Handbook 4155.1, REV-5, paragraph 2-3(c), 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 credit worthiness with the lender documenting its reason for approving a mortgage where the borrower has collection accounts or judgments. However, D & R did not provide documentation of its analysis.

Comment 25 The borrower's credit report identified a recently delinquent Capital One credit card account which the borrower explained that he did not pay timely because he did not always receive a monthly bill. The borrower's credit report disclosed the borrower was 90 days late three times, 30 days late three times, and 60 days late once, within three months before the loan closed. According to HUD's requirements, when delinquent accounts are revealed, the lender must document its analysis as to whether the borrower's late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including delayed mail delivery or dispute with creditors. D & R's analysis was not included in the borrower's loan file.

Comment 26 As indicated in our discussion draft memorandum report, the borrower's loan file contained statements from his cable provider as an additional credit reference. However, D & R's underwriter notated on the underwriting worksheet contained in the borrower's loan file that the credit reference was not good because the borrower did not make timely payments. Consequently, the underwriter required the borrower to provide a different credit reference.

The borrower provided two additional credit references, one from an art gallery and another from a party company. These credit references were not installments or revolving accounts, and were not provided directly by the creditors. Further, the borrower used traditional credit as evidenced by his credit report. Therefore, the use of alternative credit references to support the approval for this loan was not appropriate. Further, HUD Handbook 4155.1, REV 5, paragraph 2-3, states for those borrowers who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider. The handbook also states that the basic hierarchy of credit evaluation is the manner of payments made on previous housing expenses, including utilities, followed by the payment history of installment debts and then revolving accounts.

Comment 27 The borrower is required to provide evidence of his rental payment history for the past 12-24 months. However, the borrower's loan file contained seven money order receipts that did not disclose the name of the person who purchased the money orders. HUD requires the lender to obtain and verify the borrower's payment history of rent directly from the landlord, or verification of mortgage directly from the mortgage servicer, or through cancelled checks covering the most recent 12-month period. The borrower's loan file contained a verification of rent for his current residence. However, the borrower's landlord did not identify whether the borrower had any late payments for the past 12 months. The form specifically requires the landlord to indicate the borrower's payment history for the previous 12 months in order to comply with secondary mortgage market requirements.

Comment 28 See comments 24, 25, and 26.

Comment 29 In reviewing the documentation provided by D & R for loan number 261-9111473, we agree that the borrowers provided a check payable to the collection agency for the medical judgment. We adjusted our memorandum report as appropriate. However, this loan remained in the report due to other material underwriting deficiencies.

Comment 30 We acknowledge that the coborrower satisfied many of his outstanding financial obligations before the loan closed. However, we disagree with D & R's statements that the coborrower's debts were incurred by others. The coborrower provided written explanations for the derogatory accounts listed on his credit report. However, his explanations were not adequately supported and consistent with other information in the loan file. For instance, the coborrower had a number of delinquent and collection accounts, some with recent late payments. However, according the coborrower's written explanations contained in the loan file, his son or former wife was responsible for making the payments. However, the coborrower's credit report indicated that he was the sole owner of the derogatory accounts. Therefore, he was responsible for paying his recurring financial obligations in a timely manner.

Comment 31 Despite the coborrower's stable employment and high income, his credit report identified he had a number of slow payments and collection accounts as previously mentioned in comment 30. According to HUD Handbook 4155.1, REV 5, paragraph 2-3, if the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, or delinquent accounts, strong compensating factors will be necessary to approve the loan. The mortgage credit analysis worksheet in the borrowers' loan file did not identify compensating factors used to justify approving the loan. Although the borrower sufficiently explained her credit deficiencies, the coborrower's whose income was a significant factor in approving the loan credit demonstrated a disregard for financial obligations. Without the coborrower being included on the mortgage, the borrowers' mortgage payment-to-income ratio would have been approximately 51 percent, which exceeded HUD's benchmark by approximately 20 percent, and their total fixed payment-to-income ratio would have been approximately 58 percent; thus exceeding HUD's benchmark by 25 percent.

Comment 32 See comment 1.

Comment 33 We partially agree with D & R's calculation of the borrower's income for loan number 483-3712823. However, since the borrower's verification of employment form did not identify the amount of the borrower's pay increase effective April 2007, we did not include the pay increase in our calculations. Therefore, using the borrower's average overtime income of $203.66, the borrower's mortgage payment-to-income and fixed payment-to-income ratios would be 35 and 45 percent, respectively. Thus, the ratios exceeded HUD's benchmark by approximately 4 and 2 percent, respectively. The mortgage credit analysis worksheet in the borrower's loan file identified that the borrower's qualifying ratios as 33.69 and 43.22 percent, respectively. However, it did not contain compensating factors.

Comment 34 Although loan number 483-3695773 contained underwriting deficiencies that D & R was unable to resolve, we agree to remove this loan from the audit memorandum report since the unresolved issues presented no material underwriting deficiencies based on the documentation provided.

Comment 35 For loan number 261-9065622, our draft memorandum report did not address whether the signatures contained on the borrower's verification of employment form were questionable or dispute the borrower's current place of employment. However, it did mention that the borrower's current employer completed the borrower's verification of employment form as the current and previous employer even though the borrower was previously employed for another company. As stated on the borrower's verbal employment verification form signed by D & R's loan processor, the borrower's previous place of employment was no longer in business. However, D & R contends that it verified the previous employment through the borrower's credit report. When we contacted the independent consumer credit reporting agency, we were informed that if the agency verified

the borrower's employment information it would be notated on the borrower's credit report. However, the borrower's credit report only disclosed the borrower's employment information without any notation that the credit report agency verified the borrower's employment.

According to HUD Handbook 4155.1, REV-4, paragraph 2-A, a credit report obtained from an independent consumer-reporting agency, the residential mortgage credit report must access at least two named repositories and meet all the requirements for the traditional residential mortgage credit report plus (a) provide a detailed account of the borrower's employment history; and (b) verify the borrower's current employment and income. It also must include a statement attesting to certification of employment and date verified.

Comment 36 D & R acknowledges that four of the borrower's pay stubs for the beginning of 2006 reflected a pay period, year-to-date earnings, and taxes withheld for a December 2005 time period. It also acknowledges that the underwriter's resolution of this discrepancy should have been documented in the borrower's loan file. However, it contends that the underwriter obtained sufficient documentation prior to closing to resolve any concerns regarding the discrepancy. We disagree. The borrower's loan file contained two additional pay stubs for February 2006, which reflected the borrower's current cumulative earnings and taxes withheld. However, these two paystubs contained year-to-date earnings that were not accurate. For instance, the borrower's weekly income was $950; however, for the paychecks ending February 12 and February 19, 2006, his cumulative year-to-date earnings were $6,650, and $7,600 respectively, which was $950 more than the amount that should have been reflected on the borrower's paystubs. Further, the borrower's verification of employment form indicated he did not work overtime or receive bonus or commission income. The borrower's paystubs and W-2's also appeared to be computer generated documents.

Comment 37 See comment 1.

Comment 38 As mentioned in our discussion draft memorandum report for loan number 483-3712823, the borrower's debt of $109 per month should have been included in the determination of the borrower's qualifying ratios even though the borrower only had nine payments remaining on the account. According to HUD Handbook 4155.1, REV-5, paragraph 2-11A, debts lasting less than 10 months must be counted if the amount of the debts affects the borrower's ability to make the mortgage payments during the months immediately after loan closing, especially if the borrower will have limited or no cash assets after the loan closing. The borrower's loan file did not contain evidence that the borrower would have cash assets after closing the loan. Therefore, the inclusion of this liability in the calculation of the borrower's qualifying ratio would have resulted in the borrower's fixed payment-to-income ratio being nearly 49 percent; thus exceeding HUD's benchmark by 6 percent.

Further, the mortgage credit analysis worksheet in the borrower's loan file identified job stability as a compensating factor for approving this loan. D & R contends that the borrower's job stability of more than six years with his current employer would have offset the effect of the excluded monthly liability. We disagree. Although the borrower was employed with his current employer for approximately three and a half years, instead of six, job stability is not an appropriate compensating factor. The borrower's employment does not compensate for the ability to manage increasing financial obligations, since the borrower would be receiving the same rate of pay. Further, the mortgage credit analysis worksheet in the borrower's file disclosed that the amount of the borrower his cash reserves were determined to be $281.20. Moreover, the borrower's mortgage payment of $1,018 would result in a 28 percent increase in his housing expense.

Comment 39 We disagree with D & R. The borrower made 10 payments until the first 90-day default was reported by the mortgage servicer. However, the borrower had been delinquent in making his mortgage payments every month starting with his first mortgage payment.

Comment 40 See comment 34.

Comment 41 For loan number 262-1650023**,** the borrower's loan file contained documentation that the borrower was obligated to pay child support. Specifically, section VIII of the borrower's initial and final loan applications disclosed that the borrower was obligated to pay alimony, child support, or separate maintenance. Further, the borrower's statement of earnings, dated December 8, 2006, identified a wage garnishment of $95.80 for child support. The borrower's loan file also contained a petition for bankruptcy document, dated December 2002, that disclosed the borrower paid child support of $409.50 per month since 1993. Further, the ages of the borrower's dependent children indicated that the borrower's child support obligation would have continued after the loan closed.

Comment 42 We disagree with D & R. The inclusion of the borrower's child support obligation would have resulted in the borrower's mortgage payment-to-income ratio being 37 percent and the fixed payment-to income ratio being 49 percent; thus, exceeding HUD's benchmark of 31 and 43 percent, respectively. D & R did not notate any compensating in the remarks section of the mortgage credit analysis worksheet. However, D & R contends that the borrower's past two years of verified rental payments of $590 per month was a strong compensating factor to justify approving the loan. As previously mentioned in comment 10, the borrower' proposed mortgage expense of $1,259 would be a 113.39 percent increase from his current monthly housing obligation of $590. Further, the borrower's credit report indicated that the borrower had difficulty meeting his other financial obligations even though his current rental payment was less than half of the proposed mortgage.

Comment 43 D & R acknowledged that the borrower's installment debt of $75 was inadvertently omitted from the qualifying ratio calculation for loan number 261-8996673. As stated in our discussion draft memorandum report, if D & R's underwriter had included the $75 installment debt in calculating the borrower's fixed payment-to income ratio, the ratio would have been 44.5 percent; thus exceeding HUD's benchmark by 1.5 percent without documentation of compensating factors in the borrower's loan file or on the mortgage credit analysis worksheet.

D & R contends that the borrower's slightly higher than average ratio would have been offset by the borrower's excellent 12-month rental payment history, stable employment, and the eligibility for a homestead tax exemption. We agree that the borrower's loan file contained a verification of rent form, which indicated that he paid his rent in a timely manner. However, the borrower's credit report disclosed a prior collection account derived from a previous delinquent rental obligation that was still outstanding at time the loan closed. The borrower's report also identified a collection account from a telephone carrier and a revolving account with three 30-day, one 60-day, and three 90-day late payments. Three of these delinquencies occurred within six months of the loan closing.

The borrower's credit report disclosed he had difficulty meeting his financial obligations at his current employment pay rate. Further, the borrower's proposed mortgage expense increased the borrower's monthly housing obligation from $675 to $844, a 25 percent increase. Therefore, using the borrower's employment as a compensating factor would not adequately justify approval for the loan.

Further, the loan closed on December 6, 2005, and according to public records the property's 2006 property winter tax (county tax) was due in December 2006 and the summer 2007 tax (city tax) was due in August 2007. The property taxes are due annually. However, since the borrower defaulted on the loan within the first 12-months of the mortgage, the borrower did not benefit from the homestead property tax reduction, which was reduced during the second year of the mortgage. Therefore, using the homestead property tax reduction as a compensating factor would not be appropriate since it did not decrease the borrower's housing obligation.

Comment 44 For loan number 261-9177201, the mortgage credit analysis worksheet in the borrower's loan file indicated that the borrower needed $13,898 to close. The borrower's loan file contained a verification of deposit, dated January 24, 2007, which indicated that the borrower's bank balance was $4,145. A second verification of deposit disclosed that the borrower had a balance of $9,904 as of February 27, 2007. The borrower's bank balance increased by $5,759 over a one month period. Further, a teller receipt in the borrower's loan file identified that the borrower's bank balance was $15,401, an increase of $5,497. The borrower's loan file did not contain any written explanations for the large increases in the borrower's bank account.

The borrower's loan file contained a summary printout from Turbo Tax that disclosed the borrower was expected to receive an income tax refund of $10,243. However, the summary printout, which was not filed, signed, or dated, contained a reminder to the user preparing the tax documents that the tax payer's taxes were not finished until all steps were completed. Therefore, the amount of the borrower's alleged anticipated tax refund was not adequately supported to justify the large increases in the borrower's bank account.

Comment 45 The recommendations in the discussion draft memorandum report are appropriate based on the issues cited. Violations of FHA rules are subject to civil and administrative action.