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TO: Jenise T. Hight, Associate Deputy Assistant Secretary for Single Family Housing, HU

Dane M. Narode, Associate General Counsel for Program Enforcement, CACC

//signed//

FROM: James D. McKay, Regional Inspector General for Audit, Atlanta Region, 4AGA

SUBJECT: Prospect Mortgage, LLC, Sherman Oaks, CA, Did Not Always Comply With Federal Housing Administration Underwriting and Quality Control Requirements

HIGHLIGHTS

What We Audited and Why

We audited Federal Housing Administration (FHA)-insured loans underwritten by Prospect Mortgage, LLC (Prospect), within Region IV of the U. S. Department of Housing and Urban Development (HUD) Office of Inspector General (OIG). Region IV is located within the jurisdiction of HUD's Atlanta Homeownership Center. We selected Prospect for review because of its high underwriter default activity in Region IV. Prospect is an FHA-approved direct endorsement lender, located in Sherman Oaks, CA. The audit was a part of our annual audit plan.

Our objective was to determine whether Prospect complied with HUD's requirements for (1) origination and underwriting relative to cash assets, income, and creditworthiness; (2) quality controls; and (3) branch office operations.

What We Found

Prospect did not always follow HUD's underwriting and quality control requirements for FHA-insured loans. Specifically, Prospect did not

- Properly underwrite 25 of the 33 loans reviewed. The improperly underwritten loans contained deficiencies that affected the insurability of the loans, including improper documentation or assessment of borrowers' credit, income, debts, cash assets, and compensating factors. As a result, HUD insured 25 loans that placed the FHA insurance fund at risk for $550,257 in questioned costs and nearly $1.7 million in funds to be put to better use. We attribute the violations to a failure by Prospect and its managers to ensure that it implemented and complied with HUD's underwriting and quality control requirements for loans primarily originated at two branch offices which had high default rates.

- Properly implement quality controls over its underwriting process for a specific group of defaulted loans approved by high default rate underwriters at two of its branch offices. The improper quality controls placed the FHA insurance fund at risk for losses on additional defaulted loans with mortgages of more than $26.1 million that were underwritten by two of Prospect's high-default-rate branch offices. The two branches employed most of the high-default-rate underwriters who were the focus of the review. We attribute the quality control deficiencies to a failure by Prospect management to ensure that it implemented and documented quality control practices that complied with HUD requirements.

What We Recommend

We recommend that the Associate Deputy Assistant Secretary for Single Family Housing take appropriate administrative action against Prospect based on the information contained in this report. This action should, at a minimum, require Prospect to reimburse or hold HUD harmless against any losses for the 25 improperly underwritten loans in finding 1 that involve $550,257 in questioned costs and $1,694,217 in funds to be put to better use and for the improper management of its quality control function. The quality control deficiencies have placed the FHA insurance fund at a higher risk for losses on additional defaulted loans with mortgages totaling more than $26.1 million that were underwritten by two high-default-rate branch offices. Therefore, we recommend that HUD review Prospect's underwriting for any of the defaulted loans included in the $26.1 million which have already gone to claim or on which a claim is filed within 5 years of the loan endorsement dates. If HUD determines that the claim was filed for loans that did not meet requirements, Prospect should be required to reimburse HUD for the claim, the loss on the loans, or to indemnify HUD from losses.

We also recommend that HUD's Associate General Counsel for Program Enforcement pursue civil and or administrative action against Prospect and or certain of its underwriters for incorrectly certifying to the integrity of the data used to underwrite 25 loans that placed the FHA insurance fund at risk for $550,257 in questioned cost, potential losses of $1,694,217 and, for inadequate quality controls over the underwriting process.

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

Auditee's Response

We discussed the findings with Prospect officials during the audit and provided the draft report to Prospect on May 5, 2011. We discussed the report with Prospect officials at the exit conference held on May 19, 2011, and Prospect provided written comments on May 20, 2011. The comments generally disagreed with our findings and case studies. The complete text of Prospect's response (minus exhibits), along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVE

Prospect Mortgage, LLC (Prospect), is a Federal Housing Administration (FHA)-approved nonsupervised direct endorsement lender which operates from its home office located in Sherman Oaks, CA. Prospect was originally approved to originate FHA loans under the name of Metrocities Mortgage, LLC, on July 6, 1999. Metrocities Mortgage, LLC, changed its name to Prospect Mortgage, LLC, on February 23, 2009. At the time of our audit, Prospect had 264 active branches and 95 terminated branches and operated in the Atlanta, Denver, Philadelphia, and Santa Ana Home Ownership Center jurisdictions. During the period covered by the review, December 1, 2007, through December 31, 2009, Prospect had a high 12.29 percent default rate for the Atlanta Homeownership Center jurisdiction which included the states of Alabama, Florida, Georgia, Illinois, Indiana, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee, and the territories of Puerto Rico and the United States Virgin Islands. We limited our review to Prospect's high default activity in HUD OIG Region IV which is located within the area included in the Atlanta Homeownership Center. Prospect's default rates for the Santa Ana, Denver, and Philadelphia Homeownership Centers were 2.7 percent, 3.18 percent, and 5.30 percent, respectively.

The audit primarily focused on manually underwritten loans within HUD OIG Region IV by high default underwriters who underwrote loans for two Prospect branch offices located in the states of Florida and North Carolina which also had high default rates. HUD OIG Region IV includes the states of: Alabama, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee and the territories of Puerto Rico and the United States Virgin Islands. We determined that Prospect employed nine underwriters, who underwrote 211 defaulted loans in HUD OIG Region IV with default rates that ranged from 9 to 54 percent. More than 76 percent of Prospect's defaults in HUD OIG Region IV were originated at the two branches located in Florida and North Carolina. During the period of our review, the Florida branch had a default rate of 21.49 percent, and the North Carolina branch had a default rate of 11.70 percent.

Our objective was to determine whether Prospect complied with HUD's requirements for (1) origination and underwriting relative to cash assets, income, and creditworthiness; (2) quality controls; and (3) branch office operations.

RESULTS OF AUDIT

Finding 1: Prospect Did Not Fully Comply with HUD's Underwriting Requirements

Prospect did not fully comply with HUD's underwriting requirements. Specifically, it violated underwriting requirements for 25 of 33 FHA-insured loans that exposed HUD's insurance fund to actual and potential for losses of more than $2.2 million for loans reviewed during the audit. We attribute the violations to a failure by Prospect and its managers to ensure that it implemented and complied with HUD's underwriting and quality control requirements for loans primarily originated by two high default rate branches that employed underwriters who had high default rates (finding 2). The violations detected during the audit affected the insurability of the loans and we questioned more than $2.2 million for 25 loans, listed in appendices C and D, which did not meet requirements. The $2.2 million includes 5 claim terminated loans with actual losses that totaled more than $344,000 to HUD's insurance fund and 20 loans with potential losses that could total to more than $1.9 million. The prevalence of significant underwriting violations in the sample indicates that HUD may also be exposed to a high risk for losses on other defaulted loans underwritten by the high-default-rate underwriters at the two branches for loans that we did not review.

Inappropriate Loan Approvals

Prospect inappropriately approved loans that involved repetitive and significant underwriting deficiencies for 20, or 87 percent, of the 23[1] loans reviewed. The deficiencies for each loan are summarized in appendix C followed by a detailed discussion in appendix E.

Deficiency type	Totals[2]
Questionable or undocumented compensating factors	14
Credit not properly assessed	15
Income not properly assessed	9
Debts not properly assessed	6
Inadequate assessment of cash assets	11
Gift funds not properly assessed	15
Excessive seller contributions	1
Other	6

The violations, listed in appendix C, include 5 loans on which HUD paid claims and resold them at losses that totaled more than $344,000, and 20 loans where we

[1] We conducted a limited scope review of 10 additional loans discussed later in the finding. (appendix D).
[2] The number of deficiencies exceed the number of loans reviewed because, as shown in appendix C, a single loan may involve deficiencies in multiple categories.

estimate potential losses could total more than $1.9 million. The 20 loans include 4 loans where Prospect over-insured the mortgages by more than $3,200.

HUD Handbook 4155.1, REV-5, Mortgage Credit Analysis for Mortgage Insurance on One-to Four-Unit Mortgage Loans, provides requirements that lenders must follow when underwriting FHA loans and evaluating, among other requirements, borrower assets, income, and creditworthiness. The lender's decision to approve a loan must be documented and supported. The following section discusses some of the more significant violations, which are detailed in the case narratives presented in appendix E.

Questionable or Undocumented Compensating Factors

Prospect consistently approved loans that exceeded HUD's 43 percent debt-to-income ratio benchmark without providing valid and supported compensating factors. The audit sample (23 loans) included 20 loans that exceeded HUD's debt-to-income ratio benchmark, which required the documentation of compensating factors. In 14 of the cases (70 percent), Prospect either did not provide compensating factors or the factors provided were not valid or were not properly supported.

Description	Number of instances[3]
Compensating factor(s) not provided	2
Invalid compensating factors provided	14
Valid but unsupported compensating factor(s)	14
Total	30

The absence of legitimate compensating factors was significant because the 14 loans had debt-to-income ratios that ranged from 46.2 to 57.2 percent. The loans were not eligible for approval without valid and supported compensating factors.

For example, the 14 invalid compensating factors included but were not limited to the following type claims:

[3] The number of compensating factors that we did not accept exceeds the number of loans reviewed because a single loan may involve multiple compensating factors that were not valid or that were not properly supported.

Description of invalid compensating factors	Number of cases
Borrower is a minimal debt user	4
Borrower's spouse* receives additional income	2
Job stability	2
Borrower has 2 months in reserves	1
Borrower has good credit	1
Tax benefit of home ownership	1
Total	11
*The spouse referred to was not a party to the loan.	

Prospect did not agree with our assessment that the above compensating factors were not valid. For example, we identified two instances of invalid compensating factors for spouses who were not a party to the loans. Prospect stated that income earned by a spouse who was not a party to the loan could be used as a compensating factor based on underwriting criteria for homes purchased as a result of a relocation (Handbook 4155.1, paragraph 2-13). The cited cases did not involve relocations. We considered the compensating factors to be invalid because the spouses' credit was not assessed, and there was no assurance that their income would be available to assist with paying the mortgage.

Mortgagee Letter 2005-16 allows a back ratio of 43 percent for manually underwritten mortgages, but it provides that if the ratio is exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios that exceed the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation. Appendix F provides a list of the compensating factors cited in HUD requirements that may be used to justify approval of mortgage loans with ratios that exceed HUD's benchmark guidelines.

Prospect generally disagreed with our conclusions. It stated that the audit used inappropriate statistics to support assertions that it approved loans with debt-to-income ratios above benchmark guidelines without adequate compensating factors. We assessed Prospect's response to our tentative conclusions and made deletions and/or revisions when warranted. The statistics cited in the above table are an accurate summary of the invalid and unsupported compensating factors presented in the case narratives (appendix E).

Credit Not Properly Assessed

Prospect approved 15 of the 23 loans reviewed (65 percent) without thoroughly assessing or documenting whether the borrowers met HUD's credit requirements. Each loan involved borrowers whose credit reports showed collections, charge-offs, and/or bank statements which showed recent fees for returned items.

- Unpaid collection accounts – The sample included 13 loans for which the credit reports showed that the borrowers and/or coborrowers had unpaid collection accounts that ranged from $892 to more than $19,000. Prospect did not document compensating factors to justify why it approved the loans despite the derogatory credit indicated by the collection accounts.

Unpaid collection and charge off accounts	
Account dollar range	Number of cases
$0-$1,000	1
$1,001- $5,000	5
$5,001-$10,000	3
$10,001-$15,000	2
$15,001-$20,000	2
Total	13

For example, Prospect approved loan number 381-8867369, although the credit report showed that the borrower and the coborrower owed more than $19,200 for 58 collection accounts. A majority of the collections were for medical bills that totaled more than $15,000. Prospect's quality control review also reported that the borrowers had a significant amount of derogatory credit.

- Returned items – Prospect approved two loans without documenting what consideration it gave to returned items documented in the loan files. The returned items included two for loan 105-3720079, and 5 for loan 105-4101563.

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, 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.

Prospect generally disagreed with our conclusions and stated that the audit was attempting to hold it accountable for the auditor's opinion of how credit requirements should be followed rather than the clear language of HUD's guidelines. Prospect stated that periods of financial difficulty in the past do not necessarily make the risk unacceptable. We assessed Prospect's response to our tentative conclusions and made deletions and clarifications when warranted. As presented in the case narratives, appendix E, Prospect approved loans that involved credit problems without documenting compensating factors and its assessment to determine why the borrowers had not honored their debt obligations.

Income Not Properly Assessed

Prospect did not accurately assess the income for 9 of the 23 borrowers (39 percent) included in the sample. The debt-to-income ratios for eight of the nine borrowers exceeded HUD's 43 percent benchmark and are among the loans, discussed above, for which Prospect did not provide valid and supported compensating factors. For the 9 loans, we identified 17 violations related to improper assessment of income.

Type violations	Number of instances
Inaccurate or unsupported income calculations	3
Employment not properly verified	5
Overtime & bonus income allowed when earned less than 24 months	3
Gaps in employment history not properly assessed or explained	1
Stability of income not properly assessed	3
Overtime income not properly verified	2
Total	17

For example, in case number 381-8673508, Prospect overstated the borrower's overtime pay by more than $435 per month. The overstatement occurred because Prospect calculated the amount using a 16-month average versus the required 24-month average. Adjustment for the overstatement increased the debt-to-income ratio from 57 to more than 64 percent. The verification of employment showed that the likelihood of continued employment was good but the likelihood of continued overtime pay was "unknown."

HUD Handbook 4155.1, REV-5, paragraph 2-7(A), 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. Paragraph 2-7 provides that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first 3 years of the mortgage loan.

Prospect generally disagreed with our conclusions. For instance, it stated that the audit was trying to use artificially inflated statistics that had no factual basis and that the audit declined to accept Prospect's rebuttal to the majority of the issues. We assessed Prospect's response relative to our tentative conclusions and made deletions and/or revisions in instances in which they were warranted. The statistics cited in the above table are an accurate summary of the violations discussed in appendix E.

Debts Not Properly Assessed

Prospect approved 6 of the 23 loans reviewed (26 percent) without adequately documenting that it included all of the required monthly payments in the borrower's debt-to-income ratio calculations. As a result, it understated the ratios it used to approve the loans. These six loans included two instances in which Prospect inappropriately excluded debts with fewer than 10 months of payments remaining (case numbers 381-8674809 and 381-8594116).

For example, in case number 381-8594116, Prospect understated the borrower's monthly debts by $219. It omitted one debt and understated the monthly payments for two other debts. The omitted debt had a $191 monthly payment, but it had less than 10 months remaining on the loan. In view of the high 52.6 percent debt-to-income ratio, we believe that the debt would have affected the borrower's ability to make mortgage payments during the months immediately after the loan closed. Prospect did not agree with this assessment. The two understated debts included one account in which Prospect used $23 less than the credit report showed and another account in which it used $5 less than the credit report showed. Adjustment for the understated debts increased the debt-to-income ratio from 52.6 to 58.4 percent.

HUD Handbook 4155.1, REV 5, paragraph 2-11(A), provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing.

Prospect generally disagreed with our conclusions. For instance, it stated that for every loan in the audit sample in which debts had fewer than 10 payments remaining, the audit cited Prospect for failing to include the debts in its debt-to-income ratio calculations. We cited the violations because, as discussed in the case narratives (appendix E), our assessments showed that the debts affect the borrower's ability to make the mortgage payment during the months immediately after the loans closed.

Inadequate Assessment of Cash Assets

Prospect did not properly assess the cash assets for 11 of the 23 loans included in our sample (48 percent). The loans involved 20 violations.

Deficiency type	Number of instances
Inadequate verification borrower funds used to close the loan	4
Minimum downpayment not made or understated	6
Improper assessment of premium pricing	6
Inaccurate tax figure in settlement statement	1
Large deposit not properly assessed	2
Earnest money paid to inappropriate source	1
Total	20

For example, in case number 461-4115484, Prospect allowed the loan to close with the borrower paying $645 less than the required minimum downpayment, which resulted in the mortgage being overinsured by that amount. Prospect incorrectly calculated the downpayment to be $3,095, yet it only required the borrower to pay $2,505, or $590 less than the amount it calculated. However, we determined that the minimum downpayment was supposed to be $2,921, of which the borrower only paid $2,276 ($2,505 - $229 = $2,276), or $645 less than the required amount. We offset the borrower's downpayment by $229 because the settlement statement indicated that the amount was deducted from the nonprofit gift to pay off a debt. HUD does not allow the use of nonprofit gift funds to pay off debts.

HUD Handbook 4155.1, REV-5, paragraph 1-7, provides that the borrower must make a cash investment that is at least equal to the difference between the sales price and the resulting maximum mortgage amount but that the cash investment must equal at least 3 percent of the contract sales price.

Prospect generally disagreed with our conclusions and stated that the audit treated immaterial issues as though they were major problems. We assessed Prospect's response to our tentative conclusions and made deletions and/or revisions when warranted. We considered the violations relative to cash assets in conjunction with the overall violations for each borrower as presented in the case narratives (appendix E).

Excessive Seller Contributions

Prospect did not properly assess the funds a seller contributed to close one loan. As a result, it allowed the seller to contribute more than the 6 percent allowed by HUD's requirements. For example, in case number 105-3247562, Prospect did not identify that the seller, a quasi-public corporation, exceeded HUD's 6 percent contribution requirement by $4,979. The excess contribution should have been but was not treated as an inducement to purchase with a write-down of the mortgage by the amount of the excess contribution.

HUD Handbook 4155.1, REV-5, paragraph 1-7(A), states that the seller may contribute up to 6 percent of the property's sales price toward the buyer's actual closing costs, prepaid expenses, discount points, and other financing concessions.

Contributions exceeding 6 percent of the sales price or exceeding the actual cost of prepaid expenses, discount points, and other financing concessions will be treated as inducements to purchase, thereby reducing the amount of the mortgage.

Prospect generally disagreed with our conclusion. We assessed Prospect's response and found no support that warranted revisions to our tentative conclusion.

Gift Funds Not Properly Verified

Prospect did not properly verify gift funds paid to closing agents for 15 of the 23 loans included in our original sample (65 percent). In each case, the borrowers received gifts from nonprofit donors. The missing documentation was required to provide assurance that the gifts were paid by the nonprofit organizations and not by other interested parties to the loan transactions. Prospect provided no explanation as to why it did not properly verify whether the settlement agents received the gift funds.

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

In its initial response Prospect disagreed with our conclusions concerning its responsibility to verify gift funds received from nonprofits. Prospect later revised its response and acknowledged that it was required to verify that the closing attorney received the funds and it agreed with our determination that the required documentation was not located in the loan file.

Other Less Significant Deficiencies

Prospect also underwrote two loans (case numbers 105-3428714 and 105-3692606) containing underwriting deficiencies that did not affect the loans' insurability. These loans involved four of the same violations cited for some of the cases discussed above relative to verification of cash to close, minimum downpayment, premium pricing (lender's contributions to borrower closing cost), and gift funds. The less significant deficiencies did not relieve Prospect from its responsibility to follow all facets of HUD requirements when originating FHA loans.

HUD's Insurance Risk Was Increased Due to High-Default-Rate Underwriters

The number of repetitive and significant violations detected by the audit raised a concern about the quality of Prospect's high-default-rate underwriter performance at the two branches that caused Prospect's high default rate for the Atlanta Homeownership Center. In addition to the loans reviewed, the two branches originated 184 manually underwritten defaulted loans with mortgages that totaled more than $26 million (appendix G). Neighborhood Watch showed HUD paid claims that totaled more than $2.5 million on 18 of the loans and that 128 of the loans, with mortgages that totaled more than $18.4 million, were in default and were 3 to 22 months delinquent. The loans were underwritten by underwriters whose overall default rates for the loans they underwrote for Prospect ranged from 9 to more that 54 percent.

Underwriter[4]	Overall underwriter default rate[5]	Total mortgage amounts	Number of defaulted loans at branch 1(Florida)	Number of defaulted loans at branch 2 (North Carolina)	Total	Loans with significant deficiencies not listed in this table
A	49.39%	$9,747,429	66		66	9
B	42.03%	$3,547,899	28		28	1
C	31.34%	$2,176,477	16		16	3
D	54.17%	$1,969,559	13		13	
E	45%	$1,358,448	9		9	
F	9.2%	$352,356	3		3	1
G	33.02%	$3,467,473		27	27	7
H	39.13%	$2,656,525		17	17	1
I	11.94%	$862,044		5	5	
Totals		$26,138,210	135	49	184	22

The number of the recurring significant violations detected in the original audit sample raised a concern about the quality of Prospect's high-default-rate underwriter performance for the above loans originated by the two branches. Because of this condition, we expanded our sample to review 10 more loans, focusing only on the most prevalent violations detected by our original sample. The violations involved compensating factors and collection accounts. We focused only on loans that were in default, which had back ratios that exceeded HUD's 43 percent benchmark. We identified 60 loans in that category with

[4] The sample for manually underwritten loans included two loans that were not underwritten by one of the high default rate underwriters listed in this table. We selected the two loans based on the findings included in Prospect's quality control reviews.

[5] The information in this table was obtained from HUD's Neighborhood Watch system for the underwriters overall default rates for the Atlanta Homeownership Center jurisdiction and their origination activity at the two Prospect branches (located in Florida and North Carolina).

mortgages that totaled more than $9 million. We used a random number generator to identify the 10 sample loans after we arranged the loans by closing dates.

The review identified the following violations for 5 of the 10 loans (50 percent), which are discussed in appendix D

			Type of violation	
Case number	Underwriter	Back ratio	Invalid compensating factors	Inadequate assessment of collections
381-8363464	H	47.8%	X	
105-3425304	C	46.0%	X	
105-3683691	B	43.7%	X	X
105-3440738	C	44.6%	X	X
105-3682405	A	44.7%	X	X
Totals			5	3

The results of the review further validated our concern about high risk associated with the quality of the underwriting by Prospect for the remaining defaulted loans by the two high default branches. The violations affected the insurability of the loans and could result in potential losses to HUD’s insurance fund totaling more than $486,000. As discussed in finding 2, we attribute the high default activity at the two branches to a failure by Prospect and its management to ensure that it implemented and complied with HUD’s underwriting and quality control requirements. The results of the review apply only to the loans reviewed and cannot be projected to the universe of loans.

Prospect disagreed with our conclusions. It stated that this was an example of the audit attempting to hold Prospect responsible using information that is available today to cite Prospect for failing to take action at an earlier point, at which time most of the information upon which the audit based its allegation was not available.

We considered Prospect’s response and determined that the high default rate trend for loans the underwriters underwrote for Prospect did not begin to show up in HUD’s Neighborhood Watch System until the fourth quarter of 2008. By that time, underwriters A through H had left their jobs at Prospect. We did not determine when underwriter I left because Prospect could not locate and provide the personnel file. However, as discussed in finding 2, when Prospect hired most of the underwriters, they already had default rates that ranged from 12.12 to 58.62 percent for loans they underwrote for other lenders. This should have prompted Prospect to give closer scrutiny to the quality of the underwriters’ compliance with HUD’s underwriting requirements before their default rates at Prospect began to increase.

Conclusion

We detected significant violations that affected the insurability of 25 of the 33 loans examined, or 76 percent of the sample. The violations resulted in losses on 5 loans that totaled more than $344,000 to HUD's insurance fund and the potential for losses on the remaining 20 loans of more than $1.9 million (see appendices C and D for a list of the loans). The violations exposed HUD's insurance fund to actual and potential for losses of more than $2.2 million. HUD will review and make a final determination concerning whether the loans met requirements for insurance, along with its consideration of additional information that Prospect provides.

We attribute the violations to a failure by Prospect and its managers to ensure that it implemented and complied with HUD's underwriting requirements discussed above and quality control requirements discussed in finding 2. Prospect did not identify or document the high default rate pattern for the two branches and their high-default-rate underwriters. As a result, Prospect did not take steps to determine the extent of the underwriters' involvement in problem cases. The significant and consistent violations detected by the audit caused us to question the quality of other defaulted loans underwritten at the branches. The results of our expanded sample provided further justification for our concern. This issue was especially significant considering that the operations at the two branches accounted for 76 percent of Prospect's defaults in the Atlanta Homeownership Center, excluding loans originated in Illinois and Indiana.

Recommendations

We recommend that the Associate Deputy Assistant Secretary for Single Family Housing

1A. Require Prospect to reimburse HUD $344,326 for the actual loss sustained on five claim-terminated loans that HUD sold.

1B. Require Prospect to reimburse HUD for potential losses on three claim-terminated loans that HUD has not resold. We estimate the losses to be $202,655[6].

1C. Require Prospect to indemnify HUD against $1,694,217 in potential losses on 17 defaulted loans.

[6] We calculated the potential loss for recommendations 1B and 1C using the 59 percent average loss rate determined by HUD for the 2010 fiscal year for real estate owned properties that it sold. We applied the loss rate to the unpaid principal balances for loans listed in appendices C and D.

1D. Require Prospect to pay down the principal balance by $3,276 for 4 overinsured loans. If HUD has paid a claim on any of these loans then it should remit the payment to HUD.

1E. Refer Prospect to the Mortgagee Review Board for not complying with HUD's origination and underwriting requirements.

1F. Conduct a full underwriting review of the 18 claim-terminated loans originated at the two high-default-rate branches to determine if they met HUD requirements, and if the loans do not meet the requirements, require Prospect to reimburse HUD for either the claim amounts paid or for the actual loss HUD sustained.

1G. Conduct a full underwriting review of any of the remaining 166 defaulted loans (184 -18 loans with filed claims) if a claim is filed against the FHA insurance fund within 5 years of the endorsement dates for the affected loans. Prospect should be required to indemnify HUD if a claim is filed on a loan that did not meet HUD's requirement for approval.

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

1H. Determine legal sufficiency, and if legally sufficient, pursue civil action against Prospect and its underwriters for incorrectly certifying to the integrity of the data or that due diligence was exercised during the underwriting of 25 loans that placed the FHA insurance fund at risk for $550,257 in questioned costs and potential losses of $1,694,217. The penalty amount will be determined through a separate civil process.

1I. Take appropriate administrative action against Prospect and underwriters A, B, C, F, G, and H for not complying with HUD requirements. The underwriters were responsible for the violations identified in appendices C and D.

Finding 2: Prospect Did Not Effectively Implement Certain Components of Its Quality Control Processes

Prospect did not effectively implement certain components of its quality control processes that contributed to loan origination deficiencies by several underwriters and two branch offices discussed in finding 1. The deficient quality control processes involved a specific large group of defaulted loans. Specifically, Prospect did not effectively implement components of its quality control processes relative to

- Annual reviews of two recently acquired branches and their staffs,
- Identification of loan origination violations,
- Classification of loan origination violations,
- Reverification of borrower qualifying information, and
- Documentation of corrective action for quality control findings.

We attribute these issues to a past failure by Prospect management to ensure that it implemented and documented effective quality control practices that complied with HUD requirements. The above issues hindered Prospect's ability to identify and correct performance problems, which contributed to its high default rate in the Atlanta Homeownership Center. The high default activity exposed HUD's insurance fund to actual losses with an increased risk for additional losses on other defaulted loans that caused Prospect's high 12.29 percent default rate for the Atlanta Homeownership Center (finding 1).

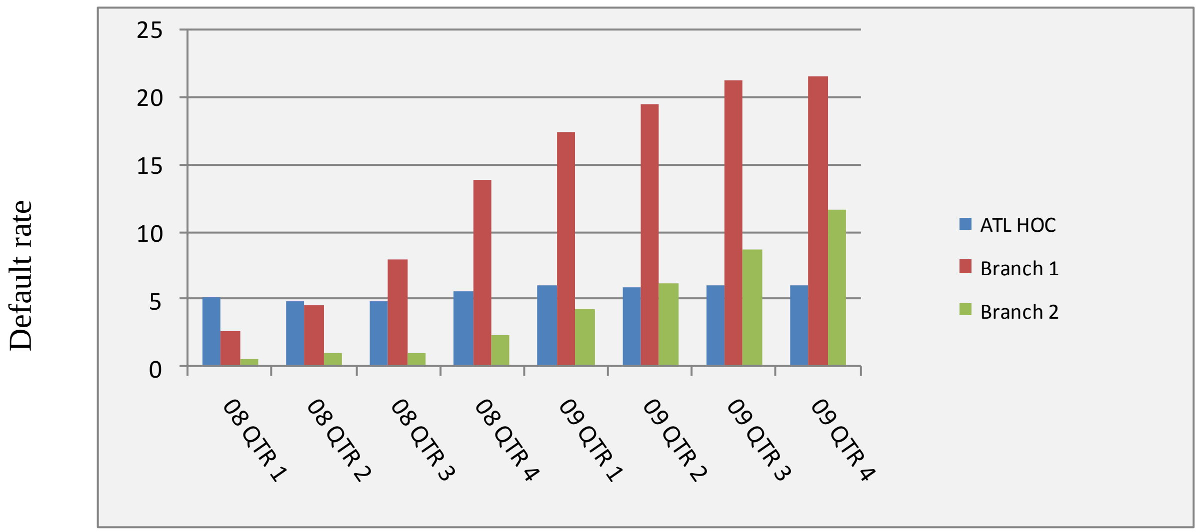
Inadequate Review of Activity by Recently Acquired Branches and Their Staffs

Prospect did not conduct or document that it conducted the required annual reviews to assess the performance of two acquired branch offices and their staffs. The acquisitions included one branch located in Florida (branch 1) and another branch located in North Carolina (branch (2). The default activity at the two branches caused Prospect's default rate for the Atlanta Homeownership Center to reach 12.29 percent for loans originated for the period December 1, 2007, through November 30, 2009.[7] This default rate was significant considering that during that same period Neighborhood Watch showed that Prospect's default rates for the Santa Ana, Denver, and Philadelphia Homeownership Centers were only 2.7,

[7] Neighborhood Watch showed that during this period, Prospect had 554 defaults for the Atlanta Homeownership Center (excluding Illinois and Indiana), of which 423, or 76 percent, of the defaults were for loans originated by the two branches. We excluded 21 defaults for Illinois and Indiana because, although they were within the Atlanta Homeownership Center, they were located outside HUD OIG's Region IV, and the loans were not underwritten by either of the two branches that were responsible for Prospect's high default activity for the Atlanta Homeownership Center.

3.18, and 5.30 percent, respectively. Prospect did not document that it took timely actions to identify and to correct performance problems at the two branches. Specifically, Prospect did not

Conduct or document annual reviews of the two branches - Prospect did not conduct or document that it conducted the required annual reviews of the newly acquired branches 1 and 2, including the performance of the underwriters who were included in the acquisitions. Prospect acquired the branches and some of their staff members, including underwriters from two lenders based on terms stipulated in the acquisition agreements it executed with them. It acquired branch 1 in July 2007 and branch 2 in August 2007. As discussed below, when Prospect purchased the branches most of the branch underwriters already had default rates that ranged from 12.12 to 58.62 percent for FHA loans they underwrote for other lenders. After the acquisitions, the default rates for the branches began and continued to climb based on defaults on loans the underwriters approved for Prospect.



Atlanta Homeownership Center Default Rate Activity

The two branches had 423 defaults that included 195 automated loans and 228 loans that were manually underwritten (the primary focus during the audit). Prospect provided no documentation to support that it identified, assessed, and corrected performance problems that caused or contributed to the high defaults.

Prospect acknowledged that it did not conduct the annual reviews of the branch offices and the underwriters. However, it disagreed with our assessment because it no longer employed the underwriters by the time their high default rates for Prospect loans began to show up in the fourth quarter of 2008. Prospect also explained that the issues we raised were moot, because it later implemented organizational and management changes and improvements that took away many of the type of loans at issue in the audit. We did not audit the stated improvements because the audit focused on manually underwritten loans, and Prospect had substantially reduced the volume of such loans.

We disagree with Prospect's position that the issues were moot because of the improvements it made in operations and the departure of the problem underwriters discussed below. The departure of the underwriters did not eliminate the effects of their default activity at the two branches, which continue to pose a risk for increased losses to the FHA insurance fund. The annual reviews could have provided Prospect with an opportunity to identify underwriting problems which lead to the above high default rates that began to show up in the fourth quarter of 2008. As discussed below, most of the underwriters already had high default rates for FHA loans they underwrote for other lenders before Prospect hired them. The high default rates increased the need for the required annual reviews which Prospect did not conduct or document.

Assess the performance of underwriters with high default rates - Prospect did not document that it assessed and addressed the high default activity of nine underwriters who underwrote loans at the two branches discussed above. The underwriters had overall default rates that ranged from 9 to more than 54 percent associated with loans they underwrote for Prospect. Prospect explained that it aggressively managed the performance of underwriters and had parted ways with problem underwriters, either through terminations or voluntary dismissals. Despite this explanation, the personnel files for the underwriters showed no evidence that any of them had their employment terminated for performance problems.

Branch and underwriter	Loans in default	Overall underwriter default rate for Prospect loans	Mortgage Amounts	Loans reviewed that involved significant deficiencies
Branch 1				
A	79	49.39%	$11,652,682	9
B	29	42.03%	3,687,664	1
C	21	31.34%	2,993,684	3
D	13	54.17%	1,969,559	
E	9	45%	1,358,448	
F	4	9.2%	702,921	1
Subtotal	155		$22,364,958	
Branch 2				
G	33	33.02%	$4,362,649	7
H	18	39.13%	2,896,975	1
I	5	11.94%	862,044	
Subtotal	56		$8,121,668	
Totals	211		$30,486,626	22

Prospect could not produce records to support that it had identified the above pattern of defaults and followed up to address the cause for this condition. This was important because underwriters A, B, C, F, G, and H had default rates of

41.94 percent, 58.62 percent, 33.33 percent, 37.72 percent, 50 percent, and 12.12 percent respectively prior to their employment at Prospect[8].

We assessed the quality of the underwriters' work during the review of origination activity discussed in finding 1. Based on the violations detected by the reviews, we concluded that their performance was a factor that caused or contributed to their high default rates at Prospect. For instance, underwriters A, B, C, F, G, and H had high default rates before they came to Prospect and they underwrote 184, or 87 percent, of the manually underwritten loans that went into default at the two Prospect branches. Our sample included 22 deficiently underwritten loans by those six underwriters which are summarized in appendices C and D. Each of the loans contained one or more significant underwriting violations, which individually or collectively affected the insurability of the loans. The prevalence of significant underwriting violations in the sample exposed HUD to a high risk for losses on other defaulted loans underwritten at the two branches by the high-default-rate underwriters listed in the above table.[9]

To illustrate, underwriters A and G had the highest default volume at the two branches, but their personnel files contained no evidence that Prospect had raised concerns about their underwriting performance or their previous high default rates. The file showed that underwriter A was hired on February 5, 2002, by the prior lender, who owned the branch, and that Prospect terminated the underwriter's employment on November 4, 2008, due to a "lack of work." The file contained no evidence that Prospect questioned the underwriter's high default rate and/or performance for the period before or after it employed the underwriter. The file showed that Prospect hired underwriter G on March 25, 2008, and that it terminated the underwriter on December 31, 2008. The file contained no performance reviews, and it did not document a reason for the termination. Also, the file contained no evidence that Prospect questioned the underwriter's high default rate for the period before it employed the underwriter.

HUD Handbook 4060.1, REV-2, paragraph 7-3(G)(2), provides that annual visits are mandatory for offices meeting certain higher risk criteria such as high early default rates, new branches or new key personnel, sudden increases in volume, and past problems. Paragraph 7-5(C) provides that lenders must identify patterns of early defaults and that they must identify commonalities among participants in the mortgage origination process to learn the extent of their involvement in problem cases. Loans involving loan officers, processors, underwriters, etc., who have been

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[8] We downloaded the underwriter default data from HUD's Single Family Data Warehouse for the 2 year period ended June 30, 2007. This data was not currently available in the Neighborhood Watch System but it was available in that system at the time Prospect purchased the two branch offices and hired the underwriters. At that time Prospect could have retrieved the Neighborhood Watch reports to determine and to assess the underwriters' default rates.

[9] The prevalence of violations identified by the sample caused us to have concern about the quality of Prospect's underwriting of other high risk loans originated by the high default rate underwriters who underwrote loans at the two high default rate branches.

associated with problems, must be included in the review sample. Paragraph 7-3(F) provides that the lender must expand the scope of the quality control review when patterns of deficiencies are uncovered to review an increased number of files and to perform a more indepth review. Paragraph 7-6(C) (1) provides that emphasis should be placed on any participants that have large volumes of loans or show sudden increases in loan volumes or loan default rates.

Inadequate Identification of Violations

Prospect's quality control reviews often did not identify noncompliance with HUD's underwriting requirements. For instance, the following table shows examples of 13 early payment default loans for which our review identified violations that were not identified by Prospect quality control reviewers. The 13 defaults include eight loans underwritten by the previously discussed high default underwriters A (six loans) and G (two loans).

	Violation type detected by	
Deficiency type	OIG*	Prospect
Questionable or undocumented compensating factors	8	2
Credit not properly assessed	12	7
Inadequate assessment of cash assets	8	1
Income not properly assessed	6	2

*Office of Inspector General

The violations not detected by Prospect's review further contributed to its failure to identify and correct performance problems at the two branch offices for loans that were underwritten by high-default-rate underwriters.

HUD Handbook 4060.1, REV-2, paragraph 7-3(F), provides that the quality control reviews must thoroughly evaluate the lender's origination function to determine the root cause of deficiencies. HUD Handbook 4060.1, REV-2, paragraph 7-3(E), provides that the quality control review must evaluate the accuracy and adequacy of the information and documentation used in reaching decisions in the origination process.

Prospect did not agree with our assessment because it took exception to our conclusions. We assessed Prospect's response to our tentative conclusions and made deletions and/or revisions in instances when warranted. The statistics cited in the above table are an accurate summary of the violations detected by the audit.

Inadequate Classification of Violations

Prospect did not consistently classify the severity of the violations detected by its quality control reviews. HUD suggests that lenders classify the severity of all violations detected by quality control reviews. We examined Prospect's quality control review summaries for both its 10 percent sample reviews and its early payment default reviews. Prospect classified the severity of violations for its 10 percent sample quality control reviews but did not classify the violations detected in its early payment default reviews. HUD suggests the use of classifications to enhance lenders' ability to identify patterns and to assess the significance of the review results. The classifications also would have assisted management in identifying violations that it was required to report to HUD.

HUD Handbook 4060.1, REV-2, paragraph 7-4, recommends that quality control reports include an assessment of risks to enable a lender to compare 1 month's sample to previous samples so the lender may conduct trend analysis. Management can also use this tool to respond quickly to a sudden decline in the quality of its loans and help identify and correct the problem. Lenders may consider a ratings system such as low risk, acceptable risk, moderate risk, and material risk. Material risk is for loans that involve material violations of FHA or lender requirements and represent an unacceptable level of risk.

In its initial response, Prospect disagreed with our determination and stated that it did classify the severity of violations for the early payment default loans. However, Prospect later revised their response and stated that the extent that such classifications were not made likely resulted from their switch from a external to an internal quality control review process.

Inadequate Reverifications of Borrower Information

Prospect either did not conduct or did not maintain documentation to support that it conducted all of the required reverifications as part of its quality control review process. We examined the quality control files for 15 loans and determined that

- 15 did not contain updated credit reports,
- 15 did not include reverification of gift payments,
- 11 did not include reverification of deposits, and
- 8 did not include reverification of employment.

HUD Handbook 4060.1, REV-2, paragraph 7-6(E), provides that the quality control program must provide for the review and confirmation of information on all loans selected for review. Paragraph 7-6(E)(2) provides that documents contained in the loan file should be checked for sufficiency and subjected to written reverification. Examples of items that must be reverified include but are not limited to the borrower's employment or other income, deposits, gift letters, alternate credit sources, and other sources of funds.

In its initial response, Prospect disagreed with our determination. However, Prospect later revised their response and stated that to the extent that the re-verifications were not documented this condition likely resulted from reviews completed during an out-dated quality control process on loans originated under a prior management team.

Inadequate Documentation of Corrective Action

We reviewed Prospect's quality control results for 15 loans and determined that it did not document what actions, if any, it took to resolve the findings. The reports and the quality control files did not contain or reference the required corrective actions and timetables for completing corrective actions. We requested this documentation, but Prospect did not produce the documentation needed to support actions it took to resolve the finding. Prospect's representative stated that Prospect did not take corrective action because several of the employees involved with the violations were no longer employed by it. Prospect's failure to document that it took appropriate corrective action may have contributed to the continued high default activity previously discussed for branches 1 and 2.

Prospect Acknowledged Past Problems with Its Quality Control Processes

Prospect's management acknowledged past problems with its quality control processes. Prospect's representatives stated that in 2009, among other actions, the Company brought in a new management team which revised and improved its quality control systems and procedures. The representative stated that the company went from an out-sourced contractor to conduct quality control reviews to an in-house quality control review process. Prospect's representatives attribute the reduction in the Company's compare ratio for the Atlanta Homeownership Center to its improved quality control processes. We did not audit the cited improvements because Prospect had substantially reduced the volume of manually underwritten loans that were the focal point of the audit. However, we validated that in 2009 Prospect brought in a new management team who revamped the company's quality control processes and converted from an external contractor to its in-house staff process. We also validated that Prospect used its in-house staff to not only review the origination activity for loans made after the transition but also reviewed and prepared reports on a large number of loans approved before the transition.

We reviewed the HUD Neighborhood Watch system and determined that Prospect's overall compare ratio for the Atlanta Homeownership Center dropped from 164 percent for the quarter ended December 31, 2009 to 93 percent for the quarter ended

March 31, 2011. We could not determine to what extent the reductions were attributed to the improvements Prospect implemented in its quality control processes. The improvements, however, did not remove the high risk to HUD for the loans discussed in finding 1 which we attribute to past failures in Prospect's quality control processes. Those processes contributed to Prospect's failure to identify and take actions to address the cause for the high default rate underwriters and branch offices discussed in finding 1. The above sections discuss the areas in Prospect's past quality control processes that exposed HUD's insurance fund to actual losses and the ongoing potential for additional losses.

Conclusion

Prospect did not document and support that its past quality control review process was adequate to ensure the (1) annual review of activity by the two recently acquired branches and their staffs, (2) consistent identification of material underwriting violations, (3) consistent classification of violations, (4) documentation of reverification of borrower information, and (5) documentation of corrective action taken on quality control findings. As a result, Prospect did not identify or document that it identified and resolved a pattern of high default activity at two of its branches. The default activity associated with the branches and their underwriters increased Prospect's overall default rate for the Atlanta Homeownership Center to 12.29 when its default rates for the Santa Ana, Denver, and Philadelphia Homeownership Centers were only 2.7, 3.18, and 5.30 percent, respectively. The high default activity at the two branches exposed HUD's insurance fund to actual losses and the potential for additional losses on 184 defaulted loans with mortgages that totaled more than $26 million (finding 1).

We attribute the above issues to a past failure by Prospect management to ensure that it implemented and documented quality control practices that complied with HUD requirements.

Recommendations

We recommend that the Associate Deputy Assistant Secretary for Single Family Housing

2A. Refer Prospect to the Mortgagee Review Board for not complying with HUD's quality control requirements that exposed the insurance fund to losses and the risk for additional losses on the defaulted loans discussed above and in finding 1.

SCOPE AND METHODOLOGY

We performed the audit between January 2010 and March 2011 and conducted the audit fieldwork at Prospect's Sherman Oaks, CA, home office and our office in Atlanta, GA. The audit covered the period December 1, 2007, through December 31, 2009, and we extended the period as necessary.

We did not review and assess general and application controls over computer-processed data for HUD's Neighborhood Watch system. Instead, we conducted other tests and procedures to assure the integrity of computer processed data that was relevant to our audit objectives. The tests included a comparison of the information shown in Neighborhood Watch, for the audit samples discussed below, to what the actual HUD-1 settlement statements, mortgage credit analysis worksheets, and loan applications showed for

- Borrower's name,
- Loan purpose,
- Qualifying debt-to-income ratios, and
- Mortgage amounts.

Our analysis showed that the qualifying debt-to-income ratios in the HUD system were not accurate for 2 of the 33 loans reviewed based on documents contained in the loan files. We did not identify any discrepancies for the other three areas tested. The incorrect qualifying debt-to-income ratios did not impact our review because we relied on the source documentation contained in the FHA loan files provided by Prospect.

To achieve our objective, we reviewed HUD's rules, regulations, and guidance for proper origination and submission of FHA loans. In addition, we interviewed HUD staff to obtain background information on HUD requirements and background information on Prospect. On a selective basis, we interviewed borrowers and visited the offices of settlement agents to review their records relative to the receipt and disbursement of funds to close certain loans.

We interviewed Prospect's management and staff to obtain information regarding its policies, procedures, and management controls. We reviewed Prospect's written policies and procedures to gain an understanding of how its processes were designed and functioned. The primary focus of the review was to assess the quality of manually underwritten loans due to the high default rate activity for that loan type. We sampled 33 of the 554 loans that defaulted during the audit period based on default data obtained from HUD's Neighborhood Watch system. We selected the 33 loans based on specific selection criteria. The sample included

- 23 loans that we reviewed to determine compliance with requirements for borrowers' assets, income, liabilities, and creditworthiness. The 23 loans included 18 loans which we selected from a universe of 254 defaulted loans that were manually underwritten by high default rate underwriter which we selected based on a risk assessment. The assessment gave weighted consideration to a number of factors including but not limited to high-default-rate underwriters, high debt-to-income ratios, low payment defaults, and

Prospect's quality control review findings. The review included 3 loans selected from the universe of 254 manual loans that were not underwritten by high default rate underwriters. This includes two manually underwritten loans selected based on the results of Prospect's quality control review findings and one automated loan that was incorrectly shown as manually underwritten in Neighborhood Watch. The sample also included two automated loans from the universe of 300 automated loans that Prospect made during the audit period. We limited our review of loans from this universe to include only those loans which contained major violations based on Prospect's quality control findings.

- 10 manually underwritten loans selected as an extended sample based on the results of our review of the above sample. These loans were selected from a universe of 60 loans, which were a subset of the 254 defaulted loans discussed above that were manually underwritten. We extracted the 60 loans from the larger universe of defaulted loans using as criteria loans that had a debt-to-income ratio of at least 43 percent which were also underwritten by one of Prospect's high-default-rate underwriters employed by either branch 1 or 2. The extended sample focused only on the adequacy of compensating factors and the borrower's credit history based on the trends revealed from the results of the above sample. We sorted the 60 loans by closing date and used EZ-Quant Statistical Analysis Software's random number generator to identify the random numbers used to select the 10 loans. The results of our review for the sample apply only to the loans reviewed and cannot be projected to the universe of loans.

The amounts shown in appendix A for questioned costs and funds to be put to better use apply only to loans reviewed during the audit. The ineligible cost ($347,602) represents the actual loss HUD incurred on the resale of the affected properties ($344,326) and overinsured mortgage amounts ($3,276). The unsupported cost ($202,655) and the amounts reported as funds to be put to better use ($1,694,217) represents 59 percent of the unpaid principal balance (shown in appendices C and D) based on information provided in Neighborhood Watch. The 59 percent loss rate is supported by HUD's Single Family Acquired Asset Management System's Case Management Profit and Loss by Acquisition as of September 2010 based on actual sales.

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

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

We assessed the relevant controls identified above.

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

Significant Deficiencies

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

- Prospect did not fully comply with HUD underwriting requirements (see finding 1).

- Prospect did not effectively implement certain components of its quality control processes (see finding 2).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A	$344,326		
1B		$202,655	
1C			$1,694,217
1D	$3,276		
Total	$347,602	$202,655	$1,694,217

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. See appendix C for the loans that make up the amount in this column, which includes $3,276 associated with the over-insurance of 4 loans.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures. In this instance, we estimated unsupported costs to be 59 percent of the unpaid balance paid based on information provided by HUD. The amount in this column consists of $137,964 for loans listed in appendix C and $64,691 for loans listed in appendix D, for a total of $202,655.

3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this instance, we estimated funds to be put to better use at 59 percent of the unpaid principal balance. HUD provided information that shows its loss on sales averages 59 percent of the claim paid. We used 59 percent of the unpaid principal balance because HUD had not paid claims for these loans. The amount in this column consists of $1,227,270 for loans listed in appendix C and $421,938 for loans listed in appendix D, for a total of $1,694,217.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

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PROSPECT MORTGAGE

May 20, 2011

VIA ELECTRONIC MAIL AND FEDERAL EXPRESS

Mr. James D. McKay
Regional Inspector General for Audit
U.S. Department of Housing
and Urban Development
Office of the Inspector General
Atlanta Region, 4AGA
Richard B. Russell Federal Building
75 Sprint Street, SW
Room 330
Atlanta, Georgia 30303-3388

RE: Prospect Mortgage, LLC
HUD OIG Draft Audit Report

Dear Mr. McKay:

Prospect Mortgage, LLC ("Prospect" or "Company") is in receipt of the Draft Audit Report ("Report"), dated May 5, 2011, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of Inspector General ("OIG"). The Report is based on a review of the Company conducted during an extensive fourteen-month period beginning in January 2010 and ending in March of 2011. The audit reviewed Federal Housing Administration ("FHA") loans originated by the Company during the period December 1, 2007 through December 31, 2009.

Comment 1

The Report states that its objective was to determine whether Prospect complied with HUD requirements in the origination and Quality Control review of FHA-insured loans underwritten within Region IV of the HUD OIG during the audit period. The Report contains two findings, alleging underwriting deficiencies in 25 adversely selected cases underwritten by a specific group of former underwriters in two branch offices and concerns with the implementation of quality control reviews over its underwriting process during the review period. Based on these findings, the Report recommends that HUD, among other things, require Prospect to: (1) indemnify or reimburse the Department in connection with 25 loans involving underwriting findings; (2) conduct an underwriting review of an additional 184 loans originated in two specific branch offices and request indemnification where instances of noncompliance are found; and (3)

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implement Quality Control procedures to ensure the timely identification and resolution of underwriter performance issues.

Comment 2

It bears noting at the outset of this response that Prospect takes issue with the manner in which loans were selected for review by the Office of the Inspector General. Of the 25 loans in which the OIG cites alleged deficiencies, 24 (96%) were manually-underwritten; 18 (72%) were made to African-American borrowers; 19 (76%) were located in underserved census tracts; and all had credit scores lower than 620. The additional 184 loans in which the Report recommends that HUD conduct a full underwriting review have similar socio-economic components. Of these 184 loans: 63% were made to borrowers located in underserved census tracts; 63% were made to African-American or Hispanic borrowers; and 79% had credit scores lower than 620. There are broader fair lending implications to the methodology employed to select loans for review by the OIG and to the loans which the OIG indicates that Prospect should not have originated that cannot be ignored.

Comment 3

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

I. BACKGROUND

Prospect received approval as a Direct Endorsement mortgagee in July of 1999. Headquartered in Sherman Oaks, California, Prospect operates in several states through approximately 238 FHA-approved branch offices and employs approximately 1,800 individuals. Prospect sells most loans that it originates into the secondary market on a servicing-released basis, and its primary investors include Wells Fargo Home Mortgage, Bank of America and GMAC Mortgage. The Company enjoys excellent relationships with both consumers and its investors, and Prospect's employees consistently strive to produce high quality loans in compliance with HUD/FHA standards.

FHA lending constitutes approximately 40% of Prospect's overall business operations. Because FHA lending represents a substantial portion of Prospect's overall production, the Company takes its responsibilities under the FHA program seriously. We strive to comply with applicable rules and regulations and are committed to educating and training our employees on issues of FHA compliance. In addition, Prospect is dedicated to fair lending and to providing excellent customer service. We aim to make the lending process as simple as possible for borrowers and work closely with each individual applicant to ensure that he or she receives the type of financing that best fits his or her needs. Throughout our existence, we have endeavored to provide dependable and professional service and have repeatedly demonstrated our commitment to borrowers and allegiance to the FHA Program.

Comment 4

We believe it is important to note that the FHA-insured loans cited in the Report were originated in two branch offices of the Company located in Charlotte, North Carolina and Sarasota, Florida, that were part of two acquisitions Prospect completed in August and September, 2007, respectively, one of which has been closed, and underwritten by nine individuals who are no longer employed by the Company, and have not been employed by Prospect since well before the OIG began its review in January of 2010. Given these circumstances, and the significant changes the Company has made to its management, personnel, underwriting policies and Quality Control procedures, we believe that many, if not all, of the issues raised in the Report were addressed timely and were effectively resolved before the onset of this audit.

For instance, in early 2009, Prospect retained a new senior management team, including several key compliance officers including a General Counsel, Chief Compliance Officer, and Quality Control manager. Upon arrival, these senior managers conducted a full-scale review of the Company's existing policies, procedures, and internal controls and made several changes and enhancements to improve loan quality and performance. Importantly, Prospect restructured the management and oversight of its underwriters to ensure that all underwriters consistently underwrote loans pursuant to the Company's and HUD's underwriting requirements. The Company established Regional Underwriting Managers to implement Company-wide underwriting standards who report to Divisional Underwriting Managers and ultimately to the Chief Risk Officer and Chief Operations Officer. All underwriters report directly to the Regional Underwriting Managers, who are located at underwriting centers throughout the Company to provide enhanced quality, monitoring, management support, and training to Prospect's underwriters. The Company also employs Escalation Underwriters, who are responsible for addressing data discrepancies identified in the underwriting process.

The Company has also continued to strengthen its underwriting guidelines since the audit period. As an example, Prospect conducts income verifications prior to closing for all income-qualifying loans by obtaining a processed IRS Form 4506 and has created an affordability calculation to ensure borrowers can demonstrate an ability to make timely mortgage payments. Prospect also formed a Credit Risk Management Committee ("CRMC"), which is comprised of senior managers including, among others, the Chief Risk Officer, General Counsel, Chief Operations Officer, and Quality Control Manager. To date, the CRMC has implemented several policies and procedural changes to mitigate risk trends in the Company's loan portfolios, including: (1) running FraudGuard on all loans; (2) reprogramming its loan origination system to limit the employees authorized to approve loans with higher risk scores and require specific approval from authorized staff for loans with certain risk characteristics; (3) implementing maximum debt ratio overlays to automated underwriting systems; (4) screening all loans through ComplianceEase four times throughout the origination process to ensure that loans comply with applicable federal and state guidelines; and (5) establishing an Appraisal Management group to oversee and centralize the ordering of appraisals and appraiser management. As discussed in detail below, Prospect has also significantly enhanced its Quality Control department and FHA loan review process to identify and resolve deficiencies.

As a result of these and other enhancements to the Company's underwriting policies and Quality Control procedures, the quality and performance of the Company's FHA-insured loan portfolio has greatly improved. With regard to both underwriting and Quality Control, Prospect is in many ways a different company than at the time it originated and performed Quality Control reviews of the loans identified in the Report.

II. RESPONSE TO THE FINDINGS

The Report contains two findings, including several sub-findings, in which it alleges that Prospect did not originate 25 adversely-selected loans in accordance with HUD requirements or prudent lending practices, and did not implement Quality Control procedures to ensure the timely identification and resolution of underwriter performance issues. The loans selected for review were almost exclusively manually-underwritten loans made to minority borrowers with low FICO scores located in underserved census tracts. Upon receipt of the draft Report, Prospect conducted a thorough review of the findings and loan files, as well as examined applicable HUD/FHA guidelines and internal Company procedures at the time these loans were originated, in an effort to provide pertinent information and documentation with this response. Our review indicated that several of the findings in the Report are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability. While we recognize that there is always room for improvement, at no time did the Company intentionally disregard HUD guidelines or knowingly misrepresent information to the Department. Where a deficiency existed, we have acknowledged it and

Comment 5

Mr. James D. McKay
May 20, 2011
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strengthened our policies and procedures to assure compliance with HUD's requirements. As noted above, the OIG's underlying review evaluated loans originated between 2007 and 2009, and took over one year to complete. Thus, the Report's findings identify issues present in the Company's files four years ago. As discussed above, Prospect is a different company than it was during the time period covered in the OIG's review. In fact, Prospect's compare ratio in the Atlanta Homeownership Center is 82% for the two-year period ending April 30, 2011, which means that Prospect's loans are performing better than the average for the area. Prospect's nationwide compare ratio also is 78%, which means that Prospect is performing better than the average lender. We detail the changes Prospect has made, from its management to its underwriting procedures to its Quality Control processes.

Comment 4

Nevertheless, the Report only cursorily acknowledges the significant changes Prospect independently undertook before the audit began and the profound improvements in loan quality and performance that resulted from these changes. For this reason, as discussed in detail below, several of the allegations regarding loan underwriting and Quality Control processes should be removed from the final report. At a minimum, the Report should be significantly amended to acknowledge throughout the Report the progress Prospect has made in enhancing its underwriting and Quality Control policies, the renewed commitment to loan quality and accountability that the Company's new senior management has demonstrated, and the profound positive improvements to loan performance and quality that have resulted from these changes, all of which occurred before the OIG began its review in January of 2010.

We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate Prospect's general compliance with HUD/FHA requirements and adherence to prudent lending standards in the loans at issue, as well as our efforts to enhance policies and procedures to ensure strict adherence to HUD requirements and improvement in overall loan performance. Below we reply to the individual matters raised in the Report, evidence our adherence to FHA requirements in connection with the findings and several cited loans, set forth our opposition to the manner in which the recommendations are presented in the Report, and take strong exception to the recommendations that HUD conduct a full underwriting review of all loans underwritten by the two branch offices during the audit period.

Comment 1

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A. FINDING 1 – PROSPECT COMPLIED WITH HUD's UNDERWRITING REQUIREMENTS

Finding 1 of the Report asserts in several sub-findings that the Company did not originate 25 of the 33 loans[1] reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) compensating factors for high qualifying ratios; (2) credit analysis; (3) income assessment; (4) debt assessment; (5) asset documentation; (6) seller contribution calculations; (7) gift fund documentation; and (8) certain "other" deficiencies.[2]

Comment 6

At the outset, however, we note that, as expressly acknowledged in the Report, the OIG in fact reviewed only 23 of the 33 loans identified, and alleges deficiencies in only 20 of these cases. In the remaining 10 loans, only a limited scope review that focused on compensating factors and the evaluation of collection accounts was completed, and the Report asserts deficiencies in only five of these loans. Prospect takes issue with these assertions, as they are based on a cursory review of the loan file documentation and do not take into consideration the full underwriting analysis or documentation relied upon by the underwriter to make determinations of creditworthiness for these borrowers. As you know, the underwriting process is subjective and cumulative based on a thorough analysis of the borrower's complete credit profile, financial situation, and particular circumstances. A review of only pieces of the information utilized by an underwriter to conduct this evaluation will not paint an accurate picture of the borrower's eligibility for FHA financing and, thus, should not be used as the basis for making serious allegations that result in recommendations of indemnification or administrative action. For these reasons, citation to deficiencies in any of the 10 loans in which only a limited scope review was performed is inappropriate and should be removed from the final report. We address the individual assertions made in the remaining 20 loans in turn below.

Comment 7

[1] While the Report refers to a total sample size of 33 loans, Prospect provided approximately 170 loan files to the OIG during the course of its audit.

[2] We note that the draft Report asserts that two loans contained "less significant deficiencies" that were not serious enough to negatively impact loan approval. As Prospect addressed these issues throughout the OIG's review, and the auditors determined that these findings do not warrant further action by HUD, we have not provided individual responses to these two cases herein.

1. Compensating Factors

a. Prospect Materially Adhered to HUD Requirements

In fourteen 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 Report makes a similar assertion in five additional cases in which a full review was not performed; rather, the OIG conducted only a cursory review of the compensating factors and collection accounts reflected in the loan file documents.

Comment 6

Comment 5

The Department has acknowledged that "[u]nderwriting is more of an art than a science and requires the careful weighing of the 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, if two underwriters were to review the same file, one might approve a loan where the other would deny a loan. Significantly, each underwriter may have made a reasonable and prudent underwriting decision.

Furthermore, the Department expressly permits a mortgagee to approve FHA financing to a borrower with qualifying ratios that exceed the benchmark guidelines of 31% and 43% where significant compensating factors can be documented to justify loan approval. See, e.g., HUD Handbook 4155.1, REV-5, ¶¶ 2-12, 2-13; Mortgagee Letter 2005-16.[3] 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

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

Comment 8

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. The Report does not appear to understand this nuance of FHA underwriting, as illustrated by their repeated characterization of benchmark ratio guidelines as "limits." The benchmark guidelines are not limits and should not be treated as such for loan approval.

Comment 5

It is Prospect'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 benchmark guidelines must be justified by significant compensating factors. Contrary to the allegations in this sub-finding, when compensating factors or other justifications were required, Prospect 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 in the majority of cases cited.

Comment 9

The Report takes specific issue with income earned by a non-borrowing spouse as a compensating factor, as the spouse's credit had not been assessed. However, that interpretation is at odds with other compensating factors guidance provided by HUD. For example, HUD Handbook 4155.1 REV-5, paragraph 2-13(J) indicates that prospective income from a secondary wage earner can be used as a compensating factor if the primary wage earner has been relocated. There is no requirement that the secondary wage-earner be obligated on the mortgage to qualify for this compensating factor. In fact, this compensating factor specifically excludes the word "borrower" while other enumerated compensating factors include that term. There is also no requirement that the secondary wage-earner's credit be assessed to qualify for this compensating factor. HUD Handbook 4155.1 REV-5, paragraph 2-2(D) specifically limits the requirement to review the credit of a non-purchasing spouse to properties located in community property states, which is not the case for the loans at issue. If *prospective* income from a non-obligated spouse is acceptable as a compensating factor without assessing that spouse's separate credit in a non-community property state, it certainly stands to reason that actual, documented, income should be acceptable as well.

Comment 10

We also note that the Report identifies a total of 30 deficiencies regarding compensating factors, although it references only 14 FHA-insured loans in connection with this sub-finding. As discussed above, HUD's requirement with regard to compensating factors states that, if a borrower's qualifying ratios exceed HUD's threshold percentages, the underwriter must identify and document compensating factors. HUD does not impose a minimum number of compensating factors that must be used to effectively justify higher-than-average ratios. In each FHA-insured loan originated, an underwriter either meets this standard by identifying sufficient compensating factors based on his or her delegated discretion, or does not document sufficient compensating factors to justify loan approval. In any case in which an underwriter listed multiple factors that the OIG, and ultimately HUD, may deem invalid or unsupported, these multiple factors do not constitute multiple violations of HUD requirements, but rather one instance of non-compliance with HUD's guidelines regarding the documentation of compensating factors. Moreover, if an underwriter lists

Comment 10

an invalid compensating factor alongside other valid compensating factors, the invalid factor's presence does not nullify the existence of valid compensating factors on the loan. To suggest otherwise, as the Report does, is inflammatory and appears to constitute an effort to justify the fourteen-month audit, rather than identify substantive deficiencies involving the presence of sufficient compensating factors to support the loan approval decision in the individual loans identified in this sub-finding.

b. Example of Compliance with HUD Requirements

As indicated above and in the Company's individual responses to the OIG's concerns throughout this audit, Prospect maintains that it adhered to HUD guidelines

Comment 11

regarding documentation of compensating factors in high-qualifying ratio loans identified in the Report. For example, in the loan, **FHA Case No. 105-3451957**, the sub-finding asserts that the compensating factors of minimal debt user and increased earning potential were insufficient in this instance. Prospect respectfully disagrees.

In this case, the borrower's back-end ratio was 46% **(Exhibit A-1)**, which only slightly exceeded HUD's benchmark percentage of 43%. See HUD Handbook 4155.1 REV-5, ¶ 2-12; Mortgagee Letter 2005-16. For this reason, along with other notes in the Remarks section, including the borrowers FICO score, the underwriter properly documented compensating factors of "minimal debt user" and "earning potential is increasing with raises per written VOE" **(Exhibit A-1)**. The written VOE expressly stated that the borrower would receive a pay increase of 4-5% within the year **(Exhibit A-2)**. HUD guidelines expressly state, and the Report expressly acknowledges in both Appendices E and F, that the potential for increased earnings is a valid compensating factor. See HUD Handbook 4155.1 REV-5, ¶ 2-13(I). The loan file and MCAW clearly documented this valid factor, which compensated for the borrower's slightly higher-than-benchmark back-end ratio.

Nevertheless, the Report asserts that, if the borrower's income were recalculated based on this future raise, the ratios would not be reduced to the 43% benchmark cited in HUD guidelines. We are not, however, aware of, and the Report does not cite, any FHA requirement that the compensating factors identified, when applied to the qualifying ratios, must decrease the ratios to percentages at or below HUD's benchmark

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ratios. In fact, such a requirement would be impossible, as certain permissible compensating factors, such as a minimal increase in housing expense, see HUD Handbook 4155.1 REV-5, ¶ 2-13(F), by definition would not decrease a borrower's qualifying ratios. Rather, HUD has delegated to underwriters the discretion to consider the weight of compensating factors that affect the underwriting decision and FHA guidelines require underwriters to document these factors on the MCAW. Prospect strictly adhered to these guidelines in documenting the borrower's potential for increased earnings in this case. See id. ¶ 2-13(I).

Comment 11

Additionally, the underwriter also noted, as supported by the borrower's credit report, that the borrower was a minimal credit user. The borrower had only two automobile loans, and was making timely payments on both accounts **(Exhibit A-3)**. While we acknowledge that HUD guidelines also require a borrower to have a demonstrated ability to accumulate savings to rely upon this factor, the borrower's minimal use of credit was nevertheless relevant to his overall credit picture. Along with the documented valid compensating factor of potential increased earnings, the underwriter reasonably determined that the borrower qualified for FHA financing in compliance with HUD requirements.

Comment 5

In summary, contrary to the assertions in the Report, Prospect documented valid compensating factors that justified loan approval in this case. Prospect adhered to HUD guidelines in this, and several additional loans cited in this sub-finding. Thus, these assertions should be removed from the final report.

2. Credit Analysis

Comment 6

In 17 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, charge-off accounts, and/or non-sufficient fund fees, but the files did not document compensating factors to justify loan approval in these cases. The Report makes a similar assertion in three additional cases in which a full review was not performed; rather, the OIG conducted only a cursory review of the compensating factors and collection accounts reflected in the loan file documents.

Comment 5

At the outset, we note that the Report appears to misstate HUD requirements regarding the assessment of a borrower's creditworthiness in connection with FHA-insured loans. With regard to creditworthiness, HUD guidelines expressly require FHA-approved lenders to "examine the overall pattern of credit behavior, rather than isolated occurrences of unsatisfactory or slow payments." HUD Handbook 4155.1 REV-5, ¶ 2-3. When delinquent accounts, such as unpaid collection accounts or not-sufficient funds fees, are revealed, FHA guidelines instruct the lender to "document their 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, including delayed mail delivery or disputes with creditors." Id. The Report, however, alleges that, upon identifying such derogatory accounts, rather than obtain an explanation for the derogatory item and analyze the borrower's full credit profile, the Company was required to document compensating factors to justify why it approved the loan despite the derogatory credit. As discussed at length above, FHA-approved lenders are only required to document compensating factors when a borrower's qualifying ratios exceed HUD's threshold percentages. Id. ¶¶ 2-12, 2-13. We are not aware of, and the Report does not cite, any requirement that compensating factors are necessary to offset collection accounts or other derogatory items in a borrower's credit history. Rather, HUD guidelines instruct lenders to obtain explanations for these credit issues and analyze the borrower's overall pattern of credit behavior. Id. ¶ 2-3.

Comment 12

Comment 13

In addition, the Report confuses specific banking terms in its analysis of this issue. Specifically, in the section entitled "Returned Items," the Report asserts that four loan files did not contain explanations regarding overdrafts that appeared on the borrowers' bank statements and refer to these overdrafts being assessed for "insufficient funds." Overdrafts are not the same as insufficient funds or returned items. The borrowers in these cases had overdraft protection that was linked to other depository accounts that they held with their financial institutions. The borrowers in question availed themselves of a service that was provided by their banks that transferred funds into their accounts if their account balance in a specific account was lower than a requested payment. That is a qualitatively different concept from what has been asserted in the Report. These borrowers did not have items returned for insufficient funds. They merely had funds moved from one depository account to another, which does not reflect on the borrowers' regard for financial obligations or ability to manage debt. In fact, the presence of overdraft protection on the borrowers' accounts show that the borrowers held their financial obligations in high regard and wished to ensure that their debtors were paid as expected.

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

That being said, we note that HUD delegated to FHA lenders the responsibility for analyzing a borrower's credit and determining an individual's creditworthiness. See

HUD Handbook 4155.1 REV-5, ¶ 2-3. While HUD has established specific guidelines, credit analysis remains largely subjective. For example, where derogatory credit items are present, lenders have discretion to consider the borrower's unique circumstances and determine whether financing is appropriate, which includes an analysis of the age of the derogatory item, the type of obligation, and the reason for its origin. 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 Prospect's policy to carefully scrutinize a borrower's credit history to obtain any documentation or explanation necessary to assess a borrower's credit risk. See Mortgagee Letters 00-24 and 95-07; see also HUD Handbook 4155.1 REV-5, ¶ 2-3. While two underwriters may make different decisions about a borrower's credit in the same case, both underwriters may have complied with FHA requirements and made reasonable underwriting decisions. Prospect takes its underwriting responsibility seriously and would never knowingly approve a loan to an unqualified borrower.

Comment 5

In the cases cited in the Report, Prospect complied with FHA guidelines by examining the borrowers' overall pattern of credit behavior and reasonably determining that the borrowers qualified for FHA financing. The Company properly considered each borrower's previous housing obligations, recent and/or undisclosed debts, collections, and non-sufficient funds circumstances, and Prospect underwriters reasonably determined that past derogatory items did not reflect a current disregard for financial obligations. The loan files contain required documentation and Prospect prudently exercised the discretion granted to it by the FHA. As a result, Prospect adhered to FHA requirements by reasonably determining that the borrowers were creditworthy and qualified for FHA loans.

Comment 14

For example, in the loan, **FHA Case No. 381-8479987**, the Report asserts that the borrower's credit report evidenced a $1,290 unpaid collection account; however, the file did not document whether the collection accounts were based on a disregard for financial obligations or factors beyond the control of the borrower, and should have documented compensating factors to justify loan approval in this instance. Prospect respectfully disagrees.

Comment 14

In the loan, the borrower's most recent credit report evidenced that the borrower had one unpaid collection account in an amount of $1,297 **(Exhibit B-1)**. This account was opened in May of 2000 **(Exhibit B-1)**, eight years prior to the loan closing in July of 2008 **(Exhibit B-2)**. Nevertheless, contrary to the assertion in the Report, Prospect obtained an explanation from the borrower regarding this derogatory account **(Exhibit B-3)**. In that letter, the borrower stated that, at the time the account was open, she was working only part-time and was attending school to advance her degree and earning potential **(Exhibit B-3)**. As a result of these efforts, she obtained her

Comment 14

associates degree, as well as full-time employment. Based on this explanation, the underwriter reasonably determined that the borrower had resolved her past credit issues that led to the delinquent account and represented an acceptable credit risk. Contrary to the Report's assertions, the underwriter was not obligated to document compensating factors to justify loan approval in this instance. Rather, the underwriter, as required, obtained explanations of past derogatory issues and, based on an evaluation of the borrower's overall credit profile, reasonably determined that the borrower qualified for FHA financing. Thus, these assertions, as well as assertions in several additional loans cited in this sub-finding in which the loan files document explanations for past derogatory items that have been resolved or were outside of the borrowers' control, should be removed from the final report.

3. Income Assessment

Comment 5

In nine of the loans audited by the OIG, the Report contends that the Company did not properly assess the borrowers' income. Prospect respectfully disagrees with the allegations in several of the cases included in this sub-finding.

Prospect understands and appreciates that, when determining whether a borrower qualifies for FHA financing, a lender must analyze a borrower's income from all sources to ensure its stability and continuance. With regard to employment income, it is the Company's policy and procedure to obtain all required documentation of the borrower's employment and earnings, see HUD Handbook 4155.1 REV-5, ¶ 3-1, verify the information directly with the borrower's employer, and calculate monthly earnings based on the evidenced earnings. See HUD Handbook 4155.1 REV-5, ¶¶ 2-6, 2-7. Prospect also analyzes income in each FHA-insured transaction to ensure it documents a two-year employment history, and obtains and analyzes explanations for any gaps in employment greater than 30 days. See id. With regard to overtime and bonus income, it is Prospect's policy to adhere to HUD guidelines regarding documenting and calculating such income to ensure its stability and continuance. See id. ¶ 2-7. Prospect maintains that it complied with these requirements in several loans cited in the Report.

Comment 15

As an example, in the loan, **FHA Case No. 381-8578816**, the Report asserts that the loan file did not verify the borrower's likelihood of continued employment, as the borrower had only worked for her current employer for 1.5 months.

Comment 15

To document the borrower's employment in this case, Prospect obtained a verbal VOE **(Exhibit C-1)**, employment letter, and pay stub **(Exhibit C-2)** from the borrower's current employer, , in Raleigh, North Carolina. The verbal VOE and employment letter evidenced that the borrower had been employed in this position since May 12, 2008 **(Exhibits C-1, C-2)**. Because these documents reflected only a 1.5 month history prior to closing on June 27, 2008 **(Exhibit C-3)**, the

Company obtained written and verbal VOEs and a W-2 form from the borrower's prior employer, , located in New York, NY, reflecting that she had been employed with this company from November 20, 2006 though March 31, 2008 **(Exhibits C-1, C-4)**. Prospect also verified that the borrower briefly worked at during the brief gap between these two permanent positions in April and May of 2008 **(Exhibit C-1)**. The loan file also documented the borrower's employment with , located in Morrisville, North Carolina, from January 1, 2006 through November 15, 2006, **(Exhibit C-1, C-5)**. These documents evidenced the borrower's history of employment in the counseling field for more than two years leading up to loan closing in June of 2008 **(Exhibit C-3)**.

Although the borrower had only recently begun her new position with , the loan file evidenced, and the addresses of her employers confirmed, that the borrower had moved from North Carolina in November of 2006 to care for her ill parent **(Exhibits C-4, C-5, C-6)**, had worked as a counselor in New York for 1.5 years **(Exhibit C-5)**, and had recently returned to North Carolina to continue her career as a counselor in her current position **(Exhibits C-1, C-2, C-6)**. (See table below)

Time Period	Employer	Location	Reason for Leaving
5/12/08 - Current		NC	N/A
4/1/08 – 5/31/08		NC	Found job in chosen field
11/20/06 – 3/31/08		NY	Return to NC
1/1/06 – 11/15/06		NC	Move to NY to care for ill parent

Though she had recently begun her new position, Prospect adhered to HUD guidelines in verifying the likelihood of her continued employment. Specifically, FHA requirements state that:

Comment 15

> To analyze and document the probability of continued employment, lenders must examine the borrower's past employment record, qualifications for the position, previous training and education, and the employer's confirmation of continued employment. A borrower who changes jobs frequently within the same line of work, but continues to

advance in income or benefits, should be considered favorably. In this analysis, *income* stability takes precedence over *job* stability.

Comment 15

HUD Handbook 4155.1 REV-5, ¶ 2-6 (emphasis in original). Prospect adhered to these requirements in analyzing the borrower's likelihood of continued employment in this case. The borrower had a strong employment record as a counselor, was qualified for the position, and had held previous jobs in this profession. The loan file further evidenced that the reason for her recent job changes were due to a geographic move based on personal circumstances, rather than issues related to job performance. Other than the borrower's employment status after closing, which would not have been known to the underwriter at the time the loan decision was made, the Report does not cite, and there is no evidence to suggest, that the borrower's employment was unlikely to continue after closing. Prospect adhered to HUD's income assessment requirements in this case, as well as other cases cited in the Report. As a result, these assertions should be removed from the final report.

Comment 16

Finally, we note that, although the Report identifies concerns with income assessment in only nine loans, the chart on page 10 identifies 17 deficiencies regarding income. As discussed above, the standard for compliance with HUD guidelines regarding income assessment is whether, in any given loan, the lender obtained sufficient information and properly analyzed such information to determine that the borrower qualified for FHA financing. In each FHA-insured loan originated, the underwriter either meets or does not meet this standard. In any case in which the OIG, and ultimately HUD, may determine that an underwriter did not properly assess a borrower's income such that the borrower did not qualify for the FHA-insured loan, such assessment does not constitute multiple violations of this standard, but rather one instance of non-compliance with HUD's guidelines regarding income assessment. To suggest otherwise, as the Report does, is inflammatory and appears to constitute an effort to justify the fourteen-month audit, rather than identify additional substantive deficiencies in the nine individual loans identified in this sub-finding.

4. Debt Assessment

Here, the Report alleges that, in six loans, the file did not adequately document that all of the borrowers' monthly obligations were included in the debt-to-income ratio calculations.

The Company understands and appreciates that, in determining a potential borrower's qualification for an FHA-insured loan, a lender must consider all of the borrower's liabilities, including all installment loans, revolving charge accounts, real estate loans, alimony, child support, and other continuing obligations *extending ten months or more*. See HUD Handbook 4155.1 REV-5, ¶ 2-11(A). HUD guidelines require the inclusion of debts with less than ten payments at the time of closing only 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. Id. Prospect's policy and procedure mandates strict adherence to these requirements in all FHA-insured loan transactions it

Comment 5
Comment 17

originates and, contrary to the assertions in the Report, the Company maintains that it did so in several of the loan cited in this sub-finding. It bears noting that in all loans selected for audit in which debts with fewer than ten payments remaining were excluded from qualifying ratios, the Report cites their exclusion as a deficiency. The clear implication of this interpretation is that the Report concludes that all debts with fewer than ten payments affect the borrower's ability to repay the mortgage in the months immediately after loan closing. This interpretation would render the exception the rule and would render the current guideline governing this issue moot.

Comment 17

For instance, in the loan, **FHA Case No. 381-8674809**, the Report asserts that the Company should have included a $376 payment for an automobile loan **(Exhibit D-1)** with less than ten payments remaining after closing **(Exhibit D-2)**, into the borrower's qualifying ratios calculation, because the debt would have affected the borrower's ability to repay the loan. Contrary to this assertion, the borrower had sufficient resources to satisfy this debt prior to closing. The loan file documents, and the Report acknowledges, that the borrower had $2,300 in reserves as of June 30, 2008 **(Exhibit D-3)**, which was more than the $1,470 remaining balance left on the loan **(Exhibit D-1)**. Based on this information, there was no evidence to suggest that the borrowers would not be able to continue to make the remaining payments on this account in a timely fashion. For these reasons, the underwriter adhered to HUD requirements and properly excluded this debt from consideration of the borrowers' eligibility for FHA financing.

Despite these facts, Appendix E to the Report maintains that, as the funds were held in a joint account, and as the borrower did not in fact satisfy the automobile loan prior to closing, the debt should have been included in the borrower's qualifying ratios. Neither the Report nor Appendix E cites, nor are we aware of, any provision that requires a borrower to satisfy outstanding debts with less than ten payments remaining prior to closing. Rather, as expressly stated above, HUD guidelines merely require lenders to evaluate such debts to determine if they will affect a borrower's ability to repay the mortgage loan after closing. Prospect's underwriter satisfied this requirement in this instance and reasonably determined based on the substantial reserves available to the borrower that the debt would not affect the borrower's future loan repayment ability. Prospect adhered to HUD guidelines and this allegation, as well as other allegations in this sub-finding, should be removed from the final report.

5. Asset Documentation

In this sub-finding, the Report asserts that, in eleven cases, the loan files did not evidence assessments of cash assets held by the borrowers at the time of closing.

Comment 18

In several cases, the Report and/or Appendix E assert that the loan file did not adequately document the source of large or earnest money deposits ("EMD"), despite the fact that many of the "large" deposits were for amounts as low as $500. Prospect respectfully disagrees with the assertions in several of these loans.

Comment 18

As an example, in the loan, **FHA Case No. 105-3353198**, the Report takes issue with the borrower's provision of a $1,000 EMD to the real estate agent six months prior to closing **(Exhibits D-1, D-2)**, and asserts that the loan file should have contained documentation of the source of the EMD funds. Contrary to this assertion, the $1,000 deposit was much less than two percent of the sales price **(Exhibit D-2)**, and, thus, the Company was not required to document the source of these funds. See HUD Handbook 4155.1 REV-5, ¶ 2-10(A).

Comment 19

Additionally, in six loans, the Report asserts that the costs covered by the premium pricing contributions were not itemized on the HUD-1 Settlement Statement ("HUD-1"). Prospect understands and appreciates that, at the time these six loans were originated, HUD guidelines required FHA-approved lenders to include on the HUD-1 an itemized statement indicating which items are being paid on the borrower's behalf. See HUD Handbook 4155.1 REV-5, ¶ 1-9(J). During the time period in which the loans at issue were originated, it was Prospect's policy and procedure to include an itemized list of all costs covered by premium pricing in FHA-insured loans. Any oversights regarding the itemization of costs covered by premium pricing in the six cases identified in the Report were isolated instances. Moreover, any deficiencies in this regard constituted, at worst, harmless error. The Report does not allege that the premium pricing provided was contrary to HUD guidelines, and the Department has since removed its requirement that lenders itemize costs covered by premium pricing. See HUD Handbook 4155.1 5.A.2.i. For these reasons, we believe the issues regarding premium pricing disclosures in these six cases did not constitute material violations of HUD guidelines and, therefore, inclusion of these findings in the final Report would be inappropriate.

6. Seller Contribution Calculation

Comment 20

In two loans, the Report asserts that the Company did not properly assess the sellers' contributions to the transaction. For instance, in the loan, **FHA Case No. 381-8479987**, the Report alleges that the seller's contributions exceeded the maximum allowable six percent contribution, as the HUD-1 and settlement agent disbursement records show that the seller, rather than the borrower, paid for the land in the manufactured home loan transaction.

Comment 20

Prospect respectfully disagrees that the seller contributed excess funds in this case. This loan provided funds for the purchase of a manufactured home, as well as for the underlying land contract on which the home was placed **(Exhibits F-1, F-2)**. The HUD-1 demonstrates that the total contract sales price was $111,000, which consisted of $96,000 for the manufactured home purchased from **(Exhibit F-1)** and $15,000 for the land contract purchased from **Exhibit F-2)**. The borrower obtained an FHA-insured loan to cover the purchase of both the land and the manufactured home as reflected on the HUD-1 **(Exhibit B-3)**. The HUD-1 documents that the seller of the manufactured home, , received the full amount of the loan proceeds, minus the costs reflected as paid by the seller. One of those costs was the $15,000 for the land contract, which was forwarded to , as indicated on the HUD-1 **(Exhibit B-3)**. Although the HUD-1 suggests that purchased the land contract as part of their loan proceeds, this is not the case. The purchase contracts for the manufactured home and land contract evidence that was entitled to only $96,000 of the $111,000 in loan proceeds **(Exhibit F-1)**, which it received minus allowable costs **(Exhibit B-3)**, and was entitled to the remaining $15,000 to cover the land contract **(Exhibit F-2)**, which it also received from the loan proceeds **(Exhibit B-3)**. Although the HUD-1 disclosure of this transaction may have caused some confusion, the purchase contracts make clear that, contrary to the assertions in the Report, the sellers in this case did not contribute more than six percent of the sales price to the transaction. Rather, the loan proceeds covered the costs of both the manufactured home and the land contract in this case, and were properly disbursed to and , respectively. Prospect adhered to HUD requirements in this case and, thus, this allegation should be removed from the final report.

7. <u>Gift Fund Documentation</u>

Comment 21

In 15 cases, the Report asserts that the loan files did not contain proper verification of gift funds received by FHA borrowers. In all but one loan, the Report alleges that the loan file did not contain complete documentation to evidence that gift funds from non-profit downpayment assistance organizations had been received by the closing agents at or before closing.

FHA guidelines require a lender to verify and document the transfer of gift funds used by a borrower. <u>See</u> HUD Handbook 4155.1 REV-5, ¶ 2-10(C). While the Department no longer permits such assistance in FHA-insured loans, <u>see</u> P. Law 110-289, Section 2113, at the time the loans at issue were originated HUD permitted borrowers to obtain gift funds from non-profit entities providing downpayment assistance. Until 2004, Page 2-11 of HUD's Single Family Reference Guide ("Guide") expressly stated that, with respect to gifts provided by a nonprofit or municipality through a downpayment assistance program, "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." In each of the loans cited in the Report in which downpayment assistance was provided, the HUD-1 documents the transfer of the funds, and the settlement agents certified to the accuracy of the information reflected on the HUD-1. It was not until HUD issued Mortgagee Letter 2004-28 that the Department's guidelines expressly required lenders to obtain and keep the documentation of the wire transfer in its mortgage loan application binder in connection with downpayment assistance gift transfers.

Comment 21

At the time the loans at issue were originated, Prospect understands and appreciates that it was required to obtain and retain evidence of the wire transfer of gift funds from the downpayment assistance provider in its loan file. We acknowledge, as indicated in the draft Report, that this documentation was not available in the loan files at the time of the OIG's review. Nevertheless, in preparation of this response, the Company contacted each settlement agent and obtained evidence that the funds identified on the HUD-1s were in fact transferred by the non-profit assistance provider to the agent at settlement. To document the borrowers' receipt of downpayment assistance in the remaining cases, we have attached: (1) the gift letter from the downpayment assistance organization; (2) the HUD-1 evidencing the gift funds; and (3) the wire transfer documentation confirming that the settlement agent received these funds at or before closing. This documentation is attached as follows:

Borrower	FHA Case No.	Gift Letter	HUD-1	Wire Transfer
	381-8514681	G-1	G-2	G-3
	381-8479987	H-1	H-2	H-3
	105-3365433	I-1	I-2	I-3
	105-3323949	J-1	J-2	J-3
	381-8578816	K-1	K-2	K-3
[4]	105-3353198	L-1	L-2	
	461-4313298	M-1	M-2	M-3
	105-3405939	N-1	N-2	N-3

[4] Prospect is in the process of obtaining the wire transfer documentation from the settlement agent in this case; however, we note that the Report expressly acknowledges that the settlement agent has already provided the OIG with documentation sufficient to evidence that the borrower in fact received the downpayment assistance funds in this case.

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Borrower	FHA Case No.	Gift Letter	HUD-1	Wire Transfer
	105-4101563	O-1	O-2	O-3
	105-3535564	P-1	P-2	P-3
	105-3451957	Q-1	Q-2	Q-3
	461-4115484	R-1	R-2	R-3
	381-8673508	S-1	S-2	S-3
[5]	381-8674809		T-1	T-2

Comment 21

The attached documentation demonstrates, in addition to the HUD-1 reference to the gift funds, that each of these borrowers in fact received the downpayment assistance gift from the nonprofit provider. While the wire transfer documentation was omitted from the loan files in these cases, any oversight constituted, at worst, harmless error. The attached documents evidence that the borrowers in all of the cited cases in fact received the downpayment assistance funds at the time of closing and qualified for FHA financing. For these reasons, these allegations and any requests for administrative action in connection with these cases should be removed from the final report.

8. Recommendations

In addition to opposing several of the individual allegations contained in the Report, Prospect strongly disagrees with certain aspects of the recommendations made in connection with the loans referenced.

a. Recommendations Regarding Potential Losses to the Department

Comment 22

The Report recommends, among other things, that the Department require the Company to indemnify HUD for potential losses of $1,694,217 in connection with the 17 active loans referenced. To derive these estimated losses, the Report indicates that it included 59 percent of the unpaid principal balance in these cases. According to Appendix A, this multiplier was selected based on information provided by HUD showing that its losses on sales average 59 percent of the claim paid.

[5] Prospect was unable to locate a copy of the gift letter in this case; however, the HUD-1 and wire transfer documents confirm that the borrower in fact received the downpayment assistance funds at closing from an appropriate source.

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Comment 22

Prospect does not take issue with the OIG's inclusion of the Department's actual or potential losses in connection with loans for which claims have been made. The Company does, however, take strong exception to inclusion of the $1,694,217 in estimated losses in the 17 cited loans. First, we note that the $1,694,217 figure does not represent a payment that the Report recommends Prospect pay to HUD, but rather reflects a mere estimate of the losses the Department could incur if all 17 loans ultimately result in claims to HUD. The Report merely recommends that HUD request indemnification, but any amounts paid to HUD in connection with any indemnifications will be determined based on the actual losses to HUD upon resolution of the claim made to the Department, rather than the estimates included in this document.

All 17 of the loans at issue remain active. Prospect appreciates that these loans may have entered default at some point; however, none of these loans have been foreclosed, terminated, or resulted in insurance claims to the Department. To date, HUD has not incurred any loss in connection with these cases and it is not possible to determine whether the Department will ever incur losses in these cases. In fact, the Report expressly states that, in four of these loans, the borrowers are current with their mortgage payments. Moreover, in the event that HUD does pay a claim in any of these loans, there is no guarantee that the Department will sustain monetary loss, as HUD may be able to recoup the claim amount in the sale of the underlying property.

Comment 22

Notwithstanding these facts, the Report suggests that the Department will experience losses in the amount of 59% of the unpaid principal balance of each one of these loans, and lists the financial risk to the Department, which it defines as "funds to be put to better use," as $1,694,217. This calculation assumes that every one of the active loans will go into foreclosure and result in a claim to HUD. Such an assumption would be supportable if 100% of the loans that enter default resulted in claims to HUD; however, that percentage is significantly lower. Thus, there is no reason to believe that any of these loans, let alone all of them, will result in a claim or financial loss to the Department. Based on these facts, absent evidence that the 17 loans at issue will result in an actual claim to the Department, the potential loss figure is greatly inflated and does not paint an accurate picture of the risks associated with this matter. It appears that inclusion of such an inflammatory figure in the final report serves only as an attempt to justify the costs of the fourteen-month audit of this Company, rather than portray the precise amount of the potential losses that HUD may incur in connection with these loans.

Comment 22

Moreover, as noted above, this arbitrary monetary figure is included with a mere recommendation to the Department to require the Company to indemnify it in connection with certain loans. Upon receiving the final report, the Department will have an opportunity to independently review the audit findings and make an independent

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Comment 5

determination of whether indemnification is warranted in any of these cases. As discussed at length earlier in this response, Prospect disagrees that the majority of the findings set forth in the Report warrant indemnification. HUD may also disagree with the Report's assertions and decide not to pursue indemnification in some or all of the cited cases. Notwithstanding the fact that these findings are preliminary, the OIG's recommendations assume that HUD will accept each allegation and pursue indemnification in each case.

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

Comment 23

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 ADDRESSEES, THE HUD ASSISTANT SECRETARY FOR HOUSING – FEDERAL HOUSING COMMISSIONER AND THE ASSOCIATE GENERAL COUNSEL FOR PROGRAM ENFORCEMENT, WHO WILL ULTIMATELY DECIDE WHETHER TO ACCEPT THE REPORT'S RECOMMENDATIONS IN WHOLE OR IN PART OR REJECT THEM.

Comment 22

The above discussion demonstrates that the estimated loss figure is unrepresentative of the Department's actual loss risk in connection with the 17 active loans cited in the draft Report. Inclusion of this overstated figure in the Report unfairly represents the loss exposure to HUD, and ultimately the Company, as a result of this audit. Therefore, Prospect strongly opposes the inclusion of this figure in the final report and requests that it be removed or amended to portray a more accurate picture of the potential losses in the active FHA loans cited in the Report. As the recommendation regarding these loans is that the Company indemnify HUD, the Report should merely state this recommendation without including estimated losses that are difficult, if not impossible, to predict accurately in these loans. At the very least, if the final report continues to include the average claim loss paid for these 17 loans as the potential financial risk to HUD and the Company, the Report should also clarify the percentage of defaulted loans that result in a claim to HUD and include the potential losses based on this significantly reduced number of loans. This figure would present readers with a more accurate and fair picture of the financial risks associated with the loans identified in the Report.

b. Recommendations Regarding Additional Underwriting Reviews

Comment 1

In connection with Finding 1, the draft Report also recommends that HUD conduct a full underwriting review of the remaining 184 defaulted loans originated in the two branch offices identified in the Report either now for those 18 loans in which HUD has already paid a claim or at the time a claim for FHA insurance benefits is filed for the remaining 166 loans. To the extent the Department identifies noncompliance with HUD guidelines in any of these cases; the Report recommends that HUD request indemnification. The Report notes in several places that the total mortgage amount in these loans is more than $26.1 million.

Comment 6

Prospect takes strong exception to the inclusion of these recommendations in the final report. The Report makes this recommendation without even a cursory review of the loan files at issue, and makes no substantive allegations in connection with any of these loans. The Report provides in Appendix G a list of these loans, but makes no specific findings in these cases to which the Company could respond. This recommendation, however, suggests to the reader that each of these loans involve underwriting deficiencies, which is likely not the case. As discussed at length above, underwriting is a subjective process based on an evaluation of the cumulative facts of each individual loan application package. The mere presence of underwriting issues in certain of an underwriter's loan files does not automatically lead to the conclusion that all of the loan files of a particular underwriter will demonstrate additional underwriting concerns. Moreover, it is important to note that 95% of these loans had debt-to-income ratios below benchmark guidelines as compared to the original group of 23 loans where all of the loans exceeded benchmark ratio guidelines, 50% made ten or more payments, and HUD's own data indicates that 84% of the borrowers defaulted due to factors outside of Prospect's control such as post-origination curtailment of income, unemployment or illness. Nevertheless, the Report suggests as much by recommending that HUD expend significant resources to conduct loan file reviews outside its normal Quality Assurance process based on some perceived risk in these

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remaining loans. This recommendation does not conform to standard audit procedures and, as such, is inappropriate and should be removed from the final report.

Comment 24

We also take strong exception to the repeated references to the total mortgage amount of $26.1 million in these 184 loans. Although the Report expressly acknowledges that only 18 of these 184 loans have resulted in insurance claims to HUD, by citing the total mortgage amount of all 184 loans, the Report suggests that the Department will experience losses in the amount of 100% of the unpaid principal balance of each one of these loans and that all claims will be based on underwriting issues rather than on default reasons, such as job loss, outside of a lender's control. This calculation assumes that <u>every one of the remaining 166 loans will go into foreclosure and result in a claim to HUD</u>. There is no reason to believe that any of these loans, let alone all of them, will result in a claim or financial loss to the Department. Based on these facts, absent evidence that the 166 loans at issue will result in an actual claim to the Department, the total mortgage amount figure is greatly inflated and does not paint an accurate picture of the risks associated with this matter. This is particularly troubling in this context, as the Report makes no substantive findings of non-compliance in a single loan referenced in connection with this recommendation.

Comment 1

Moreover, as discussed above, this recommendation and arbitrary monetary figure are included with a mere recommendation to the Department to conduct an underwriting review of these 184 loans and, to the extent non-compliance is identified, request indemnification. Upon receiving the final report, the Department will have an opportunity to independently review the audit findings and make an independent determination of whether any additional underwriting review is warranted. HUD may disagree with the Report's assertions and decide not to pursue this course of action.

Comment 24

The inclusion of such an inflammatory recommendation and the corresponding citation to the total mortgage amount of the additional loans referenced in Appendix G occurred at the very end of the audit process and appears to serve only as an attempt to justify the costs of the fourteen-month audit of this Company, rather than portray the precise amount of the potential losses that HUD may incur in connection with these loans. This recommendation is highly unusual and inappropriate and Prospect requests that it and any reference to the total mortgage amount in the loans identified in Appendix G be removed from the final report.

B. FINDING 2 – PROSPECT ADHERES TO HUD's QUALITY CONTROL REQUIREMENTS

In Finding 2, the Report alleges that the Company did not effectively implement components of its Quality Control procedures relative to: (1) annual reviews of two recently acquired branch offices; (2) identification of loan origination deficiencies; (3)

classification of the severity of its Quality Control findings; (4) reverification of borrower information; and (5) documentation of corrective action for Quality Control findings. The Report asserts that these past issues hindered the Company's ability to identify and correct performance issues by the specific underwriters and branch offices referenced in Finding 1 in a timely manner and contributed to the Company's high default/claim rate in the Atlanta Homeownership Center's geographic region. As a result, Finding 2 recommends that HUD refer the matter to the Mortgagee Review Board.

Comment 25

Prospect practices strict Quality Control and adheres to a detailed Quality Control Plan. See HUD Handbook 4060.1 REV-1, ¶ 6-1. We continuously strive to improve the Company's Quality Control department and have taken significant steps to enhance our Quality Control review procedures to ensure full compliance with HUD guidelines and to allow Prospect's management to identify and remedy any issues that may affect loan quality or performance in a timely manner.

Comment 25

The Report expressly states that Finding 2 is based on a review of Quality Control procedures and loan review reports that were in place or conducted between 2007 and 2009. As discussed in detail above, prior to the OIG's review, the Company took several significant steps to enhance its Quality Control procedures to ensure improvements underwriting quality and overall loan performance. In early 2009, well before the audit detailed in the Report began, the Company retained a new senior management team, including a General Counsel in January 2009, as well as a Chief Compliance Officer and a Quality Control Manager as of February 2009. Upon arrival, these senior managers conducted a full-scale review of the Company's existing policies, procedures, and internal controls and made several changes and enhancements to improve loan quality and performance, which are detailed in the Background section above. In addition to the significant changes to the oversight of the Company's underwriters, as well as our underwriting guidelines, Prospect made several changes to its operations and personnel. Most notably in connection with this audit, Prospect closed one of the two branch offices in which the majority of the loans at issue in the Report were originated. In addition, underwriting authority was removed from the remaining branch such that all FHA loans from the area are now underwritten from a centralized location. As acknowledged in the Report, all nine of the underwriters who underwrote the loans identified in this matter left the Company before this audit began.

Comment 25

Moreover, during the majority of the time period reviewed in this audit, Prospect outsourced its Quality Control reviews to a third-party vendor. In mid-2009, in conjunction with the substantial changes Prospect's new management was undertaking, the Company began performing Quality Control reviews internally, and greatly enhanced its analysis and reporting of Quality Control findings to improve its detection of trends and performance issue and take prompt action to remediate any identified

Comment 25

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deficiencies. Moreover, in mid-2009, the Company re-reviewed all current defaults that had defaulted in the first six payments, even if the loan had previously been reviewed by the outside Quality Control vendor, to acquire as much data on our defaulted loans into our internal Quality Control system as possible to allow for better trending and reporting of defaulted loans. These enhancements have greatly improved Prospect's overall loan quality, as well as our ability to address issues quickly and ensure that any deficiencies do not negatively impact our default/claim rate.

Since implementing these changes, the default/claim rate for loans underwritten by the Company has dramatically improved, particularly in the Atlanta Homeownership Center's geographic region. As evidenced by the most recent Neighborhood Watch data, Prospect's default/claim rate for underwriting in the Atlanta Homeownership Center's geographic region was 82% for the two-year period ending April 30, 2011 **(Exhibit U)**. The Company believes that this significant improvement in loan performance evidence that the comprehensive changes brought about by the new senior management team have had a demonstrable effect on the Company's underwriting.

Despite the fact that the OIG's review of 33 loans took fourteen months to complete, the review did not include an evaluation of the Company's current Quality Control process, which would have revealed the hard work the Company has performed to improve its Quality Control program and the resulting improvements in loan quality. Thus, rather than acknowledge the significant changes Prospect has made to its Quality Control program and the profound positive effect these changes have had on our loan quality and underwriting performance, the Report makes only passing reference to these changes and instead focuses on the Company's Quality Control program as it existed almost two years ago, before these substantial improvements were implemented. The result is a Report that paints a picture of a Company that is not engaging in Quality Control, when in fact Prospect identified and addressed all of the issues identified in Finding 2 prior to the OIG's review.

To that end, the Report takes issue with five general areas of Prospect's former Quality Control review procedures. We address each of these areas in detail below. As these responses will demonstrate, Prospect independently analyzed and changed its Quality Control process to actively monitor the Company's origination and underwriting performance and take prompt action to address any issues identified. For these reasons, administrative action would be inappropriate. After reviewing this response, we hope the Report will be amended to focus on the Company's substantial improvements to its Quality Control program, as well as our resulting improved loan performance statistics in the Atlanta Homeownership Center region, rather than dwell on past procedures that the Company independently identified and addressed well before the audit began.

Comment 25

1. **Branch Office Reviews**

With regard to the assertion that the Company did not conduct annual reviews of two recently acquired branch offices, and the corresponding claim that the Company did not timely assess the performance of underwriters located in these two offices, we note that the Report focuses on two branch offices that Prospect obtained through business acquisitions in 2007, one of which has been closed, and nine underwriters associated with those two offices who are no longer with the Company. Prospect understands and appreciates that a mortgagee's offices engaged in origination and underwriting must be reviewed to determine that they are in compliance with HUD guidelines, and that annual on-site reviews are required in circumstances in which the office or key personnel are new, or when the office has a high default/claim rate. See HUD Handbook 4060.1 REV-5, ¶ 7-3(G). We acknowledge that, at the time of the acquisition of the branches at issue in 2007, the Company's prior management did not strictly adhere to the Department's on-site review requirements. As discussed at length above, however, Prospect's management was overhauled in early 2009, and the Company made significant changes to both its underwriting criteria and its Quality Control policies and procedures. One of these important changes was to create a branch audit team to review all offices of the Company in 2009 and 2010 to ensure that each branch office was complying with all HUD guidelines regarding its operations and origination and underwriting functions. As a result of this review, as well as a review of the branch offices' high default/claim rates by the new management team, Prospect closed one of the two offices in question and no longer employs any of the underwriters associated with the loans identified in the Report.

Comment 25

In addition to the substantial changes the Company made beginning in 2009, in the course of responding to the draft Report, Prospect identified a document created in November of 2008 that lists the corrective actions the Company instituted to enhance the performance of the two branch offices identified in the Report **(Exhibit V-1)**. We also made changes to our credit underwriting criteria on a quarterly basis beginning in the first quarter of 2008. Attached as **Exhibit V-2** is a summary of the changes we made in the credit risk grid on a quarterly basis.

Comment 26

With regard to its review of underwriter performance, Prospect respectfully disagrees with the assertions in this sub-finding. This finding is based on hindsight and ignores the reality of when information became available upon which to base an action. The Report references defaults that aggregated over a two year time period, asserting that Prospect should have acted upon this information more quickly than it did. This is best illustrated by looking at underwriters A and G, who collectively underwrote 16 of

Comment 26

the 25 loans which the OIG claims contain deficiencies. Underwriter A was hired by Prospect via an acquisition of another lender in July of 2007 and left Prospect's employ at the beginning of November 2008. Underwriter G was hired by Prospect in March of 2008 and left Prospect's employ at the end of December 2008. They were employed for approximately 15 months and 9 months, respectively.

Comment 26

The sixteen loans underwritten by underwriters A and G that are included in the Report had first payment dates that ranged from February 1, 2008 to November 1, 2008 and their borrowers made an average of five payments each before defaulting. After considering the first payment dates of the loans in question, the number of payments that were made before the first 60 day default, the reporting delay before default information is made available on FHA Connection, and a reasonable audit period to discover any underwriting errors, it is clear that only two of the sixteen defaulted loans would have been reviewable before the underwriters were terminated.

Comment 26

Both of these loans were underwritten by underwriter A with first payment dates of 2/1/2008. Both loans made 1 payment before defaulting, meaning they defaulted as of the 3/1/2008 payment. These loans would become 60 days delinquent on 5/1/2008 and would be reported as 60 days delinquent on FHA Connection in the third week of May, 2008. HUD generally describes a reasonable audit period as 90 days, so the earliest point that Prospect could have reviewed any of the loans at issue and taken any action in response was the end of August, 2008, approximately 60 days before underwriter A was terminated. Since both of these loans defaulted due to post-origination curtailment of income, their defaults would not be attributable to underwriting deficiencies. These two loans fail to support a trend or an argument that a decision to take action based on these defaults could have been made much earlier than it was. Actions that are based on trends, by definition, take some time to develop. It is inappropriate to look at trend data developed long after the fact and extrapolate findings based upon those trends to points earlier in the process when the majority of the data used to establish the trend was not available.

Comment 4

In summary, although the Report takes issue with the fact that these reviews and actions were not conducted sooner, Prospect nevertheless reviewed these branch offices' and underwriters' performance, found them to be unacceptable, and resolved these issues well before the OIG began its audit in January of 2010. For these reasons, we respectfully request that this sub-finding be removed from the Report.

2. **Identification of Origination Deficiencies**

In this sub-finding, the Report alleges that the Company's Quality Control reviews did not identify areas of non-compliance with HUD's underwriting requirements, as the audit identified underwriting deficiencies that were not identified in the Company's Quality Control review reports.

Comment 5

Prospect respectfully disagrees with these assertions. As an initial matter, as indicated in our response to Finding 1 above, Prospect maintains that, contrary to the Report's assertions, the Company adhered to FHA underwriting guidelines in a significant number of the loans identified in Finding 1 of the Report. As the Company maintains that several of the issues identified in these cases in the Report do not constitute violations of HUD guidelines, such issues should not have been identified in the Company's Quality Control reviews. Moreover, as indicated above, at the time the

Comment 25

Quality Control reviews of the loans identified in the Report were conducted, Prospect utilized a third-party vendor to complete such reviews. Since that time, however, Prospect has retained a Quality Control Manager, greatly enhanced its internal Quality Control department, and currently conducts Quality Control reviews on its own loan portfolio. Prospect's Quality Control process is robust and, as set forth in our Quality Control plan, includes a careful review for compliance with all areas identified in HUD requirements. See HUD Handbook 4060.1 REV-2, ¶ 7-7. When issues are identified, the Quality Control department works closely with the line of business managers to ensure that any compliance issues are promptly addressed and reports these actions directly to senior management on a routine basis.

Comment 25

Again, the issues raised in this sub-finding focus on Quality Control reviews conducted under an out-dated Quality Control process of loans originated under a prior management team. Prospect has made significant changes to its Quality Control department since the time of these reviews; however, the Report leads the reader to believe that the issues raised have not been addressed. For these reasons, inclusion of this sub-finding in the Report would be inappropriate. At the very least, the Report should be amended to acknowledge within this sub-finding the Company's proactive approach to improving its Quality Control department and processes, which have in turn enhanced our loan quality and performance, under the Company's new management structure.

3. Classification of Quality Control Findings

Finding 2 of the Report acknowledges that Prospect classified the severity of deficiencies identified in its overall sample of loan files, but asserts that the Company did not provide such classifications for its Quality Control reviews for its reviews of early payment default loans. Initially, we note that the Report itself does not classify the severity of alleged deficiencies; rather, it cites numerous issues that would be classified as minor, harmless errors but reports them as though they were significant issues impacting loan approval.

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With regard to classification of the severity of issues identified in Quality Control reports, HUD guidelines regarding Quality Control indicate that "[t]he Department recommends that Quality Control reports to mortgagee management include an assessment of risks … on the basis of the severity of the violations found during the review." HUD Handbook 4060.1 REV-1, ¶ 7-4 (emphasis added). While the Department has set forth a risk ratings system that suggests lenders place each QC report into one of four categories of risk, from low to material, HUD requires only that "[m]ortgagees may consider [the] ratings system" set forth in this Handbook. Id. (emphasis added).

Comment 25

As acknowledged in the Report, these provisions make clear that, while HUD prefers that mortgagees include a risk rating system in their Quality Control procedures, such a rating system is not required by the Department but is merely a suggestion. Moreover, the Handbook indicates that, while the low to material risk designation provides one potential format for such a system, mortgagees may develop their own system for evaluating Quality Control samples on the basis of the severity of the violations found during the review. Id. Nevertheless, in accordance with these recommendations, and as indicated in the Report, Prospect has consistently include such risk ratings as part of our Quality Control processes, both for our sampled Quality Control reviews and our reviews of early payment default loans. To the extent that such ratings were not included in the Quality Control reports reviewed during the audit, this circumstance likely resulted from the transition to an internal, rather than external, Quality Control process. In any event, the Company presently includes a risk rating for Quality Control findings for both its 10% sample of loans reviewed, as well as its early payment defaults. For these reasons, and because any risk rating system is merely recommended, rather than required under HUD guidelines, inclusion of this sub-finding is inappropriate and we request that it be removed from Finding 2 of the Report.

4. **Re-verification of Borrower Information**

Comment 25

With regard to the sub-finding concerning re-verification of borrower information as part of the Quality Control process, Prospect understands and appreciates that HUD guidelines require FHA-approved lenders to subject loan file documentation to written re-verification to determine whether the loan origination and underwriting fully complied with HUD guidelines. See HUD Handbook 4060.1 REV-2, ¶ 7-6(E). It is Prospect's policy and procedure to send written verification forms to re-confirm information in the loan file, including employment and assets for all loans, and the Company obtains a new credit report for each FHA-insured loan subject to a Quality Control review. To the extent that Quality Control reviews examined during the course of the audit did not contain re-verifications of loan file information, we again note that these reviews were completed during an out-dated Quality Control process on loans originated under a prior management team. Prospect has made significant changes to its Quality Control department since the time of these reviews, including ensuring that all loan file documentation is re-verified in each loan reviewed by Prospect's Quality Control department. Had the review focused on the Company's current Quality Control procedures, rather than dwelling on Quality Control reviews completed several years ago, our current compliance with this requirement would have been apparent. Therefore, inclusion of this sub-finding in the Report is unwarranted. At the very least, the Report should be amended to acknowledge within this sub-finding the Company's proactive approach to improving its Quality Control department and processes, which have in turn enhanced our loan quality and performance, under the Company's new management structure.

Comment 25

5. **Documentation of Corrective Actions**

Finally, the Report alleges that the Company did not document the corrective actions it took to address and resolve findings included in the Quality Control reports it reviewed.

Prospect understands and appreciates that final Quality Control reports must identify actions being taken, the timetable for their completion, and any planned follow-up activities the lender will take to ensure corrective action based on Quality Control findings. See HUD Handbook 4060.1 REV-1, ¶ 6-3(I). It has consistently been Prospect's policy and procedure to examine all Quality Control reports, identify issues that required follow-up responses and corrective action, and provide counseling and training to Company employees where necessary. While Prospect consistently has taken such corrective actions in response to Quality Control findings, the Company acknowledges that it's prior management and Quality Control program did not always diligently explain such action in its Quality Control records in every instance. Any oversight in that regard in the Quality Control reports reviewed in this audit, however, has been resolved. As discussed at length above, Prospect has made significant changes to its Quality Control department since the time of these reviews, including documenting all corrective actions taken in response to Quality Control findings that suggest underwriting or origination deficiencies or non-compliance with HUD guidelines. For these reasons, inclusion of this sub-finding in the Report is unwarranted. At the very least, the Report should be amended to acknowledge within this sub-finding the Company's proactive approach to improving its Quality Control department and processes, which have in turn enhanced our loan quality and performance, under the Company's new management structure.

Comment 25

III. CONCLUSION

Comment 5

Comment 25

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

We believe that this response and accompanying exhibits demonstrate that the Report's recommendations in connection with the cited loans are unwarranted. We respectfully request that the OIG revise its recommendations to fit the facts of this case and remove allegations from the Report in those instances in which Prospect has demonstrated its compliance with HUD requirements or has addressed the issues raised sub-finding through procedural or policy changes.

If you have any additional questions, or if you need additional information, please do not hesitate to contact our Washington counsel, , at (202) 778-9257.

Thank you for your kind consideration.

Sincerely,

Federal and State Examination Coordinator

Enclosures

cc:

OIG Evaluation of Auditee Comments

Comment 1 Prospect incorrectly stated that we recommended that HUD conduct an underwriting review of 184 loans. We recommended that HUD conduct an underwriting review of any of the 184 loans that result in claim requests to HUD.

Comment 2 Prospect took issue with our sample alleging broader fair lending implications based on the socio-economic composition of the sample. The socio-economic composition of the sample has no bearing on whether or not FHA underwriting requirements were complied with. The process we used to select the sample is explained in the methodology section of the report, and it did not consider the borrowers' socio-economic status. The sample selection criteria included, but were not limited to, objective factors such as early payment defaults, high front and back ratios, and approvals by underwriters who had high default rates.

Comment 3 Prospect requested an opportunity to respond to any substantive comment that we make in the report after we consider their written response. During the audit we provided Prospect several opportunities to respond to our conclusions after which we made revisions where appropriate, and we noted in the report where Prospect disagreed with our conclusions (see comment 5). We explained to Prospect that our reporting policy is to incorporate their final response into the report followed by our assessment of their comments. We informed Prospect that we would not give them the opportunity to respond to our assessment in the report but that it will have the opportunity to provide further comments to HUD as they consider our recommendations and whether or not to accept them.

Comment 4 Prospect commented that before the audit began that it had made significant changes to the company's management, personnel, underwriting policies, and quality control procedures. Given these circumstances, Prospect commented that many, if not all, the issues raised in the report were addressed and resolved before the onset of the audit. Our report recognized that Prospect made certain changes noted in its response, but they did not resolve the reported violations nor did they remove the risk of losses the loans pose to HUD's insurance fund

Comment 5 Prospect commented that its review indicated that several of the findings in the report are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability. Prospect also commented that underwriting is more of an art than a science and that an underwriter has to exercise discretion in deciding whether or not to approve or reject a loan. We acknowledge Prospect's position, however the underwriter's decision to approve a loan should still fall within FHA requirements and the decision must be adequately documented and supported. During the audit, we provided Prospect several opportunities to review our tentative conclusions and to provide documentation to support that the loans met requirements. Based on the information Prospect provided during the audit and in this response, we revised the report to delete several issues where the documentation supported Prospect's position and we revised several other issues to clarify our presentation. We concluded that the remaining deficiencies discussed in the report represent violations which require a final determination by HUD. We included language in the report to note Prospect's disagreements.

In addition, Prospect's comments indicate that it did not disagree with all of the reported issues. However, it did not provide complete information to identify which loans involved violations it considered to be valid.

Comment 6 Prospect commented that the cursory review of the 10 loans for compensating factors and collection accounts was not sufficient to determine the creditworthiness of the borrowers. Therefore, Prospect commented that the violations reported for 5 of the 10 loans should be removed from the report. We disagree because the review, though limited to the indicated issues, was not lacking in thoroughness. We reviewed the loan files and found no documentation to justify the loan approvals given the issues detected concerning compensating factors and collection accounts. The violations detected by the review (summarized in finding 1 and detailed in appendix D) were significant enough to justify a determination that the loans did not meet HUD's requirements for approval.

Comment 7 Prospect commented that we sampled 33 loans, but it provided us with approximately 170 loan files. We identified the files requested from Prospect by a preliminary assessment of risk indicators that included, but were not limited to, defaulted loans, high default rate underwriters, high front and back ratios, and Prospect's quality control findings. We then used the files Prospect provided to gather further trend data which we used to select the audit sample.

Comment 8 Prospect correctly noted that the report referred to HUD's 43 percent benchmark as a limit. We revised the report to change the word limit to benchmark.

Comment 9 We acknowledge that HUD Handbook 4155.1, REV-5, paragraph 2-13, states that prospective income from a secondary wage earner can be used as a compensating factor in cases that involve homes purchased as a result of the relocation of the primary wage earner. The report cited two loans that involved compensating factors which we did not accept for income earned by a spouse because no relocation was involved. We discussed the two loans with a HUD representative who agreed with our determination.

Comment 10 Prospect disagreed with the report calling each instance involving a compensating factor which we did not consider to be valid or properly supported a violation. We revised the report to omit the term violation relative to these instances.

Comment 11 We acknowledge that Prospect documented that the borrower would receive a raise as evidenced on the verification of employment, but it did not establish the extent to which the raise justified exceeding HUD's benchmark ratio. Prospect cited Mortgagee Letter 2005-16 which provided HUD's 43 percent benchmark that was in effect when it made the loan. However, Mortgagee Letter 00-24 states that 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 HUD's benchmark* **(***Emphasis by OIG***)**. Thus, HUD expects the underwriter to ensure that the compensating factor is among those allowed by HUD and to assess the extent to which a factor justifies exceeding HUD's benchmark. We determined that the projected raise, though generally permitted as a compensating factor, was not valid because the increase did not significantly reduce the borrower's debt-to-income ratio. The underwriter did not consider and make this determination. Furthermore, the borrower did not meet the stated compensating factor of having a conservative attitude towards credit because that factor is coupled with a requirement for accumulated savings. The borrower's bank statement showed a balance of only $39.

Comment 12 Prospect denied that it was required to document compensating factors to support its approval of loans with credit problems. As cited in the report, HUD Handbook 4155.1, REV-5, paragraph 2-3, states that 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.

Comment 13 We agreed with Prospect's response concerning the need to revise the report relative to loans where the borrower had overdraft charges as opposed to insufficient fund charges. We revised the report to delete references to violations for items that were returned due to insufficient funds when the borrower had other accounts that covered the insufficient funds.

Comment 14 Prospect commented that it obtained a letter of explanation for the $1,290 collection account that was 8 years old at the time of the loan. The borrower's letter of explanation did not dispute responsibility for the collection account. The letter explained how the collection account occurred, but it did not explain why the borrower had not paid the debt by the time of the loan application. The loan file contained no evidence that the underwriter assessed the explanation to determine why the borrower had not paid the debt even though the borrower had a full time job.

The audit showed a pattern among the cases discussed in appendix E where the loan files contained letters of explanation for undisputed collection and delinquent accounts with no evidence that the underwriters assessed them. The assessments were required to determine if the conditions resulted from circumstances that were beyond the borrowers' control or from their disregard for the unpaid obligations. The file showed that the underwriters often accepted borrower letters of explanation for undisputed account balances with no documentation of the required assessments. HUD Handbook 4155.1, REV-5, paragraph 2-3, provides that when analyzing a borrower's credit history, lenders are required to examine the overall pattern of credit behavior, rather than isolated occurrences of unsatisfactory or slow payments. When delinquent accounts are revealed, *the* *lender must document their analysis* **(***Emphasis by OIG***)** 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, including delayed mail delivery or disputes with creditors.

Comment 15 We recognize that Prospect obtained a verbal verification of employment income and reviewed the borrower's work history. However, as cited in the report, Prospect did not confirm the borrower's probability of continued employment. HUD Handbook 4155.1, REV-5, paragraph 2-6 provides that to analyze and document the probability of continued employment, lenders must examine the borrower's past employment record, qualifications for the position, previous training and education, and *the employer's confirmation of continued employment*. **(***Emphasis by OIG***)** Prospect did not obtain the required verification from the employer concerning the borrower's probability of continued employment.

Comment 16 Prospect disagreed with several tables in the report where the number of violations exceeded the number of loans reviewed during the audit. We explained to Prospect that this occurred because several of the loans involved multiple violations. We added footnotes to the report to clarify the presentations, and we revised the report in one instance where we agreed with Prospect's observation (comment 10).

Comment 17 Prospect disagreed with the cases where we included borrower debts which had less than 10 remaining monthly payments. Prospect stated that we did not accept their exclusion of such payments in any of the loans we examined. It stated that our interpretation would render the requirement governing this issue moot. We disagree. HUD Handbook 4155.1, REV-5, paragraph 2-11(A), provides 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. We included the debts based on documentation contained in the loans file. The files showed that the borrowers already had high debt-to-income ratios, derogatory credit histories, and or low cash reserves. We concluded that the underwriters should have also included the debts because these conditions met the handbook requirement for including them.

Specifically, Prospect disagreed with our inclusion of the $376 debt in a borrower's debt-to-income ratio calculation because it had less than 10 months of remaining payments and the borrower had enough reserves ($2,300) to pay-off the $1,470 balance. We agree that the file did show that the borrower had enough reserves to pay off the debt but that did not occur. Also, as discussed in Appendix E, we had unresolved questions about the reserve balance. The debt increased the borrower's back ratio from 49.72 percent to 59.52 percent at a time when the credit report showed that the borrower owed more than $7,700 for collection accounts. We included the debt because the high ratio and collection accounts indicated the debt may affect the borrower's ability to make the mortgage payment during the months immediately after the loan closed.

Comment 18 Prospect disagreed with our assessment concerning the lack of verification of large earnest money deposits, because in several instances the amounts were as low as $500 and were less than 2 percent of the sales price. HUD Handbook 4155.1, REV-5, paragraph 2-10, required lenders to verify with documentation the deposit amount and the source of the funds if the earnest money deposit exceeds 2 percent of the sales price or appears excessive based on the borrower's history of accumulating savings. The cited cases appeared excessive based on the borrower's history of accumulating savings.

Comment 19 Prospect commented that the cited deficiencies related to the premium pricing contributions were immaterial, and HUD has since updated Handbook 4155.1 to remove the premium pricing itemization requirement. We recognize Prospect's position but the requirement was in effect when the underwriters approved the loan and they should have followed the requirement. We also recognize that by itself the premium pricing issue would not affect the insurability of the affected loans. However, as stated in the report, we considered these deficiencies in conjunction with the overall violations identified for each borrower.

Comment 20 Prospect disagreed with our assessment that there was an excess seller contribution in case 381-8479987. We examined the basis for Prospect's disagreement and we agreed with their position. We deleted this issue from the report.

Comment 21 Prospect commented that the gift wire transfer violations should be removed from the report because it was a harmless error, and they subsequently obtained the support after we cited the violation. We recognize that Prospect later obtained the missing documents needed to verify the gift funds. However, the documentation was required to be obtained and assessed during the underwriting process and before Prospect approved the loans. Thus, as cited in the report, Prospect did not comply with the requirements.

Comment 22 Prospect disagreed with the methodology we used to calculate the dollar amount cited in recommendation 1C. We based the calculations on HUD OIG's policy to estimate potential savings to HUD from indemnifications associated with improperly originated loans using the average loss severity rate supported by HUD's Single Family Acquired Asset Management System's Case Management Profit and Loss by Acquisition. The actual calculation is explained in the report.

Comment 23 Prospect requested that the report include specific language, including but not limited to, statements that the findings reflect the views of the Office of Inspector General and do not constitute a final determination which will be made by the report addressee. Finding 1 already included wording that addressed Prospect's concern.

Comment 24 Prospect objected to the report's reference to the $26 million for loans approved at two branch offices by high default rate underwriters. The reference is appropriate and necessary to inform HUD of specific activity identified during the audit that warrants further review consideration. The loans were approved by underwriters who had high default rates before and after they started to work for Prospect. Contrary to Prospect's position, finding 1 discussed the loans that make up the $26 million and the reason we concluded that they represented a higher risk to HUD. The report never stated or implied that HUD will experience losses on each of the loans.

Comment 25 Prospect's response to finding 2 concentrated on improvements it made to its quality control processes after its two branches had approved most of the loans questioned by the audit. We revised the report to recognize the quality control changes observed during the audit. In its response, Prospect commented, "We acknowledge that, at the time of the acquisition of the branches at issue in 2007, the Company's prior management did not strictly adhere to the Department's on-site review requirements."

The improvement Prospect made to its quality control processes did not eliminate the risk associated with the loans. Prospect, as a company, was responsible for maintaining proper quality controls at all times. That responsibility remained with the company and did not shift with the change in company management. The audit focused on the past quality control issues because they affected a specific group of loans approved during that period which posed an increased risk for losses to HUD. The focus on those loans was necessary to protect the Department from the risk of losses that could still result from the loans. In addition, the focus on the questioned loans was necessary to ensure that Prospect and not HUD is required to absorb losses that may result from the loans it approved under the past deficient quality control processes.

Comment 26 Prospect disagreed with the report concerning underwriter performance. It stated that the finding is based on hindsight and ignores the reality of when information became available on which to base an action. In essence, Prospect's basic position was that the questioned underwriters no longer worked for the company by the time their high default rates began to show up for the loans they approved for Prospect. We revised the report to recognize Prospect's position. However, we also revised the report to show that most of the underwriters already had high default rates with other lenders when they began to underwrite for Prospect. For instance, before being employed by Prospect, underwriters A, B, C, F, G, and H had default rates of 41.94 percent, 58.62 percent, 33.33 percent, 37.72 percent, 50 percent, and 12.12 percent respectively. The personnel files for the underwriters did not contain documentation to explain why Prospect hired the underwriters who already had such high default rates. The underwriters repeated their high default pattern with the subsequent loans they underwrote for Prospect.

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LOAN UNDERWRITING DEFICIENCY CHARTS

Loans with deficiencies that affected insurability

Case number	Questionable or undocumented compensating factors	Credit not properly assessed	Income not properly assessed	Debts not properly assessed	Inadequate assessment of cash assets	Excessive seller contributions	Gift funds not properly assessed	Other	Total errors per loan	Underwriter	Status	Unpaid Principal Balance	Ineligible	Unsupported	Funds to be put to better use
105-3247562	x					x	x		3	A	Claim-resold		$92,522		
381-8514681		x	x	x	x		x		5	G	Claim-resold		$88,746		
105-3891745		x	x	x	x			x(1)	5	A	Claim-resold		$41,720		
381-8594116			x	x	x				3	G	Claim-resold		$60,182		
105-3387915	x	x			x			x(3)	4	C	Claim-resold		$61,156		
381-8479987	x	x			x		x		4	G	Claim	$108,890		$64,245	
105-3365433	x		x				x		3	A	Claim	$124,947		$73,719	
105-3323949	x		x		x		x	x(1)	4	A	Default	$201,217			$118,718
381-8578816	x	x	x		x		x		5	*	Default	$168,136	$1,498		$99,200
105-3353198		x			x		x		3	A	Default	$182,973	$397		$107,954
461-4313298	x	x	x				x		4	G	Default	$175,120			$103,321
381-8867369		x		x				x(2)	3	*	Default	$143,253			$84,519
105-3405939	x	x					x		3	A	Default	$138,826			$81,907
105-4101563		x		x	x		x		4	**	Default	$126,217			$74,468
105-3720079	x	x							2	F	Default	$355,731			$209,881
105-3535564	x	x			x		x	x(1)	5	A	Delinquent	$122,911	$736		$72,517
105-3451957	x						x		2	A	Delinquent	$104,593			$61,710
461-4115484	x	x	x		x		x		5	G	Current	$67,941			$40,085
381-8673508	x	x	x				x	x(1)	5	G	Current	$223,574	$645		$131,909
381-8674809	x	x		x			x		4	G	Current	$145,915			$86,090
Totals	14	15	9	6	11	1	15	6	77			$2,390,244	$347,602	$137,964	$1,272,279

* This loan was not underwritten by one of the high default underwriters who were the primary focus of the review.
** This loan was automated underwritten.

x (1) – Housing cost understated
x (2) – Questionable occupancy certification
x (3) – Possible third-party verification

Appendix C - Page 2 of 2

Loans with less significant deficiencies

Case number	Inadequate assessment of cash assets	Gift funds not properly assessed	Total violations	Underwriter
105-3692606	X	X	2	*
105-3428714	X	X	2	A
Total	2	2	4	

*This loan was automated underwritten.

Not all errors pertaining to income, credit, or liabilities were considered material deficiencies. Only those errors that could have changed the underwriting decision were considered material. For instance, some errors in income or liabilities did not significantly affect the housing and debt ratios.

Appendix D

INADEQUATE ASSESSMENT OF COMPENSATING FACTORS AND COLLECTION ACCOUNTS (Expanded Sample)

Deficiencies affected loan insurability

Case number	Debt-to-income ratio	Closing date	Loan status	Underwriter	Unpaid Principal Balance *	Unsupported	Funds to be put to better use	Notes
105-3440738	44.6	04/18/08	Claim	C	$109,646	$64,691		a
105-3425304	46.0	01/25/08	Default	C	$217,785		$128,493	b
105-3683691	43.7	04/22/08	Default	B	$137,195		$80,945	c
105-3682405	44.7	05/12/08	Default	A	$102,329		$60,374	d
381-8363464	47.8	02/21/08	Current	H	$257,841		$152,126	e
Total					$824,797	$64,691	$421,938	

*Amounts obtained from HUD's Neighborhood Watch System.

	Audit Observation - While reviewing the initial loan origination sample, we identified a pattern of violations relative to inadequate support for compensating factors and inadequate consideration of derogatory credit indicated by unpaid collection accounts. As a result, we expanded our review to include additional loans to look specifically for compliance with requirements for compensating factors and the consideration of collection accounts during the underwriting process. We randomly selected 10 loans for review from a universe of 60 manually underwritten loans that defaulted during our review period and which had debt-to-income ratios the exceeded HUD's 43 percent benchmark (Mortgagee Letter 2005-16). The expanded review identified violations similar to those identified in our initial loan origination sample. Specifically, Prospect did not properly use supported and/or valid compensating factors and/or properly assess collection for five, or 50 percent, of the expanded sample loans. Due to the high sample error rate, we suspect that additional violations similar to those discussed in our original sample and below, for the expanded sample, also occurred for an undetermined number of the 50 defaulted loans we did not examine, which had debt-to-income ratios that exceeded HUD's 43 percent benchmark. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines and provides that the factor used to justify mortgage approval must be supported by documentation. See appendix F for a listing of the factors.
Notes	
A	Compensating factors - Prospect approved the high 44.6 debt-to-income ratio loan based primarily on an unsupported compensating factor which claimed that the borrower had 5 months of reserves. The file contained bank statements which showed that the borrower had $5,000 on deposit approximately 2 months before closing. The majority of that deposit was attributed to tax refund checks. HUD requires that for cash reserves to be accepted as a compensating factor, they must be documented after closing. The loan file contained no support showing that the borrower still had

	those funds after closing. Prospect also explained that the borrower had taken a first-time home buyers class but that was not listed as a valid compensating factor in HUD's requirements. Prospect also noted that the borrower had good job stability. Job stability was a separate qualifying factor and it was not valid as a separate factor to justify approving a loan with a debt-to-income ratio that exceeded HUD's 43 percent benchmark. HUD Handbook 4155.1, REV-5, paragraph 2-13 (G), provides that the borrower must have substantial documented cash reserves (at least three months' worth) after closing in order for the cash reserves factor to be used. Collection accounts - Prospect did not document why it approved the loan for this borrower, who had more than $11,200 in unpaid collections and charge-offs. The total unpaid obligations included $182 for 1 account that was less than 2 years old and $11,019 for 12 accounts that were more than 2 years old. HUD does not require collection accounts to be paid to approve a loan. However, HUD does require lenders to consider borrowers' past credit performance because it serves as the most useful guide in determining the borrower's attitude toward credit obligations and predicting a borrower's future actions. The borrower's failure to pay or to arrange to pay the collection accounts reflected a disregard for the otherwise legitimate credit obligations. HUD Handbook 4155.1 REV-5, paragraph 2-3 (C), states that court-ordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement but the FHA does not require that collection accounts be paid off as a condition of mortgage approval.
B	Compensating factors - Prospect approved the high 46 percent debt-to-income ratio loan based on an unsupported compensating factor, which claimed that the borrower had reserves. HUD requires a 3-month reserve level, but the borrower's bank statements showed that he had less than 2 months in reserves. Prospect also stated that the property was new construction and that the borrower had taken a first-time home buyers class. However, the class was not listed among the acceptable compensating factors that HUD allows. HUD Handbook 4155.1, REV-5, paragraph, 2-13 (G), provides that the borrower must have substantial documented cash reserves (at least three months' worth) after closing in order for the cash reserves factor to be used.
C	Compensating factors - Prospect approved the high 43.7 percent debt-to-income ratio loan based on an invalid compensating factor, which claimed that the borrower would have a similar housing expense. This was not a valid compensating factor, because the borrower's monthly housing expense went from $894 to $1,112, an increase of more than $200. Further, the borrower's credit history indicated that she had difficulty paying obligations, even at the lower housing expense. Prospect also stated that the borrower had excellent job history. Job stability was a separate qualifying factor, and it was not valid as a separate factor to justify approving a loan with a debt-to-income ratio that exceeded HUD's 43 percent benchmark. Collection accounts - Prospect did not document why it approved the loan for the borrower, who had more than $27,000 in unpaid collections and charge-offs. The total unpaid obligations included $12,915 for two accounts that were less than 2 years old and $14,194 for four accounts that were more than 2 years old. HUD does not require collection accounts to be paid for a lender to approve a loan. However, HUD does require lenders to consider borrowers' past credit performance because it serves as the most useful guide in determining the borrower's attitude toward credit obligations and predicting a borrower's future actions. The borrower's failure to pay or to arrange to pay the collection accounts reflected a disregard for the otherwise legitimate credit obligations. HUD Handbook 4155.1 REV-5, paragraph 2-3 (C), states that court-ordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement but the FHA does not require that collection accounts be paid off as a condition of mortgage approval.

D	Compensating factors - Prospect approved the high 44.7 percent debt-to-income ratio loan based on an invalid compensating factor, which claimed that the borrower had a minimal housing expense increase. We determined that the borrower's housing expense went up more than 20 percent, which brought the borrower's front ratio up to 40.9, or more than 9 percent higher than the 31 percent benchmark allowed by HUD. Prospect also stated that the borrower was a minimal debt user, but that compensating factor was not consistent with the borrower's derogatory credit history. Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. Collection accounts - Prospect did not document why it approved the loan for the borrower who had more than $8,300 in unpaid collections and charge-offs. The total unpaid obligations included $3,857 for four accounts that were 2 years old and $4,489 for six accounts that were more than 2 years old. HUD does not require collection accounts to be paid to approve the loan. However, HUD does require lenders to consider borrowers' past credit performance because it serves as the most useful guide in determining the borrower's attitude toward credit obligations and predicting a borrower's future actions. The borrower's failure to pay or to arrange to pay the collection accounts reflected a disregard for the otherwise legitimate credit obligations. Prospect did not document compensating factors to justify why it approved the loan despite the derogatory credit indicated by the collection accounts. HUD Handbook 4155.1 REV-5, paragraph 2-3 (C), states that court-ordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement but the FHA does not require that collection accounts be paid off as a condition of mortgage approval.
E	Compensating factors - Prospect approved the high 47.8 percent debt-to-income ratio loan based on an invalid compensating factor, which claimed that the borrower had overtime pay that was not included in its credit analysis. We assessed the additional income and determined that if it was factored into the assessment, it would only reduce the debt-to-income ratio from 47.8 to 47.1. Prospect also noted that the borrower was a conservative user of credit. We did not find adequate support for that claim, considering that the credit report showed that the borrower owed more than $27,000.

Appendix E

CASE STUDIES OF IMPROPERLY UNDERWRITTEN LOANS

FHA case number:	105-3247562
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	March 21, 2008
Loan amount:	$138,344
Debt-to-income ratio:	46.50 percent
Status:	Claim and resold with a $92,522 loss to HUD
Default reason:	Unknown - Unable to contact borrower

<u>Questionable or Undocumented Compensating Factors</u>

Prospect approved the high 46.50 percent debt-to-income ratio loan based on invalid compensating factors. We reviewed the loan file for other possible compensating factors but did not identify any. Prospect cited the following compensating factors:

- <u>Job stability</u> – Job stability is a factor lenders should consider when assessing a borrower's overall qualification for the loan, but it is not a factor HUD allows to justify approving a loan with a debt-to-income ratio that exceeds HUD's benchmark.

- <u>Cash reserves</u> – Prospect calculated reserves totaling $8,409, but the amount we calculated amounted to only $2,319, which was less than HUD's 3-month requirement to be considered a compensating factor. We could not determine how Prospect calculated the amount it showed as reserves. Our calculation included the following amounts documented in the loan file that had balances that were appropriate to be included in the reserve calculation.

Earnest money deposit	$ 500
Gift	7,399
Assets available:	
Savings	137
Money market account	517
Roth IRA*	1,165
Total	$ 9,718
Less: total cash to close	$ (7,399)
Reserve amount	$ 2,319

*individual retirement account

The reserves we calculated were $952 short of the 3-month reserve level that HUD required to count reserves as a compensating factor. Our calculation excludes a thrift savings plan (TSP) retirement account that lacked liquidity because the borrower made a

$4,050 hardship withdrawal from the account within 1 month of closing, coupled with an existing loan from the account that had a $3,639 balance. The TSP requirements would not allow the borrower to obtain another loan until 60 days after the loan was paid off and allowed no further withdrawal for 6 months from the date of the last payment.

- Additional income from rental property – This compensating factor was not valid because, as discussed below, the property was damaged by Hurricane Katrina, needed to be renovated, and was not under lease. The file contained no documentation to support when the repairs would be complete and the property would be available for rent. Prospect stated that the borrower received insurance funds to repair the rental property, but the file did not support that claim. The file showed that the borrower had applied for funds to renovate the property and had obtained conditional approval for a loan in September 2007. However, the loan had not been granted when the borrower closed on the HUD loan more than 6 months later. Thus, the file did not document that the borrower had the funds needed to repair the property so that it could be rented to earn the income Prospect claimed as a compensating factor. The borrower defaulted after making only one payment on the loan.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-6, provides requirements lenders are to follow to assess job stability. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation. Paragraph 2-13 (G) provides that the borrower must have substantial documented cash reserves (at least three months' worth) after closing in order for the cash reserves factor to be used.

Excessive Seller Contributions

Prospect did not identify that the seller, a quasi-public corporation, exceeded HUD's 6 percent contribution requirement by $4,979. The excess represents the difference between the seller's $13,613 contribution to the borrower's closing cost and gift (discussed below) and the $8,634 limit based on 6 percent of the property's sales price. The excess contribution should have been but was not treated as an inducement to purchase with a write-down of the mortgage by the amount of the excess contribution.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 1-7(A), states that the seller may contribute up to 6 percent of the property's sales price toward the buyer's actual closing costs, prepaid expenses, discount points, and other financing concessions. Contributions exceeding 6 percent of the sales price or exceeding the actual cost of prepaid expenses, discounts points, and other financing concessions will be treated as inducements to purchase, thereby reducing the amount of the mortgage.

Gift Funds Not Properly Assessed

The file showed that the seller, a quasi-public corporation, inappropriately paid a $7,399 gift on behalf of the borrower. The gift was included in the $13,613 seller contribution discussed above. As a result, Prospect allowed the loan to close without the borrower's providing a downpayment from his own funds or from another appropriate source.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), Gift Funds, provides that the gift donor may not be a person or entity with an interest in the sale of the property, such as the seller, real estate agent or broker, builder, or any entity associated with them. Gifts from these sources are considered inducements to purchase and must be subtracted from the sales price. This rule also applies to properties of which the seller is a government agency selling foreclosed-upon properties.

FHA case number:	381-8514681
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	May 2, 2008
Loan amount:	$124,019
Debt-to-income ratio:	46.75 percent
Status:	Claim and resold with a $88,746 loss to HUD
Default reason:	Curtailment of income

<u>Credit Not Properly Assessed</u>

Prospect approved the loan despite the borrower's recent history of derogatory credit. The credit report showed that the borrower owed $6,670 for nine accounts, which consisted of eight that were in collection ($6,588), mostly for medical bills, and one that was charged off ($82). The borrower was responsible for paying the collection and the charged-off amounts but had not done so. The unpaid collection accounts included $5,974 for six accounts that were less than 1 year old and $696 for three accounts that were more than 1 year old at the time when Prospect closed the HUD loan. The borrower did not adequately explain why he had not paid or arranged to pay each of the collection and charged-off accounts. The unpaid obligations indicated that the borrower had a recent and ongoing problem paying those bills. We recognize that HUD does not require collections accounts to be paid to approve a loan. Prospect should have documented compensating factors to justify why it approved the loan. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

In addition, the file showed that the borrower went from paying $600 per month for rent to a $901 per month mortgage payment. The increase was significant considering the borrower's recent credit problem and his inability to accumulate savings at the lower housing cost.

<u>HUD Requirements</u>

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, 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. Paragraph 2-3 (C), states that court-ordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement but the FHA does not require that collection accounts be paid off as a condition of mortgage approval.

<u>Income Not Properly Assessed</u>

Prospect overstated the borrower's overtime pay by at least $331 per month. The overstatement occurred because Prospect included overtime pay in its calculation of the borrower's effective income, although the amount was earned for only 6 months. HUD requires that overtime be averaged over a 2-year period, but it allows periods of less than 2 years if the lender documents in writing a reason for using the shorter period. Prospect did not document the file to justify why it allowed the overtime. Based on our overtime calculation and the omitted debt discussed below, the borrower's debt-to-income ratio increased from the 38.11 percent rate that Prospect calculated to 46.75 percent. If overtime income were excluded, due to the short 6-month earning period, the borrower's debt-to-income ratio would increase to 52.29 percent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-7(A), provides 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. Periods of less than 2 years may be acceptable, provided the lender justifies and documents in writing the reason for using the income for qualifying purposes. Paragraph 2-6 provides that HUD does not impose a minimum length of time a borrower must have held a position of employment to be eligible. However, the lender must verify the borrower's employment for the most recent 2 full years. The borrower also must explain gaps in employment spanning 1 month or more.

Debts Not Properly Assessed

Prospect understated the debts it used to calculate the 38.11 percent debt-to-income ratio that it used to approve the loan. The mortgage credit analysis worksheet showed that the borrower had no monthly debt in addition to the monthly mortgage payment. However, the file showed that the borrower was paying $50 per month toward a $10,577 medical bill. Adjustment for the omitted debt and the incorrect income calculation discussed above increased the debt-to-income ratio to 46.75 percent. The increased ratio exceeded HUD's 43 percent benchmark (Mortgagee Letter 2005-16).

HUD Requirements

Handbook 4155.1, REV 5, paragraph 2-11(A), provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing.

Inadequate Assessment of Cash Assets

Prospect allowed the loan to close based on an incorrect HUD -1 settlement statement that understated the borrower's investment in the property. The statement understated the property tax amount that was due from the seller, and it incorrectly reported the seller's pro rata tax charge in the section of the statement that was reserved to report amounts that were due from the borrower. As a result, the statement showed that no cash was due to or from the borrower when, based on the numbers shown on the statement, the borrower was due a $427 refund.

	According to the settlement statement	OIG adjustment	According To OIG
Gross amount due from borrower:			
A. Contract sales price	$125,000		$125,000
B. Settlement charges to borrower	2,571	-	2,571
C. Seller portion of property taxes	198[10]	$(198)	-
D. Gross amount due from borrower	$127,769		$127,571
Amounts paid by or on behalf of the borrower:			
E. Principal amount of new loan	$124,019		$124,019
F. Nonprofit gift	3,750		3,750
G. Seller portion of property taxes	-	$229	229
H. Total paid by/for borrower	$127,769		127,998
Cash to borrower (item D minus H)	-		($427)

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 1-7, provides that the borrower must make a cash investment that is at least equal to the difference between the sales price and the resulting maximum mortgage amount but that the cash investment must equal at least 3 percent of the contract sales price.

Gift Funds Not Properly Assessed

Prospect's file contained no documentation showing that it verified the receipt of the $3,750 in gift funds. Thus, Prospect allowed the loan to close without confirming that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

[10] The settlement statement showed that the seller owed taxes for 4 months and that the borrower owed taxes for 8 months. The statement showed that the borrower's share of taxes was $458 figured at $57.19 per month for 8 months. The statement only showed $198 for the taxes owed by the seller for the 4-month period, although the actual amount calculated to $229 (4 months x $57.19). Thus, the $198 shown on the statement for seller taxes was understated, and it was shown in the wrong section of the statement.

FHA case number:	105-3891745
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	July 21, 2008
Loan amount:	$71,633
Debt-to-income ratio:	46.01 percent
Status:	Claim and resold with a $41,720 loss to HUD
Default reason:	Curtailment of income

Credit Not Properly Assessed

Prospect approved the loan despite the borrower's recent credit problems while she lived rent free with her mother and was unable to accumulate savings. The borrower went from paying no rent to a $678 per month mortgage payment. The credit report showed that the borrower owed more than $14,000 on four collection accounts opened between December 2002 and October 2007. The most recent collection was a $153 medical account opened in October 2007, just 10 months before Prospect approved the loan. The borrower stated that one account, with a balance of more than $13,000, occurred because she lost her job. The borrower did not explain why she had not arranged to pay the account. The credit report also showed that in January, February, November, and December 2007, the borrower made late payments on an installment loan. The underwriting finding showed that the case was referred for manual underwriting because it exceeded the risk threshold for automated approval. Prospect did not document legitimate compensating factors for its decision to approve the loan.

We recognize that HUD does not require collections accounts to be paid to approve a loan. Prospect should have documented compensating factors to justify why it approved the loan. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

Prospect did not agree with our assessment, but it provided no information that warranted a revision to our conclusion.

HUD 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, 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.

Income Not Properly Assessed

Prospect did not adequately assess the stability of the borrower's income. Within 3 years before the loan closed, the borrower worked in different lines of work with four different companies, coupled with gaps in employment of more than 30 days. Prospect did not follow up or document its follow-up to clarify the gaps in employment, and it did not verify whether the borrower's most recent employment was likely to continue. Prospect's quality control review showed that the borrower was no longer employed by the employer she worked for at the time it approved the loan. Neighborhood Watch showed that the loan went into default due to a curtailment in income. This condition was consistent with the borrower's unstable work history.

HUD Requirements

HUD Handbook 4155.1, REV-5, section 2, provides that income may not be used in calculating the borrower's income ratios if it comes from a source that cannot be verified, is not stable, or will not continue. Paragraph 2-6 provides that HUD does not impose a minimum length of time a borrower must have held a position of employment to be eligible. However, the lender must verify the borrower's employment for the most recent two full years. The borrower also must explain gaps in employment spanning 1 month or more.

Debts Not Properly Assessed

Prospect understated the borrower's obligations by $20 because it understated the monthly payment for a $548 installment loan.

HUD Requirements

Handbook 4155.1, REV 5, paragraph 2-11(A), provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing.

Inadequate Assessment of Cash Assets

The borrower's bank statement showed a recent $500 unexplained deposit, which was the exact amount of the earnest money payment made 10 days later. The deposit was not consistent with the borrower's deposit pattern shown on the bank statement. We also noted that the check for the earnest money deposit was paid to a realtor, who was not the same realtor shown on the sales contract and the HUD -1 settlement statement. Prospect did not obtain a credible explanation for the source of the deposit, nor did it document follow-up to determine why the deposit was not paid to the seller or the realtor who handled the sale.

Prospect disagreed with our position, stating that the deposit was not a large one and that it was not inconsistent with other deposits made to the borrower's account. We disagree. The automatic teller deposit was from an unexplained source that was different from the usual payroll deposits made to the account.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(A), provides that if the amount of the earnest money deposit appears excessive, based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds used for the earnest money deposit.

Other - Understated Liabilities (Housing Cost)

Prospect understated the borrower's monthly housing insurance and taxes by $55. We used the insurance amount reflected on the HUD -1 settlement statement. The understatement contributed to the borrower's high 46.01 percent debt-to-income ratio.

HUD Requirements

HUD Handbook 4155.1, REV 5, paragraph 2-11(A), provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more.

FHA case number:	381-8594116
Loan purpose:	Refinance
Underwriter type:	Manually underwritten
Closing date:	June 27, 2008
Loan amount:	$166,815
Debt-to-income ratio:	58.40 percent
Status:	Claim and resold with a $60,182 loss to HUD
Default reason:	Curtailment of income

Income Not Properly Assessed

Prospect approved the loan based on regular and overtime pay that it did not verify as likely to continue and without obtaining a written explanation from the borrower for a 3-month gap in employment. The file contained no documentation to support that Prospect followed up to determine the likelihood of the borrower's continued employment and overtime pay. HUD does not allow the inclusion of income from a source that cannot be verified, is not stable, or will not continue. As a result, Prospect approved the loan at a high 52.56 debt-to-income ratio using overtime pay that was not allowed to be counted as effective income.

- Regular and overtime pay was not verified as likely to continue – The employer did not complete the section on the verification of employment to indicate the probability of the borrower's continued employment and wrote "unknown" in the section reserved for verification of the likelihood that overtime would continue. The file showed that the borrower had been employed at the position for less than 7 months.

- Overtime pay – Prospect included overtime pay in its calculation of the borrower's effective income, although the amount was earned for only 7 months, whereas HUD requires a 2-year period. HUD may allow a shorter period, provided the lender justifies and documents in writing the reason for using the income for qualifying purposes. Prospect did not provide this type of documentation and did not verify that the overtime was likely to continue. We did not exclude the overtime from the debt-to-income ratio calculation, but if it were excluded, the ratio would increase to 72.99 percent after factoring in the omitted debts discussed below.

  Prospect stated that inclusion of the overtime was justified because the borrower had been employed continuously in the same line of work for more than 2 years and regularly received overtime during the entire period. The file showed that the borrower was not continuously employed in the same line of work. He went from a position as a cable installer with a telephone company to working for a biotherapeutics company. Also, as discussed below, there was a 3-month gap in employment.

- Gap in employment not explained – Prospect did not obtain documentation to explain a 3-month gap in the borrower's employment from August through November 2007. Prospect was required to obtain an explanation from the borrower for the 3-month gap in employment.

HUD Requirements

HUD Handbook 4155.1, REV-5, section 2, provides that the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt. Income may not be used in calculating the borrower's income ratios if it comes from a source that cannot be verified, is not stable, or will not continue. Paragraph 2-7(A) provides 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. Periods of less than 2 years may be acceptable, provided the lender justifies and documents in writing the reason for using the income for qualifying purposes. Paragraph 2-6 provides that HUD does not impose a minimum length of time a borrower must have held a position of employment to be eligible. However, the lender must verify the borrower's employment for the most recent 2 full years. The borrower also must explain gaps in employment spanning 1 month or more.

Debts Not Properly Assessed

Prospect understated the borrower's debts by $219 per month. The understatement occurred because Prospect omitted one debt and understated the monthly payments for two other debts. The omitted debt had a $191 monthly payment, but it had less than 10 months remaining on the loan. In view of the high debt-to-income ratio, we believe that the debt would have affected the borrower's ability to make mortgage payments during the months immediately after the loan closed. Prospect did not agree with this assessment. The two understated debts included one account for which Prospect used $23 less than the credit report showed and another account for which it used $5 less than the credit report showed. The understated liabilities increased the borrower's already high 52.56 percent debt-to-income ratio that Prospect calculated to 58.40 percent.

HUD Requirements

HUD Handbook 4155.1, REV 5, paragraph 2-11(A), provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing.

Inadequate Assessment of Cash Assets

Prospect did not itemize the costs paid by its premium pricing contribution[11]. The good faith estimate and the HUD -1 settlement statement did not itemize the specific borrower closing costs paid by the $175 premium pricing contribution Prospect made on behalf of the borrower at closing. Prospect was required to itemize the cost paid by the contribution versus stating the amount as a lump sum.

[11] Premium pricing refers to contributions made by the lender at closing to pay a portion of a borrower's closing costs.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 1-9(J) provides that lenders may pay the borrower's allowable closing costs and/or prepaid items by premium pricing. The good faith estimate and the HUD -1 settlement statement must include an itemized statement indicating which items are being paid on the borrower's behalf; disclosing only a lump sum is not acceptable.

FHA case number:	105-3387915
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	January 14, 2008
Loan amount:	$204,874
Debt-to-income ratio:	48.27 percent
Status:	Claim and resold with a $61,156 loss to HUD
Default reason:	Curtailment of income

Questionable or Undocumented Compensating Factors

Prospect claimed four invalid compensating factors to justify its approval of the 48.27 percent debt-to-income ratio loan.

- The borrower received documented income from his spouse that was not reflected in effective income – This was not a valid factor because the borrower's spouse was not a party to the loan and she was not employed when Prospect approved the loan.

- The borrower's spouse would be returning to work soon and had a history of employment in the same line of work – The file did not document support for this compensating factor. Prospect claimed that this was a valid compensating factor because the spouse had a history of working and provided evidence that she would be starting a new job soon. The file contained no evidence to support the spouse's prior work history, nor did it contain support showing that the spouse had received a job offer. The only support for Prospect's claim was a December 27, 2007, letter from the borrower, which stated that his wife would began work on January 28, 2008. The company she was to work for had a name that was similar to that of the seller. Prospect did not verify the job offer.

- Tax benefit to home ownership – Tax benefits were not listed as a valid compensating factor in HUD's requirements.

- The borrower had the potential for increased earnings – The file contained inadequate documentation to support the compensating factor including, as discussed below, Prospect's failure to independently verify the borrower's income.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

Credit Not Properly Assessed

Prospect approved the loan despite the borrower's recent history of derogatory credit. The underwriting finding showed that the case was referred for manual underwriting because it exceeded the risk threshold for automated approval. The credit report showed that when Prospect approved the loan, the borrower owed more than $2,700 for accounts that were in collection ($2,090) or charged off ($658). The borrower was responsible for paying the charge-off amounts but had not done so. The total unpaid obligations included $1,194 for three accounts that were less than 1 year old and $1,554 for two accounts that were more than 2 years old. The unpaid obligations indicated that the borrower had a recurring problem managing debts following a bankruptcy that was discharged in September 2003. The file showed that the borrower was going from paying $1,000 per month for rent to a $1,612 per month mortgage payment. The increased payment for housing cost was significant for a borrower with derogatory credit who already had a problem paying his debts.

We recognize that HUD does not require collections accounts to be paid to approve a loan. Prospect should have documented compensating factors to justify why it approved the loan. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

HUD 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, 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.

Inadequate Assessment of Cash Assets

Prospect understated the borrower's minimum downpayment for the property and did not itemize the cost paid by its premium pricing contribution.

- Minimum downpayment understated – Prospect understated the borrower's minimum downpayment on the mortgage credit analysis worksheet by $516 because the estimates it used to calculate the amount were substantially lower than the amounts shown on the HUD -1 settlement statement. The incorrect calculation caused HUD to overinsure the mortgage by $516. The borrower defaulted on the mortgage, and HUD has paid the insurance claim on the loan. Therefore, Prospect should reimburse HUD for the excess mortgage amount plus interest from the time the loan closed to the date HUD paid the claim.

- Premium pricing contribution – The good faith estimate and the HUD -1 settlement statement did not itemize the specific borrower closing costs paid by the $1,000 premium pricing contribution Prospect made on behalf of the borrower at closing. Prospect was required to itemize the cost paid by the contribution versus stating the amount as a lump sum.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 1-7, provides that the borrower must make a cash investment that is at least equal to the difference between the sales price and the resulting maximum mortgage amount but that the cash investment must equal at least 3 percent of the contract sales price. Paragraph 2-10(A) provides that if the amount of the earnest money deposit appears excessive, based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds used for the earnest money deposit. Paragraph 1-9(J) provides that lenders may pay the borrower's allowable closing costs and/or prepaid items by premium pricing. The good faith estimate and the HUD -1 settlement statement must include an itemized statement indicating which items are being paid on the borrower's behalf; disclosing only a lump sum is not acceptable.

Other - Possible Third-Party Verification

The file did not contain support needed to show that Prospect properly verified the borrower's employment. The employment verification contained in the file was addressed to the seller, and it contained language indicating that the borrower had the probability for continued employment. However, the file contained no information to show how Prospect obtained the verification. Prospect disagreed with our assessment and stated that it completed a verbal verification of the borrower's employment. The loan file did not contain a record of the verbal verification. We tried to contact the employer, but the telephone number for the employer was disconnected.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-7, provides that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first 3 years of the mortgage loan. Paragraph 3-1 provides that 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 interested third parties (e.g., real estate agents, builders, sellers) or by using their equipment.

FHA case number:	381-8479987
Loan purpose:	Construct new home
Underwriter type:	Manually underwritten
Closing date:	July 22, 2008
Loan amount:	$110,129
Debt-to-income ratio:	51.20 percent
Status:	Claim paid, $64,927
Default reason:	Unemployment

Questionable or Undocumented Compensating Factors

Prospect approved the high 51.20 percent debt-to-income ratio loan based on two invalid compensating factors:

- Low payment shock – Prospect's claim that the borrower had a low payment shock was not supported. The borrower's monthly housing cost for the HUD-insured loan was 63 percent higher than her previous housing cost.

- Recent child support increase – The file contained no documentation to support that the borrower had received a recent increase in child support.

We reviewed the loan file for other allowable compensating factors but did not identify any.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

Credit Not Properly Assessed

Prospect approved the loan, although the credit report showed that the borrower owed more than $1,290 for a collection account that was 8 years old and had not arranged to pay it. The file contained no documentation from the borrower disputing responsibility for the account. We recognize that HUD does not require collections accounts to be paid to approve a loan. Prospect should have documented compensating factors to justify why it approved the loan. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

Prospect did not agree with our assessment because the collection account was old and the borrower had reestablished good credit since that time. Prospect did not provide the required analysis to determine whether the collection resulted from a disregard for financial obligations.

HUD 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, 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.

Inadequate Assessment of Cash Assets

Prospect allowed the loan to close without requiring the borrower to make the required minimum downpayment and without properly verifying the source of borrower funds.

- Minimum downpayment not made – Prospect allowed the loan to close without requiring the borrower to make the minimum downpayment. Prospect calculated the minimum downpayment to be $4,584, but the settlement statement supported a downpayment of only $3,330, or $1,254 less than the calculated amount. We calculated the minimum downpayment to be $4,145, which reflected an $815 underpayment.

	According to Prospect	According to OIG
Required downpayment	$4,584	$4,145
Less: funds provided by or for borrower		
gift amount (the only borrower funds paid)	($3,330)	($3,330)
Shortfall in borrower downpayment	$1,254	$815

  We did not give the borrower credit for $1,055, which the settlement statement showed was paid outside closing due to questionable support, which is discussed below.

- Inadequate verification of funds paid outside closing – Prospect did not verify or document that it verified the source of $1,055 for hazard insurance, an inspection fee, and the appraisal, which the HUD -1 settlement statement showed was paid outside closing. The file contained no documentation to support that the borrower had the funds needed to pay the cost. The settlement statement and the loan file did not document who paid the costs which we attributed to the borrower. The file did not include bank statements for the borrower or other documentation to support that the borrower had the funds to pay the cost. If the seller paid the amounts, it would have further increased the inducement to purchase discussed below.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 1-7, provides that the borrower must make a cash investment that is at least equal to the difference between the sales price and the resulting maximum mortgage amount but that the cash investment must equal at least 3 percent of the contract sales price. Paragraph 2-10 provides that the cash investment in the property must equal the difference between the amount of the insured mortgage; excluding any upfront mortgage insurance premiums, and the total cost to acquire the property, including prepaid expenses and closing costs.

Gift Funds Not Properly Assessed

Prospect's file contained no documentation showing that it verified the receipt of the $3,330 in gift funds. Thus, Prospect allowed the loan to close without confirming that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction. We obtained the documents needed to confirm receipt of the gift from the settlement agent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

FHA case number:	105-3365433
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	December 28, 2007
Loan amount:	$125,072
Debt-to-income ratio:	46.35 percent
Status:	Claim paid, $135,323
Default reason:	Curtailment of income

Questionable or Undocumented Compensating Factors

Prospect approved the high 46.35 percent debt-to-income ratio loan based on questionable compensating factors. Specifically, Prospect cited the following compensating factors with which we did not agree:

- The borrower had bonus income that was not used in the qualifying income – We agree that HUD allows lenders to claim a compensating factor for certain amounts that were not used as qualifying income. In this case, the bonus income averaged only $83 per month. If the amount had been included as effective income, the borrower's debt-to-income ratio still would have exceeded HUD's benchmark and required a legitimate compensating factor.

- The borrower had 2 months of reserves in a retirement account – HUD requires that borrowers have at least 3 months worth of reserves after closing as a basis for claiming cash reserves as a compensating factor.

- The borrower was a minimal debt user – The claimed compensating factor is not consistent with the credit report, which showed that the borrower had a recent judgment and a delinquent account. HUD Handbook 4155.1, paragraph 2-13(C), provides that borrowers must have demonstrated an ability to accumulate savings and have a conservative attitude toward the use of credit. The file contained no evidence that the borrower had accumulated savings outside the retirement account discussed above.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

Income Not Properly Assessed

Prospect overstated the borrower's income based on an average income amount which it did not verify as reasonably expected to continue. Prospect calculated the hourly waged borrower's base income using a 35.65-month average without documenting and explaining why the borrower’s 2007 income with the same employer was more than $13,000 less than the amount earned in 2006. We recognize that in situations that involve overtime and bonus pay, HUD allows lenders to average income over multiple years when the income amount varies from year to year. However, lenders are only allowed to include income amounts that are likely to continue through at least the first 3 years of the loan. The file contained no evidence that Prospect followed up with the employer to obtain an explanation for why the verification of employment reflected decreased earnings in 2007 and to determine the average number of hours the borrower worked per week and the likelihood that the borrower would maintain the income level it used to approve the loan. Prospect needed that information to accurately calculate the borrower’s net effective income. The borrower’s back ratio would have increased from the 46.35 rate Prospect calculated to more than 63 percent if net effective income had been calculated based on the borrower’s 11.65-month year-to-date pay for 2007. Neighborhood Watch showed that the reason for default was curtailment of income.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-7, provides that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first 3 years of the mortgage loan.

Gift Funds Not Properly Assessed

Prospect’s file contained no documentation showing that it verified receipt of a $3,811 gift paid to the closing agent by a nonprofit donor. Thus, Prospect allowed the loan to close without verifying that the closing agent received the nonprofit gift used to pay the borrower’s required investment in the property.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower’s account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

FHA case number:	105-3323949
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	December 21, 2007
Loan amount:	$194,805
Debt-to-income ratio:	52.81 percent
Status:	Default
Default reason:	Curtailment of income

<u>Questionable or Undocumented Compensating Factors</u>

Prospect approved the loan based on a 49.15 percent debt-to-income ratio that exceeded HUD's 43 percent benchmark without documenting compensating factors to justify its approval. The remarks section of the mortgage credit analysis worksheet referenced an addendum to the worksheet, but the loan file initially provided by Prospect did not contain an addendum to the worksheet. We requested the missing documentation from Prospect, and Prospect provided it. The documentation showed that Prospect justified its approval of the high 49.15 debt-to-income ratio based on two compensating factors:

- <u>The borrower is a minimal credit user</u> – Prospect's claim that the borrower had a conservative attitude toward credit was plausible, but it was not consistent with the overdrafts discussed below. In addition, for this compensating factor, HUD requires that borrowers have demonstrated an ability to accumulate savings. The borrower did not have a pattern of saving.

- <u>The coborrower had potential for increased income</u> – The claimed compensating factor was not supported. Specifically, the borrower's prior year's earnings did not increase significantly, and there was no documentation in the file to support that the borrower's current earnings would increase.

<u>HUD Requirements</u>

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and a back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides that compensating factors may be used to justify approval of mortgage loans with ratios exceeding the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported and documented.

<u>Income Not Properly Assessed</u>

Prospect approved the loan based on an effective monthly income that included $1,212 for a job which the borrower had held for less than 3 months following an extended 20-month period of unemployment. The loan file showed that the gap in employment occurred during a period when the borrower was ill and on disability pay. HUD requires borrowers to be employed for at least 6 months following an extended gap in employment to establish stability of income. In addition, the verification of employment did not answer the question concerning the borrower's probability of continued employment. HUD does not allow effective income to include amounts that are not likely to continue. We contacted the employer and determined that the borrower resigned in January 2008, less than 2 months after the loan closed. Adjustment for the ineligible income and understated housing cost, discussed below, resulted in a 52.81 percent debt-to-income ratio, compared to the 49.15 percent ratio that Prospect calculated.

HUD Requirements

HUD Handbook 4155.1, REV-5, section 2, provides that income may not be used in calculating the borrower's income ratios if it comes from a source that cannot be verified, is not stable, or will not continue. Paragraph 2-6 provides that in some cases, a borrower may have recently returned to the workforce after an extended absence. In these circumstances, the borrower's income may be considered effective and stable, provided the borrower has been employed in the current job for 6 months or more.

Inadequate Assessment of Cash Assets

Prospect did not itemize the cost paid by its premium pricing contribution. The good faith estimate and the HUD -1 settlement statement did not itemize the specific borrower closing costs paid by a $600 premium pricing contribution that Prospect made on behalf of the borrower at closing. Prospect was required to itemize the cost paid by the contribution versus stating the amount as a lump sum.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 1-9(J) provides that lenders may pay the borrower's allowable closing costs and/or prepaid items by premium pricing. The good faith estimate and the HUD-1 settlement statement must include an itemized statement indicating which items are being paid on the borrower's behalf; disclosing only a lump sum is not acceptable.

Gift Funds Not Properly Assessed

The loan file contained no documentation showing that Prospect verified receipt of a $5,890 gift paid at closing by a nonprofit donor. Thus, Prospect allowed the loan to close without support showing that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction. We obtained the documents needed to confirm receipt of the gift from the settlement agent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

Other - Understated Liabilities (Housing Cost)

Prospect understated the borrower’s monthly housing cost by $24 because it omitted city property taxes from the amount it used to determine the borrower’s monthly housing cost. Adjustment for the understatement further contributed to the borrower’s already high debt-to-income ratio.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-11(A), provides that lenders must include the monthly housing expense and all additional recurring charges extending 10 months or more.

FHA case number:	381-8578816
Loan purpose	Purchase
Underwriter type:	Manually underwritten
Closing date:	June 27, 2008
Loan amount:	$168,136
Debt-to-income ratio:	47.80percent
Status:	Default
Default reason:	Curtailment of income

Questionable or Undocumented Compensating Factors

Prospect did not provide compensating factors to justify its approval of the high debt-to-income ratio loan. This issue was specifically important considering the borrower's derogatory credit history. We reviewed the loan file for possible compensating factors but did not identify any.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and a back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported and documented.

Credit Not Properly Assessed

Prospect approved the loan despite the borrower's derogatory credit and high debt-to-income ratio. The automated underwriting finding report referred the loan for manual underwriting because it exceeded the risk threshold for automated approval.

- Derogatory credit – The credit report showed that the borrower owed $2,577 for eight unpaid medical collection accounts. The accounts were opened from 2003 through 2005. The borrower's failure to pay or to arrange to pay the collection accounts reflected a disregard for the otherwise legitimate credit obligations. The unpaid accounts were also significant because the file showed that the borrower did not pay them, although she had no monthly housing cost from November 2006 until the loan closed, after which she had a mortgage payment that totaled more than $1,305 per month. We recognize that HUD does not require collections accounts to be paid to approve a loan. Prospect should have documented compensating factors to justify why it approved the loan. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

  In addition, the credit report showed that in 2007, the borrower was 90 days delinquent for 5 months (February through June) on an automobile loan with payments of more than $350 per month. The borrower explained that the late payments occurred because she mistakenly thought that an automatic withdrawal was set up from her account to make the payments.

Prospect's quality control review stated that the loan had many risk factors which probably contributed to the default, including a derogatory credit history, a housing cost increase of 100 percent, limited savings, excessive debt ratios, and a minimal cash investment in the transaction.

HUD 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, 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.

Income Not Properly Assessed

The file contained no documentation to support that Prospect verified the borrower's likelihood of continued employment. The borrower had only worked for the employer for 1.5 months. The employment was preceded by a 1-month gap from a job she held for 17 months with another employer in the same line of work. Prospect's quality control review showed that the borrower's hours were reduced within 2 months after the loan closed and the borrower was unemployed within 5 months after the loan closed.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-7, provides that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first 3 years of the mortgage loan. HUD Handbook 4155.1, REV-5, paragraph 2-6, provides that to analyze and document probability of continued employment, lenders must examine the borrower's past employment record, qualifications for the position, previous training and education, and the employer's confirmation of continued employment.

Inadequate Assessment of Cash Assets

Prospect allowed the loan to close without adequate resolution or documentation related to the minimum downpayment, earnest money deposit, and premium pricing.

- Minimum downpayment not paid – Prospect allowed the loan to close without requiring the borrower to pay the full $6,294 minimum downpayment that it calculated to be required on the mortgage credit analysis worksheet. The file showed that the borrower only invested $5,585 in the property, which consisted of a questionable $500 earnest money deposit and a $5,085 gift. The borrower's documented downpayment was $709 ($6,294-$5,585) less than the amount Prospect calculated to be required. This issue was also significant because, as discussed below, Prospect understated the borrower's minimum downpayment by $789 and did not properly verify payment of the earnest money deposit. Thus, the borrower did not pay a total of $1,498 that we determined to be the required minimum downpayment, and Prospect did not verify that the borrower had the funds needed to pay that amount.

- Minimum downpayment understated – Prospect understated the borrower's minimum downpayment on the mortgage credit analysis worksheet by $789 because the estimates it used to calculate the amount were less than the amounts shown on the HUD -1 settlement statement. The incorrect calculation caused HUD to overinsure the mortgage by the $789 shown here and the $709 discussed above for a total overinsurance of $1,498. Therefore, Prospect should buy down the mortgage by the overinsured amount.

- Earnest money deposit not verified as paid – The file contained a bank statement, which showed that the bank returned the borrower's $500 check for the earnest money deposit due to insufficient funds. The file contained no evidence that Prospect verified that the borrower deposited funds into her bank account to cover the check and that the check cleared the bank. The returned check should have prompted Prospect to verify payment of the earnest money deposit.

- Premium pricing contribution – The good faith estimate and the HUD -1 settlement statement did not itemize the specific borrower closing costs paid by the $750 premium pricing contribution that Prospect made on behalf of the borrower at closing. Prospect was required to itemize the cost paid by the contribution versus stating the amount as a lump sum.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 1-7, provides that the borrower must make a cash investment that is at least equal to the difference between the sales price and the resulting maximum mortgage amount but that the cash investment must equal at least 3 percent of the contract sales price. Paragraph 2-10(A) provides that if the amount of the earnest money deposit appears excessive, based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds used for the earnest money deposit. Paragraph 1-9(J) provides that lenders may pay the borrower's allowable closing costs and/or prepaid items by premium pricing. The good faith estimate and the HUD -1 settlement statement must include an itemized statement indicating which items are being paid on the borrower's behalf, and disclosing only a lump sum is not acceptable.

Gift Funds Not Properly Assessed

Prospect's file contained no documentation showing that it verified the receipt of the $5,085 in gift funds. Thus, Prospect allowed the loan to close without confirming that the closing agent received the nonprofit gift used to pay a portion of the borrower's required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction. We obtained the documents needed to confirm receipt of the gift from the settlement agent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

FHA case number:	105-3353198
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	December 21, 2007
Loan amount:	$183,643
Debt-to-income ratio:	45.48 percent
Status:	Default
Default reason:	Curtailment of income

<u>Credit Not Properly Assessed</u>

Prospect approved the loan despite the borrower's and coborrower's history of derogatory credit. The automated underwriting finding report referred the loan for manual underwriting because the loan exceeded the risk threshold for automated approval.

- <u>Inadequate assessment of the borrower credit</u> – Prospect approved the loan, although the borrower demonstrated that she had a problem making payments to creditors during a bankruptcy process and after she was dismissed from the bankruptcy. The borrower was dismissed from the bankruptcy in February 2005 because she defaulted on the payment plan. After being dismissed from the bankruptcy, the credit report showed that the borrower accumulated more than $1,736 in unpaid collections on four accounts that were less than 2 years old when Prospect approved the loan. The file also showed that the borrower was late six times on payments on a credit card account during the 12-month period before Prospect approved the loan. The dismissal of the bankruptcy, recent collection accounts, and late payments indicated that the borrower had a continuing problem managing and paying her credit obligations.

- <u>Inadequate assessment of the coborrower's credit</u> – The credit report showed that the coborrower had $1,229 in unpaid collections for three different accounts opened in 2006 or 2007. The loan closed in December 2007. The collection accounts included $725 for one account that was less than 1 year old and $504 for two accounts that were 12 to 19 months old when Prospect approved the loan.

  The borrower's failure to pay or to arrange to pay the collection accounts reflected a disregard for the otherwise legitimate credit obligations. We recognize that HUD does not require collection accounts to be paid to approve a loan. Prospect should have documented compensating factors to justify why it approved the loan. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

  Prospect disagreed with our conclusion, citing that the derogatory credit which led to the bankruptcy occurred because the borrower was unemployed for awhile to take care of a sick relative. The file did not explain why the borrower developed derogatory credit after the bankruptcy and contained no evidence that Prospect analyzed the reason for the poor credit following the bankruptcy.

HUD 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, 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.

Inadequate Assessment of Cash Assets

Prospect understated the borrower's minimum downpayment for the property and did not adequately verify or document that it verified the source of $1,347 that the borrower used for an earnest money deposit and to pay off a debt.

- Minimum downpayment understated – Prospect understated the borrower's minimum downpayment on the mortgage credit analysis worksheet by $397 because the estimates it used to calculate the amount were substantially lower than the amounts shown on the HUD -1 settlement statement. The incorrect calculation caused HUD to overinsure the mortgage by $397. This issue was significant because as discussed below, Prospect did not verify that the borrower had adequate funds to close the loan based on the lesser minimum downpayment and closing cost shown on the HUD -1 settlement statement, let alone the increased investment reflected by our calculation. Prospect should buy down the mortgage by the over insured amount.

- Inadequate verification of the earnest money deposit – Prospect did not verify the source of funds that the borrower used to purchase a $1,000 money order to pay the earnest money deposit. This was an important omission considering that the file contained no documentation to support that the borrower had a history of savings. The file showed that the real estate broker stated that the earnest money payment was received in June 2007, 6 months before the loan closed. The missing document was required to provide assurance that the earnest money was paid by the borrower and not by some other interested party. The file only provided bank statements for the coborrower, which did not show the withdrawal of the funds and did not show a savings or earnings pattern that would allow for accumulation of the funds to cover the earnest money deposit. Prospect disagreed with our assessment because the amount of the earnest money deposit was less than 2 percent of the purchase price.

- Inadequate verification of the source of funds the borrower paid at closing – The HUD -1 settlement statement showed that the borrower paid $347 at closing. However, the loan application showed that the borrower had no cash. The file contained no evidence to show the source of the $347 and whether the funds came from an allowable source. This issue was also significant because, as discussed above, Prospect understated the borrower’s minimum downpayment by $397. The understatement would have required more cash from the borrowers to close the loan at a time when they did not have the documented cash to close the loan based on the lesser cost shown on the HUD -1 settlement statement.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10, provides that all funds for the borrower’s investment in the property must be verified and documented. Paragraph 2-10(A) provides that if the amount of the earnest money deposit appears excessive based on the borrower’s history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds.

Gift Funds Not Properly Assessed

The loan file contained no documentation showing that Prospect verified receipt of a $5,553 gift paid at closing by a nonprofit donor. Thus, Prospect allowed the loan to close without support showing that the closing agent received the nonprofit gift used to pay the borrower’s required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction. We obtained the documents needed to confirm receipt of the gift from the settlement agent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower’s account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

FHA case number:	461-4313298
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	May 9, 2008
Loan amount:	$177,625
Debt-to-income ratio:	62.18 percent
Status:	Default
Default reason:	Curtailment of income

Questionable or Undocumented Compensating Factors

The compensating factor Prospect used to approve the high 55.77 percent debt -to-income ratio loan was not valid and did not justify the approval. Prospect based its approval on a compensating factor that read, "Spouse works and receives child support of $379/month, ratios are very low." This was not a valid compensating factor because the "spouse" was not a party to the loan; therefore, her income should not have been a factor in assessing the borrower's eligibility. In addition, the file contained unresolved discrepancies as to whether the borrower was married at the time of the loan. The loan application showed that the borrower was single, and the file contained a divorce decree from a previous marriage. The underwriter did not resolve the discrepancies in the loan file concerning the borrower's marital status and the effect it had on the accuracy of the stated compensating factor. Also, the reference to the low ratios was not true, considering that the approved 55.77 percent ratio that Prospect approved exceeded the HUD 43 percent benchmark by more than 12 percentage points.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and a back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides a list of compensating factors that may be used to justify approval of mortgage loans with debt ratios that exceed the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

Credit Not Properly Assessed

Prospect approved the loan despite the borrower's history of credit problems. The automated underwriting finding report referred the loan for manual underwriting because the loan exceeded the risk threshold for automated approval. Prospect's quality control review showed that the loan was a high-risk transaction and that the borrower's credit history did not support an ability to manage monthly payments similar to the monthly mortgage payment. The credit report showed that when Prospect approved the loan, the borrower owed more than $18,400 for accounts that were in collection ($17,903) or charged off ($535). The total unpaid obligations included more than $18,300 for accounts that were less than 2 years old and $108 for an account that was more than 2 years old. The unpaid obligations indicate that the borrower had a continued trend of credit problems. Thus, at the time Prospect approved the loan, the borrower had not developed and maintained a record of good payments needed to justify the approval.

For instance, one of the collections was for automobile loans that had a balance of more than $17,200. The borrower provided a written explanation stating that the vehicles were awarded (in a divorce decree) to his ex-wife and that she was responsible for the payments. However, the file did not provide documentation to support the borrower's claim. We recognize that HUD does not require collection accounts to be paid to approve a loan. Prospect should have documented compensating factors to justify why it approved the loan. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

HUD 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, 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.

Income Not Properly Assessed

Prospect calculated the borrower's monthly income based on a salary amount it obtained in a telephone interview with the employer, but the amount was not consistent with the borrower's pay stubs. Prospect also did not verify the borrower's likelihood of continued employment. The pay stubs showed that the borrower was an hourly laborer, but the income amount Prospect calculated was based on a salary. Also, the borrower's monthly income based on the pay stubs amounted to $2,860 versus the $3,189 that Prospect calculated, a monthly difference of $329. We did not include overtime because the file did not contain information needed to support overtime pay for 2007 and prior years, nor was the income amount verified as likely to continue. Adjustment for the overstated income increased the borrower's debt-to-income ratio from the already high 55.77 percent rate Prospect calculated to 62.18 percent. We also noted that the pay stubs in Prospect's files were faxed by the seller versus Prospect's obtaining the documents directly from the borrower.

Prospect disagreed with our conclusion and stated that we should have considered overtime reflected on the borrower's pay stub. As discussed above, we did not include overtime because it was not properly supported or verified as likely to continue.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-7, provides that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first 3 years of the mortgage loan. Paragraph 2-7(A) provides 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. Periods of less than 2 years may be acceptable, provided the lender justifies and documents in writing the reason for using the income for qualifying purposes. Paragraph 3-1 provides that lenders may not accept or use documents relating to 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.

Gift Funds Not Properly Assessed

Prospect's file contained no documentation showing that it verified the receipt of $8,894 in gift funds that was supposed to be paid to the closing agent by a nonprofit donor. Thus, Prospect allowed the loan to close without confirming that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

FHA case number:	381-8867369
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	February 3, 2009
Loan amount:	$143,467
Debt-to-income ratio:	52.09 percent
Status:	Default
Default reason:	Unknown - Unable to contact borrower

Credit Not Properly Assessed

Prospect approved the loan, although the credit report showed that the borrower and the coborrower owed a total of more than $19,200 for 58 collection accounts and had not arranged to pay them. Prospect's quality control review also reported that the borrowers had a significant amount of derogatory credit. The majority of the collections were for medical bills that totaled more than $15,000. The file contained no documentation from the borrowers disputing responsibility for the accounts. We recognize that HUD does not require collections accounts to be paid to approve a loan. Prospect should have documented compensating factors to justify why it approved the loan. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower. Neighborhood Watch showed that the borrowers defaulted on the loan 9 months after closing.

Prospect disagreed with our assessment and stated that HUD's mission does not state that HUD provides affordable housing to all who have adequate medical insurance. The response indicates that Prospect did not consider the medical collection accounts to be an issue that should have affected its approval of the loan. We recognize that conditions that require individuals to incur medical bills are normally beyond one's control. However, the responsibility to pay such accounts is not only within one's control, but also reflects an individual's responsibility toward debt obligations.

HUD 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, 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.

Debts Not Properly Assessed

Prospect did not properly assess and report the borrower's debt-to-income ratio calculation. The 52.33 percent debt-to-income ratio Prospect showed on form HUD-92900-LT (FHA Loan Underwriting and Transmittal Summary) did not match the 37.94 percent rate supported by the numbers it entered on the form. This condition occurred because Prospect understated the debts and apparently entered the higher ratio based on another calculation, which was not documented in the file. HUD's Neighborhood Watch system showed a lower 37.90 debt-to-income ratio. We calculated a 52.09 debt-to-income ratio based on information contained on the borrowers' loan applications and credit reports. The 52.09 percent rate that we calculated was only slightly different from the unsupported 52.33 rate that Prospect calculated and the much lower 37.90 percent rate that was entered into HUD's system. The incorrect data distorted information HUD uses to monitor lender loan origination activity.

<u>HUD Requirements</u>

HUD Handbook 4155.1, REV 5, paragraph 2-11(A), provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing.

<u>Other – (Questionable Occupancy Certification)</u>

Prospect approved the loan without requiring the coborrower to provide specific information about her occupancy certification for the FHA property, when she and her husband owned and lived in another property located less than a half mile from the FHA property. The loan application provided inconsistent information regarding the borrower's occupancy status. Specifically, the loan application showed that the borrower intended to both occupy and not occupy the property. The file showed that the coborrower and her husband had a first and second mortgage on the other property. The coborrower's loan application listed the other property as a rental, but at the time of the loan application, the property was listed as her residence. The file contained no other information about the coborrower's and her husband's plans to lease the other property and to move into the FHA property. HUD requires the borrower to establish bona fide occupancy in the FHA property as the borrower's principal residence within 60 days after he or she signs the security agreement. Prospect did not follow up to obtain specific information to support when the coborrower and her husband planned to move into the FHA property.

<u>HUD Requirements</u>

HUD Handbook 4155.1, REV-5, paragraph 1-2, states that a principal residence is a property that will be occupied by the borrower for the majority of the calendar year. At least one borrower must occupy the property and sign the security instrument and the mortgage note for the property to be considered owner-occupied. The security instruments require a borrower to establish bona fide occupancy in the home as the borrower's principal residence within 60 days after signing. Paragraph 1-4 states that an investment property is a property that is not occupied by the borrower as a principal residence or as a secondary residence. With permission from the appropriate HOC, private investors may obtain FHA-insured mortgages.

FHA case number:	105-3405939
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	January 28, 2008
Loan amount:	$144,077
Debt-to-income ratio:	46.81 Percent
Status:	Default
Default reason:	Unemployment

Questionable or Undocumented Compensating Factors

Prospect provided no compensating factors to justify its approval of the 46.81 percent debt-to-income ratio which exceeded HUD's 43 percent benchmark. The remarks section of the mortgage credit analysis worksheet commented that the parties to the loan cleared HUD's limited denial of participation list and the General Services Administration's list of parties excluded from Federal procurement or nonprocurement programs. However, these were not compensating factors but were requirements that all borrowers must meet. We reviewed the loan file for other allowable compensating factors but did not identify any. Thus, Prospect allowed a debt-to-income ratio that exceeded HUD's benchmark without providing valid compensating factors to justify its approval of the loan. This issue was particularly significant considering the borrower's derogatory credit discussed below.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

Credit Not Properly Assessed

Prospect approved the loan, although the credit report showed that the borrower owed more than $5,100 for collection accounts and had not arranged to pay them. The unpaid obligations included more than $3,400 for four accounts that were less than 2 years old and more than $1,600 for four accounts that were more than 2 years old. The file contained no documentation from the borrower disputing responsibility for the accounts. We recognize that HUD does not require collections accounts to be paid to approve a loan, yet Prospect should have documented compensating factors to justify why it approved the loan. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower. Prospect's quality control review also reported that the borrowers had an outstanding derogatory credit.

Prospect disagreed with our conclusion, citing that the derogatory credit occurred because the borrower was unemployed for a while to take care of sick relatives. The file showed that the borrower claimed that the derogatory credit occurred because she had to help her parents. We recognize that conditions such as those explained by the borrower occur and that the condition itself may have been beyond a borrower's control. However, the responsibility to pay debts that resulted from such conditions was within the borrower's control and, as discussed above, Prospect did not assess or document its assessment as to why the borrower did not pay the collection accounts.

HUD 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, 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.

Gift Funds Not Properly Assessed

Prospect's file contained no documentation showing that it verified the receipt of the $4,356 in gift funds. Thus, Prospect allowed the loan to close without confirming that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction. We obtained the documents needed to confirm receipt of the gift from the settlement agent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

FHA case number:	105-4101563
Loan purpose:	Purchase
Underwriter type:	Automated
Date of loan closing:	September 29, 2008
Loan amount:	$135,099
Debt-to-income ratio:	Unknown
Status:	Default
Default reason:	Unemployment

Credit Not Properly Assessed

Prospect underwrote the loan with no support for how it assessed the borrower's credit history. The loan file did not contain a credit report, although Prospect was required to obtain either a traditional or nontraditional credit report on the borrower. HUD requires lenders to consider borrowers' past credit performance, because it serves as the most useful guide in determining the borrower's attitude toward credit obligations and predicting a borrower's future actions. The missing credit report rendered the automated approval invalid, and the loan should have been referred for manual underwriting. For instance, the findings report commented that if the bankruptcy (discussed below) was not reported on the credit report, the loan must be referred to an underwriter for compliance. The report also required Prospect to obtain and review the credit report for other issues, including but not limited to inquiries, and the payoff of outstanding judgments. In addition, the file showed that the borrower

- Filed for Chapter 13 bankruptcy protection in 2001. The file did not contain documentation concerning the disposition of the bankruptcy or whether the borrower made satisfactory payments under the terms of the bankruptcy agreement.

- Incurred $385 for five insufficient fund charges approximately 1 month before the loan closed. The borrower explained that the returned items occurred because "things were tight at the time."

Prospect's quality control findings stated that the reason for default appeared to be several factors that included the debt ratios, minimal cash investment, and a history of derogatory credit.

HUD 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, 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. Paragraph 2-4 requires that lenders obtain either traditional or nontraditional credit reports. Total Scorecard Userguide states that a manual downgrade becomes necessary if additional information, not considered in the automated underwriting system decision, affects the overall insurability or eligibility of a mortgage otherwise rated as an accept or approve. It further provides that manual downgrades may be triggered by inaccuracies in credit reporting and for issues associated bankruptcy.

Debts Not Properly Assessed

Prospect underwrote the loan with no support for how it calculated the borrower's monthly debts. The loan file did not contain a credit report, although Prospect was required to obtain either a traditional or nontraditional credit report on the borrower. Due to the missing documentation, we were unable to determine whether the debts entered into HUD's automated system were complete and accurate.

HUD Requirements

HUD Handbook 4155.1, REV 5, paragraph 2-11(A), provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of the debts affects the borrower's ability to make the mortgage payments during the months immediately after loan closing. Paragraph 2-4 require that lenders obtain either traditional or nontraditional credit reports.

Inadequate Assessment of Cash Assets

Prospect did not itemize the cost paid by its premium pricing contribution. The good faith estimate and the HUD -1 settlement statement should have but did not itemize the specific borrower closing costs paid by the $1,000 premium pricing contribution Prospect made on behalf of the borrower at closing. Prospect was required to itemize the cost paid by the contribution versus stating the amount as a lump sum.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 1-9(J) provides that lenders may pay the borrower's allowable closing costs and/or prepaid items by premium pricing. The good faith estimate and the HUD -1 settlement statement must include an itemized statement indicating which items are being paid on the borrower's behalf; disclosing only a lump sum is not acceptable.

Gift Funds Not Properly Assessed

The loan file contained no documentation showing that Prospect verified receipt of a $6,792 gift paid at closing by a nonprofit donor. Thus, Prospect allowed the loan to close without support that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

FHA case number:	105-3720079
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	May 29, 2008
Loan amount:	$350,565
Debt-to-income ratio:	49.79 percent
Status:	Default
Default reason:	Illness of mortgagor family member

Questionable or Undocumented Compensating Factors

Prospect approved the high 49.79 percent debt-to-income ratio loan based on the following invalid compensating factors:

- Reimbursement for mileage – This was not a valid compensating factor because mileage reimbursement is not income. The reimbursement is designed to compensate the payee for the cost of operating the vehicle used for official travel. Further, the borrower's reimbursement amounts were not significant.

- Bonus income – The loan file contained no documentation to support that the borrower would receive bonus income.

We reviewed the loan file for other allowed compensating factors but did not identify any.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

Credit Not Properly Assessed

Prospect approved the loan without documenting what consideration it gave to the fact that the borrower had 2 return items for insufficient funds during the month the loan closed. Prospect's quality control review also reported that the borrowers had a significant amount of derogatory credit.

HUD 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.

FHA case number:	105-3535564
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	March 28, 2008
Loan amount:	$120,076
Debt-to-income ratio:	47.17 percent
Status:	Delinquent
Default reason:	Excessive obligations

Questionable or Undocumented Compensating Factors

Prospect approved the high 46.19 percent debt-to-income ratio loan based on questionable compensating factors. Specifically, Prospect cited the following compensating factors, which we determined were not valid:

- The borrower was a minimal debt user – This was not a valid compensating factor because, as discussed below, the borrower not only had debts, but also showed a lack of responsibility toward paying them.

- The borrower had a minimal housing increase – This was not a valid compensating factor because, as discussed below, the borrower had credit problems immediately before the loan closing at which time her monthly housing cost was $166 less than it was after the loan closed.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

Credit Not Properly Assessed

Prospect approved the loan despite the borrower's recent history of credit problems at a time when her monthly rent payment was $166 less than the mortgage on the new property. The credit report showed that the borrower owed more than $890 in collections that included $760 for five accounts that were less than 2 years old and $132 for an account that was more than 2 years old. The automated underwriting finding report referred the loan for manual underwriting because it exceeded the risk threshold for automated approval. The borrower disputed responsibility for $308 of the collections amount, but she agreed to pay off four collection accounts with balances that totaled $610, discussed below. We recognize that HUD does not require collections accounts to be paid to approve a loan, yet Prospect did not document the required 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.

Prospect's quality control review showed that the borrower was not able to maintain a satisfactory credit history or establish a savings pattern at the lower rent amount.

HUD 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, 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.

Inadequate Assessment of Cash Assets

Prospect understated the borrower's minimum downpayment, did not adequately verify the source of cash the borrower contributed to the transaction, and did not itemize the closing costs paid with its premium pricing contribution.

- Minimum downpayment understated – Prospect understated the borrower's minimum downpayment on the mortgage credit analysis worksheet by $736. The understatement occurred because the estimates Prospect used for closing cost were substantially lower than the amounts shown on the settlement statement. Based on the file, the borrower did not have the cash needed to pay the additional downpayment that would have been required if Prospect had correctly calculated the downpayment. The incorrect calculation caused HUD to overinsure the mortgage by $736. Therefore, Prospect should buy down the mortgage by the overinsured amount.

- Inadequate verification of borrower cash – Prospect did not adequately verify or document its verification that the borrower had accumulated the $651 in cash used to pay the $500 earnest money deposit and $151 at closing. The file showed that the borrower did not have a bank account. The file contained no evidence that the borrower provided the required written explanation of how the funds were accumulated and the amount of time taken to do so. The file contained two money orders (one for $400 and one for $100) for the earnest money deposit that were made payable to the seller. The file did not indicate how the borrower paid the $151 that was due at closing. Prospect disagreed with our conclusion and stated that further verification of the source of the funds was not required due to the low dollar amounts involved.

  In addition, Prospect did not properly verify the source of funds the borrower used to pay off $610 for four collection accounts. The file indicated that the accounts were paid with the proceeds from a cashier's check, which the seller faxed to Prospect, but the payment was actually made at closing. The check was made payable to the borrower versus the creditors or the settlement agent, and it was purchased by another individual on the date of closing. The file did not document what relationship the other individual had with the borrower, nor did it document what the borrower did with the cashier's check. The settlement statement listed the four collection accounts as part of the borrower's closing cost, but it did not list the $610 cashier's check as part of the funds provided to close the loan. We assessed the sources and application of funds shown on the settlement statement and determined that the debts were paid from the borrower's earnest money deposit and the cash she provided at closing.

- Premium pricing contribution – The good faith estimate and the HUD -1 settlement statement did not itemize the specific borrower closing costs paid by a the $369 premium pricing contribution Prospect made on behalf of the borrower at closing. Prospect was required to itemize the cost paid by the contribution versus stating the amount as a lump sum.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 1-7, provides that the borrower must make a cash investment that is at least equal to the difference between the sales price and the resulting maximum mortgage amount but that the cash investment must equal at least 3 percent of the contract sales price. Paragraph 2-10 provides that all funds for the borrower's investment in the property must be verified and documented. Paragraph 2-10(M) provides that borrowers are permitted to use cash saved at home if they are able to demonstrate adequately the ability to do so. The asset verification process requires the borrower to explain in writing how such funds were accumulated and the amount of time taken to do so. The lender must determine the reasonableness of the accumulation of the funds based on the borrower's income stream, the period during which the funds were saved, the borrower's spending habits, documented expenses, and the borrower's history of using financial institutions. Paragraph 1-9(J) provides that lenders may pay the borrower's allowable closing costs and/or prepaid items by premium pricing. The good faith estimate and the HUD -1 settlement statement must include an itemized statement indicating which items are being paid on the borrower's behalf, and disclosing only a lump sum is not acceptable.

Gift Funds Not Properly Assessed

The loan file contained no documentation showing that Prospect verified receipt of a $ 3,630 gift paid at closing by a nonprofit donor. Thus, Prospect allowed the loan to close without support that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction. We obtained the documents needed to confirm receipt of the gift from the settlement agent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

Other - Understated Liabilities (Housing Cost)

Prospect understated the borrower's monthly housing cost by $42. We used the amounts reflected on the HUD -1 settlement statement for housing costs. The $42 is the net of a $27 understatement for taxes and an ($15) overstatement for insurance. The understated amount contributed to the borrower's high debt-to-income ratio.

HUD Requirements

HUD Handbook 4155.1, REV 5, paragraph 2-11(A), provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more.

FHA case number:	105-3451957
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	February 29, 2008
Loan amount:	$100,059
Debt-to-income ratio:	46.29 percent
Status:	Delinquent
Default reason:	Illness of principal mortgagor

Questionable or Undocumented Compensating Factors

Prospect approved the high 46.29 percent debt-to-income ratio loan based on invalid or unsupported compensating factors.

- Minimal debt user – The minimal use of debt was not a compensating factor allowed by HUD. HUD Handbook 4155.1, paragraph 2-13(C), provides that borrowers must have demonstrated an ability to accumulate savings and have a conservative attitude toward the use of credit. The borrower's bank statement, dated approximately a week before closing, showed a balance of only $39.14.

- Potential earning increase – The potential for increased earnings was a valid compensating factor, but it was not supported as applicable in this case. The verification of employment showed that the hourly wage borrower had the potential for a 4 to 5 percent raise in approximately 9 months after closing. The raise, if calculated at the higher rate, would result in a 45.18 percent debt-to-income ratio, which was still higher than HUD's 43 percent benchmark. Thus, the projected pay increase was not supported as a valid compensating factor.

We reviewed the loan file for other allowed compensating factors but did not identify any.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

Gift Funds Not Properly Assessed

Prospect's file contained no documentation showing that it verified the receipt of the $3,024 in gift funds. Thus, Prospect allowed the loan to close without confirming that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction. We obtained the documents needed to confirm receipt of the gift from the settlement agent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

FHA case number:	461-4115484
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	April 17, 2008
Loan amount:	$82,845
Debt-to-income ratio:	52.53 percent
Status:	Current
Default reason:	Curtailment of income

<u>Questionable or Undocumented Compensating Factors</u>

Prospect approved the high 49.32 percent debt-to-income ratio loan based on two invalid compensating factors.

- <u>All derogatory credit old</u> – The resolution of past credit problems was not a valid compensating factor to justify approving a debt-to-income ratio that exceeded HUD guidelines. Separate and apart from compensating factors, borrowers are expected to have good credit to be approved for a HUD-insured loan. As discussed below, Prospect approved the loan, although the borrower had three unpaid collection accounts.

- <u>Job stability</u> – Job stability was not a valid compensating factor to justify the approval of a debt-to-income ratio that exceeded HUD guidelines. Without regard to compensating factors, borrowers are expected to have job stability to qualify for a HUD-insured loan.

We reviewed the loan file for other allowed compensating factors but did not identify any.

<u>HUD Requirements</u>

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

<u>Credit Not Properly Assessed</u>

Prospect approved the loan, although the credit report showed that the borrower owed a total of more than $1,800 on three collection accounts. One collection account, with a $229 balance, was inappropriately paid from gift funds at closing and is discussed further below. The borrower did not dispute responsibility for the two other collection accounts, but the loan file contained no evidence to show that the borrower had arranged to pay them. We recognize that HUD does not require collections accounts to be paid to approve a loan, yet Prospect did not document the required 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.

Prospect's quality control review showed that the borrower was not able to maintain a satisfactory credit history or establish a savings pattern at the lower rent amount.

HUD 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, 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.

Income Not Properly Assessed

Prospect overstated the borrower's monthly income by $164 because the amount it allowed for child support income exceeded the amount supported by documentation contained in the file. Adjustment for the overstated income increased the borrower's debt-to-income ratio from the 49.32 percent rate Prospect calculated to 52.53 percent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-7(F), provides that child support income may be considered as effective if such payments are likely to be consistently received for the first 3 years of the mortgage. The borrower must provide a copy of the final divorce decree, legal separation agreement, or voluntary payment agreement, as well as evidence that payments have been received during the last 12 months.

Inadequate Assessment of Cash Assets

Prospect allowed the loan to close without properly verifying the source of borrower funds and without requiring the borrower to make the required minimum downpayment.

- Inadequate verification of a large cash deposit – Prospect did not verify the source and use of a $4,887 deposit to the borrower's savings account. The deposit was made in January 2008. The deposit was not consistent with the borrower's savings pattern for an account that had a balance of only $446 in December 2007. The credit report was obtained in March 2008, less than 2 months from the date of the large deposit. The relationship between the large deposit and the credit report was significant because the credit report showed that the borrower paid off three debts between the date of the deposit and the credit report date. The report did not show the payoff amounts. However, the close proximity between the large deposit and the payoffs should have prompted Prospect to verify that the deposit was from a legitimate source and that the borrower used her own cash assets to pay the debts.

- Minimum downpayment not made – Prospect allowed the loan to close with the borrower paying $645 less than the minimum downpayment. As a result, Prospect over-insured the loan by that amount. We noted that Prospect miscalculated the minimum downpayment to be $3,095 because it overstated closing costs used to calculate the amount, yet it only required the borrower to pay $2,505, or $590 less than the downpayment amount that it calculated. We calculated the minimum downpayment to be $2,921, of which the borrower paid only $2,276, or $645 less than the required amount. We offset the borrower's downpayment by $229 because, based on our assessment, the closing statement indicated that amount was deducted from the nonprofit gift to pay off a debt. HUD does not allow the use of nonprofit gift funds to pay off debts.

Required downpayment		$2,921
Less: funds provided by or for borrower		
gift amount (the only borrower funds paid)	$2,505	
less: amount used to pay off debt	(229)	2,276
Shortfall in borrower downpayment		$645

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(B), provides that if there is a large increase in an account or the account was opened recently, the lender must obtain a credible explanation of the source of those funds. Paragraph 1-7, provides that the borrower must make a cash investment that is at least equal to the difference between the sales price and the resulting maximum mortgage amount but that the cash investment must equal at least 3 percent of the contract sales price. Paragraph 2-10(C) provides that FHA does not allow nonprofit entities to provide gifts to home buyers for the purpose of paying off installment loans, credit cards, collections, judgments, and similar debts.

Gift Funds Not Properly Assessed

Prospect's file did not contain documentation to show that it verified the receipt of the $2,505 in gift funds. Thus, Prospect allowed the loan to close without confirming that the closing agent received the nonprofit gift used to pay the borrower's required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

FHA case number:	381-8673508
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	September 29, 2008
Loan amount:	$208,354
Debt-to-income ratio:	64.93 percent
Status:	Current
Default reason:	Curtailment of income

Questionable or Undocumented Compensating Factors

Prospect approved the high 57.16 percent debt-to-income ratio loan based on invalid compensating factors. Specifically, Prospect cited the following invalid compensating factors:

- Additional income from the borrower’s spouse – This was not a valid compensating factor. The borrower’s spouse was not a party to the loan, and her income was not relevant to the transaction, nor was there anything requiring her to obligate assets to maintain the mortgage.

- The borrower’s current year-to-date income – The use of the borrower’s income as a compensating factor was questionable because, as discussed below, Prospect overstated the borrower’s overtime pay, which increased the borrower’s already high 57.16 percent debt-to-income ratio to 64.93 percent. Further, the year-to-date income included overtime, which was not verified as likely to continue.

- The borrower’s good credit – The claimed compensating factor was not consistent with the credit problems discussed below.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

Credit Not Properly Assessed

Prospect approved the loan without determining the conditions behind a previous foreclosure and despite the borrower’s history of credit problems. The credit report showed that several of the credit problems were recent, with more than $11,300 in collection accounts that had not been paid. This issue was significant, considering that items number one, two, and three of the underwriting findings showed that the loan was referred for manual underwriting because the risk and expense ratio exceeded the thresholds for automated approval. In addition to the income issues discussed below, we identified the following credit problems:

- The credit report showed that the borrower purchased a home in November 2002 using a conventional loan that was later foreclosed upon. The loan was paid off in May 2008, about 4 months before Prospect approved the borrower for this loan. The credit report and the loan file did not show when the foreclosure occurred, and there was no documentation showing that Prospect followed up to determine whether the foreclosure would impact its decision to approve the loan. This issue was significant because FHA does not allow the approval of borrowers who had a foreclosure on their principal residence or other real property within the previous 3 years unless there were extenuating circumstances that were beyond the control of the borrower and the borrower has reestablished good credit since the foreclosure. The borrower had unresolved collection accounts that dated back to at least 9 months after he purchased the previous property. Thus, the borrower's qualification was questionable even if the foreclosure resulted from extenuating circumstances.

- The credit report showed that when Prospect approved the loan, the borrower owed more than $11,300 for accounts that were in collection ($10,364) or charged off ($978). The borrower was responsible for paying the charge-off amounts but had not done so. The total unpaid obligations included more than $10,072 for accounts that were more than 2 years old and more than $1,270 for accounts that were less than 2 years old. We recognize that HUD does not require collections accounts to be paid to approve a loan, yet Prospect should have documented compensating factors to justify why it approved the loan. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower.

  For instance, the collections included $8,422 for an automobile loan that the borrower made in 2003 but failed to pay. The explanation shown in the loan file indicated that the borrower dropped the new vehicle off at the dealer and walked away from his loan obligation because the vehicle had a number of mechanical problems. The file contained no indication that the borrower tried to resolve the matter in a way that recognized his responsibility for the debt and to obtain a proper remedy to the problem. This attempt would have included but was not limited to pursuing a remedy through the State's lemon law.

<u>HUD Requirements</u>

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, 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. HUD Handbook 4155.1, REV-5, paragraph 2-3(D), provides that a borrower whose previous principal residence or other real property was foreclosed upon or who has given a deed in lieu of foreclosure within the previous 3 years is generally not eligible for a new FHA-insured mortgage. However, if the foreclosure was the result of documented extenuating circumstances that were beyond the control of the borrower and the borrower has reestablished good credit since the foreclosure, the lender may grant an exception to the 3-year requirement.

Income Not Properly Assessed

Prospect overstated the borrower's overtime pay, which caused an understatement of the borrower's already high 57.16 percent debt-to-income ratio. In addition, Prospect did not verify that the overtime pay was likely to continue.

- Overtime pay was overstated – Prospect overstated the borrower's overtime pay by more than $435 per month. The overstatement occurred because Prospect calculated overtime based on a 16-month average versus the required 24-month average, although the information needed for the 24-month calculation was in the loan file. Based on the correct overtime amount, the borrower's debt-to-income ratio increased from the 57.16 percent rate Prospect calculated to 64.93 percent. The debt ratio exceeded HUD's 43 percent benchmark. As discussed above, Prospect did not document legitimate compensating factors to justify its approval of the high debt ratio it calculated, let alone the higher 64.93 percent ratio based on the corrected overtime calculation.

- Overtime pay was not verified as likely to continue – Prospect did not verify that the borrower's overtime pay was likely to continue for the first 3 years of the loan. Before the loan closing, the borrower had worked for the same employer for at least 28 months and had consistently received substantial overtime pay. However, the borrower's verification of employment showed that the likelihood of continued employment was good but the likelihood of continued overtime pay was "unknown." The loan file contained no evidence that Prospect followed up with the employer to obtain an explanation for the response concerning overtime pay. Neighborhood Watch showed that the borrower defaulted on the loan due to a curtailment of income. In the absence of follow-up on the overtime issue, the default reason appeared consistent with the employer's response that it was unknown whether the overtime pay would continue. Given the borrower's high debt ratio, the continued availability of substantial overtime pay was critical to the borrower's ability to make the mortgage payments and Prospect's decision to approve the loan.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-7(A), 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. Periods of less than 2 years may be acceptable, provided the lender justifies and documents in writing the reason for using the income for qualifying purposes. Paragraph 2-7 provides that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first 3 years of the mortgage loan.

Gift Funds Not Properly Assessed

Prospect's file contained no documentation showing that it verified receipt of a $6,300 gift paid to the closing agent by a nonprofit donor. Thus, Prospect allowed the loan to close without confirming that the closing agent received the gift used to pay the borrower's required investment in the property. Proof of the payment was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction. We obtained the documents needed to confirm receipt of the gift from the settlement agent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

Other - Understated Liabilities (Housing Cost)

Prospect understated the borrower's monthly housing cost by $68. We used the amounts reflected on the HUD -1 settlement statement for housing costs. The understatement includes $51 for taxes and $17 for insurance. Adjustment for the understatement further contributed to the borrower's already high 64.93 percent debt-to-income ratio.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-11(A), provides that lenders must include the monthly housing expense and all additional recurring charges extending 10 months or more.

FHA case number:	381-8674809
Loan purpose:	Purchase
Underwriter type:	Manually underwritten
Closing date:	July 25, 2008
Loan amount:	$149,408
Debt-to-income ratio:	59.52 percent
Status:	Current
Default reason:	Illness of borrower

Questionable or Undocumented Compensating Factors

Prospect approved the high 49.72 percent debt-to-income ratio loan based on the following invalid compensating factors:

- Older derogatory credit – Prospect stated that all of the borrower's derogatory credit was old. However, as discussed below, that claim was not valid as demonstrated by the credit report, which showed that the borrower owed more than $7,700 for 13 collection accounts.

- Automobile almost paid off – Prospect correctly noted that the borrower's automobile was almost paid off. However, this was not a valid compensating factor, because Prospect did not consider the more significant issues associated with the borrower's debts including more than $7,700 for 13 collections accounts. The file contained no evidence that the borrower had arranged to pay the accounts.

- Child support payments would end soon – Prospect stated that the borrower's child support payments of more than $535 per month would end soon. However, the file contained no documentation to support when the payments would end.

HUD Requirements

Mortgagee Letter 2005-16 increased the front ratio to 31 percent and the back ratio to 43 percent for manually underwritten mortgages by direct endorsement underwriters. The letter further provided that if either or both ratios are exceeded, the lender must describe the compensating factors used to justify mortgage approval. HUD Handbook 4155.1, REV-5, paragraph 2-13, provides compensating factors that may be used to justify approval of mortgage loans with ratios above the benchmark guidelines. A compensating factor used to justify mortgage approval must be supported by documentation.

Credit Not Properly Assessed

Prospect approved the loan, although the credit report showed that the borrower owed more than $7,700 for collection accounts and had not arranged to pay them. The unpaid obligations included $7,175 for eight accounts that were less than 2 years old and $541 for five accounts that were more than 2 years old. The file contained a letter from the borrower, which stated that the collection accounts occurred because he had health problems that resulted in medical bills that made it very difficult to pay other bills. We recognize that HUD does not require collections accounts to be paid to approve a loan, yet Prospect should have documented compensating factors to justify why it approved the loan despite the collection accounts. Also, Prospect did not document the required analysis to determine whether the collection accounts were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower. Also, we recognize that health conditions, such as those explained by the borrower, occur and that the condition itself may have been beyond the borrower's control. However, the responsibility to pay debts that resulted from such conditions was within the borrower's control, but Prospect did not assess or document its assessment as to why the borrower did not pay the collection accounts.

HUD 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, 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.

Debts Not Properly Assessed

Prospect understated the borrower's monthly debts by $376 because it did not include payments on an automobile loan that had less than 10 months of payments remaining and a balance of $1,470. We included the payment because the borrower had a high debt-to-income ratio, experienced increased housing cost (going from no housing cost to a monthly mortgage of more than $1,200), and had collection accounts discussed above. Adjustment for the debt would have increased the borrower's already high 49.72 percent debt-to-income ratio to 59.52 percent.

Prospect disagreed with our position and stated that the borrower had sufficient cash on deposit to pay off the loan. We acknowledge that the bank statements showed a balance of more than $2,300 as of June 30, 2008. However, the file showed that the account was a joint checking account, which the borrower had with his daughter. The daughter was not a party to the loan.

HUD Requirements

HUD Handbook 4155.1, REV 5, paragraph 2-11(A), provides that in computing the debt-to-income ratios, the lender must include the monthly housing expense and all additional recurring charges extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing.

Gift Funds Not Properly Assessed

Prospect allowed the loan to close without confirming that the closing agent received the $7,750 nonprofit gift used to pay the borrower's required investment in the property. The HUD -1 settlement statement showed that the gift was paid. The missing document was required to provide assurance that the gift was paid by the nonprofit organization and not by some other interested party to the loan transaction. We obtained the documents needed to confirm receipt of the gift from the settlement agent.

HUD Requirements

HUD Handbook 4155.1, REV-5, paragraph 2-10(C), provides that if the gift funds are not deposited into the borrower's account before closing, the lender must obtain verification that the closing agent received funds from the donor for the amount of the gift.

Appendix F

SCHEDULE OF ALLOWED COMPENSATING FACTORS

HUD Handbook 4155.1, REV-5, paragraph 2-13, provides the following compensating factors that may be used to justify the approval of mortgage loans with ratios that exceed HUD's benchmark guidelines. Any compensating factor used to justify mortgage approval must be supported by documentation.

A. The borrower has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12-24 months.

B. The borrower makes a large downpayment (ten percent or more) toward the purchase of the property.

C. The borrower has demonstrated an ability to accumulate savings and a conservative attitude toward the use of credit.

D. Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses.

E. The borrower receives documented compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and similar public benefits.

F. There is only a minimal increase in the borrower's housing expense.

G. The borrower has substantial documented cash reserves (at least three months' worth) after closing. In determining if an asset can be included as cash reserves or cash to close, the lender must judge whether or not the asset is liquid or readily convertible to cash and can be done so absent retirement or job termination.

H. The borrower has substantial non-taxable income.

I. The borrower has a potential for increased earnings, as indicated by job training or education in the borrower's profession.

J. The home is being purchased as a result of relocation of the primary wage earner, and the secondary wage-earner has an established history of employment, is expected to return to work, and reasonable prospects exist for securing employment in a similar occupation in the new area. The underwriter must document the availability of such possible employment.

Appendix G

LOANS APPROVED BY UNDERWRITERS WITH HIGH DEFAULT RATES WHICH WERE NOT REVIEWED DURING THE AUDIT

Underwriter	Overall default rate	FHA case number	FHA status *	Endorsement date	State	Mortgage amount
A	49.39%	105-3283436	C	12/26/2007	GA	$ 49,608
A	49.39%	105-3314028	A	1/03/2008	GA	136,619
A	49.39%	105-3292829	C	1/15/2008	GA	73,080
A	49.39%	105-3283632	C	1/16/2008	GA	173,280
A	49.39%	105-3237527	A	1/16/2008	GA	159,268
A	49.39%	105-3300659	A	1/17/2008	GA	182,446
A	49.39%	105-3328736	C	1/17/2008	GA	148,824
A	49.39%	105-3312917	A	1/17/2008	GA	165,238
A	49.39%	105-3295979	A	1/22/2008	GA	68,918
A	49.39%	105-3336811	C	1/22/2008	GA	173,057
A	49.39%	381-8276371	A	1/25/2008	NC	155,500
A	49.39%	105-3299290	A	1/28/2008	GA	148,182
A	49.39%	105-3321557	A	1/28/2008	GA	256,683
A	49.39%	105-3294614	A	1/29/2008	GA	82,671
A	49.39%	105-3324655	A	1/29/2008	GA	123,068
A	49.39%	105-3314585	A	1/30/2008	GA	152,014
A	49.39%	105-3341624	A	1/30/2008	GA	173,280
A	49.39%	105-3224683	A	2/05/2008	GA	163,706
A	49.39%	381-8308576	A	2/11/2008	NC	161,800
A	49.39%	105-3173727	A	2/14/2008	GA	137,531
A	49.39%	105-3353849	A	2/14/2008	GA	123,167
A	49.39%	381-8287736	A	2/18/2008	NC	183,500
A	49.39%	105-3397929	C	3/03/2008	GA	144,485
A	49.39%	105-3476032	A	3/11/2008	GA	178,589
A	49.39%	105-3440114	A	3/11/2008	GA	124,033
A	49.39%	105-3329760	A	3/14/2008	GA	167,982
A	49.39%	105-3517014	A	3/20/2008	GA	105,383
A	49.39%	105-3397891	A	3/21/2008	GA	165,191
A	49.39%	105-3479916	A	3/24/2008	GA	123,931
A	49.39%	105-3309527	A	3/25/2008	GA	82,832
A	49.39%	105-3504509	A	3/31/2008	GA	126,499
A	49.39%	105-3503736	A	4/03/2008	GA	153,681
A	49.39%	105-3428221	A	4/03/2008	GA	128,981
A	49.39%	381-8414385	A	4/03/2008	NC	107,648

A	49.39%	381-8391891	A	4/03/2008	NC	108,300
A	49.39%	105-3513841	A	4/14/2008	GA	199,233
A	49.39%	093-6283696	A	4/15/2008	FL	173,733
A	49.39%	105-3568250	A	4/28/2008	GA	181,701
A	49.39%	105-3565761	C	4/29/2008	GA	150,709
A	49.39%	105-3548183	A	5/02/2008	GA	110,465
A	49.39%	105-3579145	A	5/02/2008	GA	157,328
A	49.39%	105-3491798	A	5/06/2008	GA	118,232
A	49.39%	105-3588413	A	5/08/2008	GA	110,846
A	49.39%	105-3554960	C	5/15/2008	GA	203,392
A	49.39%	381-8340095	A	5/23/2008	NC	94,254
A	49.39%	105-3585939	A	5/29/2008	GA	95,819
A	49.39%	105-3693574	A	6/05/2008	GA	111,497
A	49.39%	105-3618124	A	6/11/2008	GA	134,335
A	49.39%	105-3569420	A	6/12/2008	GA	194,986
A	49.39%	105-3750166	C	6/20/2008	GA	201,160
A	49.39%	461-4321111	A	6/21/2008	SC	84,333
A	49.39%	381-8356247	A	6/24/2008	NC	107,153
A	49.39%	011-5898642	A	6/26/2008	AL	151,205
A	49.39%	105-3746648	A	6/27/2008	GA	93,532
A	49.39%	105-3703058	T	6/27/2008	GA	108,300
A	49.39%	105-3646574	A	6/28/2008	GA	95,009
A	49.39%	105-3757243	A	7/01/2008	GA	211,779
A	49.39%	105-3728276	A	7/03/2008	GA	51,530
A	49.39%	105-3830308	A	7/14/2008	GA	97,541
A	49.39%	381-8532367	C	7/25/2008	NC	105,169
A	49.39%	105-3768529	A	8/05/2008	GA	173,108
A	49.39%	381-8439341	A	8/26/2008	NC	168,564
A	49.39%	381-8695736	A	9/09/2008	NC	89,455
A	49.39%	461-4265032	A	10/28/2008	SC	187,775
A	49.39%	381-8662586	A	10/31/2008	NC	101,500
A	49.39%	381-8682341	A	12/10/2008	NC	234,153
B	42.03%	105-3292184	A	1/28/2008	GA	66,871
B	42.03%	105-3345518	A	1/28/2008	GA	163,192
B	42.03%	105-3331691	A	1/29/2008	GA	181,037
B	42.03%	011-5740670	A	2/04/2008	AL	89, 274
B	42.03%	105-3352396	A	2/15/2008	GA	120,074
B	42.03%	105-3402471	A	2/19/2008	GA	113,223
B	42.03%	381-8330749	A	2/28/2008	NC	117,372
B	42.03%	105-3493782	A	3/25/2008	GA	112,683
B	42.03%	105-3320393	A	3/31/2008	GA	139,050
B	42.03%	105-3554120	C	4/15/2008	GA	75,638
B	42.03%	105-3560394	A	4/15/2008	GA	132,850

B	42.03%	105-3562740	A	4/17/2008	GA	258,825
B	42.03%	105-3449215	A	5/08/2008	GA	162,704
B	42.03%	381-8270260	A	5/12/2008	NC	147,831
B	42.03%	461-4292639	A	5/16/2008	SC	124,019
B	42.03%	381-8491160	A	5/27/2008	NC	150,727
B	42.03%	105-3628570	A	6/05/2008	GA	116,216
B	42.03%	011-5886224	A	6/13/2008	AL	85,310
B	42.03%	105-3659424	A	6/13/2008	GA	139,259
B	42.03%	105-3513812	A	6/18/2008	GA	114,755
B	42.03%	381-8485545	C	6/18/2008	NC	94,598
B	42.03%	105-3689629	A	6/24/2008	GA	118,241
B	42.03%	381-8569548	A	6/30/2008	NC	99,216
B	42.03%	381-8554067	A	7/07/2008	NC	126,514
B	42.03%	381-8311995	A	7/14/2008	NC	159,869
B	42.03%	381-8791481	A	10/21/2008	NC	160,131
B	42.03%	381-8822487	A	11/11/2008	NC	105,387
B	42.03%	381-9195528	A	4/15/2009	NC	105,440
C	31.34%	381-8228780	A	12/14/2007	NC	149,291
C	31.34%	105-3253819	A	12/19/2007	GA	143,645
C	31.34%	105-3376987	A	2/05/2008	GA	230,125
C	31.34%	381-8277558	A	2/19/2008	NC	227,200
C	31.34%	381-8317998	A	2/22/2008	NC	173,450
C	31.34%	105-3534914	A	3/31/2008	GA	88,002
C	31.34%	105-3579116	A	5/01/2008	GA	137,025
C	31.34%	105-3606648	C	5/09/2008	GA	145,847
C	31.34%	105-3604873	A	5/12/2008	GA	210,206
C	31.34%	461-4192609	C	5/27/2008	SC	81,357
C	31.34%	105-3743556	A	6/26/2008	GA	181,902
C	31.34%	105-3765437	A	6/28/2008	GA	160,730
C	31.34%	381-8576713	A	7/08/2008	NC	142,358
C	31.34%	381-8650390	A	8/18/2008	NC	153,784
C	31.34%	381-8645621	A	10/08/2008	NC	86,275
C	31.34%	381-8814987	A	11/10/2008	NC	212,403
D	54.17%	105-3212010	A	1/09/2008	GA	143,468
D	54.17%	105-3314005	A	1/22/2008	GA	138,902
D	54.17%	105-3336408	A	1/30/2008	GA	111,488
D	54.17%	105-3430181	A	2/29/2008	GA	107,704
D	54.17%	105-3392967	A	3/03/2008	GA	126,004
D	54.17%	381-8299518	A	3/11/2008	NC	123,068
D	54.17%	105-3447368	A	3/12/2008	GA	127,343
D	54.17%	105-3419090	A	3/31/2008	GA	156,449
D	54.17%	105-3552215	A	4/08/2008	GA	210,139
D	54.17%	105-3528412	A	4/14/2008	GA	164,044

D	54.17%	105-3528767	A	4/14/2008	GA	236,160
D	54.17%	381-8487570	A	5/23/2008	NC	282,753
D	54.17%	105-3725149	A	6/25/2008	GA	132,421
E	45%	011-5702059	A	1/16/2008	AL	93,633
E	45%	105-3350258	A	1/30/2008	GA	157,325
E	45%	105-3365745	A	2/05/2008	GA	158,680
E	45%	105-3418898	A	2/29/2008	GA	145,652
E	45%	105-3520287	A	3/25/2008	GA	152,605
E	45%	105-3495783	C	3/25/2008	GA	122,575
E	45%	105-3506227	A	3/31/2008	GA	109,518
E	45%	105-3420704	A	4/16/2008	GA	103,909
E	45%	105-3612433	A	5/13/2008	GA	111,447
F	9.20%	105-3470315	A	3/12/2008	GA	137,520
F	9.20%	105-3466837	A	4/04/2008	GA	123,931
F	9.20%	461-4422544	A	10/6/2008	SC	178,994
G	33.02%	105-3304104	C	12/28/2007	GA	163,192
G	33.02%	105-3289422	A	1/11/2008	GA	174,344
G	33.02%	105-3323462	A	1/28/2008	GA	96,780
G	33.02%	105-3374674	A	2/04/2008	GA	158,289
G	33.02%	105-3357364	A	2/04/2008	GA	103,687
G	33.02%	105-3331820	A	2/13/2008	GA	123,068
G	33.02%	105-3379478	A	2/25/2008	GA	167,272
G	33.02%	381-8330489	A	2/25/2008	NC	168,997
G	33.02%	381-8341583	A	2/28/2008	NC	201,400
G	33.02%	105-3416876	A	3/07/2008	GA	114,086
G	33.02%	105-3497183	A	3/21/2008	GA	140,070
G	33.02%	105-3407845	A	3/31/2008	GA	95,866
G	33.02%	105-3460749	A	3/31/2008	GA	86,317
G	33.02%	381-8415657	A	4/07/2008	NC	118,047
G	33.02%	381-8391311	A	4/07/2008	NC	181,685
G	33.02%	105-3541786	A	4/14/2008	GA	163,953
G	33.02%	105-3550729	A	4/16/2008	GA	151,940
G	33.02%	105-3562690	A	4/23/2008	GA	147,896
G	33.02%	105-3525118	A	4/28/2008	GA	115,188
G	33.02%	105-3460000	A	5/14/2008	GA	149,306
G	33.02%	105-3534972	A	5/15/2008	GA	199,760
G	33.02%	105-3680485	A	6/05/2008	GA	173,829
G	33.02%	381-8549356	A	6/24/2008	NC	115,090
G	33.02%	105-3733848	A	6/25/2008	GA	125,352
G	33.02%	105-3587401	A	6/30/2008	GA	88,761
G	33.02%	105-3666527	A	7/01/2008	GA	145,417
G	33.02%	105-3551538	A	8/01/2008	GA	165,181
H	39.13%	105-3298765	A	1/11/2008	GA	128,212

H	39.13%	105-3308045	A	1/16/2008	GA	84,829
H	39.13%	105-3302348	A	1/28/2008	GA	153,589
H	39.13%	105-3305939	A	1/28/2008	GA	122,967
H	39.13%	105-3287467	C	1/29/2008	GA	162,755
H	39.13%	105-3373968	A	2/07/2008	GA	183,539
H	39.13%	381-8300639	A	2/20/2008	NC	148,750
H	39.13%	105-3438229	C	3/03/2008	GA	170,723
H	39.13%	105-3475215	A	3/25/2008	GA	234,386
H	39.13%	105-3450787	A	3/25/2008	GA	143,673
H	39.13%	381-8351227	A	3/31/2008	NC	125,352
H	39.13%	381-8410360	A	4/02/2008	NC	125,037
H	39.13%	105-3528671	A	4/08/2008	GA	97,962
H	39.13%	381-8486539	A	5/22/2008	NC	115,288
H	39.13%	461-4376876	A	8/19/2008	SC	124,019
H	39.13%	105-3770455	A	8/22/2008	GA	81,707
H	39.13%	381-8531355	A	10/06/2008	NC	77,388
I	11.94%	381-8278372	A	1/22/2008	NC	197,500
I	11.94%	105-3373026	A	2/11/2008	GA	256,683
I	11.94%	105-3491985	A	3/19/2008	GA	90,814
I	11.94%	105-3596960	A	5/27/2008	GA	315,507
I	11.94%	381-8679359	A	8/29/2008	NC	196,348
						$26,138,210

*FHA status codes:
A = Active
C = Claim
T = Terminated