Issue Date November 24, 2009
Audit Report Number 2010-NY- 1004

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

FROM: Edgar Moore, Regional Inspector General for Audit, New York/New Jersey, 2AGA

SUBJECT: Ark Mortgage, Incorporated, North Brunswick, New Jersey, Did Not Always Comply with HUD/FHA Loan Origination Requirements

HIGHLIGHTS

What We Audited and Why

We audited Ark Mortgage, Incorporated (Ark Mortgage), a nonsupervised [1] direct endorsement lender located in North Brunswick, New Jersey. Ark Mortgage was selected for review because its default rate of 12.99 percent for loans with beginning amortization dates from October 1, 2006, to September 30, 2008, was significantly higher than the state of New Jersey's default rate of 5.76 percent.

The audit objectives were to determine whether Ark Mortgage officials (1) originated insured loans in accordance with U.S. Department of Housing and Urban Development/Federal Housing Administration (HUD/FHA) requirements and (2) developed and implemented a quality control plan that complied with HUD/FHA requirements.

What We Found

Ark Mortgage officials did not always comply with HUD/FHA requirements in originating 11 of 12 loans reviewed during the audit. Specifically, (1) four loans exhibited significant underwriting deficiencies such as inadequate verification of

[1] A nonsupervised lender is an FHA nondepository financial entity that has as its principal activity the lending or investing of funds in real estate mortgages. A nonsupervised lender may originate, underwrite, purchase, hold, service, and sell FHA-insured mortgages and submit applications for mortgage insurance.

funds to close, insufficient cash reserve for certain property, and inadequate verification of income and liabilities; (2) two loans, including one loan with a significant underwriting deficiency, were not closed as they were underwritten; and (3) six remaining loans exhibited technical deficiencies such as having an inadequately verified employment history and excessive debt-to-income ratios with inadequate compensating factors. As a result, lenders were approved for potentially ineligible borrowers, causing HUD/FHA to incur an unnecessary insurance risk. These deficiencies occurred because Ark Mortgage lacked adequate controls to ensure that loans were processed in accordance with all applicable HUD/FHA requirements.

Ark Mortgage had weaknesses in the implementation of its quality control plan as it did not always comply with HUD's quality control requirements. Specifically, Ark Mortgage officials did not (1) perform reviews of all early payment default loans, (2) conduct quality control reviews in a timely manner, (3) conduct reviews for the rejected loans, and (4) follow the required reverification processes for loans it reviewed. As a result, the effectiveness of Ark Mortgage's quality control plan, which was designed to ensure accuracy, validity, and completeness in its loan origination and underwriting processes, was lessened.

What We Recommend

We recommend that the Deputy Assistant Secretary for Single Family Housing require Ark Mortgage to (1) indemnify HUD against future losses on four loans with significant underwriting deficiencies, (2) buy down one loan so that the value of insurance equals 75 percent of the value of the property if HUD is not provided with the additional documents to support that the property was owner occupied, and (3) implement its quality control plan to fully comply with HUD's requirements. We also recommend that HUD's Homeownership Center's Quality Assurance Division follow up with Ark Mortgage officials within six months to ensure that quality control reviews have been properly implemented.

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

Ark Mortgage officials agreed with our conclusion for quality control but generally disagreed with our conclusions and recommended corrective actions related to its underwriting. We provided the draft report to Ark Mortgage officials on October 6, 2009 and requested a response by October 22, 2009. They provided written comments on October 22, 2009.

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

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVES

Ark Mortgage, Incorporated (Ark Mortgage), became an approved U.S. Department of Housing and Urban Development (HUD) nonsupervised direct endorsement lender in 1985. The company originates loans and then sells them to other investors, banks, or mortgage banks.

Ark Mortgage currently originates all of its loans at its home office in North Brunswick, New Jersey, since it closed its branch office in Saddle Brook, New Jersey, in August 2008.

Federal Housing Administration (FHA) mortgage insurance programs help low- and moderate-income families become homeowners by encouraging lenders to approve mortgages for creditworthy borrowers who may not be able to meet conventional underwriting requirements. Through Direct Endorsement, approved lenders underwrite and close mortgage loans without prior HUD review or approval. Approved lenders are responsible for complying with all applicable HUD regulations and are required to evaluate the borrower's ability and willingness to repay the mortgage debt. These lenders are protected against default by FHA's Mutual Mortgage Insurance Fund, which is sustained by the mortgage insurance premiums paid by the borrowers.

Ark Mortgage underwrites loans using an automated underwriting system that can communicate with the FHA Technology Open to Approved Lenders (TOTAL) Scorecard to evaluate borrower creditworthiness for FHA loans. The FHA TOTAL Scorecard is developed by HUD to evaluate the credit risk of FHA loans. The TOTAL Scorecard provides two risk classifications: Accept/Approve or Refer. An "Accept/Approve" classification indicates that FHA will ensure the borrower's loan with reduced documentation. If the loan receives a "Refer" classification, the lender will be required to manually underwrite the loan based on obtaining all documentation required by HUD Handbook 4155.1, REV- 5. Currently, a full-time employed underwriter and, occasionally, the president of Ark Mortgage underwrite the loans. Ark Mortgage officials outsource their quality control function to a third party contractor, and minimize their involvement in the quality control process. From October 1, 2006, through September 30, 2008, Ark Mortgage originated 331 FHA loans, including 151 refinancing loans, valued at approximately $105 million for properties located in New Jersey. During this period, 43 loans (12.99 percent) defaulted, including one loan for which a claim was paid by the FHA insurance fund. Ark Mortgage's default rate of 12.99 percent was significantly higher than the New Jersey state average default rate of 5.76 percent.

The audit objectives were to determine whether Ark Mortgage (1) originated insured loans in accordance with HUD/FHA requirements and (2) developed and implemented a quality control plan that complied with HUD/FHA requirements.

RESULTS OF AUDIT

Finding 1: Ark Mortgage Officials Did Not Always Comply with HUD/FHA Underwriting Requirements

Ark Mortgage officials did not always comply with HUD/FHA requirements in originating 11 of 12 loans reviewed during the audit. Specifically, (1) four loans exhibited significant underwriting deficiencies such as inadequate verification of funds to close, insufficient cash reserve for certain property, and inadequate verification of income and liabilities; (2) two loans, including one loan with a significant underwriting deficiency, were not closed as they were underwritten; and (3) six remaining loans exhibited technical deficiencies, such as having an inadequately verified employment history and excessive debt-to-income ratios with inadequate compensating factors. As a result, mortgages were approved for potentially ineligible borrowers, causing HUD/FHA to incur an unnecessary insurance risk. These deficiencies occurred because Ark Mortgage lacked adequate controls to ensure that loans were processed in accordance with all applicable HUD/FHA requirements.

Significant Underwriting Deficiencies

HUD Handbook 4155.1, REV-5, entitled "Mortgage Credit Analysis for Mortgage Insurance," prescribes basic underwriting requirements for FHA-insured single-family mortgage loans. According to the handbook, the lender must ensure that the borrower has the ability and willingness to repay the mortgage debt. In addition, chapter 3-1 of the handbook requires that the application package contain sufficient documentation to support the lender's decision to approve a mortgage. While this decision involves some subjectivity, our review of 12 loans approved by Ark Mortgage officials disclosed significant underwriting deficiencies in the approval of four loans.

Ark Mortgage officials did not always (1) adequately verify the source of funds to close, (2) ensure that the three-month cash reserve requirement was met for a three-unit property, (3) properly verify the borrower's employment and/or income, and (4) sufficiently verify the borrower's monthly debt payment liability. The deficiencies noted were not independent of one another, as one loan may have contained more than one deficiency.

The frequency of the significant deficiencies[2] for the four loans is noted in the chart below.

[2] A deficiency is considered material if its omission, non-disclosure or misstatement would cause/mislead users when making evaluations or decisions (e.g. affects loan approval). For example, a liability (which increases risk) is omitted and has significant impact on the loan being approved.

Areas of deficiencies	Number of loans
Inadequate verification of funds to close	**2 of 4 loans**
Three-month cash reserve requirement not met	**1 of 4 loans**
Inaccurate disclosure of liability	**2 of 4 loans**

Specific examples of these significant underwriting deficiencies follow:

For FHA case # 352-5504892, the lender did not report a $404 monthly loan repayment and a $524 monthly payment for child support on the mortgage credit analysis worksheet[3]. HUD Handbook 4155.1, REV-5, section 2-11A, requires the lender to include the monthly housing expenses and any additional recurring charges extending 10 months or more, such as payments on installment loans, in computing the debt-to-income ratios. Rental income on the worksheet was also overstated as the $1,500 monthly rental income was used to determine the effective rent, whereas the appraisals in the files only supported monthly rental income of $1,400. Since the debt to income ratio is the percentage of a borrower's monthly gross income that goes toward paying monthly obligations, the decrease of the monthly payment and the increase of income will reduce the ratio. After taking into consideration overstated monthly income and understated liabilities, the back end debt-to-income ratio (total fixed monthly payment to effective monthly income) increased to 58.04 percent, which exceeded the HUD 43 percent limit; also, the cited compensating factor of having a good savings pattern was not supported. In addition, funds used to close the loan were not adequately verified as five nonpayroll deposits totaling $2,572 and the balance of a share account had not been verified. As a result, including the monthly $404 automatic loan repayment and removing the unexplained nonpayroll deposits, would have resulted in insufficient funds being available to close the loan (see appendix D-1).

For FHA case # 352-5574149, the lender did not adequately verify whether the borrowers had cash reserves equivalent to three months' principal, interest, taxes, and insurance (PITI). HUD Handbook 4155.1, REV-5, section 1-8C, requires that the borrower have reserves equivalent to three months' PITI after closing on the purchase transactions for three- and four-unit properties. The handbook also provides that reserves cannot be derived from a gift. The coborrower's checking account was recently opened, and the account balance was used for the closing.

[3] The Mortgage Credit Analysis Worksheet (MCAW) is an underwriting form (HUD Form -92900) developed by HUD to assist the lenders to determine the eligibility of FHA mortgage insurance applicants. The specific areas include the borrowers' information, settlement requirements/mortgage calculation, monthly effective income, debts and obligations, future monthly payments, ratios (mortgage payment-to-income & total fixed payment-to-income), seller's contribution, and borrower rating.

However, the coborrower's two-month bank transaction printout for the checking account did not contain any deposits, and there was no earlier bank account activity provided to support the source of the account balance. As such, the lender did not obtain a credible explanation for the source of funds in this checking account, as required by HUD Handbook 4155.1, REV-5, section 2-10B. In addition, (1) the lender did not verify the rental history for the coborrower, and (2) the loan had front end (mortgage payment expense to income) and back end (total fixed payment expense to income) ratios of 38.60 and 49.53 percent, which exceeded HUD's 31 and 43 percent limits, without adequate compensating factors (see appendix D-3).

For FHA case # 352-5611530, the lender did not disclose monthly child support of $867 as a liability. As a result, the borrowers' total debt-to-income (back end) ratio increased to 62.04 percent without adequate compensating factors. In addition, the percentage of nonresidential use of this three-story building[4] appeared to be greater than 25 percent of the total floor space, because the space designated on the first floor as the storage area for a residential unit was not used for that purpose. Based on a site visit on July 17, 2009, the space appeared to be an integral part of the commercial entity on the first floor, which means that one third of the property seemed to be used as commercial space. HUD Handbook 4905.1, REV-1, section 2-6, provides that the nonresidential use of the property shall not be greater than 25 percent. Therefore, if the total space for commercial use is greater than 25 percent of the total floor space of the property, this loan would not be eligible for the insurance (see appendix D-5).

Closing Not in Compliance with Underwriting

Two loans were closed in a manner that was not consistent with how the loans had been underwritten.

Specifically, for FHA case # 352-5594478,[5] the lender allowed the borrower's employer to be added to the HUD-1 settlement statement and security notes without being underwritten as a coborrower or cosigner. HUD Handbook 4155.1, REV-5, section 3-10B, indicates that the loan must close in the same manner in which it was underwritten and approved. In addition, section 2-2A requires the lender to determine the creditworthiness of all coborrowers/cosigners by considering their income, assets, liabilities, and credit history. However, there was no documentation showing that the lender had considered or evaluated the creditworthiness of the borrower's employer see appendix D-4).

[4] The subject property is a three-story building with the commercial space occupying the first floor and two residential apartments occupying the second and third floors.
[5] This case is one of four cases with significant underwriting deficiencies.

For FHA case # 352 -5513337, although the lender acknowledged that the borrower was married to someone other than the coborrower and both borrowers had different last names, the lender failed to verify the relationship between the borrowers. The affidavit of title signed by the borrower and coborrower at closing certified that one borrower would not occupy the property. However, the lender did not resolve this issue by determining who would reside at the property before it submitted the loan documentation to HUD for insurance. HUD Handbook 4155.1, REV-5, section 1-8B, indicates that when there are two or more borrowers, if one or more will not occupy the property as a principal residence, the maximum mortgage must be limited to a 75 percent loan-to-value ratio, unless there is documented evidence of a family or family-like relationship that is a longstanding and substantial relationship and not arising out of the loan transaction. The loan was closed with a 97 percent loan-to-value ratio when the maximum allowable loan-to-value ratio is 75 percent. Therefore, the loan should be written down to 75 percent of the value of the property (see appendix D-2).

Technical Underwriting Violations

The remaining six loans contained technical underwriting deficiencies that, while they resulted in noncompliance with HUD requirements, did not cause conditions serious enough to negatively impact approval of the loans.

These deficiencies are summarized in the chart below.

Technical underwriting violations	Number of loans
Inadequate compensating factors	4 of 6 loans
Inadequate verification of income	2 of 6 loans
Inadequate verification of employment history	1 of 6 loans
Insufficient verification of income/cash reserve during the interim period	1 of 6 loans
Insufficient verification of costs paid outside of closing	1 of 6 loans

Specific examples of these violations follow:

In four loans, Ark Mortgage officials listed compensating factors that were invalid and/or were not adequately documented in accordance with HUD Handbook 4155.1, REV-5, section 2-13. For instance, job stability, job history, or good credit history was commonly cited as a compensating factor, although none of them was an allowable compensating factor according to section 2-13. The allowable compensating factors, such as excellent cash reserve after the closing and excellent saving pattern were not supported by adequate documentation.

Income was overstated for two loans. For one of these loans, Ark Mortgage officials did not (1) verify the coborrower's employment for the most recent two full years and (2) obtain an adequate explanation for two employment gaps, each gap spanning more than two months, although HUD requires the lender to obtain an explanation for any gap in employment spanning one month or more. For the other loan, Ark Mortgage officials approved refinancing the loan without verifying whether the borrower had enough cash reserves to support the mortgage payment and other monthly obligations without incurring additional debts during the interim period between loan closing and the restart of employment, as required by HUD Handbook 4155.1, REV-5, section 2-7R.

In one loan, Ark Mortgage officials did not verify the outside-of-closing fees ($425 for appraisal fee and $741 for hazard insurance premium for one year) listed on the HUD-1 settlement statement, although HUD Handbook 4155.1, REV-5, section 2-10, requires that all funds for the borrower's investment in the property be verified and documented.

Conclusion

Ark Mortgage officials did not always comply with HUD regulations in the approval of loans. As a result, HUD remains at risk for more than $1.6 million for the value of four loans with significant underwriting deficiencies[6] (see appendix C). The final loss that HUD incurs will depend upon what HUD realizes when it disposes of the property. HUD's most recent data disclosed that its loss rate is 42 percent. Net sales proceeds after considering carrying and sales expenses may mitigate the amount of the claim paid. Loans for which HUD remains at risk can be mitigated by requesting that the lender indemnify HUD. In this case, the lender reimburses HUD for any insurance claim, taxes, interest, and other expenses connected with the disposition of the property, reduced by any amount recouped by HUD via sale or other disposition.

Appendix C of this report provides a summary of the underwriting deficiencies, while appendix D provides the detailed case narratives.

[6] The amount of cost savings or funds to be put to better use on the loans for which indemnification is recommended is estimated at $672,158 based on HUD's 42 percent default loss experience.

Recommendations

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

1A. Indemnify HUD against future losses of $672,158 on four loans with significant underwriting deficiencies.

1B. Provide additional documentation for one loan for a property that was not owner occupied to be insured at 97 percent of its value. If proper documentation is not provided, Ark Mortgage officials should buy down this loan by $79,860[7] so that it equals 75 percent of the value or indemnify HUD for the amount of the original loan.

1C. Establish procedures to ensure that all HUD underwriting requirements are properly implemented and documented.

[7] The difference between $272,250 (75 percent of the full value of $363,000) and the original loan amount of $352,110 (97 percent of the full value) is $79,860.

Finding 2: Ark Mortgage Had Weaknesses in the Implementation of Its Quality Control Plan

Ark Mortgage had weaknesses in the implementation of its quality control plan as it did not always comply with HUD's quality control requirements. Specifically, Ark Mortgage officials did not (1) perform reviews of all early payment default loans, (2) conduct quality control reviews in a timely manner, (3) conduct reviews for the rejected loans, and (4) follow the required reverification processes for the loans it reviewed. This condition occurred because Ark Mortgage did not have adequate controls over the quality control review process while relying on an outsourced contractor, which appeared to be unfamiliar with HUD requirements. As a result, the effectiveness of Ark Mortgage's quality control plan, which was designed to ensure accuracy, validity, and completeness in its loan origination and underwriting processes, was lessened.

Early Payment Default Loans Not Reviewed

Loans that defaulted within the first six payments (early payment defaults) were not reviewed as required by HUD regulations and Ark Mortgage's own quality control plan. HUD Handbook 4060.1, REV-2, section 7-6 D, requires lenders to review all early payment default loans including the loans that become 60 days or more delinquent within the first six payments. Of the loans approved by Ark Mortgage officials during our audit period, at least 20 became 90 days or more delinquent within the first six payments. Ark Mortgage officials reviewed only two of these early payment default loans.

Ark Mortgage officials stated that privacy rules prohibit servicers from providing Ark Mortgage with information on defaulted loans once they are sold. However, Mortgagee Letter 00-20 announced the availability of HUD's Neighborhood Watch[8] system to allow all FHA-approved lenders to analyze their early default loans and claims. Therefore, Ark Mortgage officials should have used Neighborhood Watch to obtain data on the early default loans.

Untimely Quality Control Reviews

HUD Handbook 4060.1, REV-2, section 7-6 A, states that loans must be reviewed within 90 days from the end of the month in which the loan is closed. However, Ark Mortgage's quality control reviews of all 63 FHA loans that closed during

[8] The Neighborhood Watch system is a web-based software application that displays loan performance data for lenders and appraisers, by loan types and geographic areas using FHA-insured single family loan information.

our audit period were not completed within 90 days from the end of the month in which the loans were closed; e.g. for all loans that closed during the audit period, quality control reviews were not conducted until four to five months after loan closing.

Further, Handbook 4060.1, REV-2, section 7-6 B, indicates that for lenders closing more than 15 loans monthly, quality control reviews must be conducted monthly and must address one month's activity. However, Ark Mortgage's quality control reviews were conducted bimonthly, although it closed more than 15 loans monthly.

Rejected Loans Not Reviewed

HUD Handbook 4060.1, REV-2, paragraph 7-8A(1), requires that of the total loans rejected, a minimum of 10 percent or a statistical random sampling that provides a 95 percent confidence level with 2 percent precision must be reviewed. However, for 25 loans rejected between June 1, 2007 and September 30, 2008, no quality control reviews were conducted.

Required Reverification Not Sufficiently Conducted

HUD Handbook 4060.1, REV-2, section 7-6 E, 2, states that the quality control program must provide for the review and confirmation of information on all loans selected for review. It further states that documents contained in the loan file should be checked for sufficiency and subjected to written reverification, and the examples of items that must be reverified include the borrower's employment, other income, deposits, gift letters, alternate credit sources, acceptable sources of funds, and mortgage or rent payments. It also prescribes that if the written reverification is not returned to the lender, a documented attempt must be made to conduct a telephone reverification, and if the original information is obtained electronically or involved alternative documents, a written reverification must still be attempted. However, Ark Mortgage's outsourced contractor for quality control reviews stated that he only verified income. The returned verification of employment from the borrowers' employers was the only documented reverification of income. There was no other documented reverification including telephone reverification for the unreturned verifications of employment.

In addition, HUD Handbook 4060.1, REV-2, section 7-6 E, 1, requires lenders to obtain new credit reports for loans, other than streamline refinance or loans that were processed using an FHA-approved automated underwriting system, when performing quality control reviews of loans. However, new credit reports were ordered for only 4 of 63 FHA loans reviewed during our audit period.

Conclusion

Ark Mortgage officials did not ensure that (1) all early payment default loans were reviewed, (2) quality control reviews were conducted in a timely manner, (3) quality control reviews for the rejected loans were conducted, and (4) the reverification processes for the loans were completed as required. This condition occurred because Ark Mortgage officials relied on an outsourced contractor for review and did not adequately monitor the process. As a result, the effectiveness of Ark Mortgage's quality control process was lessened.

Recommendations

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

2A. Ark Mortgage officials to implement a quality control plan in accordance with HUD requirements to ensure that (1) all loans that defaulted within the first six payments are reviewed; (2) quality control reviews are conducted in a timely manner; (3) an appropriate number of the rejected loans are selected for quality control review; and (4) for the selected loans, all critical loan documents are reverified and new credit reports are obtained as applicable.

2B. Ark Mortgage officials to monitor its quality control contractor's quality control review process to ensure that the quality control reviews are conducted in accordance with HUD requirements.

2C. HUD's Homeownership Center's Quality Assurance Division to follow up with Ark Mortgage in six months to ensure that the lender has implemented the quality control procedures as required.

SCOPE AND METHODOLOGY

To accomplish our audit objectives, we reviewed applicable laws, regulations, HUD handbooks, mortgagee letters, and reports from HUD's Quality Assurance Division. We reviewed independent audit reports from Ark Mortgage's independent auditor, interviewed Ark Mortgage's staff, and used the questionnaires completed by the staff and quality control contractor to obtain an understanding of the auditee's internal controls.

From October 1, 2006, through September 30, 2008, Ark Mortgage originated 331 FHA loans, including 151 refinancing loans, valued at approximately $105 million for properties located in New Jersey. We selected 25 of 43 defaulted loans, including 6 refinancing loans, from the Neighborhood Watch system that were underwritten by Ark Mortgage with beginning amortization dates between October 1, 2006, through September 30, 2008. We used the following criteria to select the loans: (1) defaulted within 10 or fewer payments, (2) not terminated, (3) claim not paid, (4) not indemnified by HUD, (5) not reviewed by the Homeownership Center's Quality Assurance Division[9], and (6) not streamline refinanced[10]. After review of the preliminary sample of 25 loans with loan amounts totaling $8.7 million, we selected 12 loans, including one refinanced loan, with loan amounts totaling $4 million, which appeared to have significant underwriting deficiencies for on-site verification in Ark Mortgage's files. The results of our detailed testing only apply to the 12 loans tested and cannot be projected.

We performed detailed testing and review of the underwriting procedures for the 12 loans. We reviewed documentation from both HUD's Homeownership Center loan endorsement files and the loan files provided by the auditee. Our detailed testing and review included (1) analysis of borrowers' income, assets, and liabilities; (2) review of the borrowers' saving abilities and credit history; (3) verification of selected data on the underwriting worksheet and settlement statements; and (4) confirmation of employment and gifts. In addition, we reviewed the appraisal reports, a floor plan, and conducted a site visit to one property on July 17, 2009. We also discussed issues with HUD and Ark Mortgage officials.

We reviewed Ark Mortgage's quality control plan and the quality control review reports for 120 loans including 63 FHA loans along with the supporting documentation completed by the quality control contractor to determine the sufficiency and timeliness of the quality control reviews conducted on closed loans. We selected 3 of 25 rejected loans from the period June 1, 2007 to September 30, 2008 to determine the adequacy of quality control reviews conducted for the rejected loans.

[9] HUD Homeownership Centers (HOC) approves single family mortgages for FHA insurance and oversees the selling of HUD homes. The Quality Assurance Division (QAD) is responsible for evaluating and monitoring lenders in its territory to ensure that HUD/FHA approved lenders are originating quality loans and servicing FHA-insured loans in compliance with the Department's requirements.

[10] Streamlined refinances are designed to lower the monthly principal and interest payments on a current FHA-insured mortgage and must involve no cash back to the borrower, except for minor adjustments at closing not to exceed $250. They can be done with or without an appraisal.

We performed the audit fieldwork at Ark Mortgage's home office at 1254 Route 27, North Brunswick, New Jersey, from April through June 2009.

We performed our review 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 objectives.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

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

- Validity and reliability of data - Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

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

- Safeguarding resources - Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

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We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- Ark Mortgage officials did not ensure that certain loans were processed in accordance with all applicable HUD underwriting requirements (see finding 1).

- Ark Mortgage officials did not adequately implement its quality control plan to ensure compliance with HUD's quality control requirements (see finding 2).

APPENDIXES

Appendix A

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

Recommendation number	Unsupported 1/	Funds to be put to better use 2/
1A		$672,158
1B	$79,860	

1/ 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.

2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (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, if HUD implements our recommendations to have Ark Mortgage indemnify four loans that were not originated in accordance with FHA requirements, it will reduce FHA's risk of loss to the insurance fund. The amount above reflects HUD's statistics reflecting that FHA has an average loss experience of 42 percent of the claim amount when it sells a foreclosed property.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

ARK
MORTGAGE, INC.
A promise for your future.

October 22, 2009

Mr. Edgar Moore
Regional Inspector General for Audit, NY/NJ
US Department of Housing and Urban Development
Office of Inspector General
26 Federal Plaza, Room 3430
New York, NY 10278-0068

RE: Ark Mortgage, Inc.
FHA # 3030909998

Dear Mr. Moore,

Ark Mortgage, Inc. ("Ark" or the "Company") once again appreciates the opportunity to provide our comments, this time regarding the draft of the proposed audit report of the Office of Inspector General ("OIG") arising out of the audit of the Company's HUD-FHA insured mortgage lending practices.

Ark also appreciates that the OIG, after considering the Company's earlier response to the OIG's tentative observations, proposes to recommend action regarding only five of the twelve loans originally identified. Our dialog, in essence, has resolved the issues concerning seven loans and narrowed the issues on the remaining five. Nevertheless, Ark still respectfully disagrees with the OIG's conclusions and recommended actions concerning the five loans that are the subject of the draft report.

Ark again wants to reassure the OIG that the Company remains committed to achieving best in class status in the origination of FHA insured mortgage loans and complying fully with HUD-FHA requirements. As set forth in our earlier response to the OIG, Ark has been in the mortgage business for over a quarter of a century and has been underwriting and originating loans for the FHA for almost as long. Ark takes very seriously its professional and ethical obligation to identify and correct any potential problems in loan origination and underwriting. In order to ensure that the quality control review is completely objective and impartial, Ark has, for over twenty years, contracted out quality control to an independent third party vendor. Before this most recent review by HUD, Ark has been audited a number of times by state regulatory authorities of New York and New Jersey and by HUD itself without any findings of violations of quality control regulations.

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Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

Finally, Ark also wishes to note that its apparent default rate has been significantly overstated and misleading. For example, we have recently uncovered that the Company's Neighborhood Watch numbers incorrectly include 4 to 6 loans in default; these loans are actually current. Adjusting for this correction, Ark's most recent Neighborhood Watch numbers for New Jersey would be no more than 147%.

We provide below our comments with respect to the OIG's draft of the proposed audit report.

Very truly yours,

Richard A Rosenberg,
President

2

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

QUALITY CONTROL

Comment 1

When, during the course of the on-site review, it was brought to Ark's attention that Ark was not in complete compliance with current HUD QC criteria, Ark immediately acted to cure any oversights and prevent any future oversights:

- Ark contacted the QC vendor to make sure that it was aware of the time requirements for completing the QC reviews.
- Ark advised the QC vendor that Ark would send, in addition to the appropriate sample of closed loans, all loans that defaulted within the first six payments for review and the required sample of rejected loans.
- Ark arranged for the immediate return of the outstanding QC sample and provided to the QC vendor a list of all the loans that closed for the four month period ending January 31, 2009, thus bringing Ark in compliance with the 90-day review window.
- Ark assigned to one member of senior management the responsibility of monitoring the vendor's compliance with QC procedures.
- Ark assigned to one member of management the responsibility of reviewing, upon its issuance, the Neighborhood Watch Early Default Report to identify all Ark-originated loans that entered the list.
- Ark assigned to one member of senior management the responsibility of identifying all Ark-originated loans listed in the Neighborhood Watch Early Report and that defaulted within the first six payments and including them in the monthly QC review by the QC vendor.
- Ark runs an in-house report of rejected loans during the same monthly period to include in the QC review for the month.
- Ark attempts to contact the borrower on any defaulted loan to determine the cause of the default.

Comment 2

Finally, Ark has informed the QC vendor of the assertion that there has been insufficient re-verification of loan documents. The QC vendor has confirmed that, in fact, it routinely reviews and confirms information on all loans selected for review. In this regard, Ark will supply to HUD such assurances as are appropriate.

Ark believes that this action plan has satisfactorily addressed HUD's four concerns. Ark remains committed to take further steps to address the concerns if appropriate

3

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

FHA Case # 352-5504892
Loan Amount: $458,810
Settlement date: 9/15/2006
Default Status: Bankruptcy Plan Confirmed

A. Understated Liabilities

Comment 3

Even if one factors in the re-calculations of liabilities for an auto loan and child support as proposed by the draft report, the underwriter still had the discretion to consider compensating factors and apply a flexible standard to the qualifying ratios. As shown in paragraph D-F below, the underwriter properly exercised this discretion in applying the flexible standards to the qualifying ratios.

B.-C. Overstated Rental Income/Inadequate Verification of Income

Comment 4

The discrepancy between the rental income as reported in the appraisal and on Form 1033 was only $85.00 per month, which is a marginal amount and not material to the borrowers' default.

As to the verification of co-borrower's overtime and bonus income, the underwriter properly relied on the 2005 W-2 IRS form, which showed total income of over $65,000, confirming that the co-borrower had received earnings in excess of her base salary. This conclusion was further supported by the employer's statement that the overtime would likely continue.

D.-F. Incorrect/Excessive Ratios and Inadequate Evaluation of Credit Report

Comment 5

Under the flexible standards to be applied to qualifying ratios, the underwriter had the discretion to determine the applicable compensating factors and the extent to which ratios may be exceeded. The underwriter duly stated the compensating factors that she used to support loan approval: both borrowers had excellent job stability with the potential for increased earnings (one of the borrowers had maintained two jobs for over seven years), had demonstrated an excellent savings pattern, and had completed credit counseling class. These are all compensating factors specified in the HUD handbook. The underwriter further noted that she felt that the circumstances causing past credit problems were not likely to re-occur. Although the review states that there was insufficient documentation concerning savings history because the borrowers had withdrawn from their retirement funds (in order to buy their home) and used credit excessively, the fact that they had a 401K plan establishes a savings pattern. It is further respectfully submitted that since HUD requirements specifically permit withdrawals from a 401K to purchase a house, to count their 401K withdrawal against the borrower would be counterproductive of HUD policy.

G.-Inadequate Verification of Assets and Funds to Close

4

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	**Auditee Comments**
Comment 6	The proposed draft suggests a scenario by which the borrowers would have insufficient funds to close. But the borrowers did in fact have the funds to close, and the underwriter documented sufficient reasons to justify that belief. The individual non-payroll deposits (totaling under $2,600) were not large enough to require further verification of source since they were consistent with cash that the borrowers retained at home out of their pay and then subsequently deposited in their account in their discretion. As to the two projected additional automatic deductions from the share balance account totaling $808, the account's history of steady payroll deposits exceeding the amount of the automatic withdrawals supports the underwriter's conclusion that the account's balance at least remained the same, if not increased.

5

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	Auditee Comments

FHA Case # 352-5513337
Loan Amount without UFMIP: $352,110
Settlement date: 10/31/2006
Default Status: Partial claim of $22,417 paid on 5/24/09 – reinstated after loss mitigation.

A. Excessive Loan-to-Value Percentage

The draft report proposes that there was an excessive loan-to-value percentage because both borrowers did not occupy the premises post-closing and they were not related.

Comment 7

The Company has confirmed that the borrowers are father and daughter. *See* attached letter from closing attorney. This letter constitutes sufficient verification. (See HUD Handbook 4155.1.9)

While this relationship was known at the time of the closing, there was no verification in the file because the borrowers had stated in both their initial and final applications their intention to both occupy the property. *See* attached applications. Thus, verification would be superfluous. It was only after the affidavit of one of the borrowers stated his intention not to occupy the premises that their relationship became relevant. Since the borrowers are in fact related, the loan did not exceed the guidelines for a loan's maximum percentage.

B. Inadequate Verification of Income

Comment 8

The attached IRS Form 1099-R states that the source for the distributions for the years 2004 and 2005 is the "NYC Employees Retire System". Further, the bank statements show monthly direct deposits that match the distributions.

Recommended Action

Comment 9

The draft report recommends that if proper verification is not provided, Ark should buy down this loan by about $80,000, or to approximately 75%, or indemnify in the full amount of the loan. As shown in the preceding sections, this loan has been properly verified and therefore neither action is justified.

6

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	Auditee Comments

FHA Case # 352-5574149
Loan Amount: $467,168
Settlement date: 4/30/2007
Default status: First Legal Action to Commence Foreclosure/Delinquent

A.-C. Inadequate Funds to Close and Verification of Assets/Inadequate Cash Reserves

Comment 10

The bank statement covering the two months before closing and its balance of over $16,300.00 verified sufficient funds to cover closing costs and 3 months PITI reserves (combined estimate of no more than about $15,600.00). The source of funds for the down payment was the Ameridream program, and at the closing the seller gave a concession towards the closing costs. The letter from the bank confirmed that the co-borrower was the co-owner of the account. The source of funds therefore becomes immaterial.

Since the draft report's proposed finding that there were inadequate cash reserves is predicated on the inadequate funds to close and inadequate verification of assets, the previous paragraphs showing that there were adequate funds and verification of assets also resolves the issue of inadequate cash reserves in the Company's favor.

D. Excessive Ratios

Comment 11

While each borrower may not have individually satisfied all the compensating factors, the underwriter determined that collectively the borrowers had sufficient compensating factors to approve the underwriting of the loan.

E. Insufficient Verification of Rental Payment History

Comment 12

The initial application and the final application specifically state that both of the borrowers "resides with family." The final application also has checked off "rental" for this was apparently in error. In the case of "resides with family," the lender does not need to verify rental payments. In discussing the differences among the pay stubs, driver's license and the current address, the co-borrower did not state that he was not living with family, only that he was not living with the family members at the prior addresses. With respect to the borrower, the file contains a letter signed by the borrower that he lives with his cousin and his family.

Recommended Action

Comment 13

This loan did not go into default until there was a major fire on the premises, rendering it uninhabitable. Ark has been in contact with the borrowers, who confirmed that they have been forced to move and that they have not yet received compensation from the insurer and are in litigation to collect the insurance funds. In view of these extraordinary circumstances unrelated to any suggested underwriting errors, Ark respectfully submits that the proper course of action is to await the outcome of the borrowers' claims against their insurer. If for some reason there is no insurance coverage, the servicers' umbrella insurance should cover same.

7

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	Auditee Comments

FHA Case # 352-5594478
Loan amount: $255,526
Settlement date: 7/18/07
Default status: First Legal Action to Commence Foreclosure/Modification Started

A.-B Not Closed As Underwritten/Inadequate Closing Documents

Comment 14

Ark has determined that: the HUD-1 and the mortgage differ from the initial application in that the employer was added as an additional buyer; and the employer is currently listed as located at the property. At the time of the application, however, Ark matched the address of the employer on borrower's payroll check with the address of the employer on the application, which was 8 Lisa Court, North Haledon, NJ. As a result, Ark is investigating its rights against third parties.

C-D. Inadequate Verification of Assets and Earnest Money Deposit

Comment 15

In verifying the assets, the underwriter followed one of the recommendations as per the D.U. underwriting requirements, item #30. The borrower did have assets in an account. While the account was opened during a period of seasonal unemployment, this fact alone did not present an issue at the time of the application because the account was borrower-owned and was seasoned. It is common for borrowers to have accumulated his/her savings during the period of employment before a seasonal lay-off. Further, the down payment was verified by a certification from the borrower's employer that the down payment was a bonus.

8

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	Auditee Comments

FHA Case # 352-5611530
Loan amount: $428,279
Settlement date: 8/31/07
Default status: First Legal Action to Commence Foreclosure/Modification Started

A. Possible Deficiencies in the Appraisal Report

Comment 16

The contention that the property **may** not have met HUD's requirements on the use of non-residential property is premised on the factual conclusion that 385 sq. ft. of storage space should have been allocated to the non-residential rather than residential portion of the premises. If that were the case, then the property would be deemed to be 33% non-residential.

Ark selected and used an appraiser from the FHA-approved roster of appraisers. The appraisal report states, in pertinent part, that: "The commercial space is less than 25% of the total subject gross living area." The appraisal report's building sketch explicitly designates a portion of the first floor as "residential storage." Ark reasonably relied on the appraisal report.

The draft report's assertion that the commercial space is more than 25% of the floor area is predicated on an on-site inspection in July, 2009, almost three years after the loan closed. There is no obligation on Ark to monitor the property's use after the closing, let alone three years after the closing. Therefore, there is no reliable or conclusive evidence that the property was not eligible for FHA insurance at the time of the closing.

B.-C. Understated Liabilities/Excessive Ratios without Adequate Compensating Factors

Comment 17

The proposed report proposes that the underwriting did not properly account for child support obligations in the calculations of liabilities and the debt-to-income ratios.

The file contains two notarized statements from the borrower's wife stating her intention to terminate child support statements as well as a copy of the motion to terminate child support. Based on this information, the underwriter had the discretion to decide that the child support obligations should not be included in the calculations of liabilities and debt-to-income ratios. Reference is made to the HUD Handbook 4155.1, rev. 5, which was in effect at the time that this loan was originated. As stated in the forward, 'while it is not FHA's intent to insure mortgages that are likely to result in default, regardless of the borrower's equity, lenders may exercise some discretion in the underwriting of home mortgages where the borrower's financial and other circumstances are not specifically addressed by this handbook.' Moreover, as set forth in the next section, there was the compensating factor of "excellent reserve after closing."

D.-E Inadequate Verification of Liabilities and Assets

Comment 18

The draft report proposes that the compensating factor of "excellent reserve after closing" may be unwarranted because the borrowers **may** have been about $800 short of the three

9

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	**Auditee Comments**

months cash reserve if the borrower or the co-borrowers paid off an outstanding delinquent obligation of the borrower in the amount of about $1,900. However, the co-borrowers had sufficient income to pay the obligation out of their earnings, so there is no reason to assume that the payment had to come out of the reserve. Finally, Ark had obtained a VOD dated 8/8/07, which was within 30 days of the closing. A VOD may be used in lieu of bank statement under DU Findings, Paragraph 34.

OIG Evaluation of Auditee Comments

Comment 1 Ark Mortgage officials generally agreed with the quality control finding and has implement new quality control procedures that is responsive to our finding and recommendations.

Comment 2 Ark Mortgage officials stated that the QC vendor reviewed and confirmed information on all loans selected for review. However, according to our review of all FHA files subject to quality control review, the QC vendor did not document that all the information that was required to be reverified by HUD Handbook 4060.1, REV-2, section 7-6 E had been reverified.

Comment 3 Ark Mortgage officials indicated that the underwriter properly applied discretion in applying flexible compensating factors to the qualifying ratios. However, the compensating factors cited by the lender were not allowable per HUD Handbook 4155.1, REV-5, section 2-7A and properly supported. See the evaluation of comment 5.

Comment 4 Ark Mortgage officials indicated that the $85 difference in projected rental income was not material. They also stated that the verification of the co-borrower's overtime and bonus income was based on the 2005 W-2 IRS form, which showed total income of over $65,000 confirming that the total earnings were in excess of the coborrower's base salary. However, the verification of employment (VOE) from the coborrower’s employer indicated overtime and bonus incomes for the current year only, not for the past two years as required by HUD Handbook 4155.1, REV-5, section 2-7 A. Further, although the VOE was checked for the likely continuance of overtime income, it did not indicate the continuation of bonus income. Moreover, the actual amount of income on the 2005 W-2 form was not $65,000; the W-2 showed wage income of $62,000. Accordingly, the total income amount for 2005 (past year) on the VOE and the lender's statement were overstated by $3,000. Monthly income was overstated by a total of $232 including $85 for projected rental income and $147 for unsupported overtime and bonus income, which resulted in the (back) debt to income ratio increasing to 58.04 percent, which is material due to the inadequate compensating factors.

Comment 5 Ark Mortgage officials stated that it was the underwriter's discretion to determine the applicable compensating factors and the extent to which ratios may be exceeded. The compensating factors listed included excellent job stability with the potential for increased earnings, excellent saving pattern, and completing credit counseling class. However, according to HUD Handbook 4155.1, REV-5, section 2-13, excellent job stability and completing credit counseling class are not listed as allowable compensating factors. Potential increased earnings and excellent saving pattern are allowable compensating factors as long as they can be supported by proper documentation. However, the files did not indicate any special job training or education in the borrowers’ professions to support potential increased earnings. Further, the borrowers have not demonstrated an ability to accumulate savings, and they had a conservative attitude toward the use of credit. Both borrowers were discharged from Chapter 7 bankruptcy in April 2003, have made extensive use of credit, and made minimum payments, which resulted in their credit card balances being either close to or higher than their credit limits. Having a 401K plan may establish a saving pattern as the officials stated; however, it is not enough to support an excellent savings pattern, which HUD accepts as a compensating factor.

Comment 6 Ark Mortgage officials indicated that the borrowers had sufficient funds to close and that $2,600 of non-payroll deposits was not large enough to require verification of the source of the funds because the $2,600 could have been retained at home from the borrowers pay. Officials also stated that the two automatic deductions totaling $808 would have been covered by the pattern of payroll deposits, which exceeded the deductions. Nevertheless, HUD Handbook 4155.1, REV-5, section 2-10 requires that all the funds for the borrower's investment in the property be verified and documented. Ark Mortgage officials did not verify all the funds to close, as a result, the borrower was short $738 at closing as total verified cash was $6,307, while the funds needed to close was $7,045. As such, we are recommending this loan for indemnification.

Comment 7 Ark Mortgage officials stated that the relationship of the borrowers had been confirmed and they provided the closing attorney's letter dated 10/8/09 at the exit conference. The closing attorney indicated that the borrowers were father and daughter. However, there was no evidence in the file that the lender had confirmed the relationship between the borrower and the coborrower by the closing date and/or before the loan file was received by the HOC, even though officials knew one of the borrowers did not intend to occupy the premises. Further, although the borrowers had different last names, officials never obtained an explanation from the borrowers regarding their family relationship. HUD Handbook 4155.1, REV-5, section 1-8B, provides that when there are two or more borrowers, if one or more will not occupy the property as a principal residence, the maximum mortgage must be limited to 75 percent of loan to value, unless there is documented evidence of a family or family-like relationship, which is a longstanding and substantial relationship, and not arising out of the loan transaction. In addition, HUD Handbook 4155.1, REV-5, section 3-10, requires the lender to resolve all problems regarding title to the real estate, review all documents to ensure compliance with all conditions of the commitment, and submit the loan documents for insurance within 60 days of loan closing or disbursement, whichever is later. However, Ark Mortgage officials did not document that it had resolved the issues with the non-occupying borrower before the closing. Therefore, the mortgage should have been reduced to 75 percent of the loan to value.

Comment 8 Ark Mortgage officials provided an IRS 1099-R form and the 2-month bank statements with direct deposits that matched the distribution. As such, the verification of income deficiency for this case was eliminated from the report, however, due to the other underwriting deficiency this loan is still recommended for buydown or indemnification.

Comment 9 Ark Mortgage officials stated that the loan was properly verified and, therefore, no buydown or indemnification should be justified. However, this loan is still recommended for indemnification based on the evaluation of comment 7.

Comment 10 Ark Mortgage officials stated that the bank statement covering two months before closing showed a balance of $16,300; therefore, sufficient funds had been verified to cover the closing and required reserves. Official also stated that the source of the funds for the down payment was the Ameridream program and the seller had made a concession at the closing. Further, because the letter from the bank confirmed that the coborrower was a co-owner of the bank account, the source of the funds was immaterial. However, HUD Handbook 4155.1, REV-5, section 2-10B, requires that all funds for the borrower's investment in the property be verified and documented. Since the borrowers were required to pay $3,910 at closing, the lender should have verified the source of the funds. Further, HUD Handbook 4155.1, REV-5, section 1-8C, requires the borrowers to have reserves equivalent to three months' principal, interest, taxes and insurance after closing on purchase transaction for three-and four-unit properties and further indicates that this reserve should not be derived from a gift. Although the co-owners (married couple) of the bank account gave the coborrower full access to use the balance of the checking account for the home purchase, without an adequate verification of the source of the funds in the bank account, the funds should not have been included as being available cash reserves. Therefore, the borrowers did not have the required three-month reserve of $11,736.

Comment 11 Ark Mortgage officials stated that the borrowers may not have individually satisfied all the compensating factors, but collectively the borrowers had sufficient compensating factors. Two compensating factors listed on the Mortgage Credit Analysis Worksheet were "good credit history" and "excellent reserves after closing." Good credit history was not an allowable compensating factor as defined in HUD Handbook 4155-1, REV-5, section 2-13. In addition, section 2-13 indicates that any compensating factor used to justify mortgage approval must be supported by documentation. However, the compensating factor of "excellent reserve after closing" was not adequately supported because the borrowers did not have sufficient verified funds to close the loan as explained above.

Comment 12 Ark Mortgage officials stated that the initial and final applications both state that the borrowers reside with family and, therefore, officials did not need to verify rental payments. HUD Handbook 4155.1, REV-5, Section 3-1J, requires that the verification of rent be in the form of a direct verification from the landlord or mortgage servicer or through information shown on the credit report. When officials asked the coborrower about the different addresses shown on the pay stubs, drivers' license, and the current resident address, the coborrower explained that he did not live with his family and lived at a different address. However, Ark

Mortgage officials did not verify the coborrower's current living arrangement and the current rent payment. Section 2-3A requires the lender to determine the borrower's payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity-of-interest with the borrower), verification of mortgage directly from the mortgage servicer, or through canceled checks covering the most recent 12-month period; this was not done.

Comment 13 Ark Mortgage officials indicated that the loan did not go into default until there was a major fire at the premises, that the default was not due to any underwriting errors, and that HUD should wait for the settlement of any insurance claim. While a subsequent event such as fire or death of a borrower can be the cause of a mortgage default, the findings and recommendations for indemnification are based on the deficiencies noted in the underwriting of the loan.

Comment 14 Ark Mortgage officials determined that the employer had been added to the HUD-1 and the mortgage as an additional buyer after the initial application and that they were investigating their rights against the third parties. Officials indicated that at the time of the application they matched the address of the employer to the borrower's payroll check. HUD Handbook 4155.1, REV-5, section 3-10B, requires that the loan close in the same manner in which it was underwritten and approved. Further, HUD Handbook 4155.1, REV-5, section 2-2A, requires the lender to determine the creditworthiness of all coborrowers/cosigners by considering their income, assets, liabilities, and credit history. Since the borrower's employer took title as a co-owner of the subject property, he should have been considered as "coborrower," and his creditworthiness should have been evaluated. Nevertheless, this loan did not close as it was underwritten.

Comment 15 Ark Mortgage officials stated that the underwriter followed the D.U. underwriting requirements by obtaining a verification of deposit for the asset verification. Officials stated that the borrower had accumulated his savings during the period of "seasonal" employment and opened the account during a period of "seasonal" unemployment and that the borrower's employer had certified that the down payment was a bonus. HUD Handbook 4155.1, REV-5, section 2-10B, requires the lender to obtain a verification of deposit, along with the most recent bank statement, to verify savings and checking accounts. However, Ark Mortgage officials only requested a verification of deposit without any recent bank statements. HUD Handbook 4155, REV-5, section 2-10, requires the lender to verify and document all the funds for the borrower's investment in the property. The borrower had opened his checking account while unemployed. Further, the borrower had only earned approximately $18,000 annually from his previous employment. As a result, officials did not obtain a creditable explanation of the sources of the funds in the bank account that had a current balance of $18,586. Furthermore, Ark Mortgage officials never obtained a credible explanation for the $6,000 earnest money deposit that had been paid by the borrower's employer. As a result, since the verification of the assets was inadequate and the loan did not close as underwritten (comment 14), this loan is recommended for indemnification.

Comment 16 Ark Mortgage officials stated that they selected the appraiser from the FHA approved roster and relied on the appraisal report, which indicated that the commercial space was less than 25 percent of the total living area. Officials indicated that there was no evidence that the property was not eligible for FHA insurance at the time of the closing and that the lender had no obligation to monitor the property's use after closing. Mortgagee Letter 2005-06 reminded mortgagees that direct endorsement lenders who select their own appraisers must accept responsibility equally with the appraiser for the integrity, accuracy and thoroughness of the appraisal and will be held accountable by HUD for the quality of the appraisal. Ark Mortgage officials did not ensure that the appraisal report was accurate by documenting that they verified the residential use portion of the property with the commercial space, which was necessary for the property to qualify for FHA insurance. The photographs taken by the appraiser did not show residential storage on the commercial floor.

Comment 17 Ark Mortgage officials stated that the underwriter used their discretion to omit the child support obligation based on two notarized statements from the mother of the coborrower's children[11]. Both statements in the file were notarized by an Ark Mortgage official (the current underwriter) based on a faxed copy of a petition form for termination of child support. However, this petition did not have a date or any signatures. Further, the child support recipient's name and social security number on this petition were different from the ones on the certification letter. This petition was faxed from an unknown source on 3/31/2008. Therefore, none of the supporting documents was considered sufficient to omit the child support obligation. In addition, based on the telephone inquiry made by OIG to the County Child Support division, the child support order was still in effect and the co-borrower's employer wages was still the source of the child support payments. Ark Mortgage officials did not adequately verify the child support obligation and excluded the monthly child support obligation in computing the debt to income ratios. Thus, the debt to income ratio (back end) increases to 62.04 percent when the child support obligation is considered.

Comment 18 Ark Mortgage officials explained that the borrowers had sufficient income to pay a delinquent $1,900 obligation. Officials obtained a verification of deposit on 8/8/07, which was within 30 days of closing and may be used in lieu of a bank statement under Direct Underwriting. As a result, we eliminated the issue regarding the inadequate verification of assets from the report. However, we kept the issue for inadequate verification of liabilities, Ark Mortgage officials did not provide documentation to show that the obligation had been satisfied with the borrower's funds and that there were sufficient reserves at the time of the closing, as required by Handbook 4155.1 REV-5, section 2-13G to qualify as a

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[11] We referred to the child support recipient as the mother of the coborrower's children because the coborrower insisted that he had never been married.

compensating factor. As such, since commercial space for this property was more than 25 percent (comment 16), officials did not adequately verify child support payments (comment 17), and there was no assurance that the borrowers' funds were used to eliminate the approximate $1,900 debt, this loan is recommended for indemnification.

Appendix C

SUMMARY OF UNDERWRITING DEFICIENCIES

FHA case number	Unpaid balance amount	Amount requested for indemni-fication 4/	Excessive ratios without adequate compen-sating factors	Inadequate funds to close	Inadequate verification of income	Understated liabilities	Inadequate verification of assets	Not closed as under-written	Other deficiencies 1/	Appendix reference
352-5504892	$457,190	$192,020	X	X	X	X	X		X	**D-1**
3525513337	N/A[2/]	$0[3/]			X					**D-2**
3525574149	$463,724	$194,764	X	X			X		X	**D-3**
3525594478	$254,192	$106,761					X	X	X	**D-4**
3525611530	$425,270	$178,613	X			X			X	**D-5**
	$1,600,376	$672,158	3	2	2	2	3	1	4	**Totals**

Notes:

1/ Each loan includes one or more of the following deficiencies: overstated rental income, incorrect debt-to-income ratios, inadequate evaluation of credit report, inadequate cash reserve, insufficient verifications of rental payment history, inadequate closing documents, inadequate verification of earnest money deposit, inadequate verification of liabilities, excessive loan-to-value percentage, and possible deficiency on appraisal report.

2/ The unpaid balance for this loan is $346,737. This loan was recommended for a reduction of the insured amount of the loan because of a nonoccupying borrower, which results in a $79,860 reduction in the loan due to a reduction in the loan-to-value ratio from 97 percent to 75 percent

3/ No amount is included in the indemnification total to avoid double counting. However, if HUD decides to seek indemnification for this loan, based on HUD's current 42 percent default loss experience, the amount of cost savings or funds to be put to better use on this loan would be $145,630 (42 percent of $346,737).

4/ The amount requested for indemnification represents the unpaid loan balance multiplied by the loss rate of 42 percent, which is currently HUD's statistic of the average loss when a foreclosed property is sold.

Appendix D

CASE SUMMARY NARRATIVES

FHA case # 352-5504892
Loan amount: $458,810
Settlement date: September 15, 2006
Unpaid principal balance as of May 31, 2009: $457,190
Default status: Bankruptcy plan confirmed

Pertinent Details:

A. Understated Liabilities

The lender understated liabilities on the mortgage credit analysis worksheet for a loan repayment and child support. The lender did not include a monthly loan payment of $404 for a $7,718 loan. The lender used a $4,758 balance of a share saving account that was linked to the loan as an asset for the available funds to close without disclosing the loan amount of $7,718. HUD Handbook 4155.1, REV-5, section 2-1A, requires the lender to include the monthly housing expenses and the additional recurring charges extending 10 months or more, such as payments on installment loans, in computing the debt-to-income ratios. If the monthly payment of $404 for the loan of $7,718 was added to the monthly liability, the debt-to-income ratio would be increased (see section D).

In addition, the lender did not adequately verify the borrower's monthly child support payment of $524[12] and, therefore, failed to report it as the borrower's liability, although the borrower's weekly pay stubs included the deduction of $121 as domestic relations. The lender used a letter from a probation office as the court order for termination of the child support. However, based on the telephone inquiry made by OIG to the County Child Support Division, the borrower's child support was not terminated until 2008. This would also increase the debt-to-income ratio (see section D).

B. Overstated Rental Income
C. Inadequate Verification of Income

The lender did not properly verify and document the borrower's projected rental income as the monthly effective income. The mortgage credit analysis worksheet indicated that the coborrower's "other income" from renting the second unit was $1,275 (85 percent of $1,500).

[12] The monthly child support can be obtained by multiplying the weekly payment of $121 by 52 weeks and then dividing the product by 12 months.

However, the amount of the current rent and the market rent for the second unit listed on two appraisal reports conducted by two different appraisers was $1,400. Based on the information given in the file, the projected rental income should not have been more than $1,190 (85 percent of $1,400), thus resulting in higher debt-to-income ratios than the stated ratios on the worksheet (see section D).

The lender also did not adequately verify the coborrower's overtime and bonus income. HUD Handbook 4155.1, REV-5, section 2-7A, allows the lender to add overtime and bonus incomes if the borrower has received such income for the past two years and it is likely to continue. However, the verification of employment from the coborrower's employer indicated overtime and bonus income for the current year but not for the past two years. Therefore, the coborrower's overtime income of $147 should not have been counted toward the monthly effective income. This would result in higher debt-to-income ratios (see section D).

D. Incorrect Debt-to-Income Ratios
E. Excessive Ratios without Adequate Compensating Factors
F. Inadequate Evaluation of Credit Report

The lender did not calculate the debt-to-income ratios correctly because of its nondisclosure of liabilities related to a loan, child support payments (section A), and overstated income (section B). The mortgage credit analysis worksheet listed the mortgage payment-to-effective income (front end) ratio as 33.47 percent and the total fixed payment-to-effective income (back end) ratio as 48.63 percent. However, we calculated the front ratio as 34.18 percent and the back ratio as 58.04 percent.

Mortgagee Letter 2005-16 states that the lender must describe the compensating factors used to justify mortgage approval when the borrower's mortgage payment-to-effective income ratio (front end) and total fixed payment-to-income ratio (back end) exceeded 31 percent and 43 percent, respectively. Although the lender listed compensating factors on the worksheet, all except one compensating factor were not acceptable based on HUD Handbook 4155.1, REV-5, section 2-13. The factor related to "saving pattern" was not supported because the borrowers withdrew or borrowed against most of their retirement funds and used their credit excessively. For example, the borrowers' credit report indicated that the borrowers opened 10 of 14 active credit cards or charge accounts in 2005 and 2006. In addition, 6 of 12 open credit cards and charge accounts exceeded their credit limits, and the balances of the remaining six accounts were close to the credit limits.

G. Inadequate Verification of Assets
H. Inadequate Funds to Close

The lender did not verify or document that the borrower had adequate funds to close, although HUD Handbook 4155.1, REV-5, section 2-10, requires that all funds for the borrower's investment in the property be verified and documented. According to the HUD-1 settlement statement, the borrower was required to pay $7,045 at closing. The amount of the assets available on the mortgage credit analysis worksheet was $9,687. However, this amount did not take into account the fact that the borrowers' checking account included nonpayroll deposits totaling $2,572 from July 3 to August 15, 2006 for which the lender did not verify the source of the funds. In addition, the lender did not verify the borrower's share account balance after July 1, 2006; two monthly loan payments of $404 (see section A) should have lowered the balance of the share account by $808. Thus, the unexplained nonpayroll deposits of $2,572 and the deduction of $808 for payment of the loan should have resulted in the reduction of $3,380 from the funds available to close, bringing the balance to $6,307, and the borrowers would not have had sufficient funds to close the loan.

FHA case # 352-5513337
Loan amount: $357,391
Settlement date: October 31, 2006
Unpaid principal balance as of May 31, 2009: $346,737
Default status: Partial claim of $22,417 was paid on May 24, 2009 - reinstated after loss mitigation intervention

Pertinent Details:

A. Excessive Loan-to-Value Percentage

The lender closed the loan using a 97 percent loan to value percentage when the loan's maximum percentage should have been 75 percent. HUD Handbook 4155.1, REV-5, section 1-8B, provides that when there are two or more borrowers, if one or more will not occupy the property as a principal residence, the maximum mortgage must be limited to 75 percent of loan to value, unless there is documented evidence of a family or family-like relationship, which is a longstanding and substantial relationship, and not arising out of the loan transaction. However, during the origination process, the lender did not verify the relationship between the borrower and the coborrower, although the borrowers had different last names.

The affidavit of title signed by the borrower and coborrower at the closing certified that one borrower would not occupy the property. HUD Handbook 4155.1, REV-5, section 3-10, requires the lender to resolve all problems regarding title to the real estate, review all documents to ensure compliance with all conditions of the commitment, and submit the loan documents for insurance within 60 days of loan closing or disbursement, whichever is later. However, the lender did not document that it had resolved the issues with the nonoccupying borrower. Therefore, it should have reduced the amount of the mortgage to 75 percent of the loan to value.

Our review of public records indicated that the borrower purchased another property with the spouse in a different state two months after the closing date of the subject property, using a conventional loan.

FHA case # 352-5574149
Loan amount: $467,168
Settlement date: April 30, 2007
Unpaid principal balance as of May 31, 2009: $463,724
Default status: First legal action to commence foreclosure/delinquent

Pertinent Details:

A. Inadequate Funds to Close
B. Inadequate Verification of Assets

The lender did not verify or document the source of all funds to close. HUD Handbook 4155.1, REV-5, section 2-10B, requires that all funds for the borrower's investment in the property be verified and documented. The mortgage credit analysis worksheet indicated that the assets available for both the funds to close and cash reserve were the coborrower's recently opened bank account with his relatives (a married couple). This account had a balance of $16,398 as of April 17, 2007. The address used for this account was the relatives' home address, and the borrowers had never lived at that address.

As the documentation to support that there were sufficient funds required for the closing, the coborrower provided the lender a letter from the bank stating that the account was opened on January 1, 2007, and the coborrower was the co-owner of the bank account. The file contained the account transaction history printout from February 2 to April 17, 2007. However, this account transaction history did not show the source of the funds because no deposits were made during this period. In addition, there was no earlier bank account activity provided to support the source of the account balance. The lender verified three withdrawals made by the relatives, two mortgage payments for their own property, and a personal check of $7,000, but did not verify the source of funds for the closing.

The lender stated that since the bank statements covered the required 60-day period preceding the closing, the underwriter did not deem it necessary (or required) to address account activity beyond the mandatory period; however, since the lender was required to verify the source of all the funds used to close the loan and the three-month cash reserve (section C), the underwriter should have verified the source of the funds.

C. Inadequate Cash Reserve

HUD Handbook 4155.1, REV-5, section 1-8C, requires the borrowers to have reserves equivalent to three months' principal, interest, taxes and insurance after closing on purchase transaction for three- and four-unit properties and further indicates that this reserve should not be derived from a gift. Although the co-owners (married couple) of the bank account gave the coborrower the full access to use the balance of the checking account for the home purchase, without an adequate verification of the source of the funds in the bank account, the funds should not have been included as being available cash reserves. Therefore, the borrowers did not have the required three-month reserve of $11,736.

D. Excessive Ratios without Adequate Compensating Factors

Mortgagee Letter 2005-16 states that the lender must describe the compensating factors used to justify mortgage approval when the borrower’s mortgage payment-to-effective income ratio (front) and total fixed payment-to-income ratio (back) exceeded 31percent and 43 percent, respectively. The lender computed the front and back ratios to be 38.60 percent and 49.53 percent, respectively, on the mortgage credit analysis worksheet.

Two compensating factors listed on the worksheet were “excellent reserves after closing” and “good credit history.” However, “good credit history” was not an allowable compensating factor as defined in HUD Handbook 4155-1, REV-5, section 2-13. In addition, section 2-13 indicates that any compensating factor used to justify mortgage approval must be supported by documentation. The compensating factor of “excellent reserve after closing” was also not adequately supported because the borrowers did not have sufficient verified funds to close the loan based on sections A and B.

E. Insufficient Verification of Rental Payment History

HUD Handbook 4155.1, REV-5, Section 3-1J, requires that the verification of rent be in the form of a direct verification from the landlord or mortgage servicer or through information shown on the credit report. When the lender asked the coborrower about the different addresses shown on the pay stubs, drivers’ license, and the current resident address, the coborrower explained that he did not live with his family and lived at a different address. However, the lender did not verify the coborrower’s current living arrangement and the current rent payment.

FHA case # 352-5594478
Loan amount: $255,526
Settlement date: July 18, 2007
Unpaid principal balance as of May 31, 2009: $254,192
Default status: First legal action to commence foreclosure/modification started

Pertinent Details:

A. Not Closed as Underwritten

The lender did not ensure that the loan was closed as it had been approved on the HUD-1 settlement statement. Specifically, the loan was approved for one borrower; however, the HUD-1 and the closing service letter included two individuals—the borrower and the borrower's employer who was not underwritten for the loan. Handbook 4155.1, REV-5, section 3-10B, requires that the loan close in the same manner in which it was underwritten and approved.

HUD Handbook 4155.1, REV-5, section 2-2A, requires the lender to determine the creditworthiness of all coborrowers/cosigners by considering their income, assets, liabilities, and credit history. Since the borrower's employer took title as a co-owner of the subject property, he should have been considered as "coborrower," and his creditworthiness should have been evaluated. In addition, the title company conducted a background search on the "coborrower" and noted that the "coborrower" had some public judgments including a state tax lien. However, the lender did not obtain an explanation from the borrower or the borrower's employer.

According to Neighborhood Watch, the borrower went into his first 90-day default after one payment due to unemployment. However, our public search indicated that the new address of the employer's company was the same as the address of the subject property.

B. Inadequate Closing Documents

HUD Handbook 4155.1, REV-5, section 2-2A, states that HUD does not permit an individual to take an ownership interest in the property at settlement without signing the mortgage note and all security instruments. However, based on the lender's closing instructions to the closing attorney, the lender did not require the borrower's employer (coborrower) to sign the mortgage note and addendum to the HUD-1, although he took an ownership interest in the subject property at settlement by signing the mortgage (security instrument) and the HUD-1. Since the "coborrower" did not sign on the mortgage note, he may not have the financial responsibility of repaying the mortgage, although he has an ownership interest in the property.

C. Inadequate Verification of Assets

HUD Handbook 4155.1, REV-5, section 2-10B, requires the lender to obtain a verification of deposit, along with the most recent bank statement, to verify savings and checking accounts. However, the lender only requested a verification of deposit without any recent bank statements.

HUD Handbook 4155, REV-5, section 2-10, requires the lender to verify and document all the funds for the borrower's investment in the property. The borrower opened his checking account on October 30, 2006, while he was not earning any income. This fact was confirmed through the verification of employment from the current employer and the previous employer, which indicated that the borrower was not compensated in 2006 and he quit his previous job on July 30, 2006. Further, the borrower had only earned approximately $18,000 annually from his previous employment. As a result, the lender did not obtain a creditable explanation of the sources of the funds in the bank account with the current balance of $18,586 and the eight-month average balance amount of $18,463

D. Inadequate Verification of Earnest Money Deposit

HUD Handbook 4155.1, REV-5, section 2-10, requires the lender to verify all of the borrower's funds for investment in the property. If the account was opened recently or there was a large increase in the account, the lender must obtain a credible explanation as to the sources of the funds. The borrower's employer made the deposit of $6,000 directly to the seller's realtor by an official bank check, which only showed the employer's name as a reference. In addition, the lender was provided with the bank transaction summary of the employer's company showing the debit of the same amount. Two months later, 10 days before the closing, the lender obtained a letter from the employer that the deposit was the bonus check for the borrower, which was promised to him before he started this new job. However, the employer's explanation that he was paying a $6,000 bonus to the borrower was not a credible explanation as the employer had taken an ownership interest in the property.

FHA case # 352-5611530
Loan amount: $428,279
Settlement date: August 31, 2007
Unpaid principal balance as of May 31, 2009: $425,270
Default status: First legal action to commence foreclosure/modification started

Pertinent Details:

A. Possible Deficiencies on Appraisal Report

The property may not have met HUD's limitations on nonresidential use of the property. The property was a three-story building with two apartments and commercial space on the first floor. The total floor space was 4,078 square feet. The first floor had 1,000 square feet designated as commercial space and 350 square feet[13] designated as storage for the residential unit on the second floor according to the appraisal. HUD Handbook 4905.1, REV-1, section 2-6, provides that areas designed or used for nonresidential purposes shall not exceed 25 percent of the total floor area. Storage areas or similar spaces, which are integral parts of the nonresidential portion, shall be included in the total nonresidential area. Nevertheless, a site visit on July 17, 2009, revealed that the space designated as storage for a residential unit did not appear to be used for that purpose and appeared to be an integral part of the commercial entity on the first floor. Therefore, since the percentage of nonresidential use appeared to be greater than 25 percent of the total floor space, the loan should not have been eligible for FHA insurance.

B. Understated Liabilities
C. Excessive Ratios without Adequate Compensating Factors

The mortgage credit analysis worksheet did not include a monthly liability for $867 for child support. As a result, the debt-to-income ratios were understated. The coborrower's pay stub for the period ending June 9, 2007, included a $200 garnishment for child support. The monthly child support obligation was $867.[14] The loan file contained documentation showing that the recipient filed for termination of the child support three days after the loan closed. However, there was no documentation in the file to show whether the child support had been terminated before or after the loan was closed. In addition, based on the telephone inquiry made by OIG to the County Child Support Division, the child support order was still in effect. HUD Handbook 4155.1, REV-5, section 2-11, provides that in computing the debt-to-income ratios, the lender

[13] By designating 350 square feet as residential storage, the property's nonresidential area was just below 25 percent to qualify for financing under section 203(b). The percentage of nonresidential area (1,000 square feet divided by 4,078 square feet in percentage) was 24.52 percent.
[14] The monthly child support payment of $866.67 was calculated by multiplying $200 per week by 52 weeks and dividing the product by 12 months.

must include the monthly housing expenses and all additional recurring charges extending 10 months or more, including payments on installment accounts, child support, or separate maintenance payments. When the child support obligation is included in computing the debt-to-income ratios, the back end ratio increases from 49.77 percent to 62.04 percent.

The compensating factor provided by the lender was "excellent reserve after closing." According to HUD Handbook 4155.1, REV-5, section 2-13G, this compensating factor requires a substantial documented cash reserve—at least three months' worth after closing. However, based on sections D, the borrowers may not have at least three months' cash reserve.

D. Inadequate Verification of Liabilities

The lender did not adequately verify the payment of a contingent liability of the coborrower. The coborrower's credit report had a delinquent account with a $1,893 balance. The coborrower indicated that he was a cosigner of the account and the account was paid off just before the closing. The updated credit report showed that this liability had been paid. However, there was no documentation in the file to show who paid the liability. HUD deems the payment of consumer debt by third parties to be an inducement to purchase. If the liability was paid by someone who was not a family member, it may be considered an inducement to purchase, and the sales price should have been reduced by the amount of the payment according to HUD Handbook 4155.1, REV-5, section 2-10C. Because the payment of the debt took place after the date of the verification of deposit and there was no bank statement in the file, there is no assurance that borrowers' available funds were used to pay the debt. If the debt had been paid using the borrowers' funds, the available reserves would have been $814 less than the three month reserve requirement of Handbook 4155.1, REV-5, section 2-13G, to qualify as a compensating factor for the high debt-to-income ratios noted in sections B and C.