Issue Date March 26, 2010	
Audit Report Number 2010-NY-1009	

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

Edgar Moore

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

SUBJECT: Somerset Investors Corporation, Melville, NY, Did Not Always Comply With HUD/FHA Loan Underwriting Requirements

HIGHLIGHTS

What We Audited and Why

We audited Somerset Investors Corporation (Somerset), dba Somerset Mortgage Bankers, a Federal Housing Administration (FHA)-approved direct endorsement lender located in Melville, NY. We selected Somerset because its 10.09 percent default and claim ratio reported in HUD's Neighborhood Watch system for insured single-family loans for the period January 1, 2007, to December 31, 2008, was more than double the New York State average ratio of 3.77 percent for the same period.

The audit objectives were to determine whether Somerset (1) originated FHA-insured refinanced loans in accordance with the requirements of the U.S. Department of Housing and Urban Development (HUD)/FHA and (2) conducted quality control reviews that complied with HUD/FHA requirements.

What We Found

Somerset did not always originate refinanced loans in accordance with HUD/FHA requirements. Specifically, 8 of 11 loans reviewed exhibited underwriting deficiencies significant enough to warrant indemnification, such as inadequate evaluation of previous mortgage payment history, excessive qualifying ratios without significant compensating factors to justify loan approval, and improper calculation of income. The remaining three loans disclosed other underwriting deficiencies that were not significant enough to request indemnification. In addition, six loans subject to Somerset's quality control review evidenced underwriting deficiencies that warrant indemnification. Consequently, 14 mortgage loans with an outstanding principal balance of over $4.6 million were approved, which presented an unnecessary risk to the FHA insurance fund.

Somerset's written quality control plan complied with HUD/FHA requirements; however, the quality control reviews conducted did not comply with HUD's and its own quality control requirements regarding sample size and reporting. Specifically, the completed quality control reviews did not include home equity conversion mortgages; did not always identify corrective actions, a timetable for completion, or planned follow-up activities; and did not report serious violations to HUD. Consequently, assurance was lessened that Somerset's quality control process would identify and address underwriting problems in a timely manner and thus protect Somerset and FHA from unacceptable risk.

What We Recommend

We recommend that the Deputy Assistant Secretary for Single Family Housing require Somerset to (1) indemnify HUD for potential estimated losses of nearly $2.8 million for 14 loans with significant underwriting deficiencies, (2) strengthen controls over its underwriting procedures to provide assurance that HUD/FHA requirements are met, and (3) implement procedures to ensure that quality control reviews comply with HUD/FHA requirements.

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

Auditee's Response

We discussed the results of the audit with the auditee during the audit and provided them a draft report on January 11, 2010, which was discussed at an exit conference on February 18, 2010. We requested written comments by February 25, 2010, which were received on that date. The auditee agreed with the request for indemnification for 9 of the 14 loans and has taken, or plans to take, action to address the other recommendations.

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

Somerset Investors Corporation (Somerset), d/b/a Somerset Mortgage Bankers, is a U.S. Department of Housing and Urban Development (HUD)-approved Title II nonsupervised lender[1] located at 290 Broadhollow Road, Suite 310E, Melville, NY. Somerset was designated a direct endorsement lender on December 9, 1992, which allows it to underwrite Federal Housing Administration (FHA)-insured single-family mortgages without prior review by FHA. Somerset is also a mortgage banker/lender licensed in 22 States and the District of Columbia.

Somerset originates primarily conventional conforming and HUD loans and sells them to investors, servicing released, and also brokers conventional loans that are closed by other investors. It serves the New York metropolitan area, with the predominant portion of its business conducted on Long Island.

HUD's Neighborhood Watch[2] system reported that Somerset had a 10.09 percent default and claim ratio for insured single-family loans with beginning amortization dates between January 1, 2007, and December 31, 2008. This rate was more than double the New York State average of 3.77 percent for the same period. As of March 31, 2009, Neighborhood Watch reported that 42 of the 404 loans originated by Somerset with beginning amortization dates between April 1, 2007, and March 31, 2009, were in default. This represents a 10.40 percent ratio, compared to the New York State average of 4.43 percent for the same period. Of the 404 loans, 385 were still active, and 19 had been terminated.

In recognition of its high default rate, in November 2008, before the start of our audit, Somerset hired a risk management consultant to develop procedures to more effectively address this rate and the risk inherent in the underwriting process. The consultant created a risk matrix to apply to all FHA loans, which determines the level of review needed before a loan will be approved.

The audit objectives were to determine whether Somerset (1) originated FHA-insured refinanced loans in accordance with HUD/FHA requirements and (2) conducted quality control reviews that complied with HUD/FHA requirements.

[1] A nonsupervised lender is a HUD/FHA-approved lending institution that has as its principal activity the lending or investment of funds in real estate mortgages and may be approved to originate, sell, purchase, hold, and/or service HUD/FHA-insured mortgages, depending upon its wishes and qualifications.
[2] Neighborhood Watch is a Web-based comprehensive data processing, automated query, reporting, and analysis system designed to highlight exceptions to lending practices to high-risk mortgages so that potential problems are readily identifiable.

RESULTS OF AUDIT

Finding 1: Refinanced Loans Were Not Always Underwritten in Accordance With HUD/FHA Requirements

Somerset did not always underwrite refinanced loans in accordance with HUD/FHA requirements. Specifically, 8 of 11 loans reviewed exhibited underwriting deficiencies significant enough to warrant indemnification, such as inadequate evaluation of previous mortgage payment history, excessive qualifying ratios without significant compensating factors to justify loan approval, and improper calculation of income. The remaining three loans reviewed disclosed other underwriting deficiencies that were not significant enough to request indemnification. In addition, six loans subject to Somerset's quality control review evidenced underwriting deficiencies that warrant indemnification. These deficiencies occurred because Somerset lacked adequate controls to address the considerable risk in underwriting refinanced mortgage loans. Consequently, 14 mortgage loans with an outstanding principle balance of over $4.6 million were approved, which presented an unnecessary risk to the FHA insurance fund.

Loans with Significant Underwriting Deficiencies

Somerset did not always underwrite refinanced mortgage loans in accordance with HUD/FHA requirements. As shown in the table below and in appendix C, 8 of 11[3] refinanced mortgage loans reviewed exhibited significant underwriting deficiencies warranting indemnification of $1,737,298 (see appendix D for a detailed description of deficiencies identified for each case). As a result, HUD is at risk of loss on these eight loans and has already incurred and paid a $1,000 loan modification claim on one of the eight loans.

Type of significant deficiency	Number of loans[4]
Inaccurate evaluation of borrower's previous mortgage payment history	8 of 11 loans
Excessive ratios without acceptable compensating factors	6 of 11 loans
Improper calculation of income	3 of 11 loans

[3] The 11 loans consisted of nine cash-outs and two no-cash-out refinanced loans.

[4] The deficiencies noted are not independent of one another, as one loan may have contained more than one deficiency.

Inaccurate Evaluation of Mortgage Payment Histories

Somerset officials did not adequately evaluate the borrowers' previous mortgage payment history in eight cases reviewed because they did not obtain satisfactory explanations for late mortgage payments, consider late mortgage payments in evaluating borrower credit history, and ensure that borrowers were current with mortgage payments before the new FHA loan closing. Chapter 2-3A of HUD Handbook 4155.1, REV-5 provides that a borrower's housing obligation payment history holds significant importance in evaluating credit and the lender must determine the borrower's payment history of housing obligations through either the credit report, verification of mortgage directly from the mortgage servicer, or canceled checks covering the most recent 12-month period. Chapter 1-10E of this handbook also prohibits inclusion in the new mortgage amount any mortgage payments that were "skipped." Therefore, borrowers must be current on their mortgage payments or bring the monthly mortgage payment check to the loan closing for settlement.

Loans with Excessive Ratios and Inadequate Compensating Factors

HUD Handbook 4155.1, REV-5, Chapter 2-13, provides that compensating factors may be used to justify approval of mortgage loans with ratios exceeding HUD's front and back ratio[5] benchmark guidelines. However, if such factors are used to support loan approval, the underwriter must explain the compensating factors in the "remarks" section of the mortgage credit analysis worksheet[6] and provide supporting documentation. Somerset officials approved six loans with ratios that exceeded the applicable HUD benchmarks of 31 percent and 43 percent without documenting acceptable compensating factors to justify approval. For example, Somerset presented stable employment as a compensating factor for case number 374-4632311; however, stable employment is not a valid compensating factor because it is a requirement for loan approval. The qualifying ratios used by the lender are shown in the chart below.

#	Case number	Mortgage payment- to-income ratio (front ratio)	Fixed payment-to- income ratio (back ratio)
1	374-4676210	55.10%	66.83%
2	374-4756404	59.80%	66.14%
3	374-4632311	52.83%	52.83%
4	374-4668220	41.88%	53.55%
5	374-4623723	47.28%	47.28%
6	374-4727545	57.85%	58.19%

[5] The front ratio is the mortgage payment-to-income ratio, and the back ratio is the fixed payment-to-income ratio; HUD's benchmarks are 31 percent and 43 percent, as set forth in Mortgagee Letter 2005-16.
[6] The mortgage credit analysis worksheet is used to analyze and document mortgage approval.

Improper Calculation of Income

Somerset officials did not properly calculate borrower income for three loans. Chapter 2 of HUD Handbook 4155.1, REV-5, provides that the lender must verify the borrower's employment for the most recent 2 full years. Further, overtime income may be used if the borrower had such income for the past 2 years and it is likely to continue; however, the overtime income must be averaged for the past 2 years, and the employment verification must not state that such income is unlikely to continue. In addition, any unemployment income must be documented for 2 years. In one case (FHA number 374-4676210), the borrower's 2006 income was used for loan qualification instead of the borrower's current 2007 year-to-date wages. In another case (FHA number 374-4632311), overtime income was used for qualification without verifying that the borrower had received this overtime income for the past 2 years or verifying that it was likely to continue. In a third case (FHA number 374-4668220), the coborrower's weekly contract rate was used for loan qualification instead of the year-to-date wages earned as shown on the coborrower's pay stub. As a result, borrower income was overstated, and the reported qualifying ratios were lower than they should have been for these three loans.

Appendix C and D provide specific details on loans reviewed. Somerset agreed to indemnification on seven of the eight loans for which we recommend indemnification.

Other Underwriting Deficiencies

For the remaining three loans reviewed, other underwriting deficiencies were found; however, they were not significant enough to request indemnification. The deficiencies are noted in the table below.

Type of deficiency	Number of loans
Incorrect calculation of income but qualifying ratios were not excessive	2 of 3 loans
Borrower demonstrated an inability to manage debt	1 of 3 loans

Analysis of Loans Reviewed by Quality Control

Analysis of 16 loans that received a quality control review by either staff from Somerset and/or its quality control contractor disclosed that six loans had serious underwriting deficiencies warranting indemnification of $1,062,534. The significant deficiencies identified by Somerset's quality control and/or confirmed in our review are summarized below.

#	Case number	Loan type	Unpaid principal balance as of 10-31-09	Indemnification amount[7]	Quality control reported deficiency	Description of significant deficiencies disclosed by audit analysis
1	374-4708496	Cash Out Refinance	$314,391	$188,635	Underwriting guidelines not followed	Back ratio was incorrectly calculated.
2	374-4819542	Cash Out Refinance	$355,971	$213,583	Underwriting guidelines not followed; serious error	Faxed employment documents were not authenticated.
3	374-4631720	Cash Out Refinance	$277,711	$166,627	Quality control review ratios exceeded HUD's benchmarks	Loan was approved with ratios exceeding HUD's benchmarks of 31 percent and 43 percent (set forth in Mortgagee letter 2005-16) without documenting acceptable compensating factors required by Chapter 2-13 of HUD Handbook 4155.1, REV-5.
4	374-4647821	Cash Out Refinance	$346,101	$207,661	Quality control review ratios exceeded HUD's benchmarks	Income was improperly calculated and this loan was approved with ratios exceeding HUD's benchmarks of 31 percent and 43 percent (set forth in Mortgagee letter 2005-16) without documenting acceptable compensating factors required by HUD Handbook 4155.1, REV-5.
5	371-3668055	Purchase	$209,677	$125,806	Serious finding - other property owned by borrower	Borrower's credit history was not properly analyzed as required by Chapter 2 of HUD Handbook 4155.1, REV-5 because additional property owned by the borrower was not considered in the underwriting of this loan.
6	374-4738032	Cash Out Refinance	$267,039	$160,223	Serious Error	Co-borrower income was improperly calculated, the borrowers' previous mortgage payment history was inadequately evaluated, and this loan was approved with ratios exceeding HUD's benchmarks of 31 percent and 43 percent (set forth in Mortgagee letter 2005-16) without documenting acceptable compensating factors as required by HUD Handbook 4155.1, REV-5.
	Total Indemnification Amount		**$1,770,890**	**$1,062,534**		

During the audit, Somerset officials had agreed to indemnify HUD for the first five loans but did not agree that indemnification was warranted for the sixth loan.

[7] Indemnification amount was calculated by multiplying the unpaid principal balance by 60 percent, which is the fiscal year 2009 loss rate as supported by the Actuarial Review of the FHA Mutual Mortgage Fund. The potential loss on the six loans in which we seek indemnification is $1,062,534 ($1,770,890 x .60). Somerset agreed to indemnification on two (374-4631720 and 374-4647821) of the six cases in the amount of $374,288.

For case number 374-4738032, officials maintained that the coborrower's income was correctly calculated, the previous mortgage history was properly evaluated, and that adequate compensating factors were presented for exceeding HUD's benchmarks. This assertion is contrary to the findings of the quality control review, which noted that the borrower had made six late mortgage payments within 12 months before closing without adequate explanation and that its ratios of 50.24 percent front and 50.55 percent back exceeded HUD's benchmarks without acceptable compensating factors. In addition, audit analysis found that the coborrower's income was incorrectly calculated, which resulted in ratios that were lower than they should have been. These deficiencies were significant enough to warrant indemnification.

At the exit conference, Somerset officials agreed to indemnify HUD for two (374-4631720 and 374-4647821) of the six loans. In support of this position, Somerset officials provided additional information and documentation at, and subsequent to, the exit conference for the remaining four loans. For case number 374-4708496, officials provided compensating factors of three months cash reserves and borrower eligibility for increasing wages, as well as a reduction in child support, resulting in a lower debt to income ratio. However, additional information also disclosed that while $150 rental income was used to qualify, IRS tax transcripts for 2006 and 2007 showed rental losses of $25,000. Including the $25,000 rental loss caused the back ratio to greatly exceed HUD guidelines. For case number 374-4819542, while a revised appraisal was provided to support data integrity in the automated underwriting system, faxed employment documents were not authenticated and in response to our inquiry it was determined that the borrower did not file tax returns. For case number 371-3668055, Somerset officials provided additional documentation showing that investment property owned by the borrower was considered in the underwriting; however, no documentation was provided to support that a third property associated with the borrower was considered. For case number 374-4738032, the borrower's income was averaged over a 14 month period; the coborrower's income was calculated as $48,516 per year using the gross weekly pay from a verification of employment dated March 2008 for employment that began in October 2007. Our review found that the co-borrower's average income over the past two years, including unemployment compensation, was only $27,363. Despite the additional documentation provided for these cases, deficiencies significant enough to warrant indemnification continue to exist.

Action Taken to Lessen Underwriting Risk

In November 2008, before the start of our audit, Somerset officials recognized that because the company had a high default rate, along with the risks inherent in the underwriting process, action was needed. Therefore, they hired a risk management consultant to develop procedures to address the high default rate. The consultant created a risk matrix, using 15 different risk factors to be applied to all FHA loans, which determines the extent to which a loan will be reviewed before approval. Each loan is rated as low, moderate, or high risk. A loan rated low risk requires one underwriter for approval, a loan rated moderate risk requires the approval of two underwriters, and a loan rated high risk goes to a three-person committee for review and approval. The committee is composed of the risk management consultant, senior vice president, and a FHA senior underwriter.

We did not review any loans that were approved under Somerset's current underwriting procedures to assess the effectiveness of this risk matrix. However, if implemented as designed, these new procedures should provide greater assurance that the risk involved in underwriting and approving FHA loans has been appropriately considered and that HUD/FHA requirements have been met.

Conclusion

Somerset officials underwrote 14 loans that did not comply with HUD/FHA requirements. Eight of eleven loans reviewed, along with six loans reviewed by Somerset's quality control process and analyzed by the Office of Inspector General (OIG), exhibited significant underwriting deficiencies that posed a material risk to the FHA insurance fund, such as inadequate evaluation of previous mortgage payment history, excessive qualifying ratios without significant compensating factors, and improper calculation of income. Thus indemnification is warranted for approximately $2.8 million ($1,737,298 per Appendix D and $1,062,534 per page 8). Other deficiencies existed in the remaining three loans reviewed that were not serious enough to warrant indemnification. While underwriting is described as more of an art than a science, inadequate controls to address the considerable risk in underwriting refinanced mortgage loans caused these deficiencies to occur. Recognizing the inherent risk in the underwriting process, Somerset officials developed new procedures using a risk matrix, which should provide greater assurance that the risk involved in underwriting and approving FHA loans will be adequately assessed and thus ensure that risk to the FHA fund is lessened.

Recommendations

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

1A. Indemnify HUD for any losses incurred for the eight loans with significant underwriting deficiencies. The projected loss is $1,737,298 based on the loss rate of 60% as supported by the Actuarial Review of the FHA Mutual Mortgage Fund for fiscal year 2009.

1B. Indemnify HUD for any losses incurred for the six loans subject to Somerset's quality control process that had significant deficiencies confirmed by our analysis. The projected loss is $1,062,534 based on the loss rate of 60% as supported by the Actuarial Review of the FHA Mutual Mortgage Fund for fiscal year 2009.

1C. Strengthen controls over its underwriting procedures to provide assurance that HUD/FHA requirements are always met in originating and underwriting refinanced loans.

Finding 2: Quality Control Reviews Did Not Comply With All HUD/FHA Requirements

Although Somerset's written quality control plan complied with HUD/FHA requirements, the quality control reviews conducted did not meet all HUD/FHA requirements. Specifically, Somerset's quality control reviews did not comply with HUD's and its own quality control requirements regarding sample size and reporting. The completed quality control reviews did not include home equity conversion mortgages; did not always identify corrective actions, a timetable for completion, or planned follow-up activities; and did not report serious violations to HUD. These deficiencies occurred due to weaknesses in Somerset's implementation of its quality control plan. Consequently, Somerset's quality control was not effective in identifying problems, assuring swift and appropriate corrective action, and protecting Somerset and FHA from unacceptable risk.

Written Quality Control Plan Complied With HUD/FHA Requirements

Somerset's written quality control plan complied with HUD/FHA requirements. Chapter 7 of HUD Handbook 4060.1, REV-2, provides that all FHA-approved lenders must implement and continuously have in place a quality control plan for the origination and/or servicing of insured mortgages as a condition of receiving and maintaining FHA approval. This chapter also provides that quality control must be a prescribed and routine function of each lender's operations whether performed by a lender's staff or an outside source. Somerset's routine quality control reviews were conducted externally by a quality control contractor, and Somerset used two different quality control contractors during our audit period.

Somerset's quality control plan provided for the following:

- Selections will be structured to comply with all requirements stated in HUD Handbook 4060.1, chapter 7, section 7-6, and will include all FHA loan programs.
- A review of loans will be completed regularly, usually no later than 90 days after the closing date.
- A written variance report shall be prepared analyzing all discrepancies.
- The variance report shall state all actions taken together with each discrepancy reported.
- Actions taken to correct deficiencies will be fully documented on the management summary provided for each loan.
- A report to the investor or government agency will be made for any violation of law or regulation, false statements, material defect, or program abuses within 30 days of discovery.

Quality Control Reviews Did Not Comply with HUD/FHA's and Somerset's Own Requirements

Somerset's quality control reviews conducted during the period April 2007 through March 2009 did not comply with all of HUD/FHA's and its own requirements. Specifically, the reviews conducted did not comply with provisions for loan sample size, identification of corrective actions, and reporting of serious violations to HUD.

Quality control review sample size requirement was not met

A review of the routine quality control reviews completed for April 2007 through February 2009 found that quality control reviews did not meet sample size requirements because home equity conversion mortgages were not included in loan selection in 14 of the 23 months. Chapter 7-6C of HUD Handbook 4060.1, REV-2, provides that a lender that originates and/or underwrites 3,500 or fewer FHA loans per year must review 10 percent of the FHA loans it originates and the sample must include all FHA programs in which the lender participates, including but not limited to 203(b), 203(k), 234(c), and home equity conversion mortgages. The auditee's risk management consultant agreed that Somerset's quality control reviews did not include home equity conversion mortgages and that its quality control contractor did not select these loans for quality control review, although they were in the population of loans that closed on a monthly basis.

Quality control reports inadequately addressed corrective actions

Chapter 7-3I of HUD Handbook 4060.1, REV-2, provides that review findings must be reported to the lender's senior management within 1 month of completion of the initial report; management must take prompt action to deal appropriately with any material findings; and the final report or an addendum must identify actions being taken, the timetable for their completion, and any planned follow-up activities. Review of the routine quality control reviews completed for April 2007 through February 2009 found that the results of quality control reviews were provided to senior management in writing within the 1 month requirement. However, the final quality control report did not always identify actions being taken, a timetable for completion of the actions to be taken, and planned follow-up activities, if any.

Loans with serious violations were not reported to HUD

Somerset did not provide HUD with written notification of those loans that its quality control reviews determined had serious violations. Chapter 7 of HUD Handbook 4060.1, REV 2, provides that findings of fraud or other serious violations must be immediately referred, in writing (along with any available supporting documentation), to the Director of the Quality Assurance Division[8] in the HUD Homeownership Center having jurisdiction. Review of Somerset's routine and early payment default quality control reviews completed for our audit period found that quality control reviews identified 24 loans[9] with serious violations, but Somerset officials only reported one of these loans to HUD. Further review of these 24 loans confirmed that, while 11 of the loans had serious violations that should have been reported to HUD, Somerset officials reported 1 of the 11 to HUD. For the remaining 10 loans with serious violations, 2 loans were reviewed in our sample of 11 loans, and 8 loans were reviewed in our sample of 16 loans, which is discussed in finding 1.

Conclusion

Although Somerset's written quality control plan complied with HUD/FHA requirements, the conducted quality control reviews did not comply with HUD's and its own quality control requirements regarding sample size and reporting. The completed quality control reviews did not include home equity conversion mortgages; did not always identify corrective actions, a timetable for completion, and planned follow-up activities; and did not report serious violations to HUD. Consequently, Somerset's quality control process was not effective in identifying problems, assuring swift and appropriate corrective action, and protecting Somerset and FHA from unacceptable risk.

Recommendations

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

2A. Implement procedures to ensure that quality control reviews (1) meet sample size requirements by including home equity conversion mortgages; (2) identify actions being taken, a timetable for completion of the actions to be taken, and planned follow-up activities, if any; and (3) report serious violations to HUD.

[8] The Quality Assurance Division monitors the performance of FHA approved lenders.
[9] One loan, 374-4668220, was reviewed internally due to its default status and reviewed externally by Somerset's contractor due to its default status. Both reviews disclosed serious violations. This loan was also in our sample of 11 loans, and indemnification is being requested in this audit report.

SCOPE AND METHODOLOGY

To accomplish our objectives, we reviewed applicable HUD handbooks, mortgagee letters, and reports from HUD's Quality Assurance Division. We reviewed Somerset's policies and procedures for processing and underwriting loans and interviewed Somerset's staff and consultant to obtain an understanding of its quality control process and other internal control procedures.

We reviewed a nonstatistical sample of 11 defaulted refinanced loans originated by Somerset, which was selected from a population of 42 defaulted loans with beginning amortization dates between April 1, 2007, and March 31, 2009. The 42 defaulted loans were originated with mortgage amounts totaling $13,798,106 and the sample of 11 FHA-insured loans were originated with mortgage amounts totaling more than $4.1 million. These loans were selected because they were currently in default, had a first default reported with six or fewer payments, and had a mortgage amount greater than $300,000. Our detailed testing of these 11 loans included review and analysis of (1) qualifying ratios and compensating factors; (2) borrowers' income, assets, and liabilities; and (3) borrowers' previous mortgage payment and credit history. The results of our detail testing only apply to these 11 loans and cannot be projected. Significant underwriting deficiencies that warrant indemnification are deficiencies related to the collateral, credit history, cash to close, and/or capacity to repay that present a material risk to FHA.

We reviewed Somerset's quality control plan to ensure that it complied with HUD/FHA regulations. Somerset's routine quality control reviews were conducted by its contractors during our audit period, and reviews of early payment defaulted loans were conducted by its own staff and its contractor. We reviewed routine quality control reviews completed for the months of April 2007 through March 2009 to determine whether Somerset complied with the sample size, loan selection, timeliness, and reporting requirements set forth in Chapter 7 of HUD Handbook 4060.1, REV-2. We reviewed a representative sample of quality control reviews for 11 loans completed by Somerset's contractors for the months of December 2007, April 2008, and January 2009 to determine whether the reviews complied with the requirements set forth in Chapter 7-6 E, F, and G and 7-7 of HUD Handbook 4060.1, REV-2. We reviewed routine quality control reviews completed on 62 loans and reviews completed on 53 defaulted loans by Somerset's contractor and/or its own staff to determine whether the reviews identified serious violations. We selected a nonrepresentative sample of 16 loans for which the quality control reviews disclosed serious violations, underwriting deficiencies, and/or ratios exceeding HUD's benchmarks to determine whether any of these loans had significant deficiencies warranting indemnification.

We performed our audit field work from July through October 2009. We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit 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:

- Management's controls to ensure that FHA-insured loans are underwritten in accordance with HUD requirements.

- Management's policies and procedures to ensure that a quality control plan is established and implemented in accordance with HUD requirements.

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:

- Somerset did not ensure that refinanced loans were underwritten in accordance with HUD/FHA requirements (see finding 1).
- Somerset did not ensure that its quality control reviews met all HUD/FHA requirements (see finding 2).

APPENDIXES

Appendix A

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

Recommendation number	Funds to be put to better use 1/
1A	$1,737,298
1B	$1,062,534
Totals	$ 2,799,832

1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an 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 indemnify loans that were not originated in accordance with HUD/FHA requirements, it will reduce FHA's risk of loss to the insurance fund. The amount above is based on the loss rate of 60% as supported by the Actuarial Review of the FHA Mutual Mortgage Fund for fiscal year 2009.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

SOMERSET investors corp.

Somerset Report Response
February 25, 2010

Mr. Edgar Moore
Regional Inspector General for Audit
HUD Office of Inspector General
26 Federal Plaza
Rm. 3430
New York, NY 10278

Dear Mr. Moore,

Somerset Investors Corp. ("Somerset" or the "Company"), appreciates this opportunity to provide our comments regarding the draft audit report of the Office of Inspector General ("OIG") with respect to the Company's HUD-FHA insured mortgage lending practices.

At the outset, the Company wants to emphasize that it has always been committed to strict compliance with all applicable HUD-FHA requirements and being a valuable partner with HUD in providing quality loans to qualified borrowers. The Company recognizes that there were shortcomings in its performance. Importantly, as part of its continuing efforts to strengthen its loan origination procedures, the Company initiated affirmative corrective action well in advance of the OIG audit. We believe that this proactive effort speaks to the Company's commitment to strict compliance with HUD-FHA requirements.

The OIG audit draft report notes two findings regarding the FHA lending practices of the Company, both isolated to the audit period, covering loans which were originated from December 1, 2006 through November 30, 2008.

Background

Prior to addressing the specific findings, the Company believes that it is important for the OIG to recognize that the need for significant changes was identified by the Company more than ten-months prior to the Company receiving notice from the OIG that an audit was going to occur. These changes were already in place for more than seven-months prior to the Company receiving notice that an audit was to occur. As a result of the less than optimal performance of its' FHA loan originations from calendar years 2007 and first half 2008, the Company's senior management recognized that it needed to restructure the philosophy of the FHA underwriting team and apply a new methodology and make changes to its' business model.

Corrective Action Was Taken by the Company Prior to the OIG Audit

Comment 1

The Company retained a risk management consultant, expert in mortgage lending in general and FHA lending in particular, in October 2008. Beginning in November 2008, a detailed analysis was made of: FHA underwriting practices and results; workflow and credit operations of its FHA lending; and the Quality Control department. A granular retroactive analysis of prior underwriting decisions on sub-performing FHA loans was performed. A time/motion study of the company credit operations department and a review of the Company Quality Control workflow and methodology were performed. An analysis of the Company marketing strategy and metrics was performed as well. In December 2008, the results of these studies were the basis of the Company restructuring underwriting, workflow and marketing.

Operational Changes Implemented by the Company

The underwriting and workflow changes implemented by the Company in December 2008 are outlined below. As recognized by the OIG auditors and stated in the draft

1

290 Broadhollow Road, Suite 310E, Melville, NY 11747

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

SOMERSET investors corp.

Somerset Report Response
February 25, 2010

audit report (page 9), under the heading "Action Taken to Lessen Underwriting Risk" - "... if implemented as designed, these new procedures should provide greater assurance that the risk involved in underwriting and approving FHA loans has been appropriately considered and that HUD-FHA requirements have been met."

An automated Risk Matrix was implemented to drive a multiple underwriter approval requirement based upon the individual risk characteristics of each loan application. Minimal rated loans require one underwriter for approval; Moderate rated loans require two underwriters to concur for approval; High rated loans require committee approval. This risk matrix is illustrated below.

RISK MATRIX

RISK GROUP PROFILE* - REFINANCES	AUS APPROVED	LTV	CASH OUT	DTI**	% HOUSING DOWN	OCC FICO	AT RISK EMP	YRS JOB	S/E	YRS OWNED	REFIS IN 48	NON OCC CB**	DEBT PAY REDUCTION	CASH IN HAND	MTG LATES
1) MINIMAL	YES	85	NO	43	20%	720 or >	NO	10	NO	10	1	NO		NO	NONE
2) MODERATE	NO	90	YES	50	15%	680 or >	POSSIBLE	5	YES	5	3	NO		YES	NONE IN 36
3) HIGH	NO	97.75	YES	>50	10%	620 or >	YES	2	YES	2 OR LESS	4 OR MORE	OK IF R/T		YES	NONE IN 12

a) columns "c" through "q" are metrics
b) any spread between two bands is range of band
c) to remain in band 1 or 2, loan must meet 11 out of 15 (c-q)
ANY PRIOR MTG LATES = INCREASE RISK ONE LEVEL

RISK GROUP PROFILE* - PURCHASES	AUS APPROVED	LTV	DTI**	OCC FICO	AT RISK EMP	YRS JOB	S/E	GIFT	PAY SHOCK	PRIOR BK	SELLER CON	NON OCC CB**	RENTAL TO QUALIFY	FIRST TIME H/B	RESERVES
1) MINIMAL	YES	80	43	720 or >	NO	10	NO	YES	50% OR LESS	NO	NO	NO	NO	NO	YES > 6 piti
2) MODERATE	NO	90	50	680 or >	POSSIBLE	5	YES	YES	100%	NO	YES	NO	NO	YES WITH 10% >	YES > 3 piti
3) HIGH	NO	96.5	>50	620 or >	YES	2	YES	NO	> 100%	YES	YES	OK	YES	YES	NO

The Company has also re-engineered the work flows for the processing and underwriting of FHA loans. The work flows are now more efficient, adding additional layers of review and, with the added level of detail and instruction, designed to ensure compliance with all current FHA requirements.

FHA LOAN WORKFLOW TASK LIST

FHA LOAN - PROCESSING TASK LIST

1) CHECK LDP LIST - all parties in loan transaction
2) CHECK CAIVRS
3) VERIFY CASE NUMBER IS CORRECT
4) CHECK COUNTY LIMITS
5) CHECK LOAN TO VALUE RATIO IS COMPLIANT
6) VERIFY MIP - UPFRONT AND ANNUAL
7) VERIFY CONDO IS FHA APPROVED
8) RUN / VALIDATE AUS
9) VERIFY APPRAISER IS FHA APPROVED
10) VERIFY LOWEST MIDDLE FICO IS GREATER THAN 640
11) RUN DRIVE SYSTEM ID VERIFY
12) VERIFY ALL DISCLOSURES PROPERLY SIGNED AND DATED
13) SUBMIT FILE TO UNDERWRITING FOR CONDITIONAL APPROVAL

AFTER CONDITIONAL APPROVAL BY UNDERWRITING

A) RUN BALANCE OF DRIVE SYSTEM
B) SEND OUT VOD, VOE, VOM, VOR
C) ORDER FLOOD CERT AND REVIEW
D) OBTAIN REQUIRED UNDERWRITING STIPS
E) ORDER PAYOFFS
F) ORDER HOI
G) EXECUTE 4506T

14) SIGN OFF ON LOAN FILE IN LPS

APPRAISAL DEPARTMENT TASK LIST

1) REVIEW ALL APPRAISALS
2) DATABASE CHECK FOR APPRAISAL FIRM ISSUES
3) DESK REVIEW ENTRY INTO LPS
4) RUN AVM IF REQUIRED FOR EVALUATION
5) VERIFY APPRAISER LICENSE IS CURRENT
6) VERIFY PROFESSIONAL INSURANCE IS IN REPORT
7) CHECK INVESTOR DATA BASES FOR APPRAISER BLACK LIST
8) SIGN OFF ON LOAN FILE IN LPS

2
290 Broadhollow Road, Suite 310E, Melville, NY 11747

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

SOMERSET investors corp.

Somerset Report Response
February 25, 2010

FHA LOAN - UNDERWRITER TASK LIST

1) REVIEW INCOME CALCULATIONS
2) EVALUATE STABILITY OF EMPLOYMENT - WAGE EARNER
3) EVALUATE STABILITY & DURATION OF SELF EMPLOYMENT
4) CHECK FOR COPY OF 4506T TRANSCRIPT - VALIDATE
5) REVIEW REVERSE LOOK UP - EMPLOYMENT PHONE / ADDRESS
6) REVIEW REVERSE LOOK UP - HOME PHONE / ADDRESS
7) VERIFY OCCUPANCY - documents & IRS transcripts
8) REVIEW TELEPHONE CONFIRMATION OF VOE
9) REVIEW TELEPHONE CONFIRMATION WITH CPA FOR S/E
10) REVIEW REVERSE LOOK UP TO VERIFY IDENTITY OF CPA
11) RE-VERIFY DOWN PAYMENT MONIES / RESERVES
12) REVIEW SOMERSET GFE AND TIL / DISCLOSURES TO APPLICANTS
13) SOMERSET CREDIT PULL - VERIFY MINIMUM 620 MIDDLE FICO
14) SOMERSET TANGIBLE BENEFIT SIGN OFF

ISSUE CONDITIONAL APPROVAL, SUSPEND FOR ADDITIONAL INFORMATION OR REFER LOAN TO UNDERWRITING MANAGER FOR REJECTION

ONCE LOAN FILE IS COMPLETE:

15) REVIEW APPRAISAL DEPARTMENT SIGN OFF AND APPRAISAL
16) REVIEW ALL STIPS, AUS VALIDATION, DATA VERIFY RESULTS
17) APPLY RISK MATRIX TO LOAN FILE
    A) IF LOW RISK, FINAL APPROVE IF WARRANTED
    B) IF MODERATE RISK, OBTAIN CONCUR FROM ANOTHER D.E.
    C) IF HIGH RISK, SUBMIT LOAN TO RISK COMMITTEE
18) CLEAR LOAN FILE FOR CLOSING IN LPS

By implementing the Data Verify DRIVE automation, the company has added an additional defense against fraud. The system performs multiple public records data bases checks with a single click, thus enabling the processing staff to devote the time gained to thorough review of each loan file prior to underwriting.

The Company has engaged an FHA approved senior appraiser to perform formal desk reviews on 100% of the appraisal reports it receives. This has reduced by half the amount of time the underwriters previously devoted to appraisal review for each loan file, enabling the underwriters to invest the additional time saved in their evaluation of the credit risk and documentation of each loan file. The additional expertise and experience of the review appraiser provides a second review and layer of protection to ensure that collateral values are accurate for all loan applications. Please note that the underwriters still fulfill their FHA requirements for their own appraisal review on each file they underwrite; the desk reviews are deployed as a second level of review and not as a replacement for the D.E. underwriter.

The Company also made significant personnel changes in the FHA department, replacing the person that was in charge of the department in 2007 and 2008. Changes have also been made in other roles within the department.

The Company has also made significant changes to the marketing plan. The changes have brought the average closed FHA loan FICO decision score up from mid 500s for the Neighborhood Watch loans to just below 700.

290 Broadhollow Road, Suite 310E, Melville, NY 11747

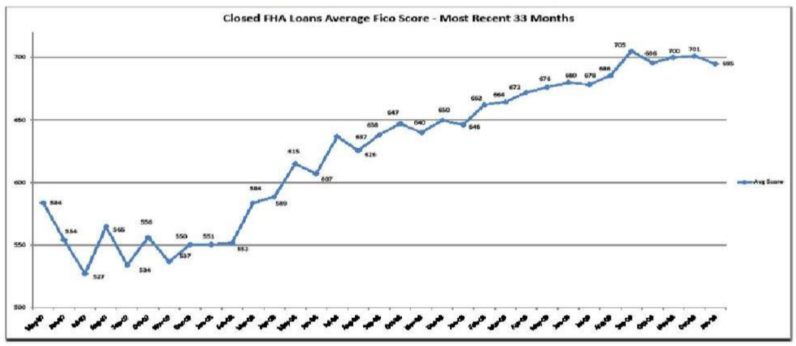
Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

SOMERSET investors corp.

Somerset Report Response
February 25, 2010



Operational Changes Have Eliminated Underwriting Weaknesses

The performance of the FHA originations of Somerset closed for the most recent thirteen months provide factual confirmation that any material underwriting weaknesses from the past have been eliminated and will not reoccur. The Company has also addressed past issues with quality control sampling and management responses. The specifics of the changes and enhancements to quality control are discussed in detail in the Company response to the quality control finding.

The Company proactively addressed all concerns noted for the audit sample period well before it received notification of the audit, and wishes to unequivocally state that we do not pose a risk to the soundness and safety of the FHA program.

Randi Marcus

Randi Marcus
President

FINDING 1 – Underwriting Critique

Company Response

Recognizing the responsibility of an FHA Direct Endorsement lender, the Company is prepared and willing to indemnify HUD on those loans that warrant it. The Company has identified what it believes to be strong mitigating factors for approval of some of the loans referenced by the auditor as indemnification requests and believes indemnification is not warranted for these loans.

The following section contains Company responses to the specific findings made by the auditor on a loan level basis.

Comment 2

Case No. 374-4631720 SMB10143HQ SIC will indemnify HUD

Case No. 374-4647821 SMB10422HQ SIC will indemnify HUD

4
290 Broadhollow Road, Suite 310E, Melville, NY 11747

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

SOMERSET investors corp.

Somerset Report Response
February 25, 2010

Case No. 374-4756404 SMB11569HQ SIC will indemnify HUD

Case No. 374-4632311 SMB10060HQ SIC will indemnify HUD

Case No. 374-4668220 SMB10802HQ SIC will indemnify HUD

Case No. 374-4623723 SMB10619HQ SIC will indemnify HUD

Case No. 374-4672543 SMB11049HQ SIC will indemnify HUD

Case No. 374-4686723 SMB10966HQ SIC will indemnify HUD

Case No. 374-4727545 SMB11224HQ SIC will indemnify HUD

Case No. 374-4708496 SMB11901HQ Indemnification does not appear to be warranted

Cited for debt to income ratios exceeding benchmark without documenting acceptable compensating factors.

Comment 3

Below are the compensating factors, as per the old 4155 that SIC finds in the subject loan:

1) Borrower had more than three months PITI reserves prior to closing – old 4155 - 2-13.G – cash reserves
2) Borrower was a police officer with 16 years of service and eligible for contractual raises based upon time on the job. This was confirmed by written VOE from NYPD which confirmed: annual base in 2006 was $56,976: annual base pay increased to $59,346 for 2007; annual base pay increased to $65,382 for 2008. There were also annual increases in the longevity portion of the borrower compensation confirmed in the same written VOE: longevity pay was $4537 in 2006; longevity pay increased to $5124 in 2007; longevity pay increase to $5745 in 2008. This clearly demonstrates potential for increased earnings and advancement – old 4155 – 2-13.I – potential for increased earnings
3) Borrowers' eldest child reached the age of emancipation (22) 6 months prior to the loan closing, and as per the divorce papers submitted in the case binder, the child support for the eldest child was no longer in force, resulting in a lower debt to income ratio than that contained in the MCAW.
4) While the borrower did perform extensive remodeling and repairs on their Georgia investment property is both 2006 and 2007, the underwriter did not carry this rental loss over to the income calculations for this FHA loan, which was approved and closed in 2008, as the repairs and remodeling which totaled almost $91,000 that caused this rental loss for two years were complete on this $100,000 property.

Case No. 374-4819542 SMB12201HQ Indemnification does not appear to be warranted

Comment 4

Cited for borrower failure to file tax returns with the IRS.

Below are SIC responses to the findings cited for this loan:

1) As to the borrower failure to file income tax returns, the underwriter relied upon a completed written verification of employment form, a letter from the employer explaining the borrower's year to date deduction breakdown, internet confirmations of the business address and phone number, which complied with the requirements as set for the Desktop Underwriter AUS Approve/Eligible (DU Casefile ID 949095955) and utilized TOTAL SCORECARD. The AUS underwriting certification was included in our original case binder submission. SIC does not dispute the subsequent discovery that the borrower failed to file tax returns, but this was not known to SIC at the time of underwriting approval or prior to the audit findings.

Comment 5

Case No. 371-3668055 SMB9310HQ Indemnification does not appear to be warranted

5

290 Broadhollow Road, Suite 310E, Melville, NY 11747

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

SOMERSET investors corp.

Somerset Report Response
February 25, 2010

Cited for failure to properly analyze credit history because additional property owned by the borrower was not included in underwriting analysis
Below are SIC responses to the findings cited for this loan:

Comment 5

1) In reviewing the case binder submission, SIC notes that the MCAW, on line 14.c (other), does reflect the negative rental income as calculated of $593.38. Said rental loss is included in line 14.d (total monthly payments). This same rental loss figure for the borrower's investment property is likewise reflected on page 3 of the final 1003 signed at closing, also submitted in our case binder for this file. The total consumer debt service, as reflected by the credit supplements included in our case binder submission, equaled $55 per month. When added to the rental loss of $593 per month, the total of $648.38 of total monthly payments reflected on line 14.d of the MCAW is an accurate reflection of the borrower debt and net rental income loss.
2) As to the property located at Chestnut Lane, Milton, NY, where the borrower resided prior to the purchase of the subject property with this FHA loan, this property was owned and occupied by the borrowers wife, who was not a part of or party to this transaction.

Case No. 374-4738032 SMB11463HQ Indemnification does not appear to be warranted
Cited for failure to adequately evaluate previous mortgage history and failure to have compensating factors for exceeding benchmark debt to income ratios and improperly calculated income
Below are SIC responses to the findings cited for this loan:

Comment 6

1) The borrower's written explanation for their prior mortgage lates noted the unexpected loss of the husband's employment after more than 11 years with his employer. Included in our case binder submission is a VOE from the Work Number from the prior employer which confirms the length of service and the termination by the employer on 8/21/2006. The borrower's written explanation also references an increase in their adjustable mortgage payment, which is confirmed by the both the payoff statement and a copy of the adjustable mortgage note, both included in the case binder submission. The interest rate on their conventional interest only adjustable rate mortgage increased from 6.25% to 9.25% in August of 2007 and to 10.25% six months later. The borrowers were current on their existing adjustable rate conventional mortgage at the time of closing. As evidenced by the payoff statement and the escrow overdraft statement included in our case binder submission, the servicer miscalculated the escrow account, resulting in an escrow shortfall of $13,413 that the servicer demanded be repaid through an additional monthly payment of $582.28 per month for 24 months, resulting in a total mortgage obligation prior to refinancing of $2838.83 per month. SIC believes that the previous mortgage history was taken into account by the underwriter. The borrowers' new FHA PITI payment was $371 less than the adjustable rate payment plus the escrow shortfall payment.
2) The income of the co-borrower was supported by both computer generated paystubs and a w-2 form for 2007 from the current employer and a written verification of employment and a verbal verification as well that indicated continued employment (W-2 forms for 2006 from prior employer and NJ Unemployment 1099 forms for 2006 and 2007 were also in the case binder submission) which confirm weekly base pay of $933 per week, which equals monthly base pay of $4043, matching the MCAW exactly. The income of the borrower was supported by computer generated paystubs, a written VOE and the indicated base income was more than $15,000 per year based upon a current year to date paystub and the written VOE. The underwriter reduced the borrower qualifying income on the MCAW by $5000 annually to monthly qualifying income of $869 per month due to unreimbursed employee expenses (which totaled only $3500)reflected on the tax transcripts (also part of our case binder submission). The borrower's commission income was not used to qualify, nor was the co-borrower overtime income used to qualify. The overall debt to income ratio calculation was conservative.
3) The loan also paid off a closed revolving account with a $623 payment (open for 42 months with a single 30 day late, as verified by the credit report). The total debt reduction between PITI and the revolving payment eliminated was $993 per month. It should be noted that the borrowers had brought their existing mortgage current after the co-borrower secured employment in October of 2007.

6
290 Broadhollow Road, Suite 310E, Melville, NY 11747

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

SOMERSET investors corp.

Somerset Report Response
February 25, 2010

Comment 7

Case No. 374-4676210 SMB10844HQ Indemnification does not appear to be warranted
Cited for excessive ratios without documentation of acceptable compensating factors and improper calculation of income
Below are SIC responses to the findings cited for this loan:

1) The mortgage history of the borrower was impacted for three years prior to the finalization of a bitter divorce in March 2007. The divorce decree and stipulation of settlement were included in our case binder submission, as well as the borrower explanation referencing the divorce as the basis for the prior mortgage lates. The mortgage history is distorted by multiple transfers of servicing during this period as well. There are mortgage lates reported on the credit report after the credit report notes the account being closed months prior. It should be noted that for a period of 12 months prior to closing the borrower was on time with their existing mortgage payments of $3729, and the new PITI payment from the FHA loan was $3249.55, a reduction of $479.55 per month and 14.6% in the borrower housing expense. Since the borrower demonstrated an ability to carry a significantly higher housing obligation on time for 12 months prior to closing, SIC believes that the debt to income ratio was reasonable for this borrower. During this period the borrower also maintained a perfect payment history for 24 months on an auto loan with monthly payments of $656 per month. There are mortgage lates reflected on the credit report from an investment property which the borrower sold approximately 11 months prior to closing. The ability to carry a $479 / 14.65 higher mortgage obligation on time for 12 months prior to closing (and subsequent to the finalization of his divorce should be considered an acceptable compensating factor.
2) The case binder submission also reflects verified reserves of $37,609 ($62,683 factored by 60%), equal to 11.6 months of PITI reserves, which should be accepted as a compensating factor.
3) The borrower income calculations were appropriate for a union member in good standing of 8 years. The written verification of employment reflected 40 hours per week at a rate of $31.25 per hour, indicating base annual compensation of $62,500 per annum. The written VOE also indicated continuance of overtime, which was not included in the underwriter's qualifying income, and also indicated a pending raise six months after closing. As a union member, the borrower had multiple employers, and the paystub included in the case binder submission reflected earnings of $9,352 in a period of 1.5 months.
4) Based upon the two strong compensating factors noted above in items 1 & 2 (reduction of 14.6% / $479 per month in housing expense after 12 months of perfect payments on the higher figure and 11.6 months of documented PITI reserves), and based upon the documented credit explanation (divorce) which caused the prior credit issues, SIC does not find indemnification to be warranted.

FINDING 2 – Quality Control - timing and sampling

Company Response

Comment 8

The quality control vendor has also acknowledged that the Company did include reverse mortgage loans in the reports sent to the vendor for sample selection; the vendor failed to select reverse mortgage loans until 2nd quarter 2009. The Company would like to state that it absolutely provided the quality control vendor with accurate reports from which the vendor was to select the sample from.

The Company has modified internal policies to ensure that any future findings of material deficiencies identified by either the Company or by the quality control vendor in its' FHA underwriting and/or quality control results will be promptly reported to HUD as required. These new procedures also ensure that the Quality Control vendor's sample selections are reviewed within 5 days of receipt to ensure that HECM loans are included.

7
290 Broadhollow Road, Suite 310E, Melville, NY 11747

OIG Evaluation of Auditee Comments

Comment 1 As recognized in the report, the auditee had acknowledged a need for significant changes in its underwriting procedures and quality control and had implemented corrective action prior to our audit.

Comment 2 The auditee agreed to indemnify HUD for nine of the 14 loans recommended for indemnification.

Comment 3 While the loan file did not properly document compensating factors as required by HUD Handbook 4155.1, REV-5, the auditee has subsequently identified the existence of acceptable compensating factors; therefore we have removed reference to the compensating factor deficiency. However, the auditee's explanation that repairs and remodeling, which created the rental loss, were completed, and therefore not included in determining income calculations, is not a valid reason for excluding the rental loss. Inclusion of this loss results in a back ratio which significantly exceeds HUD's benchmarks, even after accounting for a reduction in child support. Accordingly, we continue to recommend indemnification of this loan.

Comment 4 The auditee does not agree that indemnification is warranted because the underwriter relied upon a completed written verification of employment form, a letter from the employer explaining the borrower's year to date deduction breakdown, and internet confirmations of the business address and phone number. However, the employment documentation was faxed and the underwriter neither verified the authenticity of the faxed documents as required by HUD Handbook 4155.1, REV-5, Chapter 3-1 nor requested IRS tax transcripts as required by auditee procedures. Accordingly, indemnification of this loan is warranted.

Comment 5 While the auditee states that the questioned property not considered in the underwriting was owned and occupied by the borrower's wife, who was not a part of or party to this transaction, a previous application in the file for a mortgage on investment property reported the questioned property as jointly owned. Therefore, ownership of the property should have been considered in the underwriting of this loan. In addition, our search of Lexis Nexis disclosed that the borrower did jointly own the property with his wife. Accordingly, we continue to recommend indemnification of this loan.

Comment 6 While the auditee states that adequate compensating factors were presented and income was properly calculated, adequate compensating factors to justify loan approval were not documented and income was not properly calculated. A compensating factor of a reduced mortgage obligation is not applicable because documents in the file disclosed an escrow shortfall and late payments in the borrower's prior mortgage history. Further, while the borrower's income was averaged, the co-borrower's income was not averaged. Rather, the co-borrower's income was calculated at $48,516 while the co-borrower's averaged income would have been $27,363 over the past two years. This amount is based upon reported unemployment compensation and a verification of current employment which reported wages of $13,455 for 2007 and $12,474 for 2008 and no overtime. Accordingly, we continue to recommend indemnification of this loan.

Comment 7 While the auditee presents cash reserves of $37,609 as a compensating factor, this is not significant enough to justify approving a loan with a back ratio of 66.83 percent, incorrect calculation of qualifying income, and payment of the borrower's November and December 2007 mortgage payments 30 days past due.

Comment 8 The auditee agrees that reverse mortgages were not included in quality control sampling because its contractor did not select them and states that it has modified internal policies to ensure that any future findings of material deficiencies in its' FHA underwriting and/or quality control results identified by either the Company or by the quality control vendor will be promptly reported to HUD as required. If implemented, these actions are responsive to our recommendations.

Appendix C

SUMMARY OF SIGNIFICANT AND OTHER UNDERWRITING DEFICIENCIES

#	Case number	Loan type	Loan to value ratio	Unpaid Principal Balance as of 10-31-09	Indemnification Amount[10]	Improper Calculation of Income Resulting in Excessive Ratios	Inaccurate Evaluation of Borrower's Previous Mortgage Payment History	Excessive Ratios Without Documentation of Acceptable Compensating Factors To Justify Mortgage Approval	Other Origination Deficiencies[11]	Appendix Reference
1	374-4676210	Cash Out Refinance	73.2	$408,167	$244,900	X	X	X		D-1
2	374-4756404	Cash Out Refinance	63.0	$467,630	$280,578		X	X		D-2[12]
3	374-4632311	Cash Out Refinance	83.9	$319,967	$191,980	X	X	X		D-3[12]
4	374-4668220	Cash Out Refinance	75.6	$360,266	$216,160	X	X	X		D-4[12]
5	374-4623723	Cash Out Refinance	91.5	$323,240	$193,944		X	X		D-5[12]
6	374-4672543	No Cash Out Refinance	88.7	$339,553	$203,732		X		X	D-6[12]
7	374-4686723	Cash Out Refinance	71.5	$297,979	$178,787		X			D-7[12]
8	374-4727545[13]	No Cash Out Refinance	95.0	$378,694	$227,216		X	X		D-8[12]
9	374-4676256	Cash Out Refinance	64.6						X	
10	374-4595651	Cash Out Refinance	74.3						X	
11	374-4752807	Cash Out Refinance	90.7						X	
		TOTALS		**$ 2,895,496**	**$1,737,298**	**3**	**8**	**6**		

[10] The fiscal year 2009 loss rate is 60 percent as supported by the Actuarial Review of the FHA Mutual Mortgage Fund for fiscal year 2009. The potential loss on the eight loans in which we seek indemnification is $1,737,298 ($2,895,496 x .60).

[11] The other underwriting deficiencies include incorrect calculation of income and inadequate consideration of borrower's inability to manage debt.

[12] Somerset agreed to indemnification for seven of the eight loans for which we seek indemnification.

[13] HUD has already incurred and paid a loan modification claim of $1,000 for this case.

Appendix D

CASE NARRATIVES

Case number:	374-4676210
Loan type:	Cash-out refinance
Mortgage amount:	$416,150
Closing date:	1/23/2008
Payments before first default reported:	Seven
Default status as of 10/31/09:	Delinquent
Unpaid principal balance:	$408,167

Details of Underwriting Deficiencies:

A. Excessive Ratios Without Documentation of Acceptable Compensating Factors To Justify Mortgage Approval

The auditee approved the mortgage with qualifying ratios (55.10 percent front and 66.83 percent back) that significantly exceeded HUD's benchmarks (31 percent front and 43 percent back as set forth in Mortgagee letter 2005-16) without documenting acceptable compensating factors. Chapter 2-13 of HUD Handbook 4155.1, REV-5, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed the benchmark guidelines, and underwriters must record in the "remarks" section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation. The "remarks" section of the mortgage credit analysis worksheet noted stable employment and "Reducing PITI[14] by $550+ per month." However, HUD guidelines provide that stable employment is a requirement and not a compensating factor to justify approving a mortgage with ratios above HUD's benchmarks. Additionally, while reducing the mortgage payment can be considered a compensating factor, we do not regard the reduction as significant enough to justify exceeding HUD's benchmarks to the extent that this mortgage did, especially since the borrower's previous mortgage payment history showed late payments and this loan defaulted after seven payments.

B. Improper Calculation of Income

The lender improperly calculated borrower income because it did not use the borrower's 2007 income to qualify for the mortgage loan. Specifically, the lender calculated borrower monthly effective income as $4,537.75 using wages and unemployment compensation from the borrower's 2006 Internal Revenue Service (IRS) tax transcript. Chapter 2-6 of HUD Handbook4155.1, REV-5, provides that the lender must verify the borrower's employment for

[14] PITI refers to mortgage principle, interest, taxes, and insurance.

the most recent 2 full years, and Chapter 1 cautions that cash-out refinances for debt consolidation represent considerable risk, especially if the borrowers have not had an attendant increase in income, and such transactions must be carefully evaluated. Chapter 2-7L provides that unemployment income must be documented for 2 years. The lender obtained the borrower's IRS tax transcripts for 2005 and 2006, a verification of employment from the borrower's current employer, and the borrower's pay stubs for pay periods ending October 23, November 27, and December 18, 2007, showing regular hours of 40, 32, and 29. The IRS tax transcripts for 2005 and 2006 showed wages of $29,796 and $52,428, respectively, and unemployment compensation of $9,011 and $2,025, respectively. The verification of employment showed an hourly wage of $31.25 and an average of 40 hours per week but did not show gross earnings for any years. Since this was a cash-out refinance, the borrower's wages varied, and the verification of employment did not confirm the year-to-date wages for 2007, the lender should have averaged the borrower's wages over the 3-year period and verified and documented the unemployment compensation for the 2-year period. Averaging the borrower's wages for 2005, 2006, and 2007 and unemployment compensation for 2005 and 2006 results in borrower monthly effective income of $4,323.69 compared to the lender's $4,537.75. This calculation of borrower income results in revised qualifying ratios of 57.17 percent and 69.36 percent compared to the lender's calculated ratios of 55.10 percent and 66.83 percent, which require the documentation of significant compensating factors that the lender did not provide (see section A above).

C. Inadequate Evaluation of Borrower's Previous Mortgage Payment History

The lender did not adequately evaluate the cause of late mortgage payments reported on the borrower's credit report. Chapter 2-3A of HUD Handbook 4155.1, REV-5, provides that the borrower's housing obligation payment history holds significant importance in evaluating credit and the lender must determine the payment history through the credit report, verification directly from the mortgage servicer, or canceled checks covering the most recent 12-month period. While the borrower's credit report obtained by the auditee reported two mortgage payments that were 30 days past due during the 12 months from November 2006 to October 2007, the auditee did not obtain a letter of explanation from the borrower for these late payments. Additionally, copies of the borrower's mortgage loan statement indicated that the borrower paid the November 1 and December 1, 2007, mortgage payments late. Nevertheless, there was no documentation in the file to indicate that the underwriter considered any of these late mortgage payments in evaluating the borrower's past credit history. Consequently, the borrower's payment history for housing obligations was not adequately considered.

Case number:	374-4756404
Loan type:	Cash-out refinance
Mortgage amount:	$476,542
Closing date:	5/12/2008
Payments before first default reported:	One
Default status as of 10/31/09:	First legal action to commence foreclosure
Unpaid principal balance:	$467,630

Details of Underwriting Deficiencies: (Auditee has agreed to indemnification)

A. Excessive Ratios Without Documentation of Acceptable Compensating Factors To Justify Mortgage Approval

The auditee approved the mortgage with qualifying ratios (59.80 percent front and 66.14 percent back) that significantly exceeded HUD's benchmarks (31 percent and 43 percent as set forth in Mortgagee Letter 2005-16) without documenting acceptable compensating factors. Chapter 1 of HUD Handbook 4155.1, REV-5, cautions that cash-out refinances for debt consolidation represent considerable risk, especially if the borrowers have not had an attendant increase in income, and such transactions must be carefully evaluated. Chapter 2-13 of the handbook provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed the benchmark guidelines; however, underwriters must record in the "remarks" section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation. The underwriter listed on the mortgage credit analysis worksheet "principal, interest, taxes, and insurance decreasing over $350+ monthly, job stability in professional field, 20 year homeownership, loan to value below maximum financing, and borrowers had a loss of business hardship." However, some of these are not valid compensating factors, and others are not acceptable for the risks inherent in this mortgage, which became evident when the borrower defaulted after one payment. Job stability and loss of business hardship are not valid compensating factors. While a decrease in principal, interest, taxes, and insurance of more than $350+ monthly and 20-year homeownership are valid compensating factors, we do not view them as acceptable because as noted below, the borrower had unexplained late mortgage payments during the prior 12 months and a prior foreclosure. Further, while loan to value below maximum financing is a valid compensating factor, we do not consider it significant enough to offset the risk for this loan due to the back ratio exceeding HUD's benchmark for fixed payment-to-income ratio by more than 20 percentage points and the inadequate consideration of the borrower's housing obligation payment history.

B. Inadequate Evaluation of Borrower's Previous Mortgage Payment History

The auditee did not adequately evaluate the borrower's previous mortgage payment history because late mortgage payments shown on the borrower's credit report were not satisfactorily explained and the borrower's May 2008 mortgage payment was included in the new FHA loan. Chapter 2-3A of HUD Handbook 4155.1, REV-5, provides that the borrower's housing obligation payment history holds significant importance in evaluating credit and the lender must determine the borrower's payment history through the credit report, verification of mortgage directly from the mortgage servicer, or canceled checks covering the most recent 12-month period. The borrower's credit report noted two mortgage payments made 30 days past due (February and March 2008) and one mortgage payment that was 60 days past due (January 2008) during the prior 12 months. There was a letter in the file from the mortgage company, dated April 30, 2008, stating that the February 2008 payment was current and the credit bureaus had been notified to make the change. There was also a letter in the file from the borrower stating that the January 2008 mortgage payment was late due to "a mishap in funds available during the month in which the check was returned" and that the borrower resent new funds to cover the check. The letter further noted that the borrower did not know why the credit report showed the January 2008 mortgage payment as 60 days late or why there were additional late payments. There was no error letter in the file from the mortgage company regarding the March 2008 mortgage payment, and the lender did not follow up. In addition, foreclosure proceedings were instituted against the borrower in 2006. Additionally, the May 5, 2008, mortgage payoff statement showed that May 2008 was the next mortgage payment due date, as well as interest charges for April 1-30, May 1-31, and June 1-2, 2008, which indicates that the borrower did not make the mortgage payment for May 2008 and it was included in the new FHA loan amount. Chapter 1 of HUD Handbook 4155.1, REV-5, provides that lenders are not permitted to allow borrowers to "skip" payments and the borrower is either to make the payment when it is due or bring the monthly mortgage payment check to settlement because FHA does not permit the inclusion of any mortgage payments "skipped" by the homeowner in the new mortgage amount. For example, a borrower whose mortgage payment is due June 1 and who expects to close the refinance before the end of June is not permitted to roll the June mortgage payment into the new FHA loan amount.

Case number:	374-4632311
Loan type:	Cash-out refinance
Mortgage amount:	$327,800
Closing date:	8/27/2007
Payments before first default reported:	Two
Default status as of 10/31/09:	First legal action to commence foreclosure
Unpaid principal balance:	$319,967

Details of Underwriting Deficiencies (Auditee has agreed to indemnification)

A. Excessive Ratios Without Documentation of Acceptable Compensating Factors To Justify Mortgage Approval

The auditee approved the mortgage with qualifying ratios (52.83 percent front and back) that exceeded HUD's benchmarks of 31percent and 43 percent, respectively, without documenting acceptable compensating factors to justify approval. Specifically, the mortgage credit analysis worksheet showed 52.83 percent as the mortgage payment-to-income (front) and 52.83 percent as the fixed payment-to-income (back) ratios, and the underwriter listed stable employment as a compensating factor. Chapter 2-13 of HUD Handbook 4155.1, REV-5, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed HUD benchmark guidelines; however, underwriters must note in the "remarks" section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation. Stable employment is a requirement and not a compensating factor to justify approving the mortgage with ratios above HUD's benchmarks. The auditee agreed that this loan contained significant underwriting deficiencies.

B. Improper Calculation of Income

The auditee improperly calculated borrower income because it did not verify that overtime income used to calculate income had been received for the past 2 years or was likely to continue as required. HUD Handbook 4155.1, REV-5, Chapter 2-7A, provides that overtime income may be used to qualify if the borrower has received such income for the past 2 years and it is likely to continue. In addition, the lender must develop an average of bonus or overtime income for the past 2 years, and the employment verification must not state that such income is unlikely to continue. The auditee calculated borrower monthly effective income of $4,891 by taking the year-to-date wages from the borrower's pay stub for period ending July 21, 2007, and averaging it with the borrower's 2006 IRS W-2 gross wages over 18.75 months. However, the pay stub showed year-to-date overtime income of $3,407, which the auditee included in effective income without verifying that the borrower had received it for the past 2 years or that it was likely to continue. Further, there was no written verification of employment; the lender only obtained borrower pay stubs covering 3 weeks and not the required 30 days; and while a telephone confirmation of borrower employment was made, overtime income was not verified. Since the auditee did not verify that the borrower had received overtime income for the past 2 years or that it was likely to continue, the overtime income should not have been included in the calculation of borrower income. Therefore, based upon copies of the borrower's 2005 and 2006 IRS tax return transcripts in the file and the borrower's most recent pay stub, the borrower's verified monthly effective income was $4,576, not the $4,891 used by the lender, which increased the ratios from 52.8 to 56.4 percent.

C. Inaccurate Evaluation of Borrower's Previous Mortgage Payment History

The auditee did not accurately evaluate the borrower's previous mortgage payment history because it did not ensure that the borrower made all mortgage payments due before the new FHA loan closing. Specifically, the borrower did not make the August 1 mortgage payment, and it was rolled into the new FHA mortgage. Chapter 1 of HUD Handbook 4155.1, REV-5, prohibits lenders from allowing borrowers to "skip" payments, and the borrower is either to make the payment when it is due or bring the monthly mortgage payment check to settlement because FHA does not permit the inclusion of any mortgage payments "skipped" by the homeowner in the new mortgage amount. For example, a borrower, whose mortgage payment is due June 1 and who expects to close the refinance before the end of June, is not permitted to roll the June mortgage payment into the new FHA loan amount. The August 20, 2007, mortgage payoff statement had a payoff amount of $290,997 with a projected payoff date of August 31, 2007, and the HUD-1 settlement statement showed the mortgage payoff amount as $293,343, representing a difference of $2,346. This difference represents the borrower's August 1 mortgage payment of $2,199 and per diem interest.

Case number:	374-4668220
Loan type:	Cash-out refinance
Mortgage amount:	$368,200
Closing date:	11/28/2007
Payments before first default reported:	Two
Default status as of 10/31/09:	Special forbearance
Unpaid principal balance:	$360,266

Details of Underwriting Deficiencies (Auditee has agreed to indemnification)

A. Excessive Ratios Without Documentation of Acceptable Compensating Factors To Justify Mortgage Approval

The auditee approved the mortgage with qualifying ratios (41.88 percent front and 53.55 percent back) that exceeded HUD's benchmarks of 31 and 43 percent as set forth in Mortgagee Letter 2005-16, without documenting acceptable compensating factors to justify mortgage approval. Chapter 2-13 of HUD Handbook 4155.1, REV-5, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed HUD benchmark guidelines; however, underwriters must note in the "remarks" section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation. The underwriter listed "9.125 to 6.875 and well under maximum financing" on the mortgage credit analysis worksheet. A decrease in the mortgage interest rate from 9.125 to 6.875 could be a compensating factor if the borrowers had successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12 to 24 months. However, the borrowers' previous mortgage payment history indicated a pattern of making late mortgage payments. Specifically, the borrowers' credit report disclosed six mortgage payments that were made 30 days past due and two payments that were 60 days past due within the prior 24 months, as well as a past-due amount of $2,676. The auditee agreed that HUD's benchmarks for front and back ratios were exceeded without valid compensating factors.

B. Improper Calculation of Income

The auditee improperly calculated the coborrower's income because it did not consider the year-to-date wages earned on the coborrower's most recent pay stub or address the decrease in the coborrower's income from 2005 to 2006. Chapter 2 of HUD Handbook 4155.1, REV-5, provides that the anticipated amount of income and the likelihood of its continuance must be established to determine a borrower's capacity to repay mortgage debt, and income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue. The lender calculated the coborrower's monthly effective income as $1,416 using the coborrower's weekly contract rate of $708 from the October 26, 2007, pay stub, multiplying it by 24 pay periods, and dividing by 12 months, although the year-to-date wages shown on this pay stub were only $7,283. Since the lender had copies of the coborrower's 2005 and 2006 IRS W-2 forms and the coborrower's most recent pay stub, a more appropriate calculation of coborrower income would have been to average the income over this period. An averaging of the coborrower's 2005 and 2006 income with the year-to-date wages from the October 26, 2007, pay stub results in coborrower monthly effective income of $946 instead of $1,416. This calculation of coborrower income results in revised qualifying ratios of 44.50 and 56.89 percent compared to the auditee's calculated ratios of 41.88 and 53.54 percent, which require the documentation of significant compensating factors that the lender did not provide (see section A above).

C. Inadequate Evaluation of Borrowers' Previous Mortgage Payment History

The auditee did not adequately evaluate the borrowers' previous mortgage payment history because it did not obtain a satisfactory explanation for late mortgage payments reported on the borrowers' credit report. Chapter 2-3A of HUD Handbook 4155.1, REV-5, provides that the borrowers' housing obligation payment history holds significant importance in evaluating credit and the lender must determine the borrowers' payment history through the credit report, verification of mortgage directly from the mortgage servicer, or canceled checks covering the most recent 12-month period. The borrowers' credit report showed three mortgage payments that were made 30 days past due and a past-due amount of $2,676 during the last 12 months. The borrower explained that two of the mortgage payments were late due to a dispute with a neighbor regarding the property line, for which the borrower incurred a survey cost and court fees. However, there was no documentation in the file to support that the borrower incurred these expenses. Additionally, the borrower and coborrower explained that the recent late payment was an oversight because they thought they would be closing on the new loan and held onto the payment.

Case number:	374-4623723
Loan type:	Cash-out refinance
Mortgage amount:	$329,875
Closing date:	12/27/2007
Payments before first default reported:	Four
Default status as of 10/31/09:	First legal action to commence foreclosure
Unpaid principal balance:	$ 323,240

Details of Underwriting Deficiencies (Auditee has agreed to indemnification)

A. Inaccurate Evaluation of Borrowers' Previous Mortgage Payment History

The auditee did not accurately evaluate the borrowers' previous mortgage payment history because it did not ensure that the borrowers made no late mortgage payments during the previous 12 months. Mortgagee Letter 2005-43, issued October 31, 2005, states that FHA will insure a cash-out refinance of up to 95 percent of the appraised value, as long as the borrower has made all of his/her mortgage payments within the month due for the previous 12 months, no payment was more than 30 days late, and the mortgage is current for the month due. Neighborhood Watch reported that the borrowers were delinquent on the October 1, 2007, mortgage payment for a prior FHA-insured mortgage. Therefore, the borrowers were not eligible for an FHA-insured cash-out refinance mortgage loan. The auditee agreed that the borrowers made the October 1, 2007, payment late and was not eligible for a cash-out refinance greater than 85 percent.

B. Excessive Ratios Without Documentation of Acceptable Compensating Factors To Justify Mortgage Approval

The auditee approved the mortgage with qualifying ratios (47.28 percent front and back) that exceeded HUD's benchmarks of 31 and 43 percent set forth in Mortgagee Letter 2005-16, without documenting acceptable compensating factors to justify approval. Chapter 2-13 of HUD Handbook 4155.1, REV-5, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed HUD benchmark guidelines; however, underwriters must note in the "remarks" section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation. The underwriter listed "excellent mortgage history, going from adjusted to fixed rate, stable employment, and overall monthly savings after paying off all debts is $900+." While excellent mortgage history is a valid compensating factor, it is not acceptable for this loan because the borrowers were delinquent on the October 1, 2007, mortgage payment for a prior FHA loan. Similarly, while a decrease in interest rate is a valid compensating factor, it is not acceptable in this loan because the borrowers did not successfully demonstrate the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12-24 months, and the monthly mortgage payment actually increased (from $2,504 to $2,611). Stable employment is a requirement and not a compensating factor, and overall monthly savings after paying off all debts of $900+ is not a compensating factor but is indicative of the borrowers' poor credit history. Specifically, the $900 savings is the result of paying tax liens and collections of $5,369 and debts of $7,642. HUD Handbook 4155.1, REV-5, Chapter 2-3, states that if the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan. However, the auditee did not document strong compensating factors. Specifically, while the borrowers' letter of explanation for collections and derogatory accounts noted that the borrower got sick in 2005 and had a number of medical bills, there was no documentation in the file showing that the bills were not covered by health insurance and/or that the amounts paid by the borrower related to medical costs. Therefore, the underwriter did not present and document compensating factors that were significant enough to justify exceeding HUD's benchmarks. Additionally, the quality control review performed on this loan determined that the reason for default appeared to have been poor credit history and disregard for credit obligations.

Case number:	374-4672543
Loan type:	No-cash-out refinance
Mortgage amount:	$346,500
Closing date:	2/29/2008
Payments before first default reported:	Four
Default status as of 10/31/09:	First legal action to commence foreclosure
Unpaid principal balance:	$339,553

Details of Underwriting Deficiencies (Auditee has agreed to indemnification)

A. Inadequate Evaluation of Borrowers' Previous Mortgage Payment History

The auditee did not adequately evaluate the borrowers' previous mortgage payment history because late mortgage payments shown on the borrowers' credit report were not satisfactorily explained and the underwriter did not consider these late payments in evaluating the borrowers' credit history. Chapter 2-3A of HUD Handbook 4155.1, REV-5, provides that the borrower's housing obligation payment history holds significant importance in evaluating credit and the lender must determine the borrower's payment history through the credit report, verification of mortgage directly from the mortgage servicer, or canceled checks covering the most recent 12-month period. The borrowers' credit report, dated January 15, 2008, reported that the borrowers had made two mortgage payments 30 days past due and one mortgage payment 60 days past due during the past 12 months. Additionally, the credit report showed a mortgage delinquent date of December 2007 and a past-due amount of $4,490. The borrowers' letter of explanation, dated January 15, 2008, explained that the late mortgage payments were due to their overextending their consumer credit but that they were now up to date. This is not an acceptable explanation because it does not demonstrate the borrowers' ability to manage debt.

B. Incorrect Calculation of Income

The auditee incorrectly calculated the borrower's monthly effective income because it calculated the monthly effective income as $5,572 using wages from the 2007 IRS W-2 form without considering the borrower's 2008 current year-to-date earnings or averaging overtime income over the past 2-year period. The borrower's current year-to-date earnings should have been averaged with the wages from the verification of employment to calculate the borrowers' base pay, and the borrower's overtime earnings from the verification of employment for the past 2 years should have been averaged to calculate the borrowers' other earnings. This calculation results in borrower effective income of $5,356 as opposed to the $5,572 calculated. Additionally, the lender included overtime income in its calculation of the coborrower's monthly effective income but did not verify that the coborrower's overtime had been received for the past 2 years and that it was likely to continue. The lender calculated the coborrower's monthly effective income as $3,251; however, the documented coborrower monthly effective income was $3,115. These revised calculations result in total monthly effective income of $8,471 and qualifying ratios of 31.49 percent and 45.54 percent instead of the lender's calculated income of $8,824 and ratios of 30.23 percent and 43.71 percent. However, this miscalculation did not cause the qualifying ratios to exceed HUD's benchmarks.

C. <u>Inadequate Evaluation of Borrowers' Credit History</u>

The auditee did not adequately evaluate the borrowers' credit history because collection accounts were not sufficiently explained. While the borrowers' credit report showed four collections accounts with monthly payments totaling $1,552 and a balance owed of $6,820, these amounts were omitted from the fixed payment-to-income ratio without an explanation for their exclusion by the auditee. The borrowers' letters of explanation acknowledged that these debts were owed and would have to be repaid. Including these debts in the fixed payment-to-income ratio increases the ratio from 43.71 to 63.85 percent. The borrowers' letters of explanation also stated that the borrowers fought with the creditors and refused to pay balances owed. Chapter 2-3 of HUD Handbook 4155.1, REV-5, provides that major indications of derogatory credit—including judgments, collections, and any other recent credit problems—require sufficient written explanation from the borrower and the borrower's explanation must make sense and be consistent with other credit information in the file. The borrowers' explanation demonstrated a disregard for financial obligations, and the lender should have considered this disregard in analyzing the borrowers' credit history. The borrowers' credit report showed recurring monthly debt payments totaling $1,189 with a total outstanding balance of $39,206, and none of this debt was being paid off from the refinanced mortgage. The refinance paid off the previous mortgage, homeowners insurance, and property taxes. Additionally, the quality control review of this loan determined that the reason for default appeared to have been prior credit history.

Case number:	374-4686723
Loan type:	Cash-out refinance
Mortgage amount:	$304,700
Closing date:	1/15/2008
Payments before first default reported:	Four
Default status as of 10/31/09:	First legal action to commence foreclosure
Unpaid principal balance:	$ 297,979

Details of Underwriting Deficiencies (Auditee has agreed to indemnification)

A. Inadequate Evaluation of Borrower's Previous Mortgage Payment History

The auditee did not adequately evaluate the borrower's previous mortgage payment history because late mortgage payments made by the borrower on a previous Section 203 (k) FHA loan were not satisfactorily explained and the underwriter did not consider these late payments in evaluating the borrower's credit history. Chapter 2-3A of HUD Handbook 4155.1, REV-5, provides that the borrower's housing obligation payment history holds significant importance in evaluating credit and the lender must determine the borrower's payment history through the credit report, verification of mortgage directly from the mortgage servicer, or canceled checks covering the most recent 12-month period. The borrower's credit report showed late payments made on a prior FHA loan during the past 12 months; however, the credit report did not clearly show in which months during the past 12 months the borrower made late mortgage payments. The lender's file contained a borrower letter of explanation for a late mortgage payment made in April 2006; however, there was no letter of explanation for the various late mortgage payments made in 2007 on the prior FHA loan. The credit report ordered through quality control showed that the borrower paid January, February, and March 2007 mortgage payments 60 days past due and the April 2007 mortgage payment 30 days past due. There was no documentation in the file to indicate that the underwriter considered these late payments or obtained an explanation from the borrower in evaluating the borrower's credit history.

B. Inadequate Evaluation of Borrower's Credit History

The lender did not adequately evaluate the borrower's credit history because collections, judgments, and derogatory accounts were not sufficiently explained. The borrower's credit report showed various collections, judgments, and derogatory accounts indicating a disregard for credit obligations. The borrower's explanation for the collections and judgments was that they were from her ex-boyfriend and that while the accounts were mostly in her name, her ex-boyfriend was responsible for payment and she did not find out they were delinquent until Somerset checked her credit. Chapter 2-3 of HUD Handbook 4155.1, REV-5, states that while minor derogatory information occurring 2 or more years in the past does not require explanation, major indications of derogatory credit—including judgments, collections, and any other recent credit problems—require sufficient written explanation from the borrower and the explanation must make sense and be consistent with other credit information in the file. The borrower's explanation did not make sense because the borrower refinanced a prior 203(K) FHA loan through Somerset with an interest-only conventional mortgage for $250,000, which closed on April 30, 2007, and these collection accounts were listed to be paid off on that HUD-1 settlement statement. Therefore, the borrower's credit history demonstrates an inability to manage debt and a disregard for financial obligations, which present a material risk to FHA and warrant indemnification.

Case number:	374-4727545
Loan type:	No-cash-out refinance
Mortgage amount:	$385,700
Closing date:	3/31/2008
Payments before first default reported:	Six
Default status as of 10/31/09:	Reinstated after loss mitigation intervention
Unpaid principal balance:	$378,694

Details for Underwriting Deficiencies (Auditee has agreed to indemnification)

A. Excessive Ratios Without Documentation of Acceptable Compensating Factors To Justify Mortgage Approval

The lender approved the mortgage with qualifying ratios (57.85 percent front and 58.19 percent back) that significantly exceeded HUD's benchmarks of 31 percent and 43 percent as set forth in Mortgagee Letter 2005-16, without documenting acceptable compensating factors to justify approval. Chapter 2-13 of HUD Handbook 4155.1, REV-5, states that compensating factors may be used to justify approval of mortgage loans with ratios exceeding HUD benchmark guidelines; however, underwriters must record the compensating factors used to support loan approval in the "remarks" section of the mortgage credit analysis worksheet and any compensating factor used to justify mortgage approval must be supported by documentation. The mortgage credit analysis worksheet noted "Good Job Stability," "Good Mortgage History," and "Good Savings Pattern" as compensating factors. Good job stability is a requirement and not a compensating factor. While good mortgage history is a valid compensating factor, it is not applicable for this loan because the borrower's November 2007 mortgage payment was 30 days past due and the March 2008 payment was late with a charge of $54.43 added to the mortgage payoff amount. While good savings pattern is a valid compensating factor, it is not acceptable for this loan because the verification of deposit, dated March 26, 2008, noted a savings balance of $1 with an average balance for the previous 2 months of $2.41 and a checking balance of $4,322 with an average balance for the previous 2 months of $2,667. The lender obtained a copy of the borrower's 401(k) plan statement, which reported a balance as of December 31, 2007, of $3,391. Thus, the lender did not document a good savings pattern. Therefore, the underwriter did not present and document compensating factors that were significant enough to justify exceeding HUD's benchmarks. The auditee agreed that HUD's ratios were exceeded without valid compensating factors.

B. Inaccurate Evaluation of Borrower's Previous Mortgage Payment History

The lender did not accurately evaluate the borrower's previous mortgage payment history because the lender did not ensure that the borrower was current for the month due and made all mortgage payments due before the new FHA loan closing. Chapter 2-3A of HUD Handbook

4155.1, REV-5, provides that the borrower's housing obligation payment history holds significant importance in evaluating credit and the lender must determine the borrower's payment history through the credit report, verification of mortgage directly from the mortgage servicer, or canceled checks covering the most recent 12-month period. The borrower was not current on the mortgage being refinanced. Specifically, the borrower did not make the March 1, 2008, payment, and a late charge of $54.43 was added to the mortgage payoff amount. Mortgagee Letter 05-43, dated October 31, 2005, states that for "No Cash Out" (rate and term) refinances and streamline refinances, the mortgage being refinanced must be current for the month due. The borrower made his November 2007 mortgage payment 30 days past due and explained that the mortgage company that was refinancing his loan told him not to make the payment because a closing was set for the new loan. However, the closing did not take place on time, and when the borrower made the payment, it was 30 days past due.

C. Incorrectly Calculated Fixed Payment-to-Income Ratio (Back Ratio)

The lender did not include a monthly installment debt of $364 for an auto lease. There was a letter in the file from the loan officer stating that the auto lease was paid by the borrower's former fiancée, the lease ended in November, and the auto lease was for a car for which the borrower consigned. The loan file contained copies of bank statements from the former fiancée showing on-time payments. However, the credit report listed this account as a joint account and not a cosigned account; therefore, it should have been included in the borrower's monthly installment debt. With this debt, the total monthly installment debt increases from $20 to $384, the fixed payment increases from $3,402.36 to $3,766.36, and the borrower's fixed payment-to-income ratio increases from 58.19 percent to 64.42 percent, warranting significant compensating factors to justify mortgage approval, which were not presented or documented (see section A above).