Sun West Mortgage Company, Cerritos, CA

Federal Housing Administration Single-Family Housing Mortgage Insurance Program

Office of Audit, Region 9	**Audit Report Number: 2016-LA-1010**
Los Angeles, CA	**August 29, 2016**

To: Robert Mulderig
Acting Deputy Assistant Secretary for Single Family Housing, HU

//SIGNED//

From: Tanya E. Schulze, Regional Inspector General for Audit, 9DGA

Subject: Sun West Mortgage Company, Cerritos, CA, Did Not Always Meet HUD-FHA Loan Underwriting and Quality Control Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of Sun West Mortgage Company's underwriting of Federal Housing Administration (FHA)-insured loans.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at 213-534-2471.

Audit Report Number: 2016-LA-1010
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Sun West Mortgage Company, Cerritos, CA, Did Not Always Meet HUD-FHA Loan Underwriting and Quality Control Requirements

Highlights

What We Audited and Why

We reviewed Sun West Mortgage Company's loan underwriting activities, including quality controls, based on a citizen complaint alleging that the mortgage company was deficient in underwriting its loans. The complaint further alleged that the mortgage company used unauthorized staff in another country and shared user identification numbers to "pre-underwrite" Federal Housing Administration (FHA)-insured loans. Our objective was to determine whether Sun West followed U.S. Department of Housing and Urban Development (HUD) requirements related to underwriting, responsibilities for its employees, and control over and access to Computerized Homes Underwriting Reporting System identification numbers.

What We Found

Sun West did not always meet HUD underwriting requirements when underwriting its FHA-insured loans. Of 16 loans reviewed, 2 had significant deficiencies. HUD paid a claim of $144,891 for one loan, and the borrower for the second loan was in bankruptcy. Therefore, the HUD-FHA insurance fund was at an increased risk of an additional loss of $97,937. Sun West also did not always obtain all documentation required for review of loans that defaulted early, and did not follow up on unanswered reverifications for its routine quality control reviews. In addition, it did not include all items required by HUD in its branch office reviews.

We could not substantiate the complaint allegation that Sun West used unauthorized employees in another county to underwrite its FHA-insured loans. Although Sun West used an affiliated company in another country for services, the services provided were for quality control, not mortgage underwriting. The lender also maintained reasonable policies and procedures for its employees' user identification numbers and passwords.

What We Recommend

We recommend that HUD require Sun West to reimburse the FHA insurance fund for the $144,891, the claim amount paid by HUD for one loan. The lender should also indemnify HUD against potential losses of $97,937 for one FHA-insured loan that did not comply with underwriting requirements. In addition, the lender should improve its policies and procedures to ensure that responsible employees are aware of HUD-FHA underwriting requirements and policies related to HUD's quality control program requirements.

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Background and Objective

The Federal Housing Administration (FHA) was created by Congress in 1934 and provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. FHA is the largest insurer of mortgages in the world, having insured more than 44 million properties since its inception. FHA's Mutual Mortgage Insurance Fund provides lenders with protection against losses as a result of homeowners defaulting on their mortgage loans. Lenders bear less risk because FHA will pay a claim to the lender in the event of a homeowner's default. Loans must meet certain requirements established by FHA to qualify for insurance. FHA generally operates from self-generated income.

In December 2000, the U.S. Department of Housing and Urban Development (HUD) implemented the FHA TOTAL (Technology Open to All Lenders) Scorecard to automate the underwriting of its loans. The Scorecard assesses the credit worthiness of FHA borrowers by evaluating certain mortgage application and borrower credit information that has been statistically proven to accurately predict the likelihood of borrower default. TOTAL Scorecard relies heavily on borrower credit information. Therefore, these loans are not required to comply with traditional HUD underwriting requirements, including documented explanations for collection accounts and payment-to-income ratios that exceed HUD requirements. Loans approved using the Scorecard also do not require compensating factors when borrowers' ratios exceed HUD's benchmark guidelines of 31 percent and 43 percent of gross effective income.[1] HUD now requires all transactions to be scored using the Scorecard except for transactions involving borrowers without credit scores and loans that are streamline refinances. However, if a loan receives a "refer" decision through the TOTAL Scorecard, the lender must manually underwrite the loan using standard HUD underwriting requirements.

According to HUD's Neighborhood Watch Early Warning System,[2] Sun West Mortgage Company was approved to underwrite mortgages on October 30, 1980. The lender has 27 active and 79 terminated branches. It serves consumers nationwide, including locations in Arizona, California, Hawaii, and Nevada. Sun West's main office is located at 18000 Studebaker Road, Cerritos, CA.

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[1] HUD considers the relationship between the borrower's mortgage payment and income to be acceptable when the total mortgage payment does not exceed 31 percent of gross effective income. HUD considers the relationship between the borrower's total obligations to income to be acceptable when the total mortgage payment and all recurring obligations do not exceed 43 percent of the borrower's gross effective income.

[2] Neighborhood Watch is intended to aid HUD/FHA staff in monitoring lenders and HUD/FHA programs, and to aid lenders and the public in self-policing the industry. The system is designed to highlight exceptions, so that potential problems are readily identifiable. In addition, the system can be used to identify loan programs, geographic areas and lenders that are performing well.

On November 17, 2015, HUD's Office of Inspector General (OIG) received a complaint alleging that Sun West deficiently underwrote its loans and allowed a company based in another country to underwrite its FHA-insured mortgages. In addition, the complaint alleged that employees at Sun West shared Computerized Homes Underwriting Reporting System (CHUMS) user identification numbers with employees in another country to facilitate this practice.

Our objective was to determine whether Sun West followed HUD requirements related to underwriting, responsibilities for its employees, and control over and access to CHUMS identification numbers.

Results of Audit

Finding 1: Sun West Mortgage Company Did Not Always Meet HUD-FHA Underwriting Requirements

Sun West underwrote FHA-insured loans that did not always comply with HUD-FHA requirements. We identified two loans that contained significant underwriting deficiencies, including excessive qualifying ratios and insufficient compensating factors. The deficiencies occurred because the lender had inadequate controls in place to prevent it from disregarding HUD-FHA underwriting requirements for its manually underwritten loans. As a result, the HUD-FHA insurance fund was placed at an increased risk. HUD paid a claim of $144,891 for one loan, and the borrower for the second loan was in bankruptcy. Therefore, the HUD-FHA insurance fund was at risk for loss of an additional $97,937.[3]

Loans Contained Significant Underwriting Deficiencies

Of the 16 Sun West loans reviewed, 2 were inappropriately underwritten with deficiencies such as excessive qualifying ratios and insufficient compensating factors. The two loans were manually underwritten and did not have sufficient compensating factors to justify loan approval. The lender attempted to process the loans through the TOTAL Scorecard; however, the system returned a “refer” decision, and the lender had to manually underwrite the loans.

The two loans had borrowers with payment-to-income ratios that significantly exceeded HUD’s 31 percent and 43 percent of gross effective income benchmarks. The lender calculated borrower ratios of 47/52 for the first loan and 38/56 for the second loan. HUD Handbook 4155.1 requires lenders to provide significant compensating factors to approve loans that exceed HUD-FHA’s limits. Acceptable compensating factors include the borrower’s ability to make housing payments, a large downpayment, and minimal increases in the borrower’s housing expense (appendix C).

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[3] HUD calculates that the FHA loses an average of 50 percent of the unpaid principal balance when it sells a foreclosed-upon property. The loss rate is based on HUD’s Single Family Acquired Asset Management System’s “case management profit and loss by acquisition” computation for 2016.

The lender cited a lack of increase in the borrower's housing payments as a compensating factor for the first loan and also documented that the borrower had reestablished good credit and had a FICO score above 620. The first compensating factor was supported and complied with the requirements of the handbook. The borrower also reestablished credit after his bankruptcy (second compensating factor); however, at the time of the loan, one account was in collection and in dispute by the borrower. The third factor listed, FICO score above 620, did not comply with the requirements of the handbook. Although the borrower's housing payment did not increase, the mortgage payment represented almost 50 percent of the income that the lender calculated. In response to our report, the lender recalculated a higher monthly income by not deducting meals and entertainment expenses it had previously deducted from the borrower's income. The recalculation lowered the borrower's mortage payment-to-income ratio to 41 percent. However, the revised ratio still far exceeded the HUD benchmark of 31 percent (appendix E).

On the second loan, the lender recorded one compensating factor, stating that the borrower had a FICO score above 620. This factor was not one of the HUD-approved compensating factors listed in the handbook and, therefore, was invalid.

Additional details of our analysis for each loan is documented in appendix E of the report.

The Lender Provided Written Explanations for Deficiencies

After we notified the lender of deficiencies identified during audit fieldwork, the lender provided new analysis of the documentation that was used to underwrite the two loans. However, our objective was to determine whether the lender's original underwriting decision complied with HUD-FHA requirements. We evaluated the new information, but did not consider it to be sufficient justification to drop the related deficiencies. In response to our report, the lender provided documentation that assisted in clarifying its underwriting decision. We reviewed the information and made adjustments to our report where necessary.

Conclusion

Sun West underwrote two loans with significant deficiencies that in one case caused HUD to pay a claim of $144,891 (appendix D). The borrower for the remaining loan was in bankruptcy. The deficiencies occurred because the lender had inadequate controls in place to prevent it from disregarding standard HUD-FHA underwriting requirements for its manually underwritten loans. In addition, Sun West did not fully implement a quality control program in accordance with HUD requirements (finding 2), which contributed to its deficient underwriting of the loans. Therefore, the FHA insurance fund was placed at an additional risk for the HUD-FHA estimated loss of $97,937 (appendix D).

Recommendations

We recommend that the Acting Deputy Secretary for Single Family Housing require Sun West to

1A. Reimburse the FHA insurance fund for $144,891 in claims paid for one loan (045-8098001) that did not meet HUD underwriting requirements.

1B. Indemnify HUD against potential losses of $97,937 for one loan that did not comply with HUD underwriting requirements (048-7976048).

1C. Improve controls to prevent it from disregarding HUD underwriting requirements, particularly those related to manually underwritten loans.

Finding 2: Sun West Mortgage Company Did Not Always Comply With HUD-FHA Quality Control Requirements

Sun West did not always follow HUD quality control requirements when reviewing FHA-insured loan files. Specifically, it did not always reverify borrowers' employment, asset, and appraisal documentation for early payment defaults.[4] In addition, it did not follow up on unanswered reverifications for its routine quality control reviews and did not include all items required by HUD in its branch office reviews. This condition occurred because the lender disregarded the quality control requirements listed in its quality control plan and in HUD Handbook 4060.1. As a result, the FHA insurance fund was placed at risk for fraud, waste, and abuse. The quality control deficiencies also contributed to Sun West's underwriting issues as discussed in finding 1.

Early Payment Default Reviews Did Not Include All Required Items

Mortgagee Letter 2011-02, Quality Control Requirements for Direct Endorsement Lenders, requires lenders to perform written reverifications of early payment defaults within 45 days from the end of the month in which the loan is reported as 60 days past due. Examples of items that the lender must reverify include the borrower's employment or other income, earnest money deposits, escrow deposits, and gift funds. Sun West did not include the required items in its reviews of loans that were 60 days past due within the first six payments as follows:

- One of five loans was not reviewed within the required timeframe,
- Four of five loans reviewed did not include reverification of the borrowers' or coborrowers' employment,
- Five files reviewed did not include reverification of the borrowers' gift funds, earnest money deposits, and escrow deposits, and
- Five files reviewed did not include a desk review of the borrowers' appraisal.

Quality Control Reviews Did Not Include Followup Attempts

Sun West sent reverification requests for its routine quality control reviews to the appropriate parties. However, several loan files reviewed contained no documented followup attempt by the lender to obtain reverification. The handbook states that if a written reverification is not returned to the lender, a documented attempt must be made to conduct a telephone verification. The following items were not reverified:

- One of three files reviewed did not include a followup attempt to reverify borrower or coborrower employment,

[4] In addition to the loans selected for routine quality control reviews, HUD requires mortgagees to review all loans going into default within the first six loan payments. HUD defines early payment defaults as loans that become 60 days past due within the first six payments.

- One of three loan files did not contain a desk review of the borrower's appraisal, and
- Three files reviewed did not include a followup attempt to reverify borrower or coborrower gifts and earnest money deposits.

The table below provides additional details.

FHA case no.	Loan not reviewed within timeframe	No reverification of employment	No followup attempt to reverify employment	No reverification of assets (gifts & deposits)	No followup attempt to reverify assets (gifts & deposits)	No desk review of appraisal
Early payment defaults						
022-2372978	X	X		X		X
048-7695674		X		X		X
022-2467883		X		X		X
048-7946452		X		X		X
332-6067165				X		X
Quality control reviews						
022-2488752			X		X	
043-9328531					X	X
044-5265825					X	

The Lender Provided Additional Documentation for Quality Control Deficiencies

The lender provided additional documentation showing that it completed the missing reverifications identified during our fieldwork. However, the documentation in question was dated after our request for explanations of the missing items and did not support it had previously been done. Therefore, we did not adjust our original assessment of the lender's review of early payment defaults and routine quality control reviews.

Branch Office Reviews Did Not Include All Required Items

We reviewed branch office reports covering 2012 through 2015 for Sun West branch offices located in Arizona, California, Hawaii, and Nevada and determined that Sun West's branch office reviews were missing several required items that should have been included in its branch office review checklists:

- For 2012, Sun West did not include 5 of the required items for each of the four branch offices reviewed.
- For 2013, Sun West did not include 5 of the required items for each of the 6 branch offices reviewed.

- For 2014, Sun West did not include 5 of the required items for each of the 10 branch offices reviewed.

- For 2015, Sun West did not include six items required by HUD for three branch offices. Specifically, the branch office review reports concluded that all required items were reviewed. However, the items were missing from the review checklists, which identify the items and date reviewed.

Examples of items that were missing and that the lender must include were (1) a check to ensure that procedures are revised to reflect changes in HUD requirements and that personnel are informed of the changes, (2) a check to ensure that personnel at the branch offices are all employees of the lender or contract employees performing functions that HUD allows to be outsourced, and (3) verification that branch offices provide toll-free lines or provide for acceptance of collect calls from borrowers. These items must be reviewed to determine whether the branches, which operate under the lender's authority, comply with HUD's underwriting requirements

Conclusion

Sun West did not always follow HUD quality control requirements when reviewing FHA-insured loan files because the lender had inadequate controls to ensure that it complied with the HUD quality control requirements listed in its quality control plan and in HUD Handbook 4060.1. As a result, the FHA insurance fund was placed at an increased risk of loss and risk of fraud, waste, and abuse. The deficiencies also contributed to issues with Sun West's underwriting of loans as discussed in finding 1. Reverification of borrower documentation is an important step in ensuring that the loan underwriting decision was sound. Also, lenders must ensure that branch reviews cover all elements required by HUD to ensure consistency among offices and overall compliance with basic quality control requirements.

Recommendations

We recommend that the Acting Deputy Secretary for Single Family Housing require Sun West to

2A. Improve its quality controls to ensure that loans selected for review, to include early payment defaults, comply with HUD quality control document reverification requirements.

2B. Improve its quality controls to ensure that branch office reviews meet all HUD-FHA requirements.

2C. Provide additional training to ensure that responsible staff is aware of HUD's quality control program requirements.

Scope and Methodology

We performed our onsite audit fieldwork from November 2015 through May 2016 at Sun West's main office in Cerritos, CA. Our audit period covered loans endorsed from October 2012 through October 2015.

To accomplish our objective, we

- Reviewed HUD regulations, handbooks, and guidebooks related to single-family requirements;
- Reviewed the documentation in FHA case files and the lender's origination files for 16 loans;
- Reviewed the citizen complaint and interviewed the complainant to gain an understanding of the allegations made against Sun West;
- Reviewed Sun West's contract and invoices with its quality control contractor;
- Reviewed quality control plans and the lender's reports documenting its review of early payment defaults, quality control samples, and branch office reviews;
- Reviewed Sun West's policies and procedures related to use and safeguards for its employees' user IDs and passwords;
- Reviewed loan data in Neighborhood Watch;
- Interviewed Sun West management and staff; and
- Interviewed the responsible HUD quality assurance program representative.

We selected our loans from an audit universe of 6,757 loans that were originated and underwritten in Arizona, California, Hawaii, and Nevada. We determined that 72 of the loans were either seriously delinquent or had a claim paid. We excluded 41 of the 72 loans for potential review because they were refinanced and had different underwriting requirements than loans for purchases of property. We evaluated the remaining 31 loans based on the following risk factors:

- Fraud (as reported in HUD's Neighborhood Watch Early Warning System),
- Deficient underwriting (as reported in HUD's Neighborhood Watch Early Warning System),
- Loan defaulted in fewer than 6 payments,
- Loan defaulted in more than 6 but fewer than 12 payments,
- Loan was consistently delinquent,
- Borrower had excessive obligations, and

- Borrower had excessive payment-to-income ratios.

Based on our analysis, we identified 16 loans that contained the highest number of the above risk factors and selected those loans for review. Our audit results were limited to the loans in our sample and cannot be projected to the universe.

- To perform our review of the lender's quality controls, we requested and reviewed the quality control plans, quality control sample reviews, and branch office reviews covering our audit period. We obtained and reviewed the lender's quality control logs from October 2012 to October 2015. We selected and reviewed 3 loans from the logs that were part of our audit sample. We also reviewed Neighborhood Watch to obtain a sample of 6 early payment default loans to test the lender's compliance with HUD's quality control requirements. Although we selected 6 loans for review, one loan had been included in the lender's routine quality control sampling, and no early payment default review was conducted for the loan. Therefore, we only tested 5 early payment default reviews for compliance.

<u>Complaint Issue - Loans Underwritten by Unauthorized Parties</u>
We attempted to address the complaint issue concerning unauthorized parties from another country underwriting FHA-insured loans. We could not substantiate the complaint allegation.

- We reviewed sample loan file records (as noted above).
- We reviewed Sun West's applicable policies and procedures.
- We spoke to Sun West's underwriters handling FHA-insured loans.
- We looked into Sun West's use of an affiliate organization based in another country and reviewed the applicable contract and invoices. We determined that the activity was for quality control functions rather than underwriting.

We also interviewed the lender's employees and reviewed its policy manuals and concluded that the lender had reasonable policies and procedures related to its employees' use and safeguarding of user identification numbers and passwords.

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

Internal Controls

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

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

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

Relevant Internal Controls

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

- Controls intended to ensure that the lender underwrites (approves) FHA-insured loans in accordance with HUD's requirements (finding 1).
- Controls intended to ensure that the lender implements a quality control program that complies with HUD's requirements (finding 2).

We assessed the relevant controls identified above.

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

Significant Deficiencies

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

- Sun West did not have adequate controls to ensure that two loans were underwritten in accordance with HUD-FHA requirements (finding 1).
- Sun West did not have adequate controls to ensure that its quality control program complied with HUD quality control requirements (finding 2).

Appendixes

Appendix A

Schedule of Questioned Costs and Funds To Be Put to Better Use

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A	$144,891	
1B		$97,937
Totals	**$144,891**	**$97,937**

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations. The ineligible amount is the claim paid by HUD in association with FHA case no. 045-8098001.

2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified (FHA case nos. 048-7976048).

If HUD implements our recommendation to indemnify the loan not approved in accordance with HUD-FHA requirements, it will reduce FHA's risk of loss to the insurance fund. The amount noted reflects HUD's calculation that FHA loses an average of 50 percent of the unpaid principal balance when it sells a foreclosed-upon property (appendix D). The 50 percent loss rate is based on HUD's Single Family Acquired Asset Management System's "case management profit and loss by acquisition" computation for the first quarter of fiscal year 2015 based on actual sales. Since 2015, the rate has been reviewed quarterly but has remained relatively constant.

Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation	Auditee Comments

SunWest Mortgage Company, Inc.

NMLS ID 3277

www.swmc.com

EQUAL HOUSING OPPORTUNITY

August 1, 2016

VIA Email

Attn.: Tanya Schulze
E-mail: Tschulze@hudoig.gov
U.S. Department of Housing and Urban Development
Office of Inspector General (OIG)
300 North Los Angeles Street
Suite 4070
Los Angeles CA 90012

Cc: Vincent Mussetter

Re: Response to the DRAFT Results of Audit

Dear Ms. Schulze:

SWMC would like to thank you for the opportunity to address your draft audit findings. Please accept this correspondence from Sun West Mortgage Company, Inc. ("SWMC") in response to the findings noted in the DRAFT Result of Audit work conducted by the OIG.

If you need any additional information or documentation, please feel free to contact me.

Thank you
Sincerely,

Jennifer Vallinayagam
Chief Operating Officer
Phone: (562) 644-7707
E-mail: jennifer@swmc.com

Enclosures: As referenced above

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Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation **Auditee Comments**

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Finding 1

Finding 1: Sun West Mortgage Did Not Always Underwrite Loans in Accordance With HUD Requirements.

SWMC's Response: Below, please see SWMC's explanation for each of the issues noted for the three loans (FHA Case Nos. 048-7976048, 045-8098001 and 022-2481436) mentioned in Finding **1**.

FHA Case Number: 045-8098001
SWMC Loan Number: 113275018000
Borrower: [redacted]

Compensating factors have been documented in accordance with guidelines outlined by HUD 4155.1.

Comment 1

The FHA case number for the subject loan was generated on or about 12/20/2013. The guidelines outlined by HUD Mortgagee Letter 2014-02 (effective for case numbers assigned on or after 04/21/2014) were **not** applicable to the subject loan. The guidelines outlined by HUD Handbook 4155.1 were applicable to the subject loan. The guidelines outlined by HUD 4155.1 4.F.2.b and 4.F.2.c state that – *excessive ratios are acceptable if significant compensating factors are documented*. Please see the table below, which shows comparison of compensating factors as defined by HUD Handbook 4155.1 4.F.3.b and compensating factors documented for the subject loan. Please see **EXHIBIT 1** enclosed herewith, which provides detailed explanation and calculation for the below-mentioned compensating factors.

Compensating factors are defined by HUD Handbook 4155.14.F.3.b and include the following.	**The subject loan has four (4) compensating factors documented in accordance with the guidelines outlined by HUD 4155.1 4.F.3.b.**
Housing Expense Payments: The borrower has successfully demonstrated the ability to pay housing expenses greater than or equal to the proposed monthly housing expenses for the new mortgage over the past 12-24 months.	Satisfactory housing expenses payment history for over three years (36 months) – The borrower has made regular and timely housing expense payment in the amount of $1,100.00, which is greater than the proposed housing expense of $888.42 since March 2008. Please see Note 1 below.
Previous Credit History: A borrower's previous credit history shows that he/she has the ability to devote a greater portion of income to housing expenses.	Re-established credit after the discharge of Chapter 7 Bankruptcy reflects the borrower's willingness and ability to make the payments towards his obligations. Please see Table 1 below.
Compensation or Income Not Reflected in Effective Income: The borrower receives	Verified and documented surplus income of $284.12 that is not used as part of effective

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* Names redacted for privacy reasons

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Auditee Comments

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documented compensation or income that is not reflected in effective income, but directly affects his/her ability to pay the mortgage.	income.
Minimal Housing Expense Increase: There is only a minimal increase in the borrower's housing expense.	Minimal increase in the borrower's housing expense is a compensating factor. In case of the subject loan, the housing expenses payment is declining from $1,100.00 to $888.42 per month. There is a reduction of 19.23% [calculated as [($1,100.00 - $888.42)/$1,100.00)], which in itself a huge compensating factor.
Down Payment: The borrower makes a large down payment of 10% or higher toward the purchase of the property.	
Accumulated Savings: The borrower has demonstrated • an ability to accumulate savings, and • a conservative attitude toward using credit.	
Substantial Cash Reserves: The borrower has substantial documented cash reserves (at least three months worth) after closing.	
Substantial Non-Taxable Income: The borrower has substantial non-taxable income.	
Potential for Increased Earnings: The borrower has a potential for increased earnings, as indicated by job training or education in his/her profession.	
Primary Wage-Earner Relocation: The home is being purchased because the primary wage-earner is relocating, and the secondary wage-earner – • has an established employment history • is expected to return to work, and • has reasonable prospects for securing employment in a similar occupation in the new area.	

Comment 1

Note 1: In the "Results of Audit", it has been mentioned that – *the borrower's mortgage payment represented almost 50 percent of the income that the lender calculated. Therefore, the compensating factor that the borrower's housing payment did not increase was not strong enough to support loan approval.* SWMC would request OIG to note that the borrower has been making regular and timely rental payments since March 2008 i.e. for approximately sixty-eight (68) months. The borrower's business is booming with year-over-year increase in gross earnings from $163,597.00 in year 2011 to $282,068.00 in year 2012, which is an increase of 72.41% [calculated as {($282,068.00 - $163,597.00) /

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Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

$163,597.00)]. The net income from the business had increased from $17,060.00 in year 2011 to $34,726.00 in year 2012. It must also be noted that the borrower made regular and timely payments towards his housing expenses even with the lower income in year 2011. SWMC would like to highlight the fact that irrespective of the percentage of income which borrower spent towards managing housing payments in the year 2012, the year 2011 and even in prior years, the borrower made regular and timely payments without any late payments. Based on borrower's excellent record of making housing payments in the past for approximately sixty-eight (68) months, SWMC documented borrower's ability and willingness to manage housing payments at the time of underwriting the subject loan. SWMC thus believes that this reduction of 19.23% in housing payment is a very strong and significant compensating factor supporting loan approval.

Comment 1

Table 1: Re-established credit after the discharge of Chapter 7 Bankruptcy

Please see the table below, which shows a summary of the accounts opened by the borrower after the discharge of the Chapter 7 Bankruptcy on or about 02/23/2009.

#	Creditor	Account #	Number of payments made	Comments
1	FIRST DATA	520860259000	13	Lease / rental agreement account maintained without any late payments.
2	CRD PRT ASSO	1605055116	Not applicable	Isolated incident of an account in dispute.
3	FST PREMIER	5178006386227583	20	Credit card account maintained without any late payments.
4	CAP ONE	5178058039297000	19	Credit card account maintained without any late payments.
5	FST PREMIER	5178006397390156	2	Credit card account maintained without any late payments.
6	GECRB/CARECR	6019183226443893	17	Charge account maintained without any late payments.
7	WEBBNK/FHUT	6276455001055789	11	Charge account maintained without any late payments.

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Auditee Comments and OIG's Evaluation

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The guidelines outlined by HUD Handbook 4155.1 4. C.2.g Chapter 7 Bankruptcy state that – *A Chapter 7 bankruptcy (liquidation) does not disqualify a borrower from obtaining an FHA-insured mortgage if at least two years have elapsed since the date of the discharge of the bankruptcy. During this time, the borrower must have*

- *re-established good credit, or*
- *chosen not to incur new credit obligations.*

In compliance with the guidelines referenced above, the borrower, with the exception of one isolated incident, has made regular payments on all accounts opened after bankruptcy, and also chosen not to incur excessive debt. The borrower's monthly payment towards all other debts is only $87.00. This indicates that the borrower is a conservative user of credit. The borrower also has a documented history of managing his expenses. Based on the borrower's conservative use of credit and making regular monthly payments on the open accounts, it can be verified that the borrower's credit profile is a strong compensating factor supporting loan approval.

Comment 1

In the "Results of Audit", it has been mentioned that "*However, the lender determined that the borrower had surplus income by using a different tax schedule than was used in the original underwriting of the loan.*" SWMC would like to bring to OIG's attention that this is not the case. Surplus Income has not been calculated on the basis of different tax schedule. Please see the table below, which shows the calculation of the qualifying income at Underwriting.

Particulars	**2012**	**2011**
Net Profit	$34,726.00	$17,060.00
Less: Meals / entertainment	$3,939.00	$2,880.00
Adjusted Profit	$30,787.00	$14,180.00
Qualifying Income = ($30,787.00 + $14,180.00) / 24		**$1,873.63**

SWMC has an internal policy to deduct unallowable meals / entertainment expenses to ensure that its income calculation method is consistent for all loan programs based on the Fannie Mae Cash Flow Analysis (Form 1084). As per Internal Revenue Service (IRS), only fifty (50) percent of meals / entertainment expenses are deductible for tax purposes. Also, the meals / entertainment are not mandatory/required expenses for the business especially considering the type of business in which the borrower is engaged.

It must be noted that HUD guidelines do not require a lender to reduce meals / entertainment expenses while calculating the Schedule C Income. SWMC understood that qualifying ratios were artificially higher because of accounting for the expense which is not required or not warranted as per guideline and does not reflect a true qualifying ratio and has little effect on borrower's ability to repay. As such, at the time

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of approving the loan, the qualifying income was considered as $1,873.63. When OIG made a note that the subject loan did not have compensating factors, SWMC presented the income calculation without deducting meals / entertainment expenses from the Schedule C Income.

Particulars	2012	2011
Net Profit	$34,726.00	$17,060.00
Qualifying Income = $34,726.00 + $17,060.00 / 24	**$2,157.75**	

HUD Handbook 4155.1 4.D.4.e, states – *When qualifying a self employed borrower for a mortgage loan, the lender must establish the borrower's earnings trend from the previous two years using the borrower's tax returns.* HUD guidelines do not require a lender to reduce additional meals / entertainment expenses which is non-deductible as per IRS while calculating the Schedule C Income. Had SWMC used the income of $2,157.75 at the time of approving the loan then the ratios would have been at 41% and 45%. Please see the table below.

Income	$2,157.75
Total Mortgage Payment	$888.42
Total Fixed Payment	$975.42
Mortgage Payment to Income	41.17%
Total Fixed Payment to Income	45.20%

Comment 1

SWMC understands that 'FICO score above 620' is not an approved compensating factor as per HUD Handbook 4155.1. SWMC's Underwriter noted 'FICO score above 620' as a compensating factor on the FHA Loan Underwriting and Transmittal Summary (form HUD-92900-LT) for internal reference purposes only. At the time of underwriting the subject loan, as per SWMC's internal overlays, SWMC had a debt to income ratio restriction for loan files with FICO scores less than 620 and accordingly the SWMC Underwriter made a note of the FICO score above 620 for internal reference purposes.

In summary, SWMC would request OIG to consider the following facts for the subject loan:

- Reduction in borrower's housing payment by 19.23%
- Verified and documented surplus income of $284.12
- Borrower's re-established credit and conservative use of credit
- Year-over-year increase in business earnings
- Documented history of making a higher amount of housing payment for approximately sixty-eight (68) months without any late payments

Based on the above facts for the subject loan, SWMC believes that there was no reason to believe that the loan will not perform.

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EQUAL HOUSING OPPORTUNITY

FHA Case Number: 048-7976048
SWMC Loan Number: 114162035700
Borrower: [redacted]

Compensating factors have been documented in accordance with guidelines outlined by HUD Mortgagee Letter 2014-02.

The FHA case number for the subject loan was generated on or about 05/13/2014. The guidelines outlined by HUD Mortgagee Letter 2014-02 (effective for case numbers assigned on or after 04/21/2014) were applicable to the subject loan. Please see the table below, which shows a comparison of the compensating factors as defined by HUD Mortgagee Letter 2014-02 and the corresponding compensating factors documented for the subject loan.

Comment 2

For FICO Score of 580 and above, two (2) of the following compensating factors must be present.	**The subject loan has the following three (3) compensating factors documented in accordance with the guidelines outlined by HUD Mortgagee Letter 2014-02.**
Verified and documented cash reserves equal to at least three total monthly mortgage payments.	Verified and documented cash reserves equal to five monthly payments
Verified and documented significant additional income that is not considered effective income (i.e. part-time or seasonal income verified for more than one year but less than two years)	Significant additional income not reflected in gross effective income (Income from bonus at $382.00 per month)
Residual income	Residual income ($1,409.11) exceeding the minimum required residual income ($1,117.00)
New total monthly mortgage payment is not more than $100 or 5% higher than previous total monthly housing payment, whichever is less and there is a documented twelve month housing payment history with no more than one 30 day late payment.	NA

Please see **EXHIBIT 2** enclosed herewith, which provides a detailed explanation and calculation for the above-mentioned compensating factors.

Documentation indicating that borrower's Retirement Account is liquid and allows withdrawal for purchase of principal residence is available.

The borrower had a Retirement Account with a vested balance of $13,591.62. A copy of the statement for the Retirement Account for the period 04/01/2014 to 06/30/2014 is enclosed herewith for reference. Also, please find enclosed a copy of the documentation indicating that borrower's Retirement

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Account is liquid. On page 16 of the documentation, it can be verified that a withdrawal from Retirement Account is possible for various hardships including but not limited to:

- Medical care
- **Purchase of principal residence** (*emphasis added*)
- Tuition and educational fees
- Payment to prevent foreclosure or eviction
- Funeral or burial expenses
- Payment to repair damage to principal residence

Considering 60.00% of the effective balance in the Retirement Account is liquid, the borrower's total post closing reserves were $8,154.97 (60.00% of $13,591.62). The borrower's proposed monthly payment was $1,534.96. The reserves of $8,154.97 were thus sufficient to cover five monthly mortgage payments. In other words, the borrower had reserves equal to at least five monthly mortgage payments.

Comment 2

The borrower has a consistent history of earning bonus income.

The borrower's Verification of Employment (VOE) shows that the borrower has a consistent history of earning income over and above the base pay and overtime income. Please see the table below.

Year	Bonus Income ($)
2014 (YTD up to 06/30/2014)	2,928.16
2013	5,372.78
2012	3,798.23

The VOE has categorized this additional income under the heading "Bonus" and has listed various components such as vacation, vacation overtime, PTO, birthday, holiday and safety bonus under Bonus. Please note that even though the term "Bonus" is used on the VOE, the breakdown of income is explained on the VOE and the borrower has consistently received the bonus income for more than two (2) years. The VOE also states the likelihood of continuing to receive bonus income in the future as 'Yes'. HUD 4155.1 4.D.2.b states that *Overtime and bonus income can be used to qualify the borrower if he/she has received this income for the past two years, and it will likely continue. The lender must develop an average of bonus or overtime income for the past two years.* As per the published HUD guidelines, SWMC used the average of 2012 and 2013 of $382.00 per month (calculated as ($5,375.78 + $3,798.23) / 24) as bonus income. The qualifying income of $3,996.21 did not include the added income from bonuses of $382.00 per month. Thus, it was presented as a compensating factor.

In the "Results of Audit", in reference to the Bonus income it has been mentioned that – *The lender excluded the amount from its original income calculation. However, it included the amount in its response to our audit results to calculate residual income for the borrower.* SWMC would like to clarify to the OIG

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that the bonus income of $382.00 was not used initially at the time of loan approval. The subject loan originally had a DU approval without the use of bonus income. As such, SWMC was not required to include the bonus in the original income calculation.

Subject loan had DU approval with source of funds to satisfy the cash to close requirement as Retirement Account.

Comment 2

Additionally, SWMC would like to bring to your attention that originally the subject loan had an Approve / Eligible DU Recommendation. Please find enclosed a copy of the DU dated 07/23/2014. SWMC was originally notified that the cash to close requirement for the subject loan would be satisfied by liquidating the funds from the borrower's Retirement (401k) Account. The closing documents for the subject loan were signed by the borrower on or about 07/24/2014 with the DU showing Approve / Eligible. Subsequently, SWMC was notified that the cash to close requirement would be satisfied using gift funds instead. The borrower received a gift in the amount of $7,700.00. The gift was used to satisfy the cash to close requirement for the subject loan. The DU was re-run on or about 07/31/2014 (i.e. after signing of the closing documents) with the gift and it showed the Recommendation as Refer / Eligible. Please find enclosed a copy of the DU dated 07/31/2014.

It must be noted that all the other clauses of the DU dated 07/31/2014 and the original DU dated 07/23/2014 were identical. The source (Gift in lieu of the 401K Account) of the cash-to close funds was the only factor differentiating the previous Approve / Eligible and the subsequent Refer / Eligible. It must be noted that the borrower was not required to use the gift funds to satisfy the cash-to-close requirement. The borrower already had verified funds in his own retirement account to satisfy the cash-to-close requirement. It must also be noted that the borrower chose to utilize gift funds to satisfy the cash-to-close requirement in order to preserve funds in his own retirement account for future use. The unused Retirement (401k) Account meant that the borrower had liquid reserves of $8,154.97, which were sufficient to cover five monthly mortgage payments.

Quality Assurance Division (QAD) of HUD has reviewed the subject loan and has found it eligible for FHA insurance.

SWMC would also like to bring to your attention that the subject loan was reviewed by the Quality Assurance Division (QAD) for HUD. SWMC had provided a detailed explanation along with supporting documentation to QAD. On or about 05/13/2016, QAD issued a Closure Letter to SWMC confirming that the explanation provided by SWMC was adequate and satisfactory. Copies of the entire correspondence including (i) the Indemnification Letter issued by QAD (ii) SWMC's detailed response and (iii) the Closure Letter issued by QAD are enclosed herewith for your reference. These documents confirm QAD's review of the subject loan file, SWMC's explanation and the conclusion that the subject loan met FHA guidelines and was eligible for FHA insurance.

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FHA Case Number: 022-2481436
SWMC Loan Number: 114106006800
Borrowers: [redacted] and [redacted]

Principal reduction of $600.35 has been completed to cure minimum investment issue.

Please refer to the following table showing the calculation of the borrower's investment. It can be verified that the borrower was required to bring in $4,480.00 to satisfy the minimum statutory investment of 3.5%. It can also be verified that including the tax proration of $658.56, the total contribution by / on behalf of the borrower is $4,538.21.

Particulars	Amount ($)
Minimum Statutory Borrower Investment i.e. 3.5% of the lesser of the purchase price and the appraised value ($128,000.00)	4,480.00
Calculation of the total contribution by / on behalf of the borrower	
Earnest Money Deposit and subsequent deposits from the borrowers	2,500.00
Gift Funds	1,379.65
Prorated County taxes for the period 01/01/2014 to 06/26/2014	658.56
Total investment by the borrower	**4,538.21**

Comment 3

SWMC, however, acknowledges that the borrower did not have sufficient assets to meet the minimum statutory investment requirement of 3.5%. In order to cure the issue, SWMC wired funds in the amount of $600.35 to be applied towards the principal reduction to the present servicer (CENLAR) of the subject loan. A copy of the Wire Transfer confirming the same is enclosed herewith for your reference. Please see the table below, which shows how the amount of $600.35 was calculated.

Particulars	Amount ($)
Minimum Statutory Borrower Investment	4,480.00
Less: Actual Investment by the borrower ($2,500.00 + $1,379.65)	3,879.65
Difference between the required investment and the actual investment	600.35

CENLAR completed the principal reduction of $600.35 on or about 05/11/2016. Please find enclosed a copy of the Mortgage Payment History for the subject loan provided by CENLAR confirming the same. SWMC would like to bring to your attention that SWMC had self-reported this issue through Lender Self Reporting Function of Neighborhood Watch. As a result of self-reporting, SWMC received an Indemnification Notice from the Quality Assurance Division (QAD) of HUD. SWMC has already submitted the final response to QAD on or about 05/16/2016. Copies of SWMC's self reporting, correspondence from QAD and SWMC's responses are enclosed herewith for your reference.

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Comment 3

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Overtime income has not been included in the calculation of co-borrower's income.

Please see Table 1 below, which shows the calculation of borrowers' income as noted in the FHA Loan Underwriting and Transmittal Summary (LT).

Table 1

Particulars	Calculation of monthly income	Amount ($)
For the borrower – average of Total pay for 2013 as per VOE	$30,058.68 / 12	2,504.89
For the co-borrower – average of **BASE PAY** for 2013 and 2012 as per VOE	(**$26,933.39 + $5,245.00**) / (12 months of 2013 + 4.06 months of 2012) =$32,178.39 / 16.06	2,003.07
Total Income		**4,507.96**

It can be verified that the borrower's average Total pay for 2013 as per VOE (Verification of Employment) was considered in the income. Table 2 below shows the breakdown of the borrower's Total pay for 2013.

Table 2

Base Pay	$29,851.68
Overtime	$207.00
Total Pay	**$30,058.68**

It can also be verified that for the co-borrower, only the average of BASE PAY for 2013 and 2012 as per VOE was considered in the calculation of income. Table 3 below shows the breakdown of the co-borrower's Total pay for 2013 and 2012.

Table 3

Description	2013	2012
Base Pay	$26,933.39	$5,245.00
Overtime	$192.00	$3,129.12
Total Pay	**$27,125.39**	**$8,374.12**

Based on the information in Table 1 and Table 3, it can be verified that Overtime Income was not considered in the calculation of the co-borrower's income. SWMC acknowledges that the borrower's income includes **annual** overtime income of $207.00 (monthly $17.25, calculated as $207.00 / 12). However, SWMC would request that OIG note the trend and the amount of borrower's **base pay** in year 2013 and year 2014 as explained in Table 4 below.

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Table 4

Description	Amount ($)
Average of YTD (year-to-date) Base Pay for year 2014 = $11,814.17 / [(31+28+31+30+20) * 12 / 365] = $11,814.17 / 4.60	2,568.29
Average of Base Pay for year 2014 YTD and year 2013 = Base pay for year 2014 YTD and year 2013 / Number of months from 01/01/2013 up to 05/20/2014 = ($29,851.68 + $11,814.17) / (12 months of 2013 + 4.60 months of 2014) = $41,665.85 / 16.60	2,509.99
Qualifying income used for the borrower	**2,504.89**

Comment 3

It can be verified that the qualifying income used for the borrower is completely supported by – (i) the average of base pay for year 2014 YTD and year 2013 and (ii) the average of base pay of year 2014 YTD, without the use of overtime income. The qualifying income used is very well supported by the YTD trend of base income and average, without using overtime income. SWMC believes that the amount of overtime income for the borrower is minimal (only $17.25) and has no impact on the performance or the decision on the loan. Please see Table 5 below, which shows calculation of Total Income of the borrower and the co-borrower after excluding overtime income.

Table 5

Particulars	Calculation of monthly income	Amount ($)
For the borrower – average of BASE PAY for 2013 as per VOE	$29,851.68 / 12	2,487.64
For the co-borrower – average of BASE PAY for 2013 and 2012 as per VOE	($26,933.39 + $5,245.00) / (12 months of 2013 + 4.06 months of 2012) =$32,178.39 / 16.06	2,003.07
Total Income		**4,490.71**

It can be verified that the Total Income of the borrowers would be $4,490.71, which is short by only $17.25 (and not by $240.00 per month as mentioned in the Draft Audit Findings).

Finding 1 Summary Response

SWMC believes that for two loans (FHA Case Nos. 048-7976048 and 045-8098001) all the applicable HUD guidelines relating to compensating factors were satisfied. For the third loan (FHA Case No. 022-2481436) the guideline relating to the minimum required investment was not met. However, the risk involved with this issue has been mitigated by applying principal reduction. SWMC thus requests OIG to re-consider the recommendations asking SWMC to reimburse the FHA insurance fund $125,272.00 for FHA Case No. 045-8098001 and indemnify HUD against potential losses of $159,029 for FHA Case Nos. 048-7976048 and 022-2481436.

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Finding 2

Finding 2: Sun West Mortgage Did Not Always Comply With HUD Quality Control Requirements

SWMC's Response: Please see below SWMC's explanation for each of the issues noted in Finding 2.

Early Payment Defaults (EPD)
SWMC agrees that the loan regarding FHA Case No. 022-2372978 was not reviewed within the required timeframe.

The referenced loan ("[redacted] – Case No. 022-2372978") was closed on or about 10/26/2012. The payment for the month of March 2013 for the subject loan became 60 days past due and thus the loan became a case of Early Payment Default (EPD) as defined by HUD Handbook 4060.1, REV-2. The EPD Analysis for the subject loan was completed on or about 09/27/2013. SWMC understands that as per the guidelines outlined by HUD Handbook 4060.1, REV-2, EPD Analysis for the subject loan should have been completed within 45 days from 05/31/2013 (within 45 days from the end of the month the loan was reported as 60 days past due). SWMC will implement corrective action so that going forward EPD loans will be analyzed within the required timeframe.

Comment 4

SWMC agrees that the re-verification of employment, gift funds, deposits and appraised value (desk review) was not being performed for the loans covered under the review period.

SWMC's EPD analysis was historically focused on reviewing EPD loans for underwriting deficiencies and updating our policies and procedures accordingly to mitigate origination risks on an enterprise basis. SWMC identified a gap in its process for re-verifying employment, income, deposits and down payments/gifts on certain of its EPD loans. SWMC previously conducted re-verification of these items only on the loans included in its 10% QC (Quality Control) sample. Effective May 2016 SWMC has remedied the gap and now conducts re-verification for all EPD loans. SWMC is willing to re-verify the items you identified for the last 24 months.

Quality Control Reviews
SWMC agrees that the follow-up attempts for the re-verification of employment, gift funds, deposits and appraised value (desk review) have not been documented.
In SWMC's experience, in most cases the verifications are required to be performed through the respective company's online portal and/or a third-party online portal such as Work Number; in which case phone/written follow-ups are typically not entertained. Since February 2016, SWMC has begun documenting such efforts nevertheless. Additionally, to satisfy the requirements of this query SWMC performed the following steps.

Employment – FHA Case No. 022-2488752 ([redacted]): As requested, please find enclosed a copy of the Verification of Employment pulled through Work Number for the co-borrower, [redacted].

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Gift – FHA Case No. 022-2488752 ([redacted]): SWMC re-sent the Verification of Gift to the donor on or about 06/14/2016. Please find enclosed a copy of the Receipt of order placed confirming the same.

Deposit – FHA Case Nos. 044-5265825, 043-9328531, 022-2488752 ([redacted]): SWMC re-sent the Verification of Deposit for these loans on or about 06/14/2016. Please find enclosed copies of the Receipt of order placed confirming the same.

SWMC has received responses for some of the re-verifications sent. Please refer to the table below, which provides a summary of the Status of the re-verifications.

FHA Case #	SWMC Loan #	Borrower Name	Status
022-2488752	114063019100	[redacted]	Verification of Deposit has been received and matches satisfactorily.
043-9328531	114024019200	[redacted]	Verification of Deposit has been received and matches satisfactorily.
044-5265825	113171041900	[redacted]	Verification of Deposit for the borrower's account has been received and matches satisfactorily. Verification of Deposit for the co-borrower was rejected. It has been re-sent on or about 06/16/2016. We are awaiting responses for Verification of Deposit for the borrower and Verification of Gift.

Comment 4

SWMC agrees that the re-verification of appraised value (desk review) is not available for the loan involving FHA Case No. 043-9328531.

The referenced loan ("[redacted] - Case No. 043-9328531") was included in SWMC's May 2014 Post Closing Quality Control (QC) review cycle. SWMC was performing 'One Unit Residential Appraisal Field Review Report (Fannie Mae Form 2000)' for 10% of the samples selected for review during a Post Closing Quality Control (QC) review cycle. The referenced loan was not included in the randomly selected 10% loans for the Fannie Mae Form 2000 verification. If required, SWMC can submit Fannie Mae Form 2000 for the 10% loans selected from the May 2014 QC review cycle.

When the referenced loan was reported as an EPD (in the month of October 2014) SWMC was not performing appraised value re-verification for EPD loans. Effective October - 2015 Loan Review Cycle, SWMC has updated its Standard Operating Procedure to order Fannie Mae Form 2000 for EPD loans. As such, no appraised value re-verification was ordered for the referenced loan.

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Branch Reviews

All the elements for Branch Review were satisfactorily verified.

SWMC's company-wide policies and procedures ensure compliance with each of the "required items" that the Audit Report indicated were absent in the Branch Office Reviews. Each one of these "required items" are discussed in detail as follows:

(1) A check to ensure that procedures are revised to reflect changes in HUD requirements and that personnel are informed of the changes

SWMC's Continuing Education Policy and Change Management Procedures (See Exhibit XX enclosed herewith) ensure that SWMC's processes are updated not only when there are changes to HUD's requirements; but also when there are changes to other State, Federal and other Agency and Investor requirements.

Comment 5

(2) Personnel at the office are all employees of the mortgagee or contract employees performing functions that FHA allows to be outsourced.

As part of its corporate recruitment and hiring policy, SWMC ensures compliance with this requirement not only at its corporate office, but also at each of its Branch Offices.

(3) Verification that Branch Offices provide toll-free lines or provide for acceptance of collect calls from borrowers

SWMC provides a nationwide toll free number on its website which may be used by borrowers to contact SWMC. SWMC's website also has a 'Contact Us' page which provides information regarding office address, phone number and email address to contact SWMC's Corporate Headquarters as well as SWMC's Branches. The 'Contact Us' page is available online through the SWMC's website at the following link: https://www.swmc.com/swmc/contact_swmc.php

As evidenced, these required items are part of SWMC's standard operating procedures both at the corporate and at the branch office levels; accordingly, the respective Branch Review Reports were in compliance with HUD Handbook 4060.1 Rev-2 Paragraph 7-3(G) (1).

It can be verified that SWMC's Branch Review Process was not deficient with respect to the three missing items identified by OIG in the Audit Report. SWMC would also like to bring to your attention that in addition to the above-referenced elements, SWMC's Branch Review Process also covered the following additional items as required by HUD guidelines.

(4) The office is sufficiently staffed with trained personnel

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As per HUD Handbook 4060.1, Chapter 2: Requirements For Initial And Continuing FHA Approval, 2-12 Staffing Requirements: *An approved mortgagee must have sufficient staff or permitted contractor support for loan origination, processing, underwriting, servicing, and collection activities, to the extent that the mortgagee engages in these activities.*

Below is a summary of SWMC's compliance with each of the staffing requirement as outlined in the above referenced guideline.

A. Home office: The mortgagee must have a home office staff of at least two full time employees. A shared receptionist, while permitted, may not be used to meet this requirement.

Comment 5

SWMC's Response: SWMC has a total of two hundred and sixteen (216) employees at SWMC's Corporate Headquarters located at 18000 Studebaker Road, Suite 200 Cerritos, California 90703.

B. Branch office: A mortgagee must have at least one full time employee at each branch office. A manager must be assigned to each traditional and nontraditional branch office. A separate manager must be located at each direct lending branch.

SWMC's Response: SWMC has at least one full time employee at each Branch Office. SWMC has assigned a Manager to each of its Branch Offices.

C. Branch Managers, Loan Officers and Underwriters: Loan officers (also known as loan originators) of FHA-insured mortgages must be employees of the mortgagee. Underwriters of FHA-insured mortgages must be employees of the mortgagee; its authorized agent; or, if the mortgagee is a loan correspondent, its sponsors. Managers, loan originators and underwriters may not be independent contractors or contract employees.

SWMC's Response: As a standard company-wide policy, SWMC does not solicit or employ any Branch Managers, Loan Officers or Underwriters who are independent contractors or contract employees.

D. Centralized Centers: Processing and/or underwriting functions may be centralized in any office(s) of the mortgagee or performed at each office of the mortgagee.

SWMC's Response: SWMC is in compliance with this requirement.

(5) The office does not employ or have a contract with anyone currently under debarment or suspension, or a Limited Denial of Participation

As part of Sun West's company-wide recruitment and hiring policy, the following verifications for each prospective employee are completed prior to employment:

18000 Studebaker Road, Suite 200, Cerritos, CA 90703
Toll Free: +1 (800) 453-7884 • FAX: +1 (562) 924-6057 • www.swmc.com • NMLS ID: 3277

Ref to OIG Evaluation	Auditee Comments

SunWest Mortgage Company, Inc.

1. License check (if applicable)
2. Limited Denial of Participation (LDP)
3. System for Award Management (SAM)
4. Freddie Mac Exclusionary List
5. Federal Housing Finance Agency (FHFA's) Suspended Counterparty program (SCP)
6. Office of Foreign Assets Control (OFAC)
7. Credit Alert Verification Reporting System (CAIVRS) check
8. Regulatory Agency Verification

Comment 5

SWMC completes all the above referenced verifications for all prospective employees before they are hired and on an annual basis and thus ensures that no employee hired by SWMC is under debarment or suspension, or a Limited Denial of Participation.

Subsequent to an employee joining SWMC, SWMC has a policy to complete a background check of all employees each year or more frequently as needed.

Additionally, all contracts with third-party vendors, including those specific to one or more Branch Offices are required to go through SWMC's corporate Vendor Management due diligence.

SWMC understands that for the period 2012-2015, the **Section 2 (Review) of SWMC's Branch Review Report** for branch offices located in Arizona, California, Hawaii, and Nevada did not specifically mention these five elements required by HUD for Branch Reviews. SWMC assures you that going forward; SWMC will update the Section 2 (Review) of SWMC's Branch Review Report to specifically mention these elements.

SWMC uses XL Dynamics to perform a set of defined services as set forth in the previously provided Master Services Agreement and accompanying Exhibits.

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* Enclosures and attachments available upon request

OIG Evaluation of Auditee Comments

Comment 1 We applied the requirements of HUD Handbook 4155.1 to this loan since it was closed before Mortgagee Letter 2014-02, Manual Underwriting became effective in April 2014.

We generally agree that the file documentation shows that the borrower had a satisfactory housing payment history and had a minimal increase in housing expense. The borrower also re-established credit after his bankruptcy by opening and maintaining several new accounts. However, one account was in collection and in dispute by the borrower.

Our report stated that Sun West used the borrower's FICO score, which is not a HUD approved compensating factor, to support loan approval. In its response, Sun West stated that the FICO Score was listed on the FHA Loan Underwriting and Transmittal Summary for internal reference purposes. However, the FICO Score was listed and identified as a compensating factor along with two others on the transmittal summary. There was no notation on the form that stated or otherwise indicated that the factor was for Sun West's internal reference purposes.

Our report stated that the surplus income that was calculated for the borrower was not one of the original compensating factors used by Sun West to support loan approval. The factor was submitted in response to deficiencies we demonstrated to the lender during audit fieldwork. However, after further review, we removed the statement that a different tax schedule was used to calculate surplus income for the borrower.

We reviewed Sun West's updated calculations for the borrower's income. The new calculations result in a higher monthly income by not deducting meals and entertainment expenses, and the revised mortgage payment-to-income ratio was reduced from 47 percent to 41 percent. However, the revised ratio still far exceeded the HUD benchmark of 31 percent. Therefore, we disagree that the loan had sufficient compensating factors to perform, as stated in the Sun West response. The loan did not perform and went into foreclosure. The property was recently conveyed to HUD and HUD paid $144,891 in insurance claims.

Comment 2 We applied the requirements of Mortgagee Letter 2014-02, Manual Underwriting to this loan, since the loan case number was issued after the guidance became effective in April 2014.

We reviewed the additional documentation provided by Sun West which clarified that withdrawals could be made from the borrower's retirement account under circumstances such as purchase of a principal residence and payment to prevent foreclosure or eviction. Sun West also indicated in its response that when the loan was initially processed, it was intended for funds from the borrower's retirement account to be used to satisfy cash to close requirements. According to the borrower's account statement, the borrower had a vested account balance of $13,592. The FHA Loan Underwriting and Transmittal Summary reflected monthly mortgage payments of $1,535. Therefore, the borrower had liquid retirement account funds which could serve as cash reserves equal to or exceeding three total monthly mortgage payments, as required by Mortgagee Letter 2014-02. We made the appropriate adjustments to our report.

We disagree that the borrower had additional compensating factors, which included bonus and residual income.

Only one compensating factor, "FICO Score above 620", was provided during the original underwriting of the loan. This factor did not comply with HUD requirements and Sun West provided bonus income as a compensating factor in response to deficiencies that we demonstrated to the lender during audit fieldwork. However, we found the bonus income to be questionable because the borrower's Verification of Employment described the income as vacation, birthday, holiday, and safety pay. The verification did not clearly identify how much, if any, of the amount was bonus pay. Sun West included the amount in its calculation of the borrower's residual income, which was also presented as a compensating factor during our audit fieldwork. Since it was unclear whether the borrower had bonus income, the amount should not have been included in the residual income calculation. After excluding bonus income, the borrower had negative residual income.

The HUD Quality Assurance Division issued a March 2016 letter, which also stated that the loan did not meet manual underwriting requirements. Although HUD later closed out its findings after receiving a written response letter from Sun West, our review disclosed the loan did not comply with the requirements of Mortgagee Letter 2014-02, which states that the maximum allowable qualifying ratios for borrowers with minimum credit scores of 580 or more and one compensating factor are 37 percent and 47 percent of gross effective income. We found that the borrower's ratios of 38 percent and 56 percent of gross effective income far exceeded the maximum allowed by HUD. Additionally, there were other issues that were noted in HUD's March 2016 letter, but that were not addressed by Sun West in its response. Sun West did not document the borrower's housing payment history and failed to document explanations for a collection account and credit inquiries. These issues were also noted in our audit report.

Neighborhood Watch currently shows that a bankruptcy plan was confirmed for the borrower and that the cause for delinquency was "excessive obligations." The loan was closed in August 2014, became delinquent in November 2014, and went into foreclosure in May 2015.

Comment 3 We applied the requirements of HUD Handbook 4155.1 to this loan, since it was underwritten using TOTAL Scorecard, and manual underwriting requirements do not apply.

We acknowledge Sun West's action to pay down the outstanding minimum investment balance not met by the borrower.

Our audit report also stated that Sun West overstated the borrowers' monthly income by including overtime that would not continue. Sun West originally calculated a combined monthly income of $4,508 for the borrower and co-borrower (Table 1 in Sun West's response). The borrowers' ratios were 21 percent and 40 percent)

In response to our audit finding, Sun West recalculated the income by excluding the overtime and determined that the combined monthly income was instead $4,491 per month (Table 5 in Sun West's response). The revised amount resulted in $17 per month less in monthly income and a minimal change to the borrowers' ratios to 21 and 41 percent.

After further review and consideration of the co-borrower's Verification of Employment, which would have resulted in a combined monthly income of $4,491, we agree with Sun West's calculation.

We noted that both revised calculations did not consider base pay from all years listed on the borrower and co-borrower's Verifications of Employment. If the amounts from all years were considered, the combined monthly income for both borrowers would have been $4,450, $58 less per month than the $4,508 originally calculated by Sun West, The borrowers' ratios would have remained at 21 and 41 percent.

Given that the revised monthly income amounts calculated by Sun West and OIG did not significantly vary from the original (between $17 and $58), and there was almost no change to the borrowers' ratios, we have concluded that either shortage likely did not significantly impact the borrowers' ability to make mortgage payments. Therefore, we removed the deficiency from our audit finding and made the appropriate adjustment to the report.

Comment 4 OIG acknowledges Sun West's efforts to take the corrective actions necessary to ensure that HUD requirements are met with respect to timely review of early payment defaults and reverifications of borrower documentation for early payments and routine quality control reviews.

However, the reverifications that Sun West performed for the loans that we questioned occurred after the end of our fieldwork. Therefore, the deficiencies that we identified will remain in our report.

Comment 5 We acknowledge Sun West's commitment to update its branch review reports to include the missing items that we identified in our report. However, we disagree that Sun West's branch reviews were in compliance with HUD quality control requirements. The Sun West response stated that it complied with the handbook requirements that pertained to branch office reviews and gave examples of compliance in the areas noted in our review. However, the issue that we identified in our report was that the branch review reports or “checklists” did not include all of the items that are required by HUD Handbook 4060.1. Compliance could not be verified if the review items were not included in the branch review reports.

We adjusted our report to exclude those branch reviews that were performed after HUD revised its guidance in September 2015. The guidance eliminated specific items that must be reviewed, and now requires compliance with general staffing, office facilities, operating requirements and licensing requirements that are covered throughout HUD Handbook 4000.1. During audit fieldwork, we did not analyze the branch reviews that were conducted during or after September 2015 for compliance with the new guidance. Therefore, we revised the report to only address those branch reviews that took place before the September 2015 update.

Appendix C

Criteria

HUD Handbook 4155.1 (1)(B)(2)(c)
The lender must obtain a written Verification of Deposit (VOD) and the borrower's most recent statements for all asset accounts to be used in qualifying.

Alternative Documentation
As an alternative to obtaining a written VOD, the lender may obtain from the borrower original asset statements covering the most recent three-month period. Provided that the asset statement shows the previous month's balance, this requirement is met by obtaining the two most recent, consecutive statements.

TOTAL Scorecard Accept/Approve Recommendation
If a written VOD is not obtained, the lender may obtain a statement showing the previous month's ending balance for the most recent month. If the previous month's balance is not shown, the lender must obtain statements for the most recent two months to verify that there are sufficient funds to close.

Mortgagee Letter 2014-02, Manual Underwriting, Definition of Reserves

- the sum of verified and documented borrower funds; *minus*
- the sum the borrower is required to pay at closing, including the cash investment, closing costs, prepaid expenses, any payoffs that are a condition of loan approval, and any other expense required to close the loan; *but not including*
- the amount of cash taken at settlement in cash-out transactions or incidental cash received at settlement in other loan transactions, gift funds in excess of the amount required for the cash investment and other expenses, equity in another property, and borrowed funds from any source.

Mortgagee Letter 2014-02, Manual Underwriting, Reserve Requirement
All manually underwritten loans must meet or exceed the following minimum reserve requirements:

- 1 and 2 Unit Properties. Reserves must equal or exceed one total monthly mortgage payment.
- 3 and 4 Unit Properties. Reserves must equal or exceed three total monthly mortgage payments.

This new policy replaces the current 2-month minimum reserve requirement for one and two unit properties for borrowers with insufficient credit.

HUD Handbook 4155.1 (4)(F)(2)(a)
Qualifying ratios are used to determine if the borrower can reasonably be expected to meet the expenses involved in home ownership, and provide for his/her family. In order to make this determination, the lender must calculate

- the Mortgage Payment Expense to Effective income ratio as described in HUD 4155.1 4.F.2.b, and
- the Total Fixed Payment to Effective Income ratio, as described in HUD 4155.1 4.F.2.c

Note: The underwriter must calculate the qualifying ratios for entry into the Automated Underwriting System (AUS) in order to be evaluated by the Technology Open To Approved Lenders (TOTAL) Scorecard.

HUD Handbook 4155.1 (4)(F)(2)(b)
The relationship of the mortgage payment to income is considered acceptable if the total mortgage payment does not exceed 31% of the gross effective income. A ratio exceeding 31% may be acceptable only if significant compensating factors, as discussed in HUD 4155.1 4.F.3, are documented and recorded on Form HUD-92900-LT, *FHA Loan Underwriting and Transmittal Summary*.

HUD Handbook 4155.1 (4)(F)(2)(c)
The relationship of total obligations to income is considered acceptable if the total mortgage payment and all recurring monthly obligations do not exceed 43% of the gross effective income.

A ratio exceeding 43% may be acceptable only if significant compensating factors, as discussed in HUD 4155.1 4.F.3, are documented and recorded on Form HUD-92900-LT, *FHA Loan Underwriting and Transmittal Summary*. For those borrowers who qualify under FHA's EEH, the ratio is set at 45%.

HUD Handbook 4155.1 (4)(F)(3)(b)
The table below describes the compensating factors that may be used to justify approval of mortgage loans with ratios that exceed FHA benchmark guidelines.

Compensating Factor	Guideline Description
Housing Expense Payments	The borrower has successfully demonstrated the ability to pay housing expenses greater than or equal to the proposed monthly housing expenses for the new mortgage over the past 12-24 months.

Compensating Factor	Guideline Description
Down Payment	The borrower makes a large down payment of 10% or higher toward the purchase of the property.
Accumulated Savings	The borrower has demonstrated • an ability to accumulate savings, and • a conservative attitude toward using credit.
Previous Credit History	A borrower's previous credit history shows that he/she has the ability to devote a greater portion of income to housing expenses.
Compensation or Income Not Reflected in Effective Income	The borrower receives documented compensation or income that is not reflected in effective income, but directly affects his/her ability to pay the mortgage. This type of income includes food stamps and similar public benefits.
Minimal Housing Expense Increase	There is only a minimal increase in the borrower's housing expense.

HUD Handbook 4155.1 (5)(B)(4)(c)
The gift donor may *not* be a person or entity with an interest in the sale of the property, such as

- the seller
- the real estate agent or broker
- the builder, or
- an associated entity

Gifts from these sources are considered inducements to purchase, and must be subtracted from the sales price.

Mortgagee Letter 2014-02, Manual Underwriting
<u>Definition of Manually Underwritten Loans</u>
When a loan receiving an *Accept* scoring recommendation [through FHA's TOTAL Scorecard] is downgraded to a *Refer*, the loan must be underwritten in accordance with all provisions of this Mortgagee Letter.

<u>Borrowers With Minimum Decision Credit Scores of 580 or More and No Compensating Factors</u>
The maximum allowable qualifying ratios for borrowers with minimum decision credit scores of 580 or more and no compensating factors are as follows:

- total monthly mortgage payment may not exceed 31% of gross effective monthly income (33% for Energy Efficient Homes); and
- total monthly fixed payment may not exceed 43% of gross effective monthly income (45% for Energy Efficient Homes).

Borrower's With Minimum Decision Credit Scores of 580 or More and One Compensating Factor

The maximum allowable qualifying ratios for borrowers with minimum decision credit scores of 580 or more provided they meet one of the compensating factors specified below are as follows:

- total monthly mortgage payment may not exceed 37% of gross effective monthly income; and
- total monthly fixed payment may not exceed 47% of gross effective monthly income.

Acceptable compensating factors are limited to the following:

- Verified and documented cash reserves that equal or exceed three total monthly mortgage payments (one and two units) or that equal or exceed six total monthly mortgage payments (three and four units);
- New total monthly mortgage payment is not more than $100 or 5% higher than previous total monthly housing payment, whichever is less, and there is a documented twelve month housing payment history with no more than one 30 day late payment. In cash-out transactions *all* payments on the mortgage being refinanced must have been made within the month due for the previous twelve months.
- Residual income.

Maximum Qualifying Ratio Matrix

Manual Underwriting Matrix For Case Numbers Issued on or After April 21, 2014		
580 and above	31/43	No compensating factors required.
580 and above	37/47	One of the following: • Verified and documented cash reserves equal to at least three total monthly mortgage payments (1-2 units). • New total monthly mortgage payment is not more than $100 or 5% higher than previous total monthly housing payment, whichever is less; and there is a documented twelve month housing payment history with no more than one 30 day late payment. • Residual Income
580 and above	40/40	Borrower has established credit lines in his/her own name open for at least six months but carries no discretionary debt (i.e., monthly total housing payment is only open installment account and borrower can document that revolving credit has been paid off in full monthly for at least the previous six months).
580 and above	40/50	Two of the following: • Verified and documented cash reserves equal to at least three total monthly mortgage payments (1-2 units).

		• New total monthly mortgage payment is not more than $100 or 5% higher than previous total monthly housing payment, whichever is less; and a there is documented twelve month housing payment history with no more than one 30 day late payment. • Verified and documented significant additional income that is not considered effective income (i.e., part-time or seasonal income verified for more than one year but less than two years). • Residual Income.

HUD Handbook 4155.1 (2)(A)(2)(a)
The maximum mortgage amount that FHA will insure on a purchase is calculated by multiplying the appropriate loan-to-value (LTV) factor by the lesser of the property's

- sales price, subject to certain required adjustments, or
- appraised value.

In order for FHA to insure this maximum loan amount, the borrower must make a required investment of at least 3.5% of the lesser of the appraised value or the sales price of the property.

HUD Handbook 4155.1 (4)(D)(2)(a)
The lender must analyze the income of each borrower who will be obligated for the mortgage debt to determine whether the borrower's income level can be reasonably expected to continue through at least the first three years of the mortgage loan.

In most cases, a borrower's income is limited to salaries or wages. Income from other sources can be considered as effective, if properly verified and documented by the lender.

Mortgagee Letter 2011-02, Quality Control Requirements for Direct Endorsement Lenders
<u>Early Payment Defaults</u>
In addition to the loans selected for routine quality control reviews, mortgagees must review all loans that are originated or underwritten by their company and that are originated by their Sponsored Third Party Originators that go into default within the first six payments (referred to as early payment defaults). Handbook 4060.1, REV-2 defines early payment defaults as loans that become 60 days past due within the first six payments. Mortgagees must perform reviews of early payment defaults within 45 days from the end of the month the loan is reported as 60 days past due. The Early Payment Default review report and follow-up, including review findings and any actions taken, along with procedural information (as specified in HUD Handbook 4060.1 Rev.-2, Paragraph 7-6 (E)), must be retained by the mortgagee for a period of two years.

HUD Handbook 4060.1, REV-2, Paragraph 7-6(D)

In addition to the loans selected for routine quality control reviews, mortgagees must review all loans going into default within the first six payments. As defined here, early payment defaults are loans that become 60 days past due.

HUD Handbook 4060.1, REV-2, Paragraph 7-6(E)

Documentation Review and Verification. The Quality Control Program must provide for the review and confirmation of information on all loans selected for review.

1. Credit Report. A new credit report must be obtained for each borrower whose loan is included in a Quality Control review, unless the loan was a streamline refinance or was processed using a FHA approved automated underwriting system exempted from this requirement. A credit report obtained for a Quality Control review may be a Residential Mortgage Credit Report, a three repository merged in-file report or, when appropriate, a business credit report. The report must comply with the credit report standards described in HUD Handbook 4155.1 (as revised). A full Residential Mortgage Credit Report must be obtained from a different credit source on cases in which the in-file report reveals discrepancies with the original credit report.

2. Credit Document Reverification. Documents contained in the loan file should be checked for sufficiency and subjected to written reverification. Examples of items that must be re-verified include, but are not limited to, the mortgagor's employment or other income, deposits, gift letters, alternate credit sources, and other sources of funds. Sources of funds must be acceptable as well as verified. Other items that may be re-verified include mortgage or rent payments. If the written reverification is not returned to the mortgagee, a documented attempt must be made to conduct a telephone reverification. If the original information was obtained electronically or involved alternative documents, a written reverification must still be attempted. Any discrepancies must be explored to ensure that the original documents (except blanket verification releases) were completed before being signed, were as represented, were not handled by interested third parties and that all corrections were proper and initialed. All conflicting information in the original documentation should have been resolved before the complete file was submitted to the underwriter.

3. Appraisals. A desk review of the property appraisal must be performed on all loans chosen for a Quality Control review except streamline refinances and HUD Real Estate Owned (REO) sales. The desk review must include a review of the appraisal data, the validity of the comparables, the value conclusion ("as repaired" to meet safety and soundness requirements in HUD Handbook 4905.1 (as revised)), any changes made by the underwriter and the overall quality of the appraisal.

Mortgagees are expected to perform field reviews on 10 % of the loans selected during the sampling process outlined previously in paragraph 7-6 C and D. Field reviews must be performed by licensed appraisers listed on FHA's Roster of Appraisers. Mortgagees should select loans for field reviews based on factors such as those listed previously in paragraph 7 6(C)(2) and the following:

- Property complaints received from mortgagors;
- Discrepancies found during desk reviews;
- Large adjustments to value;
- Comparable sales more than six months old;
- Excessive distances from comparables to the subject property;
- Repetitive sales activity for the subject property;
- Investor-sold properties;
- Identity of interest between buyer and seller;
- Seller identity differs from owner of record; and
- Vacant properties.

In addition, a field review should be completed on loans selected in accordance with paragraphs 7-6(C) and (D) where the desk review revealed significant problems/deficiencies with the appraisal report. If serious deficiencies or patterns are uncovered, mortgagees must report these items, in writing, to the Quality Assurance Division in the HUD Homeownership Center having jurisdiction.

4. Occupancy Reverification. In cases where the occupancy of the subject property is suspect, mortgagees must attempt to determine whether the mortgagor is occupying the property. The failure of the mortgagor to occupy the property may be an indication that the loan contains other problems. If it is found that the mortgagor is not occupying a property mortgaged as owner-occupied, mortgagees must report this, in writing, to the Quality Assurance Division in the HUD Homeownership Center having jurisdiction. It also would be advisable to review other similar loans for occupancy.

HUD Handbook 4060.1, REV-2, Paragraph 7-3(G)(1)
Site Review. A mortgagee's offices, including traditional, nontraditional branch and direct lending offices engaged in origination or servicing of FHA-insured loans, must be reviewed to determine that they are in compliance with the Department's requirements.

1. **Review Items.** The review must include, but not necessarily be limited to, confirmation of the following items:

   - The office is properly registered with FHA and the address is current;
   - Operations are conducted in a professional, business-like environment;
   - If located in commercial space, the office is properly and clearly identified for any walk-in customers; has adequate office space and equipment; is in a location conducive to mortgage lending; and is separated from any other entity by walls or partitions (entrances and reception areas may be shared);
   - If located in non-commercial space, the office has adequate office space and equipment; displays a fair housing poster if the public is received; if it is open to receive the public, it must be accessible to persons with disabilities,

including those with mobility impairments; if it is not open to the public, but used occasionally to meet with members of the public, alternate means of accommodation may be used to serve persons with disabilities;

- The servicing office provides toll-free lines or accepts collect calls from mortgagors;
- The office is sufficiently staffed with trained personnel;
- Office personnel have access to relevant statutes, regulations, HUD issuances and Handbooks, either in hard copy or electronically;
- Procedures are revised to reflect changes in HUD requirements and personnel are informed of the changes;
- Personnel at the office are all employees of the mortgagee or contract employees performing functions that FHA allows to be outsourced; and
- The office does not employ or have a contract with anyone currently under debarment or suspension, or a Limited Denial of Participation.

Appendix D

Schedule of Actual and Estimated Losses for Loans With Significant Deficiencies

FHA case no.	Unpaid mortgage balance	Amount of Claims Paid by HUD	Estimated loss to HUD (50%)
045-8098001		$144,891	
048-7976048	$195,874		$97,937
	$195,874	**$144,891**	**$97,937**

Appendix E

Narrative Loan Summaries for Significant Underwriting Deficiencies

The following narratives provide the details for the significant underwriting deficiencies noted for finding 1.

FHA case number: 045-8098001
Loan amount: $123,117
Settlement date: February 5, 2014
Status: Claim – property conveyed to HUD
Loss to HUD: $144,891

The Borrower's Payment-to-Income Ratios Far Exceeded HUD's Benchmarks

We are seeking reimbursement for HUD losses because the borrower's monthly obligations were too high as a percentage of the borrower's income. This condition impacted the borrower's ability to meet monthly obligations. The loan was manually underwritten; therefore, the borrower's ratios were required to fall within the HUD-established limits. The borrower only made six loan payments before the first 90-day delinquency was reported. HUD was unable to contact the borrower, therefore a reason for the borrower's delinquency could not be obtained.

According to the lender's calculations, the borrower earned $1,873 per month. However, the borrower's mortgage payment was $888 per month. As a percentage, the borrower's mortgage payment represented 47 percent of the borrower's income.

The borrower's total monthly fixed payments, including the monthly mortgage, exceeded the HUD total fixed payment-to-income ratio of 43 percent. The borrower's total monthly payments were $975. As a percentage, the borrower's total monthly obligations represented 52 percent of the borrower's monthly income.

HUD Handbook 4155.1 (4)(F)(2)(b) states that a mortgage-payment-to-income ratio that exceeds 31 percent of gross effective income is acceptable only if significant compensating factors are documented on Form HUD-92900-LT, FHA Loan Underwriting and Transmittal Summary (appendix C).

Similarly, HUD Handbook 4155.1 (4)(F)(2)(c) states that a mortgage-payment-to-income ratio that exceeds 43 percent of gross effective income is acceptable only if significant compensating factors are documented on Form HUD-92900-LT, FHA Loan Underwriting and Transmittal Summary (appendix C).

In its original analysis, the lender recorded three compensating factors on the FHA Loan Underwriting and Transmittal Summary. The first stated that the borrower's housing payment was not increasing. The second factor stated that the borrower had reestablished good credit, and the third stated that the borrower had a FICO score above 620. We compared the factors listed by the lender to those listed in HUD Handbook 4155.1 (4)(F)(3)(b) (appendix C). We determined that the original factors were insufficient because the borrower had not reestablished good credit (second factor) and the third factor was not listed as an approved compensating factor in the handbook. Although the borrower's housing payment did not increase (first factor), the borrower's mortgage payment represented almost 50 percent of the income that the lender calculated. Therefore, the compensating factor that the borrower's housing payment did not increase was not strong enough to support loan approval.

During our fieldwork, the lender provided additional information, which stated that the borrower had surplus income and a satisfactory housing payment history for more than 3 years and that the borrower's housing payment had declined. We evaluated the information and confirmed, as we had in our original analysis, that the borrower had a 3-year history of housing payments as shown on the borrower's verification of rent. We also confirmed that the borrower's housing payment expense had decreased. However, the lender determined that the borrower had surplus income that was not included in the original underwriting of the loan. Therefore, we did not consider it as a compensating factor since the lender underwrote and approved the loan with the original calculation. The lender also cited that the borrower's housing payment had declined ("housing payment not increasing") in its original analysis. The remaining compensating factor, satisfactory housing payment history for more than 3 years, is comparable to the housing expense payments factor listed in HUD Handbook 4155.1, which can be used if the borrower has demonstrated the ability to pay housing expenses greater than or equal to the proposed monthly expense for the new mortgage over the past 12-24 months (appendix C). However, the factor was provided after the original underwriting of the loan and the borrower's obligations remained excessive when compared to monthly income. Therefore, we concluded that the loan did not meet FHA underwriting requirements at the time of loan approval, despite the additional information provided by the lender.

FHA case number: 048-7976048
Loan amount: $202,268
Settlement date: August 5, 2014
Status: Bankruptcy plan confirmed
Unpaid balance: $195,874

<u>The Borrower's Payment-to-Income Ratios Exceeded HUD's Benchmarks, and File Documentation Did Not Support the Borrower's Assets</u>

We are seeking indemnification of this loan because the borrower's monthly obligations were too high as a percentage of the borrower's income to justify loan approval. This condition impacted the borrower's ability to meet monthly obligations. In addition, there was no history of the borrower's housing payments in the file, and no explanations were documented for a collection account and credit inquires. The loan was manually underwritten; therefore, all of the foregoing were required before the loan was underwritten. The borrower made 8 loan payments before the first 90-day delinquency was reported. HUD listed the cause for delinquency as "excessive obligations."

According to the lender's calculations, the borrower earned $3,996 per month. However, the borrower's mortgage payment was $1,535 per month. As a percentage, the borrower's mortgage payment represented 38 percent of the borrower's income.

Similarly, the borrower's total monthly payments were $2,247. As a percentage, the borrower's total monthly obligations represented 56 percent of the borrower's monthly income.

According to Mortgagee Letter 2014-02, Manual Underwriting (appendix C), the maximum qualifying ratios for a borrower with a credit score of 580 or more and one compensating factor are 37 and 47 percent. HUD also requires that the borrower have one of the following compensating factors:

- Verified and documented cash reserves that equal or exceed three total monthly mortgage payments.
- New total monthly mortgage payment that is not more than $100 or 5 percent higher than previous total monthly housing payment, whichever is less, and there is a documented 12-month housing payment history with no more than one 30-day late payment. Residual income.

Our original analysis disclosed that the borrower's 38/56 percent ratios exceeded the 37/47 percent limit imposed by HUD. In addition, the borrower's previous housing payment was $850 per month, and the mortgage amount was $1,535. Therefore, the borrower's housing payment had increased more than the $100 or 5 percent allowed by HUD. There was no housing or rental history documented in the file for the previous 12 months, and the borrower had no residual income. The lender recorded one compensating factor on the FHA Loan Underwriting and Transmittal Summary, stating that the borrower's FICO score was above 620. This factor did not comply with the requirements of the mortgagee letter.

During our fieldwork, the lender provided additional information, stating that the loan had strong compensating factors, including verified cash reserves, debts with fewer than 10 payments, bonus income, and residual income. We evaluated the information and determined that it was not sufficient to justify loan approval. However, in response to our report, the lender provided documentation that showed the borrower had sufficient liquid retirement funds to meet HUD's verified cash reserves requirement (appendix B).

The compensating factor "debts with less than ten payments" is not a HUD-approved compensating factor. The lender did not exclude these accounts from its analysis of the borrower's liabilities during the original underwriting of the loan. However, excluding the accounts would only lower the borrower's total monthly fixed payment-to-income ratio from 56 percent to 50 percent. The ratios would still exceed the HUD limit of 43 percent.

During our original analysis, we noted that the borrower's verification of employment included bonus income that was comprised of vacation, birthday, and holiday pay. The borrower's verification of employment did not clearly show how much of the amount was bonus pay. The lender excluded the amount from its original income calculation. However, it included the amount in its response to our audit results to calculate residual income for the borrower. Since the amount was not previously included in the lender's original analysis and is questionable, the compensating factors of bonus income and residual income are not sufficient to justify loan approval. Despite the additional information provided by the lender, we determined that the loan did not meet HUD underwriting requirements at the time of loan approval.