



Issue Date	June 8, 2007
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Audit Report Number	2007-FW-1010
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TO: Brian D. Montgomery
Assistant Secretary for Housing—Federal Housing Commissioner, H

Frank E. Baca
FROM: Frank E. Baca
Regional Inspector General for Audit, Fort Worth Region, 6AGA

SUBJECT: Alethes Mortgage, LLC, and Its Dallas, Texas, Branch, Waters Edge Mortgage, LLC, Did Not Comply with All HUD Underwriting Requirements

HIGHLIGHTS

What We Audited and Why

We reviewed the operations at an Alethes Mortgage, LLC (Alethes); branch located at 12160 North Abrams, Dallas, Texas. The branch operates under the name Waters Edge Mortgage, LLC (Waters Edge). We selected Alethes' Waters Edge branch for review due to its high default rate.

Our objective was to determine whether Alethes and its Waters Edge branch complied with U.S. Department of Housing and Urban Development (HUD) regulations, procedures, and instructions in the origination of Federal Housing Administration (FHA)-insured single-family mortgages.

What We Found

Alethes did not comply with all HUD requirements. Specifically, it did not notify HUD about one loan that contained an irregularity, conducted incomplete quality control reviews, and closed loans with underwriting deficiencies. By not alerting

HUD to potential fraud or serious violations, Alethes increased the FHA insurance fund's risk.

What We Recommend

We recommend that HUD's assistant secretary for housing—federal housing commissioner and chairman of the Mortgagee Review Board require Alethes to indemnify one loan for \$168,358,¹ and ensure that it complies with HUD's underwriting requirements.

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

Auditee's Response

We provided a draft report to Alethes on April 16, 2007, and held an exit conference on April 20, 2007. Based on information provided during the exit conference, we provided a revised draft report on April 25, 2007. Alethes provided written comments on May 25, 2007. Alethes disagreed that it should indemnify one loan. However, it did agree that its quality control contractor needs to comply with all HUD requirements. Based on additional documentation provided by Alethes, we modified the report as necessary. Alethes' response along with our evaluation is included in Appendix B of this report. We redacted names of borrowers and did not include the attachments due to the volume.

¹ The projected loss is \$48,824 based on HUD's insurance loss rate of 29 percent.

TABLE OF CONTENTS

Background and Objectives	4
Results of Audit	5
Finding: Alethes Did Not Comply All HUD Underwriting Requirements	
Scope and Methodology	9
Internal Controls	10
Appendixes	
A. Schedule of Questioned Costs and Funds to Be Put to Better Use	11
B. Auditee Comments and OIG's Evaluation	12
C. Required Quality Control Review Reverifications Missing from 8 of 14 Files Reviewed	26
D. Case Narratives	27

BACKGROUND AND OBJECTIVES

The National Housing Act, as amended, authorizes the U. S. Department of Housing and Urban Development (HUD) to provide mortgage insurance for single-family homes. HUD must approve a lender that originates, purchases, holds, or sells Federal Housing Administration (FHA)-insured loans. Lenders must follow the statutory and regulatory requirements of the National Housing Act and HUD's instructions, guidelines, and regulations when originating insured loans. Lenders that do not follow these requirements are subject to administrative sanctions.

Waters Edge Mortgage, LLC (Waters Edge), previously known as HomeQuest Mortgage, is now owned by Alethes Mortgage, LLC (Alethes). Alethes created Waters Edge on October 25, 2004. Fourteen² loans originated by one Waters Edge underwriter during the review period, October 2004 through September 2006, defaulted. The majority of the loans consisted of new or existing construction with one refinanced loan. The defaults occurred after 0 to 14 payments. The mortgage amounts totaled \$1.74 million with \$439,463 paid on six claims.

Alethes was conceived as AmeriNET Mortgage in 1998. In 2001, AmeriNET was reincorporated into Alethes. Originally, Alethes was a loan correspondent. However, on October 31, 2003, it received HUD's approval to be an originator of HUD loans. HUD terminated two of Alethes' other branches located in Austin, Texas, on May 15, 2006,³ and July 6, 2006.⁴

As part of our 2006 annual audit plan, we selected Alethes' Waters Edge branch because of its high default rate involving one of its underwriters.

Our objective was to determine whether Alethes and its Waters Edge branch complied with HUD regulations, procedures, and instructions in the origination of FHA-insured single-family mortgages.

² Also, apart from the 14 loans reviewed, one additional defaulted loan closed at the Waters Edge branch but was originated by a different underwriter during the audit scope. In total, we reviewed 15 loans.

³ Mortgagee number 1756700441.

⁴ Mortgagee number 1756701004.

RESULTS OF AUDIT

Finding: Alethes Did Not Fully Follow All HUD Underwriting and Other Compliance Requirements

Alethes did not fully follow all HUD underwriting and other compliance requirements. Specifically, it did not notify HUD about a loan that contained an irregularity, conducted incomplete quality control reviews, and closed loans with underwriting deficiencies. By not alerting HUD to potential fraud or other serious violations, Alethes subjected the FHA insurance fund to risk. Further, since Alethes did not meet quality control review and origination requirements, HUD does not have assurance that loans originated by Alethes met HUD guidelines.

Alethes Did Not Notify HUD of Potential Fraud

Alethes did not notify HUD of an irregularity on one loan. The loan⁵ contained suspicious employment documents. Alethes stated that the borrower manufactured documents. However, Alethes did not notify HUD although the loan servicer required Alethes to indemnify this loan after its review.

HUD required⁶ Alethes to notify it of findings of fraud or other serious violations within 60 days of the initial discovery. Alethes' legal counsel believed that Alethes did not have to report these matters because they had not yet been adjudicated. However, HUD needs to be made aware of problems with insured loans before adjudication.

Alethes did not perform a quality control review of one defaulted loan until its servicer notified it that the loan had reached the 90-days delinquent status within 12 months of origination. The servicer's quality control review found that the borrower misrepresented income and requested Alethes to repurchase the loan. After being notified of the problem, Alethes conducted its own quality control review of the loan and also concluded that the borrower misrepresented income. To originate the loan, Alethes stated that it relied upon the manufactured documents relating to income from a second job to qualify the loan. Further, a false verbal employment verification may have occurred.

⁵ Loan number 491-8687429.

⁶ HUD Handbook 4060.1, REV-2, "FHA Title II Mortgage Approval Handbook," paragraph 7-3J.

Alethes Performed Incomplete Quality Control Reviews

Alethes did not conduct complete quality control reviews. Specifically, Alethes did not (1) use HUD's Neighborhood Watch system to determine which loans defaulted within the first six months, (2) verify all required documents during quality control reviews, or (3) select 10 percent of FHA loans for one of three months reviewed,

Neighborhood Watch system. Alethes did not use HUD's Neighborhood Watch system to determine which loans defaulted within the first six months. Instead, it relied upon its servicer to inform it when a loan defaults within the first six months (see previous section). HUD regulations state, "[i]n addition to the loans selected for routine quality control reviews, mortgagees must review all loans going into default within the first six payments."⁷ Alethes' quality control plan contains the same requirement. Alethes needs to use HUD's Neighborhood Watch as a resource to determine whether loans go into default within the first six months and not rely upon its servicer to provide this information.

Verification of documents. HUD requirements⁸ and Alethes' quality control plan⁹ require reverification of certain documents. According to Alethes' quality control plan, written reverification must be attempted, and if it cannot be obtained, then a verbal reverification may be completed. Alethes and its quality control contractor did not comply with either its quality control plan or HUD requirements for 8 of the 14 loans reviewed. See appendix C for details.

Review of 10 percent of FHA loans. For one of three months reviewed, Alethes' quality control contractor did not select and review 10 percent of FHA loans originated as required.¹⁰ Alethes' quality control contractor selects loans based on the branch and loan officer to ensure that all loan officers are reviewed based on their output. The contractor believed that it met the intention of the requirement because in some months it over selected FHA loans for review and in some months it under selected loans. However, this process did not always ensure that 10 percent of FHA loans were selected for quality control review.

⁷ HUD Handbook 4060.1, REV-2, "FHA Title II Mortgage Approval Handbook," paragraph 7-6 D.

⁸ HUD Handbook 4060.1, REV-2, "FHA Title II Mortgage Approval Handbook," chapter 7.

⁹ Alethes' quality control plan 2005, part IVA1 and 2.

¹⁰ HUD Handbook 4060.1, REV-2, "FHA Title II Mortgage Approval Handbook," paragraph 7-6 and Alethes' Quality Control Plan p 2."

Alethes Closed Loans With Underwriting Deficiencies

Alethes did not comply with all underwriting and compliance requirements in that it did not (1) always properly evaluate borrowers' credit by adding nontraditional credit items to borrowers' credit reports, (2) include compensating factors in the mortgage credit analysis worksheet as required on one loan, or (3) document the transfer of gift funds from the donor to the borrower.

Use of nontraditional credit items. Alethes' Waters Edge branch added nontraditional credit¹¹ items to borrowers' credit reports, giving the appearance that the credit was enhanced. Borrowers served by Waters Edge generally had poor credit histories. According to Alethes' employees at the Waters Edge branch, the credit score was not rescored by the addition of these items because of the cost. Waters Edge relied upon the credit company to verify the validity of the information, although at one time, it performed the verifications.

For four of the borrowers, Waters Edge added payroll deductions to the credit reports. HUD requirements¹² specifically disallow payroll insurance deductions to be considered as periodic payments on a regular basis. As shown below, Waters Edge added the medical, dental, and vision insurance payroll deductions to a borrower's credit report.

①	B	MBM CUSTOMIZED FOOD MEDICAL ACCT. UPDATED PER LETTER FROM CREDITOR	07/05 12/04	01/04 12/04	\$2624 OPEN	\$0 12 \$0	-	0	0	0	0	0	PAID
②	B	MBM CUSTOMIZED FOOD DENTAL ACCT UPDATED PER LETTER FROM CREDITOR	07/05 12/04	01/04 12/04	\$315 OPEN	\$0 12 \$0	\$0	0	0	0	0	0	PAID
③	B	MBM CUSTOMIZED FOOD VISION ACCT UPDATED PER LETTER FROM CREDITOR	07/05 12/04	01/04 12/04	\$227 OPEN	\$0 12 \$0	\$0	0	0	0	0	0	PAID

In another case, the updated credit report showed that the borrower paid for rent as well as water. However, the borrower received a housing choice voucher, which included an allowance for utilities. In this instance, the borrower's credit was enhanced by the appearance that the borrower paid monthly, when in reality HUD paid the rent and the utilities. Additionally, Alethes added the child card expense to this borrower's credit report.

B	INDIAN CREEK APTS	06/05	05/02 06/05	-	-	-	37	0	0	0	0	AS AGREED
ALSO PAID WATER BILL AS WELL AS RENT, UPDATED PER [REDACTED] non-trad (2)												
COLLECTION ACCOUNTS												

¹¹ Nontraditional credit uses trade items not normally used to establish credit such as day care expenses.

¹² HUD Handbook 4155.1, REV-5, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-4B2.

Compensating factors. For one loan, Alethes did not include compensating factors on the mortgage credit analysis worksheet when the liability factors exceed HUD benchmark guidelines. HUD regulations state that past credit history determines the borrower's attitude toward credit and strong compensating factors need to offset the borrower's slow payments, judgments, and delinquent accounts.

Documentation of gift transfers. Alethes did not document the transfer for any of the loans that received gift funds. HUD regulations state that the lender must document the transfer of funds from the donor to the borrower.

Conclusion

Alethes did not fully follow HUD requirements and sound underwriting in loans reviewed and should indemnify HUD for one loan. While the majority of loans reviewed did not disclose significant departures from HUD requirements, Alethes needs to improve its underwriting and quality control. These improvements would improve Alethes' compliance with HUD requirements and lower the risk to the FHA insurance fund.

Recommendations

We recommend that HUD's assistant secretary for housing—federal housing commissioner and chairman of the Mortgagee Review Board

- 1A. Require Alethes to indemnify the loan with an original mortgage amount of \$168,358. The projected loss is \$48,824 based on HUD's insurance loss rate of 29 percent.
- 1B. Require Alethes to ensure that its quality control contractor complies with all HUD regulations and Alethes' quality control plan, including reporting potential fraud and other serious violations to HUD and reviewing Neighborhood Watch for loans defaulting within six months, verifying required documents, and performing quality control reviews of 10 percent of FHA loans.
- 1C. Ensure that Alethes complies with HUD's underwriting requirements, including not enhancing borrowers' credit, documenting compensating factors when exceeding liability ratios, and obtaining gift transfer documentation.

SCOPE AND METHODOLOGY

To accomplish our audit objectives, we

- Reviewed applicable HUD handbooks and mortgagee letters.
- Reviewed 15 defaulted loans¹³ originated¹⁴ by Alethes from October 2004 to September 2006. We added one defaulted loan to our scope that Alethes' quality control review found contained questionable documentation.
- Examined closing documentation including credit reports, appraisals, and loan applications.
- Conducted interviews with officials of Alethes and Waters Edge; Alethes' quality assurance contractor, Covenant Mortgage; and the HUD Quality Assurance Division.
- Contacted borrowers by mail, telephone, and in-person interviews.
- Performed site visits at seven properties.
- Reviewed Alethes' quality control plan.

In addition, we relied on data maintained by HUD in its Neighborhood Watch system. However, we did not perform a detailed analysis of the reliability of this computer database.

The audit covered the period October 2004 to September 2006. We conducted our fieldwork at our office in Fort Worth, Texas; Waters Edge's office in Dallas, Texas; and Alethes' office in Austin, Texas, from December 2006 through February 2007. We performed the audit in accordance with generally accepted government auditing standards.

¹³ Out of a universe of 150 loans in the Fort Worth and Dallas jurisdiction, the underwriter reviewed closed 62 (41 percent) of the loans.

¹⁴ One underwriter originated 14 of the 15 loans selected for review.

INTERNAL CONTROLS

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

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

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

Relevant Internal Control

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

- Quality control plan—Policies and procedures that management requires to reasonably ensure implementation of HUD quality control requirements.
- Loan origination process—Policies and procedures that management requires to reasonably ensure that the loan origination process complies with HUD program requirements.

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

Significant Weakness

Based on our review, we believe no significant weaknesses existed.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS BE PUT TO BETTER USE

Recommendation number	Ineligible <u>1/</u>	Funds to be put to better use <u>2/</u>
1A		\$48,824

- 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.
- 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. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. The Inspector General Act, section 5, paragraph (4) d, states that this category includes indemnification agreements between mortgagees/lenders/issuers and the Mortgagee Review Board not to file certain claims in the future on selected FHA insurance cases.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments



May 24, 2007

VIA FEDERAL EXPRESS

Mr. Frank E. Baca
Regional Inspector General for Audit
Region VI, Office of Inspector General
U.S. Department of Housing and Urban Development
819 Taylor Street, Room 13A09
Fort Worth, Texas 76102

Re: **Alethes, LLC**
Audit Report # 2007-FW-100X

Dear Mr. Baca:

Alethes, LLC ("Alethes" or "Company") is in receipt of the letter dated April 25, 2007, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Region VI, Office of Inspector General ("OIG"). The letter concerns a draft report of findings ("Report") on Alethes, LLC's Water's Edge branch office, in Dallas Texas. The report identifies alleged deficiencies in certain Federal Housing Administration ("FHA") loans that Alethes originated. We appreciate this opportunity to address the issues raised in the Draft Report.

I. BACKGROUND

Alethes, headquartered in Austin, Texas, was incorporated on May 4, 2001. It received approval to participate in the Department's FHA mortgage insurance programs on March 18, 2003 and the Direct Endorsement approval on October 31, 2003. Alethes is currently licensed to conduct business in 12 states, operates through 40 office locations, and employs approximately 500 individuals. Alethes does not service any of the loans that it originates, but sells all mortgage loans into the secondary market on a servicing-release basis. The Company's primary conduit investors include GMAC Mortgage Corporation, SunTrust Mortgage, Inc., and Regions Financial Corporation.

FHA lending constitutes over 60% of Alethes' production. Because FHA lending comprises a substantial portion of the Company's overall business

operations, the Company is committed to its relationship with the Department and takes its responsibilities under the FHA program seriously. We outsource quality control to Covenant Mortgage Services, an independent third party; in addition the Company employs an internal quality control manager with Certified Public Accounting (CPA) credentials who oversees any quality control issues that may arise and is responsible for ensuring the timely resolution of quality control findings. Alethes' management also consistently monitors Neighborhood Watch data to evaluate the Company's default and claim performance. We would never knowingly violate FHA requirements nor endanger the reputation of Alethes or its employees.

Alethes, both on a corporate and individual level, is also entrenched in its lending communities. The company has sponsored numerous civic activities and received recognition from several local and national organizations. Individual branches and loan originators are committed to social service and to educating community members about homeownership opportunities. Alethes has worked hard to serve its customers and has earned an excellent reputation among its industry colleagues.

II. RESPONSE TO THE FINDINGS

The report contains 3 findings and cites 15 cases, which generally concern the specificity of certain loan documentation as part of its Quality Control process. In no case did Alethes misrepresent information to the Department or approve a loan to an ineligible borrower based on information the Company received. After receiving the Report, Alethes conducted a thorough review of the cited conduct and loan files. We consulted HUD handbooks, Mortgagee Letters and regulations, as well as examined Company policies and procedures, in order to provide pertinent information and documentation with this response.

A. FINDING – "ALETHES DID NOT FULLY FOLLOW ALL HUD UNDERWRITING AND OTHER COMPLIANCE REQUIREMENTS"

a. Alethes Did Not Notify HUD of Potential Fraud

The report alleges that Alethes did not notify HUD of an irregularity on one loan [REDACTED] loan, case number 491-8687429). Alethes was notified by the servicing lender (GMAC) by letter on June 16, 2006 (**Exhibit A**) that a suspicion of misrepresentation or data integrity was present in conjunction with this loan as part of an early payment default review by GMAC.

Pursuant with company policy, the Company immediately initiated a comprehensive internal quality review of this loan to determine if in-fact the Company was defrauded in this loan. This review was completed on October 27, 2006 and a final

Comment 1

report (Exhibit B) was issued and presented to company management. Upon receipt of this final report, the Company agreed to remit \$4,372.23 to GMAC on October 30, 2006 as an early payment default penalty (Exhibit C).

PAID	CHECK	Investor	Investor	Alethes'	Borrower	Borrower	Investor	Investor
DATE	#	Name	Loan #	Loan #	Last Name	First Name	Notice Date	EPD Fees/ Penalties
10/30/2006	17661	GMAC	[REDACTED]	212376	[REDACTED]	[REDACTED]	06/20/06	\$4,372.23

Concurrent to this review, the company procedurally monitored Neighborhood Watch and the [REDACTED] loan was noted during the Company's September survey of Neighborhood Watch. When a loan is sold servicing-released to a HUD approved lender such as GMAC, the Company works cooperatively to perform multiple tasks associated with the loan (e.g. Insuring, MIP remittance, default payment reporting, etc.). We believed that they had already met all required HUD reporting requirements in conjunction with the default and/or fraud reporting evidenced by the [REDACTED] loan inclusion in Neighborhood Watch and thus, our requirement was also met. The underlying predicate for this belief was that the [REDACTED] loan was sold on a servicing-release basis and due to Federal privacy laws the Company is restricted from certain borrower information held by the servicing lender and in certain circumstances resulted in incomplete information or delays in the Company becoming aware of borrower payment defaults in real time.

The Company has modified its QC plan and practice to report all instances of fraud and/or misrepresentation within sixty days of discovery, which in this case would have occurred within 60 days after 10/27/2006.

The report references an observation that "Alethes' legal counsel believed that Alethes did not have to report these matters because they had not yet been adjudicated." This was misunderstood by the OIG auditor as a defense by the Company as to why it failed to report fraud to HUD. Rather this was in reference to an investigation by the local sheriff's office of a claim filed by the co-borrower's father that the [REDACTED] co-borrower stole his identity in making application and the closing of the loan.

b. Alethes Performed Incomplete Quality Control Reviews

1. Neighborhood Watch system

Comment 2

Alethes was not solely relying on its serviced released lender to inform it of loan defaults. Alethes was using FHA Connection ("FHAC") to inform it of defaults. In fact, once per quarter Alethes was monitoring FHAC for all defaults that entered the system in the prior 90 days. In October 2006, Alethes changed its procedure so that this was being performed monthly instead of quarterly. Alethes merely stated that we rely on our servicers to report delinquencies to HUD on a timely basis so that we see them and do proper quality control checks on them.

2. Verification of Documents

[REDACTED] (492-7586253) - The report alleges (Appendix C) that the Company did not re-verify employment as part of its QC review but that is incorrect. The re-verification was performed and in the file. (Exhibit D)

HUD Handbook 4060.1, Rev-2 (08/14/06) ¶ 7-6 § E-2, requires files to be "checked for sufficiency". The Company's underwriter acted reasonably when he concluded that the funds were available based upon the documentation provided and the Company's quality control contractor concluded that the documentation met HUD's "sufficiency" standard. The company has reinforced its quality control procedures to ensure borrower funds are re-verified regardless of the dollar amount.

The down payment came from a gift from a down payment assistance company (Partners In Charity). HUD Handbook 4155.1, Rev-5, ¶ C-2b [Note], requires that "lenders are responsible for assuring that the gift to the homebuyer from the charitable organization meets the appropriate FHA requirements and the transfer of funds is properly documented. The debit and credit for this debt is reflected in the HUD-I settlement statement (Exhibit E1) as provided for in the confirmation letter (Exhibit E2).

The report alleges (Appendix C) that the Company did not re-verify rental history as part of its QC review and while true, re-verification was not called for her as the borrower resided with her parents for the period of seven years prior to making loan application. The file was

underwritten by the Company under the assumption that there was no rental history based upon a letter provided to the Company by the borrower's parents that was contained in the file (**Exhibit F**).

[REDACTED] (491-8671362) – The report alleges that the company failed to re-verify funds for closing in this instance. The borrower received a First-time Homebuyer Forgivable loan of \$10,000 (**Exhibit G1**). These funds represented the entirety of monies utilized for closing resulting in zero dollars required of the borrowers (**Exhibit G2, line #303**). Thus borrower funds were not in question and re-verification unwarranted.

The Company agrees with the report that the quality control review failed to re-verify the rental verification in the file. Training and procedural oversight has been strengthened to forestall future failures of this nature.

[REDACTED] (491-8619123) - The report alleges that the Company's QC review failed to re-verify the borrower's employment. The Company agrees with the report that the quality control review failed to re-verify employment in this case. Training and procedural oversight has been strengthened to forestall future failures of this nature.

HUD Handbook 4060.1, Rev-2 (08/14/06) ¶ 7-6 § E-2, requires files to be "checked for sufficiency". The Company's underwriter acted reasonably when he concluded that zero funds were required for closing based upon the documentation provided and the Company's quality control contractor concluded that the documentation met HUD's "sufficiency" standard even though the borrower was required to remit \$119.24 at closing. The company has reinforced its quality control procedures to ensure borrower funds are re-verified regardless of the dollar amount.

The down payment came from a gift from a down payment assistance company (Partners in Charity). HUD Handbook 4155.1, Rev-5, ¶ C-2b [Note], requires that "lenders are responsible for assuring that the gift to the homebuyer from the charitable organization meets the appropriate FHA requirements and the transfer of funds is properly documented. The debit and credit for this debt is reflected in the HUD-I settlement statement

(Exhibit H1) as provided for in the confirmation letter **(Exhibit H2)**.

The Company agrees with the report that the quality control review failed to re-verify the rental verification in the file. Training and procedural oversight has been strengthened to forestall future failures of this nature.

(491-8687429) - The report alleges that the Company's QC review failed to re-verify the borrower's 2nd job. The Company agrees with the report. Training and procedural oversight has been strengthened to forestall future failures of this nature.

The report alleges significant differences in the comparison of bank account verification to bank statements. Alethes performed good faith underwriting and fraud prevention practices but despite our best efforts, was the victim of fraud in this loan file. Nevertheless, we recognize that there is always room for improvement and that certain deficiencies may have occurred in connection with some of the findings in the Report. The Company has made improvements to its operations as a result of this review.

The down payment came from a gift from a down payment assistance company (Partners in Charity). HUD Handbook 4155.1, Rev-5, ¶ C-2b [Note], requires that "lenders are responsible for assuring that the gift to the homebuyer from the charitable organization meets the appropriate FHA requirements and the transfer of funds is properly documented. The debit and credit for this debt is reflected in the HUD-1 settlement statement **(Exhibit I1)** as provided for in the confirmation letter **(Exhibit I2)**.

The Company agrees with the report that the quality control review failed to re-verify the rental verification in the file. Training and procedural oversight has been strengthened to forestall future failures of this nature.

(491-8614421) - The down payment came from a gift from a down payment assistance company (Partners in Charity). HUD Handbook 4155.1, Rev-5, ¶ C-2b [Note], requires that "lenders are responsible for assuring that the gift to the homebuyer from the charitable

organization meets the appropriate FHA requirements and the transfer of funds is properly documented. The debit and credit for this debt is reflected in the HUD-I settlement statement (**Exhibit J1**) as provided for in the confirmation letter (**Exhibit J2**).

The Company agrees with the report that the quality control review failed to re-verify the rental verification in the file. Training and procedural oversight has been strengthened to forestall future failures of this nature.

[REDACTED] (491-8663048) – The report in Appendix “C” alleges that the Company failed to reconcile a rental payment default entry discrepancy between the credit report utilized by the Company as part of its underwriting process and a report generated at the request of the OIG auditor. This loan was not included in the normal QC selection process and thus the company was unaware of the reported default post closing until the generation of the credit for the OIG auditor. The company has initiated the reconciliation of this entry as part of a formal Quality Control review of this loan and will follow Department guidelines and company policy.

The Company agrees with the report that the quality control review failed to re-verify the rental verification in the file. Training and procedural oversight has been strengthened to forestall future failures of this nature.

The Company respectfully disagrees with the report that the quality control review failed to re-verify the borrower’s employment. The verification was included in the file and is provided within this response (**Exhibit K**)

The down payment came from a gift from a down payment assistance company (Partners in Charity). HUD Handbook 4155.1, Rev-5, ¶ C-2b [Note], requires that “lenders are responsible for assuring that the gift to the homebuyer from the charitable organization meets the appropriate FHA requirements and the transfer of funds is properly documented. The debit and credit for this debt is reflected in the HUD-I settlement statement (**Exhibit L1**) as provided for in the confirmation letter (**Exhibit L2**).

██████████ (491-8616422)- The down payment came from a gift from a down payment assistance company (Partners in Charity). HUD Handbook 4155.1, Rev-5, ¶ C-2b [Note], requires that "lenders are responsible for assuring that the gift to the homebuyer from the charitable organization meets the appropriate FHA requirements and the transfer of funds is properly documented. The debit and credit for this debt is reflected in the HUD-I settlement statement (Exhibit M1) as provided for in the confirmation letter (Exhibit M2).

The Company agrees with the report that the quality control review failed to re-verify the rental verification in the file. Training and procedural oversight has been strengthened to forestall future failures of this nature.

██████████ (491-8601428) – The report stated correctly that the 401(k) account was unable to be re-verified as part of its review. In the company's experience, this is not unusual. Additional funds contained in the borrower's checking account were not considered due to the fact that the borrower presented a written statement to the effect that they did not have a checking account. (Exhibit N) Had the company been made aware of this accounts existence, it would have only strengthened the loan file and would have been considered in a positive light.

The down payment came from a gift from a down payment assistance company (Partners in Charity). HUD Handbook 4155.1, Rev-5, ¶ C-2b [Note], requires that "lenders are responsible for assuring that the gift to the homebuyer from the charitable organization meets the appropriate FHA requirements and the transfer of funds is properly documented. The debit and credit for this debt is reflected in the HUD-I settlement statement (Exhibit O1) as provided for in the confirmation letter (Exhibit O2).

The Company agrees with the report that the quality control review failed to re-verify the rental verification in the file. Training and procedural oversight has been strengthened to forestall future failures of this nature.

3. Review of 10 percent of FHA loans

Comment 3

While it is true that Alethes had one month where it chose less than 10% of FHA loans funded that month, it is not the normal course of business for the Company to do so. However, the HUD Handbook is not specific that the selection required is to meet the 10% guideline each and every month. Paragraph 7-6 states "A mortgagee who originates and/or underwrites 3,500 or fewer FHA loans per year must review 10% of the FHA loans it originates." It goes no further to specify that this must occur each and every month. In fact, Alethes reviewed 10% of its FHA loans for every other month of the last two years and it has reviewed more than 10% of its FHA loan production on an annual basis for the last two years. We disagree that our process does not ensure that 10 percent of FHA loans were selected for quality control review. We certainly believe that the Company procedures meet the letter and the spirit of the HUD guideline relative to this matter.

c. Alethes Closed Loans with Underwriting Deficiencies

i. Use of nontraditional credit items

The report alleges that Alethes' Waters Edge branch added nontraditional credit items to borrower's credit reports. FHA Single Family Handbook / 4155.1 REV-5, § 2-3, ¶ 4, provides that the "Lender must document that the providers of nontraditional credit do, in fact, exist and verify the credit information." The company was provided non-traditional credit references for consideration. The branch office then requested that the credit reporting agency verify these items and if appropriate, include these items within the borrower's credit report to the company after independently verifying these items. Only once verified, were these items added to the credit report. Credit reporting agencies are not in the practice of rescoring the borrowers credit report based on the addition of nontraditional credit items, therefore credit was never "enhanced". In ¶2 of the same section, a lender when analyzing a borrower's credit history is directed to "examine the overall pattern of credit behavior, rather than isolated occurrences of unsatisfactory or slow payments." The Company's underwriter weighed these entries appropriately and a reasonable determination was made based on facts available at the time.

Comment 4

The report further alleges that “for four of the borrowers, Waters Edge added payroll deductions to the credit reports.” The report fails to define which four files were involved which precludes the Company from addressing each circumstance individually. However, the Company is aware that payroll deducted insurance items are specifically disallowed by HUD underwriting guidelines and did not give any consideration of these non allowed items, even as they appeared on the credit report for qualification purposes or any other purpose relative to underwriting.

Thirdly, the report alleges on page 7, that “in another case, the updated credit report showed that the borrower paid for rent as well as water. However, the borrower received a housing choice voucher, which included an allowance for utilities.” The company was unaware of this fact as it was not disclosed to us at any time during the origination, underwriting, or closing of the loan by the borrower despite reasonable efforts on the part of the Company to ascertain all relevant facts germane to the evaluation determination in making the loan. The report appears critical of the inclusion of payments to child care providers on the credit report provided to the Company. The Company is aware of the Departments policy change in its Mortgagee Letter (ML-95-7, § V.) which provides for eliminating consideration of child care as recurring debt since the Department “believe[s] that most families, in assessing their financial priorities, will find alternative means of caring for their young children if such costs become burdensome.” Appropriate consideration of this optional expense can be helpful in assessing the borrower’s credit payment ability. The inclusion of this entry was not particularly noteworthy in this instance and was weighted appropriately during underwriting by the company.

ii. Compensating Factors

The report states “for one loan, Alethes did not include compensating factors on the mortgage credit analysis worksheet when the liability factors exceed HUD benchmark guidelines.” The report fails to define which file was involved which precludes the Company from addressing this instance individually. The Company is aware of the Department’s requirement that compensating factors be specifically articulated on the Mortgage Credit Analysis worksheet (MCAW) completed by its underwriters. It is

Comment 5

Comment 6

standard procedure for Alethes' underwriters to include all compensating factors on the final MCAW.

iii. Documentation of Gift Transfers

The report alleges that Alethes did not document the transfer of monies for any of the loans that received gift funds. The Company respectfully disagrees with this statement as we believe that we complied with HUD regulations relevant to this process. The down payment came from a gift from a down payment assistance company (e.g., Partners in Charity). HUD Handbook 4155.1, Rev-5, ¶ C-2b [Note], requires that "lenders are responsible for assuring that the gift to the homebuyer from the charitable organization meets the appropriate FHA requirements and the transfer of funds is properly documented. The debit and credit for this debt is reflected in a HUD-1 settlement statement as required for in the confirmation letter provided by the DPA program provider. We believe that this practice is further reinforced by state statute that the lender must document the transfer of funds from the donor to the borrower." Texas Insurance Code Title 11, Title Insurance, Subtitle A, General Provisions, Chapter 2501, General Provisions § 2651.202. Trust Fund Account Disbursements provides the following: "(a) A title insurance company, title insurance agent, or direct operation may not disburse funds from a trust fund account until good funds related to the transaction have been received and deposited in the account in amounts sufficient to fund any disbursements from the transaction."

It is correct that the files provided to the auditor did not contain any documentation of transfer of gift funds from the donor to the title company other than the HUD-1 Settlement Statement for the loan. Prior to the publication of ML 04-28, Alethes believed that the HUD-1 was adequate documentation for the transfer of gift funds. Subsequent to the publication of ML 04-28, Alethes has amended its policy to require the transmittal by the title company to Alethes of the documentation of the transfer of the gift funds from the donor to the title company in the title package.

d. OIG Recommendations

1A – The Company respectfully disagrees with the OIG recommendation to require Alethes to indemnify the [REDACTED]

Comment 8

loan, case number 491-8687429. While it was determined that fraud was perpetrated and information was misrepresented by the co-borrower, the Company in no way was involved nor was it determined during the course of the OIG audit that there were problems with company actions up to the point of loan closing. Rather the deficiencies found were on the after action and quality control procedures which would not have prevented the fraud in this instance. The Company values its quality control process but believes that there has been room for improvement and the Company has corrected its shortcomings in this department in order to provide feedback to its origination departments to provide risk mitigation to the department and company. The report stated "while the majority of loans review did not disclose significant departures from HUD requirements, Alethes needs to improve its underwriting and quality control." The Company performed its fiduciary duties to the trust fund reasonably given the information available at the time, therefore indemnification is unwarranted.

Comment 2

1B – The Company agrees fully with this recommendation.

Comments 4,
5, & 6

1C – While the Company fully supports with compliance of all of the Departments requirements, it respectfully disagrees with the basis for the recommendation. We believe we have adequately provided explanation where needed, clarification where appropriate and correction to the reports where necessary.

B. INTERNAL CONTROLS

Comment 7

- a. **Relevant Internal Control** – The Company agrees fully with the objectives stated within the report.
- b. **Significant Weakness** – The report alleges in the report that "Alethes did not always operate in accordance with HUD requirements as they relate to quality control reviews and loan origination requirements." While the company agrees that there were instances of failed procedure and room for improvement, we respectfully disagree that the deficiencies rise to the level of "significant weakness". The company has taken significant and tangible steps to improve its quality control department along with meaningful senior management oversight to provide accountability and accessibility to QC staff thus affecting dynamic corrective change where warranted and/or beneficial.

Comment 8

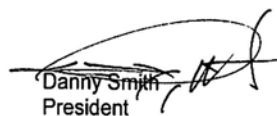
III. CONCLUSION

Alethes takes the OIG's findings seriously. Because FHA lending comprises a substantial portion of Alethes' overall business operations, the Company is committed to educating and training its employees on issues regarding FHA compliance and to assuring their adherence to HUD's rules and regulations. While the Report cites several cases, the finding generally focuses on the specificity of certain documentation as part of the quality control process rather than pre-loan closing underwriting, and Alethes at no time misrepresented information submitted to the Department or approved loans to ineligible borrowers. The Company respectfully maintains that the recommendation (OIG Draft Report, Page 8, recommendation 1A) made to the HUD assistant secretary for Housing, Federal Housing Commissioner and Chairman of the Mortgagee Review Board, that Alethes indemnify the loan does not rise to the level of indemnification and is unwarranted. Alethes performed good faith underwriting and fraud prevention practices but despite our best efforts, was the victim of fraud in this case and as of the date of this response, is the only party to-date having incurred a loss as a result (Investor EPD penalty). Nevertheless, we recognize that there is always room for improvement and that certain deficiencies may have occurred in connection with some of the findings in the Report. The Company has made improvements to its operations as a result of this review. The Company believes that loans it originated meet HUD Guidelines.

We appreciate this opportunity to work with the OIG and to strengthen our loan origination process. We trust that this response adequately addresses the OIG's concerns. Should you have any additional questions, or if you need additional information, please contact me at (512) 401-0522.

Thank you for your kind consideration.

Sincerely,


Danny Smith
President

Attachments

OIG Evaluation of Auditee Comments

1. While we appreciate Alethes for modifying its quality control plan and practice, we maintain that notification to HUD should be sooner. Alethes was notified of the potential misrepresentation on June 16, 2006, but does not believe it has a duty to report that information to HUD until 60 days after October 27, 2006, or December 26, 2006, over six months after it was notified. We maintain that Alethes should have reported this matter to HUD within 60 days of June 16, 2006.
2. Alethes agreed with the recommendation. In the instances where Alethes provided documentation to support its position, we made changes to the report.
3. Our conclusion was based upon Alethes' quality control plan that required a monthly review of 10 percent of loans.
4. Nontraditional credit is only for borrowers without normal trade references. It is not to be used to enhance the credit history of a borrower with a poor payment history.¹⁵ Alethes agreed that many of its borrowers have poor credit histories. We maintain that the purpose of adding of payroll deductions, specifically prohibited by HUD, and rental information to credit reports was to enhance borrowers' poor payment histories.
5. Alethes stated that its standard underwriting procedure is to include all compensating factors on the final Mortgage Credit Analysis Worksheet. Our review confirmed this. However, for one loan they did not add the compensating factors.
6. Alethes agreed that the files provided to the auditor did not contain documentation of the gift. Further, in an interview with Alethes' attorney and underwriter, they both agreed that Alethes did not obtain the gift transfer documentation.
7. We amended the internal control section to reflect that the issues were minor and not significant.
8. In this specific instance, Alethes had red flags of potential problems including the loan being referred to them by a builder because of insufficient income. Further, Alethes staff questioned the authenticity of income documentation and quality control staff was not able to reconfirm the existence of the bank employee that verified the borrower's bank balance. By ignoring these red flags, Alethes put the FHA insurance fund at risk; therefore, it should indemnify the loan.

¹⁵ HUD Handbook 4155.1, REV-5, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-4 B 2

Appendix C

REQUIRED QUALITY CONTROL REVIEW REVERIFICATIONS MISSING FROM 8 OF 14 FILES REVIEWED

Loan file number	Credit report reverification	Verification of employment	Verification of deposit	Verification of gift letters	Verification of mortgage or rent	Opinion of quality of loan stated?
492-7586253	Yes	Yes	No (fee required)	No	No	Yes
491-8671362	Yes	Yes	No	No	No	Yes
491-8619123	Yes	No/yes ^a	No	No	No	Yes
491-8687429	Yes	Yes/no ^b	Yes ^c	No	No	Yes
491-8614421	Yes	Yes	Yes	No	No	Yes
491-8663048	Yes ^d	Yes	No	No	No	Yes
491-8616422	Yes	Yes	No	No	No	Yes
491-8601428	Yes	Yes	No ^e	No	No	Yes ^f

- a Only the wife's employment was verified.
- b Verification of employment was for one employer and not the second employer.
- c Comparison of bank account verification to bank statements submitted for the loan revealed significant differences.
- d The credit report showed delinquent rent owed to the landlord that was verified as current at the time of the loan. The difference was not reconciled by Alethes.
- e The reviewer could not verify the 401K. The loan application said the borrower did not have a checking account, but the borrower indicated to OIG that she did have and has always had a checking account.
- f The quality control contractor questioned why this loan was approved with bankruptcy and late payments after bankruptcy. However, Alethes' underwriter stated that the bankruptcy was dismissed and was not considered for the loan approval.

Appendix D

CASE NARRATIVES

Case Narrative for 491-8687429

Mortgage Amount: \$168,358

Date of Loan Closing: August 5, 2005

Gift Amount: \$5,130

Underwriting Deficiencies Unexplained income balance changes, nontraditional credit items added to enhance credit, and gift fund transfer not documented.

Summary:

Unexplained income that should have been questioned by the lender

- The borrower's bank balance showed a \$1 balance on June 13, 2005, and \$3,280.24 on July 25, 2005, but the increase was not explained in the file. The bank statement reflected payroll from Pappas Partners which is not listed as an employer of borrower.
- Print outs of on-line bank statements provided by borrower's boyfriend/common-law husband contained alterations. For example, a faxed copy of bank statement from the boyfriend/common-law husband's account shows Denny's payroll deposited for the period of June 27, 2005 to July 25, 2005. Alterations include showing a deposit with a "-" instead of a "+" like other deposits on the bank statement.
- The borrower account used for loan purposes had no rent or everyday expenses reflected in withdrawals. The borrower stated she did not deposit her Denny's pay into her checking account, however, her Denny pay stubs reflect an automatic deposit. This conflicted with the bank statement provided by the borrower.
- Mailing address on W-2's for borrower is different for the three employers W-2's for tax years 2003 and 2004 even though borrower reported she had been renting same apartment since 2002.

HUD requires¹⁶ the lender to determine a borrower's ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties. Further HUD requires¹⁷ a verification of deposit, along with the most recent bank statement, to verify savings and checking accounts. If there is a large increase in an

¹⁶ HUD Handbook 4155.1 REV-5, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-1.

¹⁷ HUD Handbook 4155.1 REV-5 "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-10 b.

account, or the account was opened recently, the lender must obtain a credible explanation of the source of those funds.

Added non-traditional credit items to enhance credit

Waters Edge added three non-traditional credit items to enhance the borrower's credit report. HUD regulations¹⁸ do not allow a borrower with poor credit to enhance their credit with non-traditional credit.

No documentation of gift funds transfer

Alethes did not document the transfer of the gift funds. HUD regulation 4155.1 Chg 4 2-10 C. states the lender must document the transfer of the funds from the donor to the borrower.

Recommendation:

We recommend that the assistant secretary for housing—federal housing commissioner require Alethes to:

- A. Indemnify the loan with an original mortgage amount of \$168,358. The projected loss is \$48,824 based on HUD's insurance loss rate of 29 percent.

¹⁸ HUD Handbook 4155.1 REV-5 "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties," paragraph 2-4.