



Issue Date
December 15, 2009
Audit Report Number:
2010-CH-1004

TO: Vicki B. Bott, Deputy Assistant Secretary for Single Family Housing, HU  
Mary Kinney, Executive Vice President for Ginnie Mae, TP  
Dane M. Narode, Associate General Counsel for Program Enforcement, CE

FROM:   
Heath Wolfe, Regional Inspector General for Audit, 5AGA

SUBJECT: Leader Financial Services, Parma, Ohio, Did Not Perform an Adequate Due Diligence Review of Purchased Loan Components of FHA-Insured Loans

## **HIGHLIGHTS**

### **What We Audited and Why**

We performed an audit of Leader Financial Services (Leader), a Government National Mortgage Association (Ginnie Mae) issuer servicing Federal Housing Administration (FHA)-insured loans. We initiated the audit based on the 62 percent delinquency rate of Leader's mortgage-servicing package purchased from Fidelity Home Mortgage Corporation (Fidelity). Our objective was to determine whether Leader complied with the U.S. Department of Housing and Urban Development's (HUD) requirements when it purchased Fidelity's loan-servicing portfolio (mortgage-servicing rights)<sup>1</sup>.

### **What We Found**

Leader complied with HUD's requirements in the purchase and transfer of Fidelity's loan-servicing portfolio (mortgage-servicing rights). However, it failed to perform an adequate due diligence review. The loans contained a number of unacceptable and/or compliance-related underwriting deficiencies, such as excessive borrower qualifying ratios without valid compensating factors, inaccurate borrower asset and

<sup>1</sup> See Appendix D for more information on mortgage servicing rights.

income determinations, and/or credit deficiencies. As a result, Leader subjected itself to unnecessary risks.

In September 2009, American National Bank (Bank), Leader's parent company, agreed to cease and desist proceedings with the U.S. Department of the Treasury's Office of the Comptroller of the Currency<sup>2</sup> for unsafe or unsound banking practices in the Bank's mortgage-servicing program. The proceedings contain a list of provisions including that the Bank cease all residential mortgage-servicing activities, unless it follows the Office of the Comptroller of the Currency's stipulations. The Bank agreed to exit the mortgage-servicing industry. Since Leader will no longer service mortgages, this report does not contain any recommendations regarding Leader.

## What We Recommend

We recommend that the Deputy Assistant Secretary for Single Family Housing determine the appropriate actions for the two underwriters that improperly underwrote 69 percent of the loans cited in this audit report and implement adequate procedures and controls to safeguard the FHA insurance fund. 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 our discussion draft audit report to Leader's management during the audit. We conducted an exit conference with Leader on September 25, 2009.

We asked Leader to provide written comments on our discussion draft audit report by September 28, 2009. Leader's acting president provided written comments to the discussion draft report, dated September 25, 2009. The acting president disagreed with our finding. The complete text of the auditee's comments, along with our evaluation of that response, can be found in appendix A of this report, except for 95 pages of documentation that was not necessary to understand the auditee's comments. We provided HUD's Deputy Assistant Secretary for Single Family Housing and Ginnie Mae's Executive Vice President with a complete copy of Leader's written comments plus the 95 pages of documentation.

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<sup>2</sup> The Office of the Comptroller of the Currency charters, regulates, and supervises all national banks. It also supervises the federal branches and agencies of foreign banks. The Office of the Comptroller of the Currency's mission is to ensure a stable and competitive national banking system.

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## **BACKGROUND AND OBJECTIVE**

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In 1968, Congress established the Government National Mortgage Association (Ginnie Mae) as a government-owned corporation within the U.S. Department of Housing and Urban Development (HUD). Ginnie Mae does not buy loans, sell loans, or issue mortgage-backed securities. Instead, lenders pool packages of Federal Housing Administration (FHA)-insured loans and loans guaranteed by the U.S. Department of Veterans Affairs, U.S. Department of Agriculture's Rural Housing Services, and HUD's Office of Public and Indian Housing to convert the pooled loans into securities. Ginnie Mae guarantees the timely payments of principal and interest on the mortgage-backed securities to investors.

Mortgage-backed securities are pools of mortgages used as collateral for the issuance of securities in the secondary market. Mortgage-backed securities are pass-through securities because the principal and interest payment from the underlying loans are passed through to investors. The interest rate of the security is lower than the interest rate of the underlying loan to allow for payment of servicing and guaranty fees. Ginnie Mae mortgage-backed securities are fully modified pass-through securities<sup>3</sup> guaranteed by the full faith and credit of the United States government.

HUD issued Mortgagee Letter 2002-21 to strongly encourage lenders to perform due diligence using the industry's best practices before purchasing loans from other lenders. However, as of November 24, 2009, there was no federal requirement that servicing lenders perform due diligence reviews.

Ginnie Mae approved Leader Financial Services (Leader), located at 5610 Ridge Road, Parma, Ohio, for participation as a Ginnie Mae issuer on September 29, 2006. Leader is a mortgage-servicing division of American National Bank. Its business activities include purchasing and servicing mortgage loans. The servicing of loans includes the following activities: collecting, monitoring, and reporting loan payments and handling property tax payments, insurance escrows, late mortgage payments, etc. Before an issuer transfers a portfolio, Ginnie Mae must approve the transfer.

We initiated the audit based on the 62 percent delinquency rate of Leader's mortgage-servicing portfolio purchased from Fidelity Home Mortgage Corporation (Fidelity). Our objective was to determine whether Leader complied with HUD requirements in the purchase of Fidelity's loan-servicing portfolio (mortgage-servicing rights).

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<sup>3</sup> When a borrower fails to make a monthly payment to a lender, the lender must use its own funds to pay the investor.

## **RESULTS OF AUDIT**

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### **Finding: Leader Performed an Inadequate Due Diligence Review**

Leader performed an inadequate due diligence review when it purchased the mortgage-servicing rights for a portfolio of 56 loan pools from Fidelity. The loans contained a number of unacceptable and/or compliance-related underwriting deficiencies, such as excessive borrower qualifying ratios without valid compensating factors, inaccurate borrower asset and income determinations, and/or credit deficiencies. The problems occurred because Leader lacked adequate procedures and controls to identify the risks associated with purchasing the mortgage-servicing rights for loans with high default rates. As a result, Leader subjected itself to unnecessary risks.

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#### **Leader Performed an Inadequate Due Diligence Review**

In November 2007, Leader initiated the purchase of servicing rights for 56 Ginnie Mae loan pools, valued at more than \$149 million in unpaid principal balances, from Fidelity. However, 473 loans were removed (liquidated) from the pools before the purchase was finalized, thus reducing the number of loans in the pools to 986. Although Leader purchased Fidelity's loan-servicing portfolio in 2007, Ginnie Mae did not transfer the servicing portfolio until March 2008.

When Leader agreed to purchase Fidelity's loan-servicing portfolio, it was aware that the loans had high delinquency rates. Therefore, before purchasing the loans' mortgage-servicing rights, Leader performed a due diligence review on 162 of the 986 loan origination files (16 percent) to determine the feasibility of buying the servicing portfolio. The review consisted of a checklist of items to review in the loan files. However, according to Leader, the results of its due diligence review identified minor exceptions, and none of the exceptions undermined the integrity of the loans connected with the servicing portfolio.

The review identified that 49 of the 162 (30 percent) loan files contained missing and/or incomplete documentation. In reviewing the checklist, we determined that underwriting deficiencies would not have been detected during Leader's due diligence review since it only required reviewers to check for missing and incomplete documentation. Consequently, based on the results of the due diligence review, Leader purchased the mortgage-servicing rights for the loans.

We reviewed 5 of the 162 loans that were a part of Leader's due diligence review. Using Leader's checklist, we replicated its due diligence review and compared our results with Leader's. We identified that for four of the five loans, Leader's checklist contained incorrect annual percentage rates. In each instance, Leader

obtained the annual percentage rate from the initial truth-in-lending statement, instead of the final truth-in-lending statement, as required by its checklist instructions (see appendix C), to compare with the rate on the mortgage note. In addition, for one of the five loans, Leader's reviewer did not complete all of the checklist items. Specifically, one of the checklist questions required the reviewer to determine whether the loan's loan-to-value ratio exceeded 80 percent. However, Leader's checklist did not contain a response to the review question. We determined that the loan-to-value ratio exceeded 80 percent.

Additionally, we performed an underwriting review of the five loans in our sample and identified that two of the loans contained underwriting deficiencies. The borrower for case number 261-9197439 initially had an adjustable-rate mortgage. However, the loan was streamline refinanced<sup>4</sup> to a fixed-rate mortgage that exceeded the previous adjustable rate by more than 2 percent. According to HUD Handbook 4155.1, REV-5, an adjustable-rate mortgage may be refinanced to a fixed-rate mortgage provided the new fixed-rate mortgage is no more than 2 percent greater than the current rate of the adjustable-rate mortgage (see appendix C). For case number 491-8934520, the borrower's mortgage payment-to-income ratio (front-end) exceeded HUD's requirement of 31 percent by more than 7 percent without valid compensating factors. The loan was manually underwritten. Mortgagee Letter 2005-16 specifies that for manually underwritten mortgages for which the direct endorsement underwriter must make the credit decision, the qualifying ratios are raised to 31 percent, which represents the borrower's monthly mortgage payment-to-income ratio, and 43 percent, which represents the borrower's total fixed monthly payment-to-income ratio. If either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval (see appendix C).

### **Leader Did Not Obtain All Loan Files**

In addition to missing pertinent documentation in the loan files, as previously mentioned, Leader did not obtain loan files for all serviced loans. For example, for 32 of the 986 loans (3 percent), Leader did not obtain loan origination and/or loan-servicing<sup>5</sup> files. However, according to Leader, when the loans were liquidated from the Ginnie Mae pools due to foreclosure or other means, it no longer pursued obtaining the missing loan origination/servicing files. Therefore, the number of missing loan files had been reduced to 15 as of September 9, 2009.

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<sup>4</sup> Refinance an existing FHA-insured loan into a new FHA-insured loan.

<sup>5</sup> Origination files contain the loan origination documents, such as loan application, loan disclosures, the settlement statement, etc. Servicing files include information regarding the borrower's taxes, escrow, payment history, etc.

## The Remaining Portfolio of Loans Had Underwriting Deficiencies

We reviewed 37 loan files from Leader's servicing purchase. However, these loans were not a part of its due diligence review. Of the 37 loans, 31 were nonliquidated,<sup>6</sup> and six were liquidated loans.<sup>7</sup> Of the 37 loans, 24 (65 percent) contained the following unacceptable and/or compliance-related underwriting deficiencies:

- Nineteen manually<sup>8</sup> underwritten loans had one or more qualifying ratios that exceeded HUD's requirements without valid compensating factors. According to HUD's Mortgagee Letter 2005-16, for manually underwritten mortgages for which the direct endorsement underwriter must make the credit decision, the qualifying ratios are raised to 31 percent and 43 percent. If either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval (see appendix C). For these 19 loans, the range of the borrowers' mortgage payment-to-income ratios was 32 to 82 percent, thus exceeding HUD's 31 percent limit by up to 51 percent. Additionally, for the borrowers' total payment-to-monthly income ratio, the range was 43 to 82 percent, thus exceeding HUD's 43 percent limit by up to 39 percent.
- Nine loans had credit deficiencies. For instance, for one of the nine loans, the borrowers had several recent credit deficiencies, including a collection from a previous residence that was still outstanding when the borrowers closed on the loan. The borrowers' explanations for their credit deficiencies were not adequate since they did not cover recently reported credit issues. According to HUD Handbook 4155.1, REV-5, major indications of derogatory credit—including judgments, collections, and any other recent credit problems—require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file. Additionally, the payment history of the borrower's housing obligations holds significant importance in evaluating credit. The lender must determine the borrower's payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity of interest with the borrower), verification of mortgage directly from the mortgage servicer, or canceled checks covering the most recent 12-month period (see appendix C).

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<sup>6</sup> Nonliquidated loans are loans still in Ginnie Mae pools.

<sup>7</sup> Liquidated loans have been removed from Ginnie Mae pools due to refinancing and delinquent homeowner payments.

<sup>8</sup> Loans that are underwritten by a direct endorsement underwriter.

- Ten borrowers' monthly income was not accurately determined. For instance, in underwriting the loans, commission and/or overtime income was included in the borrowers' income calculations without an analysis to determine whether their income was stable and likely to continue for the first three years of their mortgage loans. According to HUD Handbook 4155.1, REV-5, income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue. Additionally, the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage loan (see appendix C).
- For four loans, the financing costs or unpaid principal balances were overestimated; therefore, the loans exceeded HUD's maximum insurable mortgage limit. As outlined in HUD Handbook 4155.1, REV-5, the maximum insurable mortgage is the lesser of (1) the statutory loan limit for the area (typically a county or metropolitan statistical area) or (2) the applicable loan-to-value ratio. Collectively, the loans were overinsured by more than \$3,000 (see appendix C).
- For five loans, the documentation maintained in the borrowers' case binders and loan files did not provide adequate documentation to demonstrate that the borrowers had sufficient funds to close. According to HUD Handbook 4155.1, REV-5, all funds for the borrower's investment in the property must be verified and documented (see appendix C).
- For two loans, not all of the borrowers' liabilities were included in the calculation of their qualifying ratios. According to HUD Handbook 4155.1, REV-5, borrowers' liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. However, for these two loans, the borrowers' child support payments were not included as part of their recurring liabilities (see appendix C).

See appendix B for a table including the full list of loan origination files reviewed and deficiencies identified for each loan.

### **Leader Lacked Adequate Procedures and Controls**

Leader lacked adequate procedures and controls to manage risks associated with purchasing mortgage-servicing rights. Its quality control plan only required the review of the consistency and completeness of loan documentation. Therefore, Leader did not review the purchased servicing portfolio for underwriting soundness. According to Leader, since it purchased the servicing portfolio fully

originated, securitized, and insured, it did not perform a more detailed review. Further, its purchase agreement with Fidelity contained an indemnification clause that required Fidelity to reimburse Leader for any losses, damages, deficiencies, claims, etcetera, which would arise from the purchase. Although Leader's purchase agreement included this indemnification clause, Leader was not prepared for Fidelity to go out of business.

In 2002, HUD issued Mortgagee Letter 2002-21 to identify and recommend the use of prudent industry practices related to due diligence in the purchase of whole loans or loan pools. The letter contained a collection of procedures developed as best practices, accumulated from lenders in the mortgage industry. The purpose of the letter was to promote the use of best practices in performing due diligence reviews when acquiring loans from other lenders. According to the mortgagee letter, effective due diligence review practices would hinder the ability of lenders to sell predatory loans to others in the mortgage industry. If predatory loans cannot be sold, they are unlikely to be made, and all borrowers, including FHA borrowers, will be protected.

However, Leader's deficient due diligence review, performed in the purchase of Fidelity's servicing loan portfolio, did not aid in preventing the mortgage servicing for risky loans from being sold. The sale allowed Fidelity to benefit from underwriting substandard loans.

### **Leader Made Revisions to Its Policies and Procedures**

In January 2009, Leader recognized that the purchase of Fidelity's loan-servicing portfolio exposed the company to unacceptable levels of risk. Therefore, according to Leader's mortgage operations manager, Leader revised its policies and procedures to include a more thorough review when making purchases in an effort to implement and strengthen its procedures. Additionally, issues with the Fidelity purchase resulted in Leader's strengthening its quality control standards beyond HUD's requirements and similar to the best practices suggested in HUD's Mortgagee Letter 2002-21.

Leader's due diligence review process now includes an audit for underwriting soundness when acquiring mortgage-servicing rights for securitized loans.

## **Incorrect Underwriters' Certifications Were Submitted to HUD**

Although various loan correspondents<sup>9</sup> originated the 986 loans, Fidelity underwrote all of the loans. Of the 986 loans, 254 (26 percent) were liquidated from the pools due to bank foreclosures and/or loss mitigation<sup>10</sup> actions, and 732 loans were still in pools as of March 2009. Of the 732 loans, 661 loans had active FHA insurance, 23 loans had terminated insurance, and HUD had paid claims on 48 loans as of September 4, 2009. Additionally, of the 732 loans still in Ginnie Mae pools as of March 2009, 109 borrowers (15 percent) defaulted on their mortgage within the first six payments.

For the 732 loans in Ginnie Mae pools, two of Fidelity's underwriters underwrote 49 percent of the loans (approximately 359 loans). Further, of the 26 previously mentioned loans with unacceptable and/or compliance-related underwriting deficiencies, the same two underwriters underwrote 69 percent of the loans. Under HUD's direct endorsement program, direct endorsement underwriters certify to the integrity of the data for automated underwritten loans, or for manually underwritten loans, the underwriter certifies that due diligence was used in underwriting the loans. All of the 26 loans were manually underwritten.

## **Conclusion**

Because of Leader's inadequate due diligence review, it subjected itself to unnecessary risks. According to a letter to Ginnie Mae, dated November 2007, Leader committed itself to protecting the credit quality of the purchased servicing portfolio by implementing additional loss mitigation efforts to work with the troubled loans. However, as previously mentioned, 26 percent of the loans had liquidated as of March 2009. Further, the missing files and/or file documentation resulted in Leader's incurring additional costs and challenged Leader's ability to meet the requirements in its quality control plan for loan servicing.

Additionally, according to HUD's mortgagee letter, if due diligence is to be an effective protection against predatory lending, purchasers must complete their due diligence review before closing the sale transaction. A rigorous prepurchase review protects the purchaser and puts sellers on notice that poor quality, predatory, or fraudulently originated loans cannot be pawned off on legitimate mortgagees simply based on the strength of the FHA insurance endorsement.

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<sup>9</sup> Companies that originate mortgage loans but do not underwrite them.

<sup>10</sup> Actions used in negotiations between a homeowner and the homeowner's lender to prevent foreclosure, such as a short sale, mortgage loan terms modification, short refinance negotiation, deed in lieu of foreclosure, etc.

## **Leader Will No Longer Service Mortgages**

The U.S. Department of the Treasury's Office of the Comptroller of the Currency issued cease and desist proceedings against American National Bank (Bank) for unsafe or unsound banking practices in its mortgage-servicing program. The Bank, in the interest of compliance and cooperation, consented to the proceedings. The proceedings contain a list of provisions including that the Bank cease all residential mortgage-servicing activities, unless it follows the Office of the Comptroller of the Currency's stipulations. Thus, Leader agreed to exit the mortgage-servicing industry. Additionally, the Bank sent a letter, dated September 29, 2009, to Ginnie Mae, indicating its agreement to exit the mortgage-servicing business and that it was seeking bids from qualified candidates in an effort to sell the mortgage-servicing rights of its servicing portfolios. Since Leader will no longer service mortgages, this report does not contain any recommendations to the Deputy Assistant Secretary for Single Family Housing regarding Leader.

## **Recommendations**

We recommend that the Deputy Assistant Secretary for Single Family Housing

- 1A. Determine appropriate actions for the two underwriters that improperly underwrote 69 percent of the loans cited in this audit report.
- 1B. Implement adequate procedures and controls to safeguard the FHA insurance fund.

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

- 1C. Determine legal sufficiency and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act against Fidelity and/or its principals who incorrectly certified that due diligence was used in the underwriting decisions and the loans cited in this audit with unacceptable underwriting deficiencies were eligible for FHA mortgage insurance.

## **SCOPE AND METHODOLOGY**

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We performed our audit work between February and August 2009. We conducted our audit at Leader's headquarters in Parma, Ohio, and HUD's Chicago regional office. The audit covered the period January 1, 2008, through January 31, 2009.

To accomplish our audit, we researched and reviewed applicable HUD handbooks, regulations, mortgagee letters, and other reports and policies related to the Ginnie Mae's mortgage-backed securities and FHA mortgage insurance programs. We also conducted interviews with Leader's and the Bank's staff and HUD's staff.

### **Due Diligence Review**

For the due diligence review, we randomly selected 5 of the 162 loans that Leader reviewed as a part of its due diligence review and performed the following steps:

- Reviewed the documentation maintained in the loan files.
- Using Leader's checklist, we performed our own analysis of the loan documentation and compared our results to Leader's.
- Performed an underwriting review of the loans.

Leader purchased the servicing rights for 986 loans from Fidelity in 2007. Using data obtained from Ginnie Mae, Leader, and Dovenmuehle (Leader's subcontracted servicer ), as well as HUD's systems such as Single Family Data Warehouse<sup>11</sup> and Neighborhood Watch<sup>12</sup>, we were able to account for 732 nonliquidated loans as of March 2009. Of the 732 nonliquidated loans, we identified 106 loans for which the borrowers defaulted on their mortgage payments within the first six payments and 16 loans on which HUD paid claims.

### **Liquidated Loans**

Using a variable sample at a 90 percent confidence level, standard deviation of \$43,752, 10 percent desired sampling precision, and sampling error of \$12,111, we statistically selected 32 loans from the universe of 318 liquidated loans that were still active, meaning that the loans' FHA insurance was not terminated through refinancing, because they were paid in full, or by some other means. Although we selected 32 loans, we were only able to review 8 of the 32 selected loans from Leader because it did not obtain and maintain sufficient records for the liquidated loans to enable us to perform an adequate and complete underwriting review. Additionally, we were unable to obtain the case binders from HUD, so the number of loans reviewed was further reduced to six. Due to the limited number of files reviewed, we combined this review with the nonliquidated loans. The universes for the liquidated and nonliquidated

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<sup>11</sup> A HUD system that contains data from FHA Single Family automated systems.

<sup>12</sup> A HUD system intended to aid HUD staff in monitoring lenders and HUD programs and to aid lenders and the public in self-policing the industry. This 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.

loans were distinct in that the nonliquidated loans were still in Ginnie Mae pools and the liquidated loans were no longer in Ginnie Mae pools. However, the loans were tested similarly concerning their compliance with FHA's underwriting requirements despite whether they had been removed from Ginnie Mae's pools. Both the liquidated and nonliquidated loans were FHA-insured loans; thus, they were expected to be compliant with HUD's underwriting requirements. Additionally, the results of the loan reviews were for informational purposes only; thus, we did not project the results.

#### Nonliquidated Loans

We reviewed 16 loans, which was the total universe of loans that had resulted in claims as of March 2009. Therefore, we performed 100 percent testing of the loans for which HUD paid claims. Additionally, using a variable sample, at a 90 percent confidence level, standard deviation of \$52,441, and sampling error of \$13,685, we statistically selected 29 of the 106 loans for which borrowers defaulted on their mortgage in the first six payments and remained in default for at least 60 days. Of the 29 loans, we concluded our review after reviewing 15 of the loans due to the significantly high error rate. Reviewing the additional 14 loans would not have influenced our determination regarding the compliance of the loans. In performing our review for compliance with FHA's underwriting requirements, we

- Reviewed the documentation maintained in the FHA case binders and Leader's files.
- Performed analyses of borrowers' income calculations, assets, employment, residential information, credit, etc.
- Reviewed and compared our results to HUD's underwriting requirements.

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 finding and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objective.

## **INTERNAL CONTROLS**

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

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

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

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### **Relevant Internal Controls**

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

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Validity and reliability of data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

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 that the following item is a significant weakness:

- Leader performed an inadequate due diligence review when it purchased Fidelity's mortgage-servicing package (see finding).

## APPENDIXES

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### Appendix A

### AUDITEE COMMENTS AND OIG'S EVALUATION

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#### Ref to OIG Evaluation

#### Auditee Comments

<b>Comment 1</b>	 <b>Leader Financial Services</b> a division of American National Bank 5610 Ridge Road, Parma, Ohio 44129
<b>Comment 2</b>	HUD - OIG OFFICE OF AUDIT CHICAGO, ILLINOIS 2009 SEP 28 PM 3:10 RECEIVED September 25, 2009
<b>Comment 3</b>	Mr. Heath Wolfe Regional Inspector General for Audit Department of HUD - Office of Inspector General 77 W. Jackson Blvd., Suite 2646 Chicago, IL 60604
<b>Comment 4</b>	Re: Response to Discussion Draft Audit Report on OIG's Audit of Leader financial Services (OIG No. 2009-CH-102X, dated September ___ 2009) (the "OIG Draft Audit Report")  Dear Mr. Wolfe:  The following is the response of Leader Financial Services, a division of American National Bank ("Leader"), to the OIG Draft Audit Report referenced above (sometimes referred to herein as the "Report").  We believe that the OIG Discussion Draft Audit Report is based on certain fundamental misunderstandings of the transactions referenced in the Report and the relationships of the parties involved. As we understand it, the Report and its conclusions and recommendations are based on an understanding that Leader purchased residential mortgage loans from Fidelity Home Mortgage Corporation ("Fidelity"). Leader did NOT at any time purchase loans or any participating interest in any loan from Fidelity. Rather, Leader purchased only mortgage servicing rights ("MSRs") from Fidelity, as set forth in the Mortgage Servicing Purchase and Sale Agreement between Fidelity, as Seller, and Leader, as Purchaser, dated as of November 1, 2007, as amended (copy of original Agreement and all amendments have been previously delivered to OIG and are therefore not enclosed). Therefore, many of the statements in the Report that state, refer to or imply that Leader purchased whole loans from Fidelity are not correct. Further, the requirements in Appendix C are related to the acquisition of loans, not the acquisition of mortgage servicing rights, and are therefore NOT applicable to this situation. By the time Leader purchased the mortgage servicing rights related to these loans, they had already been placed into loan "pools" and guaranteed by Ginnie Mae. Leader did not even acquire the MSRs until after Ginnie Mae was already obligated on the applicable loans. Indeed, Leader's purchase of the MSRs actually BENEFITED Ginnie Mae because, had Leader not purchased the MSRs, the servicing would have remained with Fidelity, which, as Ginnie Mae knows well, would not have been able to service them or to make advances as has been done by Leader. Therefore, not only should Leader not be subject to criticism on this transaction and its performance of services for Ginnie Mae and the holders of the Ginnie Mae securities, it should be thanked for doing so. Indeed, Leader has made advances with

**Ref to OIG Evaluation****Auditee Comments****Comment 5**

respect to these loans, and is currently seeking indemnity and damages from Fidelity with respect thereto and has commenced suit against Fidelity in Maryland for such purposes.

**Comment 6**

Further, Ginnie Mae expressly approved the sale and transfer of the MSRs from Fidelity to Leader by letter dated January 30, 2008 addressed to Fidelity (copy enclosed).

In addition, since there is no finding that Leader violated any Federal law or regulation, we believe that any Final Report should NOT include any recommendation or requirement regarding actions to be taken by Leader.

**Comment 7**

We will point out certain specific additional comments in the Report with which we do not agree, but we believe the essence is above. Because the above general comments affect numerous statements throughout the Report, we will not specifically address all such instances as that would merely be redundant.

We respectfully request that, after you review this letter and the related materials, OIG withdraw its Discussion Draft Report referenced above as it relates to Leader.

**Comment 8**

The following set forth statements in the Report (and the page on which they appear) and our specific responses:

*Page 1:*

*"Our objective was to determine whether Leader complied with federal requirements in the purchase of Fidelity's loan portfolio."*

To reiterate, we believe this statement in the very first paragraph identifying "What We Audited and Why" represents the crux of what we believe is the fundamental misunderstanding and erroneous basis for the entire Report—i.e., Leader did NOT purchase Fidelity's loan portfolio, Leader rather purchased MSRs—an entirely different transaction, with different responsibilities. (The same statement occurs at the bottom of page 4 of the Report, and our response is the same.)

**Comment 9**

*"...Leader subjected itself to unnecessary risks and aided Fidelity in the selling of noncompliant FHA-insured loans in the secondary market, thus increasing the risk to the FHA insurance fund."*

We do not agree that we aided Fidelity in selling noncompliant FHA loans in the secondary market. We purchased MSRs for a portfolio of Ginnie Mae loans that had already been securitized and sold in the secondary market. FHA insurance is a requirement for Ginnie Mae pool securitization. If any of the loans were "noncompliant", the noncompliance occurred before Leader ever became involved, and Leader's acquisition of the MSRs for such loans had nothing to do with either the original underwriting, any FHA compliance issues, or the sale of the loans in the secondary market.

**Ref to OIG Evaluation****Auditee Comments****Comment 10**

*Page 2:  
"What We Recommend"*

To the extent that these recommendations do NOT relate to Leader, Leader has no comment. With respect to loan files, Leader will cooperate with HUD with respect to loan files in its possession. Leader is also seeking to obtain original loan files from Fidelity, including by legal action.

**Comment 11**

We don't understand the beginning of the second paragraph or whether that relates to "management decision" by Leader; we request clarification.

**Comment 12**

*Page 5:  
"Leader subjected itself to unnecessary risks and aided Fidelity in the selling of noncompliant FHA-insured loans in the secondary market, thus increasing the risk to the FHA insurance fund."*

This issue is addressed above.

**Comment 13**

*Page 5:  
"Finding: Leader Performed an Inadequate Due Diligence Review When It Purchased Fidelity's Loan Portfolio"*

Consistent with the above, we do not agree with the Finding that Leader purchased Fidelity's loan portfolio, since that is not the fact. We also do not agree that Leader's due diligence was inadequate with respect to its purchase of the Fidelity MSRs. The due diligence standards for purchasing MSRs is not the same as the due diligence standards for purchasing loans.

**Comment 14**

The entire ensuing discussion through the middle of page 9 relates to purchase of loans, not purchase of MSRs, and is therefore inapplicable in our view.

**Comment 15**

As a result, we do not agree with the Conclusion on page 10 or the Recommendation related to Leader on page 10.

**Comment 16**

*Page 6:  
"In addition to missing pertinent documentation in the loan files, as previously mentioned, Leader did not obtain loan files for all the purchased loans."*

After the sale closed, Fidelity failed to send some of the loan files to Leader. Leader took several actions to compel Fidelity to produce the missing files. We held back funds from the sales price to motivate Fidelity to produce all missing documents and cure defects. We also engaged outside counsel to demand access to their facility, so that we could retrieve the documents. Fidelity has continued to fail to deliver certain loan files. As a result, Leader has filed a lawsuit against Fidelity in an effort to obtain possession of the applicable loan files and for other remedies related to the loans and the transaction.

## Ref to OIG Evaluation

## Auditee Comments

### **Comment 17**

Please note that all of the collateral documents for all loans with respect to which Leader acquired servicing rights from Fidelity (e.g., original Note, Mortgage and Title insurance policy) have been accounted for and are being held by our document custodian. In each case, the custodian has certified or re-certified possession of those documents to Ginnie Mae.

*Page 8:*

*"Leader lacked adequate procedures and controls to manage the risks associated with purchasing loans in the secondary market."*

Again, Leader did not purchase loans in the secondary market; Leader purchased MSRs from Fidelity.

*Page 8:*

*"According to Leader, since it purchased the loan portfolio fully originated, securitized, and insured, it did not perform a more detailed review. Further, its purchase agreement with Fidelity contained an indemnification clause that required Fidelity to reimburse leader for any losses, damages, deficiencies, claims, etc. that would arise from the purchase of the loans."*

Leader did in fact have indemnification agreements in place with Fidelity Home Mortgage. The seller failed to honor these agreements and failed to perform as agreed in the period after the agreement was signed. As stated above we are seeking legal remedies to recover our losses. It should be noted that Leader's acquisition of the portfolio has benefitted Ginnie Mae, as we understand that, at some time after Leader's acquisition of the Fidelity MSRs, Ginnie Mae determined that Fidelity was in default in its own servicing obligations to Ginnie Mae and terminated Fidelity's ability to service loans for Ginnie Mae.

*Page 9:*

*"...Leader's deficient due diligence review, performed in the purchase of the Fidelity loan portfolio, did not aid in preventing risky loans from being sold in the secondary market, and Fidelity benefitted from selling these substandard loans."*

Leader disagrees with this statement. We did not buy Fidelity loans in the secondary market. Fidelity sold the loans in the secondary market. Leader purchased the mortgage servicing rights after securitization in the secondary market. Leader's acquisition of said MSRs has benefited Ginnie Mae. As mentioned above, Ginnie Mae terminated Fidelity's ability to service loans for Ginnie Mae based on defaults by Fidelity. Therefore, Ginnie Mae would have been responsible for all of the losses associated with this servicing portfolio, if Leader had not acquired the servicing.

## **Ref to OIG Evaluation**

## **Auditee Comments**

### **Comment 20**

*Page 10:*

*"Because of Leader's inadequate due diligence review, it was subjected to unnecessary risks and aided Fidelity in the selling of noncompliant FHA-insured loans in the secondary market, thus increasing the risk to the FHA insurance fund.*

Leader disagrees with this statement. We did not aid any entity in selling noncompliant loans in the secondary market. As mentioned above, the loans were already sold in the secondary market and guaranteed by Ginnie Mae. Our acquisition of the mortgage servicing rights took place after the loans were sold in the secondary market by Fidelity. Leader not only did NOT increase the risk to the FHA insurance fund, it reduced that risk because it was better able to service the loans than was Fidelity.

*Page 10:*

*We recommend that the Deputy Assistant Secretary for Single Family Housing require Leader to implement adequate procedures and controls to ensure that it obtains complete loan files from purchased loans and/or loan portfolios to perform adequate servicing reviews under its quality control plan."*

As mentioned previously, all of the original collateral documents for the loans have been obtained and delivered to the custodian. In the acquisition of MSRs, obtaining loan underwriting documents is of lesser significance, unless they become the subject of a specific dispute or claim. Leader made every effort to obtain as many of these loan documents as possible. Our agreements have specific language in the contracts that withhold funds from the sale until the time that all defects are resolved. The delivery of complete loan documentation for all files would clearly fall under this clause of the contract. As mentioned above, we have filed a lawsuit to help recover the applicable missing loan documents.

If you determine not to withdraw the Report as it relates to Leader, but rather to modify it, we would appreciate the opportunity to review the modified Report prior to issue of a final Audit Report.

If you have any questions or require additional information, please contact David Neuman, Vice President of Leader financial Services at 440-866-0100 or via e-mail at [dneuman@leaderfinancial.net](mailto:dneuman@leaderfinancial.net).

Sincerely,



Lawrence Cardinal, Acting President

Cc: David Neuman  
Marc W. Freimuth, Esq.

## **OIG Evaluation of Auditee Comments**

- Comment 1** Leader contends that the draft audit report is based on certain fundamental misunderstandings of Leader's transaction with Fidelity and the relationships of the parties involved. Leader views the conclusions and recommendations as being based on an understanding that Leader purchased residential mortgage loans from Fidelity. We agree that we used the term "loan purchase" when discussing the Fidelity transaction. However, Leader's management and staff used the term interchangeably in discussions and written communications concerning the Fidelity purchase. Additionally, according to a representative from Ginnie Mae, mortgage-servicing rights are considered a component of a loan, as a loan is comprised of more than one asset. Nonetheless, we revised the audit report to clarify that Leader purchased Fidelity's loan-servicing portfolio.
- Comment 2** See comment 1.
- Comment 3** Leader contends that the draft audit report refers to or implies that Leader purchased whole loans from Fidelity. Additionally, the requirements in appendix C of this audit report are related to the acquisition of loans, not the acquisition of servicing rights, and are, therefore, not applicable to this situation. We disagree. The draft audit report did not state or imply that Leader purchased whole loans, meaning both the actual loan and mortgage-servicing rights, from Fidelity. Further, the criterion cited in appendix C applies to the purchase transaction since Leader purchased a component of the loan (mortgage-servicing rights). HUD's Mortgagee Letter 2002-21 refers to the purchase of loans and whole loans. Therefore, according to HUD, most servicers/lenders only purchase the servicing rights and not the whole loan. HUD created the mortgagee letter to remind servicers that a servicer/lender purchasing servicing rights or the whole loan (asset and the servicing rights) should conduct a thorough due diligence review because it is bound by all of the obligations of the seller under the contract for mortgage insurance.
- Further, Leader's management was aware of the intention of the mortgagee letter and provided written comments regarding changes made to its current quality control plan and procedures, effective January 2009. The changes included the suggestions outlined in the mortgagee letter in regard to acquiring seasoned or flow loan packages of mortgage-servicing rights. Additionally, the draft audit report acknowledges that the loans were already pooled through Ginnie Mae.
- Comment 4** Leader contends that the transaction benefited Ginnie Mae. If Leader did not purchase the mortgage-servicing rights, the rights would have remained with Fidelity, which would have not been able to service them or make advances as Leader did. Leader also contends that it should be thanked for having participated in the Fidelity transaction and not be subject to criticism. We acknowledge that Leader agreed to service high-default loans; however, if Leader had performed an adequate due diligence review, it would have identified that some of the

borrowers were not qualified for mortgage loans. Therefore, the loans' default was inevitable, and Leader subjected itself to unnecessary risks.

- Comment 5** Leader contends that Ginnie Mae expressly approved the sale and transfer of Fidelity's loan-servicing portfolio. We agree that Ginnie Mae approved the sale of Fidelity's loan-servicing portfolio. However, the approval should not negate Leader's due diligence.
- Comment 6** Leader contends that since there is no finding that Leader violated any federal law or regulation, the final report should not include any recommendation or requirement regarding actions to be taken by Leader. We agree. This final audit report contains no finding that Leader violated any federal law or regulation and states such in the background section of the draft audit report. However, Leader did not perform an adequate due diligence review or maintain loan files. A due diligence review of loans (mortgage-servicing rights) and whole loans are a prudent business practice in the mortgage banking industry. Leader was aware of this practice and revised its policies and procedures to strengthen its review of acquired seasoned and flow loan packages of mortgage-servicing rights because of the purchase of the Fidelity loan-servicing portfolio. We removed the recommendation that applies to Leader only because of its agreement with the Office of the Comptroller of the Currency to exit the mortgage-servicing business since the recommendation in the audit report would not be applicable if Leader no longer services mortgage loans.
- Comment 7** Leader contends that due to the content of its comments and related materials, OIG should withdraw its draft audit report. We disagree. Leader's written comments and provided documentation did not materially affect the overall conclusion or recommendations cited in the draft audit report. However, we removed the recommendation that applies to Leader because of its agreement with the Office of the Comptroller of the Currency to exit the mortgage-servicing business. The recommendation in the audit report would not be applicable since Leader will no longer service loans. Further, as mentioned in comment 1, we revised the audit report to clarify that Leader purchased Fidelity's loan-servicing portfolio (mortgage-servicing rights).
- Comment 8** Leader contends that the objective in the draft audit report shows a fundamental misunderstanding and is erroneous, as it states that the objective is to determine whether Leader complied with federal requirements in the purchase of Fidelity's loan portfolio. We partially agree. The objective of the report does not indicate a fundamental misunderstanding and is not erroneous. However, it should be clarified to avoid any misunderstanding in regard to Leader's purchase of Fidelity's loan-servicing portfolio. However, according to Ginnie Mae, a mortgage-servicing right is a component of a loan, and HUD considers it as part of the loan as indicated in Mortgagee Letter 2002-21. Additionally, according to HUD, most servicers do not own the whole loan; therefore, the mortgagee letter is referring to both the purchases of whole loans and/or loans (mortgage-servicing

rights). Therefore, to be consistent with HUD's terminology, we worded our objective in accordance with Mortgagee Letter 2002-21. Nonetheless, as mentioned in comment 1, we adjusted the report to clarify the purchase transaction.

**Comment 9** Leader contends that it did not aid Fidelity in selling noncompliant FHA loans in the secondary market and that the mortgage-servicing rights for a portfolio of Ginnie Mae loans that it purchased had already been securitized and sold in the secondary market. Leader further contends that if any of the loans were noncompliant, the noncompliance occurred before Leader became involved and that Leader's acquisition of the mortgage-servicing rights had nothing to do with the original underwriting, any FHA compliance issues, or the sale of the loans in the secondary market. We agree that Leader purchased the mortgage-servicing rights for loans that were securitized and already sold in the secondary market. Therefore, we adjusted the wording of the audit report, as appropriate. However, according to HUD, purchasing servicing rights binds the purchaser to the obligations of the seller under the contract for mortgage insurance. Although Leader did not underwrite the loans, it should have performed an adequate due diligence review due to the risks it assumes upon acquiring the mortgage-servicing rights.

**Comment 10** Leader contends that with respect to loan files, Leader will cooperate with HUD with respect to loan files in its possession. Leader is also seeking to obtain original loan files for Fidelity. We acknowledge Leader's cooperation in regard to working with HUD and its efforts to obtain original loan files from Fidelity.

**Comment 11** Leader requests clarification on the second paragraph of the report and whether it relates to a management decision by Leader. The second paragraph contains recommendations to the Deputy Assistant Secretary for Single Family Housing. As previously mentioned in comment 6, we removed the only recommendation that would have applied to Leader in connection with the proceedings by the Office of the Comptroller of the Currency and Leader's agreement to no longer service mortgage loans.

**Comment 12** See comment 9.

**Comment 13** Leader contends that it does not agree with the finding that it purchased Fidelity's loan portfolio. It also does not agree that Leader's due diligence was inadequate with respect to its purchase of Fidelity's mortgage-servicing rights. The due diligence standards for purchasing mortgage-servicing rights are not the same as the due diligence standards for purchasing loans. As mentioned previously, we revised the report to clarify the events of the purchase transaction. According to HUD, the industry standards and best practices referred to in Mortgagee Letter 2002-21 are guidelines for servicers/lenders that purchase whole loans or just the mortgage-servicing rights for loans. Additionally, Leader was aware that the mortgagee letter was applicable to mortgage servicers since it revised its policies

and procedures for purchasing mortgage-servicing rights in accordance with the mortgagee letter in January 2009 before our audit. Additionally, Leader confirmed its understanding in regard to the applicability of the letter in verbal and written discussions regarding the purchase.

**Comment 14** See comments 1 and 2 in which we addressed adjusting the audit report as necessary to provide clarification and avoid any misunderstanding.

**Comment 15** Leader contends that it does not agree with the conclusion on page 10 or the recommendations related to Leader on page 10 due to the discussion of the report through the middle of page 9 relating to the purchase of loans and not mortgage-servicing rights. We refer to our rebuttals made in comments 1 and 2. Additionally, we removed the recommendation that applies to Leader as discussed in comment 6.

**Comment 16** Leader contends that it took actions to compel Fidelity to produce the loan origination documentation that it had failed to provide Leader, with actions taken including withholding funds from the sale price, obtaining outside counsel to demand access to Fidelity's facilities, and filing a lawsuit against Fidelity to obtain possession of the missing documentation. Leader also contends that all of the collateral documents for all loans in which Leader acquired the servicing rights from Fidelity, such as the original note, mortgage, and title insurance policy, have been accounted for and are being held by its document custodian, and the custodian has certified or recertified possession of the documents to Ginnie Mae. We acknowledge Leader's efforts in attempting to obtain the missing documentation. We also acknowledge that a document custodian had the collateral documents and provided the necessary certifications. However, Leader cannot sufficiently perform a servicing quality control review, as outlined in its quality control plan, on a loan using only collateral documents (such as note, mortgage, and title insurance policy). Therefore, other needed documentation, such as borrowers' loan applications, verification of employment, rent, asset forms, credit report(s), appraisals, etc., also need to be reviewed.

**Comment 17** See comment 9.

**Comment 18** Leader contends that it has an indemnification agreement in place with Fidelity, Fidelity has failed to honor such agreements, and thus Leader is seeking legal remedies against Fidelity to recover its losses. Further, Leader contends that the Fidelity acquisition has benefitted Ginnie Mae, as it is Leader's understanding that Ginnie Mae determined Fidelity to be in default with its own servicing obligations. We acknowledge that Leader had an indemnification agreement with Fidelity. However, according to HUD, a servicer/lender purchasing servicing should conduct a thorough due diligence review because it is bound by all of the obligations of the seller under the contract for mortgage insurance. Therefore, the indemnification agreement does not mitigate the need to perform an adequate due diligence review as outlined in HUD's Mortgagee Letter 2002-21.

**Comment 19** See comments 1, 2, and 6.

**Comment 20** Leader contends that it did not aid any entity in selling noncompliant loans in the secondary market, since the loans had already been sold in the secondary market. Additionally, its acquisition of the mortgage-servicing rights took place after the loans were sold in the secondary market. Leader also contends that it did not increase the risk to the FHA insurance fund but, instead, reduced that risk because it was able to service the loans better than Fidelity. We agree that the loans had already been sold in the secondary market. Therefore, we made the necessary revisions to the audit report. However, we disagree that Leader did not increase the risk to the FHA insurance fund. Leader purchased the servicing rights for noncompliant FHA loans, thereby allowing Fidelity to benefit from the purchase. According to HUD's Mortgagee Letter 2002-12, effective due diligence review practices would hinder the ability of lenders to sell predatory loans to others in the mortgage industry. If predatory loans cannot be sold, they are unlikely to be made, and all borrowers, including FHA borrowers, will be protected.

**Comment 21** See comment 7.

**Comment 22** Leader contends that obtaining loan underwriting documents is of lesser significance, unless they become the subject of a specific dispute or claim. It also contends that it has filed a lawsuit against Fidelity to attempt to recover the missing documentation. Lender, as a servicing lender, should have all pertinent loan documents to perform an adequate due diligence review and to meet HUD's and its own requirements under its approved quality control plan for servicing loans. We acknowledge Leader's willingness to obtain missing loan file documentation. This documentation will aid in ensuring that it is able to perform sufficient reviews of loan files under its quality control plan for servicing loans.

**Comment 23** Leader requests that if the report is not withdrawn as it relates to Leader, but rather is modified, Leader would like an opportunity to review the modified report before the issuance of the report. We will not withdraw the audit report. However, we made necessary adjustments to the report for clarification. These adjustments did not materially affect the overall finding/conclusion of the audit.

## Appendix B

### LOANS WITH UNDERWRITING DEFICIENCIES

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FHA case number	Qualifying ratios exceeded	Income discrepancies	Asset discrepancies	Misreported liabilities	Over - insured amount	Credit deficiencies
492-7808862	X		X			X
491-8841803				X		X
492-7783226	X	X				
381-7971237	X	X				
052-4097935	X				X	
491-8891477	X					
052-3985843	X	X			\$1,728	
492-7771184	X	X				
491-8952967	X	X				
105-3000321	X				400	
541-7546991	X					X
492-7833628	X					X
495-7641373	X	X				X
492-7782266			X			X
541-7585929	X	X				
492-7669564			X		324	X
492-7861851	X					X
492-7654619	X	X		X		
491-8961447						<u>X</u>
492-7716296	X	X			<u>582</u>	
495-7519873			X			
492-7796309	X					
492-7711571	X					
483-3682407	<u>X</u>	<u>X</u>				
<b>Totals</b>	<b><u>19</u></b>	<b><u>10</u></b>	<b><u>5</u></b>	<b><u>2</u></b>	<b><u>\$3,034</u></b>	<b><u>9</u></b>

## **Appendix C**

### **FEDERAL AND LEADER'S REQUIREMENTS**

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Mortgagee Letter 2002-21, Due Diligence in Acquiring Loans, dated September 26, 2002, strongly encourages lenders to perform due diligence using the industry's best practices before purchasing loans from other lenders.

HUD Handbook 4155.1, REV-5, states that the qualifying debt-to-income ratios are 31 percent (mortgage payment/income) and 43 percent (total fixed payment/income) according to paragraph 2-12 and updated by Mortgagee Letter 2005-16. When the debt-to-income ratios are exceeded, compensating factors are needed to justify the approval of the loan. The underwriter must list any compensating factors in the "remarks" section of the mortgage credit analysis worksheet, and any compensating factor used to justify mortgage approval must be supported by documentation.

Chapter 1, section 4, paragraph 1-12, of the handbook states that an adjustable-rate mortgage may be refinanced to a fixed-rate mortgage provided the new fixed-rate mortgage is no more than 2 percent greater than the current rate of the adjustable-rate mortgage. Additionally all mortgage payments must have been made within the month due for the past 12 months.

Chapter 2, section 1, paragraph 2-3, of the handbook states that major indications of derogatory credit—including judgments, collections, and any other recent credit problems—require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file. Additionally, the payment history of the borrower's housing obligations holds significant importance in evaluating credit. The lender must determine the borrower's payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity of interest with the borrower), verification of mortgage directly from the mortgage servicer, or canceled checks covering the most recent 12-month period.

Chapter 2, section 2, of the handbook states that income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue. Additionally, income from other sources can be included as effective income with proper verification by the lender. Chapter 2-7 states that the income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage loan.

Chapter 2, section 4, paragraph 2-11, of the handbook states that the borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations.

Chapter 1, section 2, paragraph 1-6, states that the maximum insurable mortgage is the lesser of (1) the statutory loan limit for the area (typically a county or metropolitan statistical area) or (2) the applicable loan-to-value ratio.

Chapter 2, section 3, paragraph 2-10, of the handbook states that all funds for the borrower's investment in the property must be verified and documented.

Mortgagee Letter 2005-16 specifies that for manually underwritten mortgages for which the direct endorsement underwriter must make the credit decision, the qualifying ratios are raised to 31 percent and 43 percent. If either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval.

Leader's due diligence review checklist, effective November 5, 2007, required the reviewer to record the annual percentage rate and the note rate from the final truth-in-lending statement and review loan documentation to determine whether the loan-to-value ratio is greater than 80 percent.

## **Appendix D**

### **MORTGAGE-SERVICING RIGHTS**

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Mortgage servicing is a loan component. Servicers/lenders purchase the rights to service a mortgage loan or a portfolio of loans from another servicer/lender for a fee with approval from the holder of the note. Mortgage-servicing rights can be their own asset and have their own value separate from the underlying loan. A lender can originate or purchase mortgage-servicing rights.

Leader did not originate or underwrite the loans; instead, it purchased the rights to service Fidelity's 56 Ginnie Mae loan pools. A lender can purchase mortgage-servicing rights in three ways: bulk acquisitions, production flow activities, or business combinations. In a bulk acquisition transaction, an entity purchases the servicing rights only, leaving ownership of the underlying mortgages or securities to the investor. A production flow activity transaction involves a servicer/lender purchasing both newly underwritten mortgage loans and the rights to service the loans. To qualify for this activity, the lender must (1) be formally committed to sell or securitize the loans before it completes the purchase, (2) obtain a commitment to sell the mortgages to an investor within a reasonable timeframe after purchase or before the purchase date, or (3) make a commitment to deliver the mortgage loans for securitization. In a business combination, a lender enters into a business combination transaction, whereby the purchasing lender purchases the existing mortgage-servicing rights of the purchased lender as part of the business combination transaction. Of the three methods of acquiring mortgage-servicing rights, Leader's purchase of Fidelity's servicing loan portfolio was a bulk acquisition transaction. See the illustration on the following page.

## **Flowchart of mortgage-servicing rights creation and transfer**

