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**MEMORANDUM NO:
2010-CH-1810**

July 30, 2010

MEMORANDUM FOR: Vicki Bott, Deputy Assistant Secretary for Single Family, HU
Dane M. Narode, Associate General Counsel for Program
Enforcement, CACC


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

SUBJECT: Dell Franklin Financial, LLC, Millersville, MD, Did Not Properly Underwrite a
Selection of FHA Loans

INTRODUCTION

We reviewed 20 Federal Housing Administration (FHA) loans that Dell Franklin Financial, LLC (Dell), underwrote as an FHA direct endorsement lender. Our review objective was to determine whether Dell underwrote the 20 loans in accordance with FHA requirements. This review is part of Operation Watchdog, an Office of Inspector General (OIG) initiative to review the underwriting of 15 direct endorsement lenders at the suggestion of the FHA Commissioner. The Commissioner expressed concern regarding the increasing claim rates against the FHA insurance fund for failed loans.

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

We provided our discussion draft memorandum report to Dell's legal counsel during the review. We asked Dell to provide written comments on our discussion draft memorandum report by June 30, 2010. Dell's president provided written comments to the discussion draft report, dated June 30, 2010. The president disagreed with our finding and recommendations. The complete text of the lender's comments, along with our evaluation of that response, can be found in appendix C of this report, except for 22 exhibits of 60 pages of documentation that was not necessary to understand the lender's comments. We provided HUD's Deputy Assistant Secretary for Single

Family Housing and Associate General Counsel for Program Enforcement with a complete copy of Dell's written comments plus the 60 pages of documentation.

METHODOLOGY AND SCOPE

Dell is 1 of 15 direct endorsement lenders we selected from HUD's publicly available Neighborhood Watch¹ system (system) for a review of underwriting quality. These direct endorsement lenders all had a compare ratio² in excess of 200 percent of the national average as listed in the system for loans endorsed between January 1, 2005, and December 10, 2009. We selected loans that had gone into claim status. We selected loans for Dell that defaulted within the first 30 months and were associated with an underwriter (usually an individual) with a high number of claims.

BACKGROUND

Dell is a nonsupervised direct endorsement lender based in Millersville, MD. FHA approved Dell as a direct endorser in July 2003. FHA's mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to approve mortgages for otherwise creditworthy borrowers that might not be able to meet conventional underwriting requirements by protecting the lender against default. The direct endorsement program simplifies the process for obtaining FHA mortgage insurance by allowing lenders to underwrite and close the mortgage loan without prior HUD review or approval. Lenders are responsible for complying with all applicable HUD regulations and are required to evaluate the borrower's ability and willingness to repay the mortgage debt. Lenders are protected against default by FHA's mutual mortgage insurance fund, which is sustained by borrower premiums.

The goal of Operation Watchdog is to determine why there is such a high rate of defaults and claims. We selected up to 20 loans in claim status from the 15 lenders. The 15 lenders selected for Operation Watchdog endorsed 183,278 loans valued at \$31.3 billion during the period January 2005 to December 2009. These same lenders also submitted 6,560 FHA insurance claims with an estimated value of \$794.3 million from November 2007 through December 2009. During this period, Dell endorsed 1,777 loans valued at more than \$388 million and submitted 37 claims worth more than \$7.1 million.

Our objective was to determine whether the 20 selected loans were properly underwritten and if not, whether the underwriting reflected systemic problems.

We performed our work from January through May 2010. We conducted our work in accordance with generally accepted government auditing standards, except that we did not consider the internal controls or information systems controls of Dell, consider the results of

¹ Neighborhood Watch is a system that aids HUD/FHA staff in monitoring lenders and its programs. This system allows staff to oversee lender origination activities for FHA-insured loans and tracks mortgage defaults and claims.

² HUD defines "compare ratio" as a value that reveals the largest discrepancies between the direct endorser's default and claim percentage and the default and claim percentage to which it is being compared. FHA policy establishes a compare ratio of more than 200 percent as a warning sign of a lender's performance.

previous audits, or communicate with Dell’s management in advance. We did not follow standards in these areas because our objective was to aid HUD in identifying FHA single-family insurance program risks and patterns of underwriting problems or potential wrongdoing in poor-performing lenders that led to a high rate of defaults and claims against the FHA insurance fund. To meet our objective, it was not necessary to fully comply with the standards, nor did our approach negatively affect our review results.

RESULTS OF REVIEW

Dell did not properly underwrite 3 of the 20 loans reviewed because its underwriters did not follow FHA’s requirements. As a result, FHA’s insurance fund suffered actual losses of more than \$540,000 on the three loans, as shown by the following table.

<i>FHA loan number</i>	<i>Closing date</i>	<i>Number of payments before first default</i>	<i>Original mortgage amount</i>	<i>Actual loss to HUD</i>
241-7744658	6/16/06	24	\$282,170	\$107,214
241-7768099	10/17/06	4	367,100	358,049
483-3658679	9/27/06	2	<u>90,823</u>	<u>77,067</u>
Totals			<u>\$740,093</u>	<u>\$542,330</u>

The following table summarizes the material deficiencies that we identified in the three loans.

<i>Area of noncompliance</i>	<i>Number of loans</i>
Income	1
Liabilities	1
Excessive ratios	2
Assets	1

Appendix A shows a schedule of material deficiencies in each of the 3 loans. Appendix B provides a detailed description of all loans with material underwriting deficiencies noted in this report.

Income

Dell overstated the income for one loan by inappropriately including overtime income although there was no expectation of continuance of the overtime. HUD does not allow overtime income to be used in calculating a borrower’s income ratios if the borrower has not received such income for the past 2 years and it is not likely to continue (see appendix B for detailed requirements).

For loan number 241-7744658, Dell’s underwriter overstated the borrowers’ income by \$1,387 by including the overtime income although the verifications of employment did not confirm expected continuance of the overtime. The loan was processed through the automated underwriting system. The borrower’s income was overstated by \$1,101 and the coborrower’s by \$286.

Liabilities

Dell did not properly assess the borrowers' financial obligations for one loan. HUD requires lenders to consider debts if the amount of the debts affects the borrower's ability to make the mortgage payment during the months immediately after loan closing (see appendix B for detailed requirements).

For loan number 241-7768099, Dell did not include all of the borrowers' liabilities that were on the latest credit report. In the automated system, Dell's underwriter listed debts with monthly payments of \$1,220; however, the latest credit report in the loan file listed liabilities with total monthly payments of \$1,620. As a result, the borrowers' monthly liabilities were understated by \$400.

Excessive Ratios

Dell improperly approved two loans when the borrowers' ratios exceeded FHA's requirements. Effective April 13, 2005, the mortgage payment-to-effective income and total payment-to-effective income ratios were increased from 29 and 41 percent to 31 and 43 percent, respectively. If either or both ratios are exceeded, the lender is required to describe the compensating factors used to justify the mortgage approval (see appendix B for detailed requirements).

For example, for loan number 483-3658679, Dell's underwriter failed to document adequate compensating factors for the excessive total fixed payment-to-effective income ratio. The loan was initially processed through the automated underwriting system. It was rated as "refer" by the system and was then manually underwritten. The total fixed payment-to-income ratio was 45.739 percent, above the allowable 43 percent.

Assets

Dell did not properly document the source of the borrower's funds to close for one loan. HUD requires the lender to verify and document the borrowers' investment in the property (see appendix B for detailed requirements).

For loan number 241-7768099, Dell processed this loan through the automated underwriting system without confirming the source of the borrower's assets. Dell's underwriter listed total assets of \$13,614 in the system, which was comprised of \$4,104 in a savings account, \$6,616 in a checking account, and \$2,894 in a retirement account. A savings account inquiry dated October 10, 2006 showed an available balance of \$9,904. It showed deposits of \$4,203, \$4,299 and a memo credit of \$5,801. The loan file did not document or contain an explanation for the source of these funds to ensure that they were not obtained from an undocumented loan or another excludable source. For the retirement account, there was no documentation of redemption as required by HUD.

Incorrect Underwriter’s Certifications Submitted to HUD

We reviewed the certifications for the three loans with material underwriting deficiencies for accuracy, including one manually underwritten loan and two automated underwritten loans. Dell’s direct endorsement underwriters incorrectly certified that due diligence was used in underwriting the one manual loan and incorrectly certified to the integrity of the data used to determine the quality of the loan in underwriting the two automated loans. When underwriting a loan manually, HUD requires a direct endorsement lender to certify that it used due diligence and reviewed all associated documents during the underwriting of a loan, and when underwriting a loan using an automated system, HUD requires a direct endorsement lender to certify to the integrity of the data used to determine the quality of the loan.

The Program Fraud Civil Remedies Act of 1986 (231 U.S.C. (United States Code) 3801) provides Federal agencies, which are the victims of false, fictitious, and fraudulent claims and statements, with an administrative remedy (1) to recompense such agencies for losses resulting from such claims and statements; (2) to permit administrative proceedings to be brought against persons who make, present, or submit such claims and statements; and (3) to deter the making, presenting, and submitting of such claims and statements in the future.

RECOMMENDATIONS

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

- 1A. Determine legal sufficiency and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act against Dell and/or its principals for incorrectly certifying to the integrity of the data used in determining the quality of the loan or that due diligence was exercised during the underwriting of three loans that resulted in losses to HUD totaling \$542,330, which could result in affirmative civil enforcement action of approximately \$1,107,160³.

We recommend that HUD’s Deputy Assistant Secretary for Single Family

- 1B. Take appropriate administrative action against Dell and/or its principals for the material underwriting deficiencies cited in this report once the affirmative civil enforcement action cited in recommendation 1A is completed.

Schedule of Ineligible Cost 1/

<u>Recommendation number</u>	<u>Amount</u>
1A	\$542,330

³ Double damages plus a \$7,500 fine for each of the three incorrect certifications.

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations. The amount shown represents the actual loss HUD incurred when it sold the affected properties.

Appendix A

SUMMARY OF MATERIAL UNDERWRITING DEFICIENCIES

FHA loan number	Unsupported income	Excessive debt-to-income ratio	Underreported liabilities	Unsupported assets
241-7744658	X	X		
241-7768099			X	X
483-3658679		X		

Appendix B

LOANS WITH MATERIAL UNDERWRITING DEFICIENCIES

Loan number: 241-7744658

Mortgage amount: \$282,170

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: June 16, 2006

Status: Claim

Payments before first default reported: 24

Loss to HUD: \$107,214

Summary: We found material underwriting deficiencies relating to the borrowers' income and excessive ratios.

Income:

Dell overstated the borrowers' income by \$1,386 by including overtime income although the verifications of employment in the loan file did not confirm expected continuance of the income. The loan was processed through the automated underwriting system. The borrower's income was overstated by \$1,101 and the coborrower's by \$286.

For the borrower, Dell's underwriter used a calculated income value of \$3,675 in the automated system. Income was not separated into base pay and overtime pay, and the loan file did not contain documentation to show how the base income was calculated by the underwriter. Based on an hourly rate of \$14.85 as shown on the payroll documents, we calculated a base income of \$2,574. The underwriter's improperly derived calculated income of \$3,675 was comprised of base income of \$2,574 and overtime income of \$1,101. There were no documents in the loan file to show how the overtime was calculated. The borrower's employment history did not support the consistency of monthly earnings remaining the same or increasing. A telephone verification of employment with the borrower's employer did not document that the overtime income was likely to continue or expected. We calculated that the borrower's income was overstated by \$1,101 (\$3,675 minus \$2,574).

For the coborrower, Dell's underwriter used a calculated income of \$3,752 in the automated system. The underwriter calculated the base income by using the total earnings, including the overtime, for the last 17.25 months (\$64,735.94 divided by 17.25). Based on the verification of

employment and payroll information, we calculated the coborrower's base income to be \$3,466 per month. The verification of employment from the coborrower's employer documented that the overtime income was not likely to continue. As a result, Dell's underwriter overstated the base income by \$286 (\$3,752 minus \$3,466).

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-7A, states that overtime income may be used to qualify if the borrower has received such income for the past 2 years and it is likely to continue. The lender must develop an average of the overtime income for the past 2 years, and the employment verification must not state that such income is unlikely to continue. An earnings trend also must be established and documented for overtime and bonus income.

The FHA Single Family Total Mortgage Scorecard User Guide, chapter 1, states that the lender is responsible for the integrity of the loan when material changes are discovered. The lender is required to resubmit the loan through the automated underwriting system for an updated evaluation under conditions such as when borrowers' income is decreased.

Excessive Ratios:

The recomputed income for the borrowers would be \$6,040 (\$2,574 plus \$3,466). Using the recomputed income, the mortgage payment-to-income effective ratio would be 32.183 percent, and the total fixed payment-to-income ratio would be 51.916 percent, above HUD's maximum ratios of 31 and 43 percents, respectively.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-12, and Mortgagee Letter 2005-16 states for manually underwritten mortgages for which the direct endorsement underwriter must make the credit decision, the qualifying ratios were raised to 31 and 43 percent, respectively. As always, if either or both ratios are exceeded on a manually underwritten mortgage, the lender must provide compensating factors to justify approving the mortgage.

Mortgagee Letter 2005-16, dated April 13, 2005, increased the payment-to-income and debt-to-income ratios from 29 and 41 percent to 31 and 43 percent, respectively. If either or both ratios are exceeded on a manually underwritten mortgage, the lender is required to describe the compensating factors used to justify the mortgage approval.

Loan number: 241-7768099

Mortgage amount: \$367,100

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: October 17, 2006

Status: Claim

Payments before first default reported: Four

Loss to HUD: \$358,049

Summary: We found material underwriting deficiencies relating to the borrower's assets and liabilities.

Assets:

Dell processed this loan through the automated underwriting system without confirming the borrowers' source of assets. Dell's underwriter listed total assets of \$13,614 in the system, which was comprised of \$4,104 in a savings account, \$6,616 in a checking account, and \$2,894 in a retirement account.

The loan file contained a savings account inquiry dated October 10, 2006 which showed an available balance of \$9,904. It showed deposits of \$4,203, \$4,299 and a memo credit of \$5,801. The loan file did not document or contain an explanation for the source of these funds to ensure that they were not obtained from an undocumented loan, an interested party, or another excludable source. For the retirement account, there was no evidence of redemption as required by HUD.

HUD/FHA Requirements:

HUD Handbook 4155.1, REV-5, paragraph 2-10, states all funds for the borrower's investment in the property must be verified and documented. Paragraph 2-10 B specifies that verification of savings and checking accounts are to be performed. For large increases or recent account openings, the lender must obtain a credible explanation of the source of those funds. Paragraph 2-10 K specifies that evidence of redemption of retirement funds is required if these funds are used.

Liabilities:

Dell did not include all of the borrowers' liabilities that were on the latest credit report. In the automated system, Dell's underwriter listed debts with monthly payments of \$1,220. The credit

report, dated September 20, 2006, listed liabilities with total monthly payments of \$1,620. As a result, the borrowers' monthly liabilities were understated by \$400.

HUD performed a postendorsement technical review⁴ and informed Dell that FHA's Total Scorecard failed to reflect all liabilities on the borrowers' credit report. In response, Dell supplied another credit report and told HUD that this credit report was initially used to underwrite the report. However, this credit report, dated August 23, 2006, was not the latest credit report available to Dell. Dell's underwriter should have used the latest available credit report of September 20, 2006, to calculate the borrowers' monthly liabilities.

Inclusion of the additional monthly liabilities of \$400 would increase the total payment-to-income ratio to 51.85 percent, well above HUD's allowable ratio of 43 percent. Therefore, Dell's exclusion of the \$400 in monthly liabilities was material.

HUD/FHA Requirements:

The FHA Single Family Total Mortgage Scorecard User Guide states that the lender is responsible for the integrity of the data used to obtain the risk assessment and for resubmitting the loan when material changes are discovered or otherwise occur during loan processing. The lender is required to resubmit the loan through the automated underwriting system for an updated evaluation of changes that are discovered which would negatively affect the borrowers' ability to repay the mortgage.

HUD Handbook 4155.1, REV-5, paragraph 2-11A, states recurring obligations must be considered in qualifying borrowers. The borrower's recurring obligations include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other recurring charges extending 10 months or more, including payments on installment accounts, child support or separate maintenance payments, revolving accounts, etc.

HUD Handbook 4155.1, REV-5, paragraph 2-12, and Mortgagee Letter 2005-16 state that for manually underwritten mortgages for which the direct endorsement underwriter must make the credit decision, the qualifying ratios were raised to 31 and 43 percent, respectively.

⁴ HUD's Processing and Underwriting Division performs postendorsement technical reviews to ensure that lenders understand and comply with HUD's requirements. Reviews of selected mortgages after endorsement are performed to execute this function. The process includes a review of the appraisal report, mortgage credit analysis, underwriting decisions, and the closing documents from the mortgage case endorsement file.

Loan number: 483-3658679

Mortgage amount: \$90,823

Section of Housing Act: 203(b)

Loan purpose: Purchase

Date of loan closing: September 27, 2006

Status: Claim

Payments before first default reported: Two

Loss to HUD: \$77,068

Summary: We found a material underwriting deficiency relating to the borrower's ratios.

Excessive Ratio:

Dell failed to document adequate compensating factors for the excessive total fixed payment-to-effective income ratio. The loan was initially processed through the automated underwriting system. It was rated as "refer" by the system and was then manually underwritten. The total fixed payment-to-effective income ratio was 45.739 percent, above the allowable 43 percent. Two compensating factors were provided to support the underwriting of the mortgage. The first compensating factor stated that the borrower's previous credit history showed that the borrower had the ability to devote a greater portion of income to housing expenses. The second compensating factor identified that the borrower had a potential for increased earnings through job training in the borrower's profession. There were no other explanations or documentation to support these statements.

HUD/FHA Requirements:

Mortgagee Letter 2005-16, dated April 13, 2005, states that the borrower's qualifying ratios are limited to 31 percent (mortgage-payment-to-income ratio) and 43 percent (total fixed payment-to-income ratio). If either or both ratios are exceeded on a manually underwritten mortgage, the lender must provide compensating factors to justify approving the mortgage.

Mortgagee Letter 2005-16, dated April 13, 2005, increased the payment-to-income and debt-to-income ratios from 29 and 41 percent to 31 and 43 percent, respectively. If either or both ratios are exceeded on a manually underwritten mortgage, the lender is required to describe the compensating factors used to justify the mortgage approval.

APPENDIX C

LENDER COMMENTS AND OIG's EVALUATION

Ref to OIG Evaluation

Lender Comments



June 30, 2010

VIA FEDERAL EXPRESS

Mr. Muhammad Akhtar
Supervisory Forensic Auditor
U.S. Department of Housing
and Urban Development
Office of the Inspector General
Region V
77 West Jackson Boulevard
Suite 2646
Chicago, Illinois 60604

**RE: Dell Franklin Financial, LLC
HUD OIG Draft Memorandum Report**

Dear Mr. Akhtar:

Dell Franklin Financial, LLC ("Dell Franklin" or "Company") is in receipt of the Draft Memorandum Report ("Report"), dated June 16, 2010, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of Inspector General ("OIG"). The Report is based on a review of twenty Federal Housing Administration ("FHA") insured loans selected as part of HUD and the OIG's "Operation Watchdog" initiative to examine the underwriting of fifteen lenders at the suggestion of the FHA Commissioner. The twenty loans defaulted within the first 30 months and have since gone into claim status.

The Report states that its objective was to determine whether the Company underwrote the twenty selected loans in accordance with FHA requirements and, if not, whether the underwriting reflected systemic problems. The Report's "Results of Review" allege that three of the twenty loans¹ contained underwriting deficiencies and, in each of these three cases, the underwriters incorrectly certified that due diligence was used in underwriting the loans. Based on these assertions, the Report recommends that HUD: (1) take appropriate administrative action with regard to the underwriting deficiencies; and (2) in connection with the underwriting certifications,

¹ We note that page 3 of the Report references eight loans discussed in Appendix A; however, Appendix A and the remainder of the Report references only three of the twenty loans reviewed.

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determine the legal sufficiency and, if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act, 31 U.S.C. §§ 3801 et seq. ("PFCRA").

The OIG provided Dell Franklin with an opportunity to submit written comments for inclusion in the final report. This response summarizes Dell Franklin's history and operations and addresses the individual findings cited in the Report. We believe that this response and accompanying exhibits demonstrate that the Report's recommendations in connection with the cited loans are unwarranted. We appreciate this opportunity to comment on the OIG's findings and recommendations. That said, we understand that final reports routinely include auditors' comments about the lender's written response, but that the company is not provided an opportunity to respond to these additional comments. Often, these comments include substantive allegations or statements that were not a part of the draft report provided to the company. To the extent that the OIG makes such additional substantive comments in this instance, we respectfully request an opportunity to respond to these additional statements to ensure that a full picture of the issues is presented in the final Report.

I. BACKGROUND

A. DELL FRANKLIN FINANCIAL, LLC

Dell Franklin received approval as a non-supervised mortgagee in July 2003 and shortly thereafter was appointed as a Direct Endorsement mortgagee in April 2004. The Company was a dedicated FHA mortgagee until recently, when, as discussed below, it was forced to cease originating loans as a result of the Department's "probe." Dell Franklin was headquartered and maintained its only office in Millersville, Maryland and employed approximately 15 individuals. Dell Franklin sold all loans that it originated into the secondary market on a servicing-released basis, and its primary investors included BB&T and Wells Fargo Home Mortgage. At all times during its active operations, Dell Franklin's employees consistently strived to produce high quality loans in compliance with HUD/FHA standards.

In recent months, FHA lending constituted approximately 75% of Dell Franklin's business operations. Because FHA lending represented a substantial portion of Dell Franklin's overall production, the Company has consistently taken its responsibilities under the FHA Program seriously. We have always strived to comply with applicable rules and regulations and are committed to educating and training our employees on issues of FHA compliance. Throughout our existence, we endeavored to provide dependable and professional service and repeatedly demonstrated our commitment to borrowers and allegiance to the FHA Program.

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B. THE "OPERATION WATCHDOG" REVIEW

As an initial matter, we would like to take this opportunity to point out that this review was not conducted in the typical manner in which the OIG Audit Division performs audits. As acknowledged in the Report, the OIG did not follow its standard procedures of considering the Company's internal or information systems controls or the results of previous audits, and did not communicate with Dell Franklin's management in advance of issuing the Report. Moreover, instead of reviewing a statistically random sample of loans originated by Dell Franklin during the review period, the OIG examined loan files for an adverse sample of 20 loans in which the borrowers had defaulted and the lenders had made a claim to HUD for FHA insurance benefits. Rather than request that the Company provide information and loan files in the cases reviewed, which Dell Franklin would have promptly supplied, the OIG subpoenaed loan file documentation simultaneously from fifteen FHA-approved lenders, including Dell Franklin, in connection with the "Operation Watchdog" probe. While HUD and the OIG expressly stated that the review "was not based upon any evidence of wrongdoing" on the part of Dell Franklin or the other lenders subjected to this probe (**Exhibit A-1**), the Department and OIG nevertheless issued a press release announcing the "probe" before reviewing any of the loan files at issue in this matter (**Exhibit A-2**). Typically, HUD and the OIG refuse to disclose the names of entities subject to ongoing reviews by the Department; however, in this instance, the press release included the names of the fifteen lenders, including Dell Franklin, subject to this particular review (**Exhibit A-2**).

Although the OIG acknowledged in the press release that it had no evidence of wrongdoing by the Company at that time, by stating that the Department would "aggressively pursue indicators of fraud," the announcement gave the public the impression that the subject lenders had engaged in misconduct or otherwise posed some risk to the FHA Insurance Fund. Given the scrutiny by warehouse lenders and investors of originating lenders in this market, these companies immediately chose to take action against the fifteen lenders subjected to the "probe," rather than wait for the results of the Department's review. Consequently, many of the fifteen lenders involved in this matter, including Dell Franklin, lost their investors, warehouse lines, and customer base upon issuance of the press release announcing the review. Dell Franklin is one of several of the subject lenders that have been forced to cease loan originations as a result of this review.

In November of 2009, Dell Franklin made a business decision to cease operations as an independent mortgage company and planned to become a branch office of another mortgage company effective in early 2010. At the time the OIG subpoenaed Company loan files on January 12, 2010, Dell Franklin was effectively out

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of business. And, once the Company's receipt of an OIG subpoena was widely publicized, the plan to transition former Dell Franklin employees and managers to a new branch office of another mortgage company ended abruptly. Dell Franklin no longer exists as a separate mortgage company or a branch office of another lender. Nevertheless, throughout its existence, Dell Franklin was committed to complying with HUD requirements and originating quality FHA-insured loans. Therefore, upon receiving the draft Report, we conducted a thorough review of the loan file documentation in light of the issues raised. We address the individual concerns identified in the Report below.

II. RESPONSE TO RESULTS OF REVIEW

As previously noted, the Report alleges noncompliance with HUD requirements in three loans and recommends action by HUD and the Departmental Enforcement Center regarding these assertions. Based on our review, Dell Franklin strongly objects to both the recommendation for administrative action and PFCRA penalties in the cited loans. Our review indicated that several of the findings in the Report are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability. While we recognize that there is always room for improvement, at no time did the Company intentionally disregard HUD guidelines or knowingly misrepresent information to the Department. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate Dell Franklin's general compliance with HUD/FHA requirements and adherence to prudent lending standards. Below we reply to the individual matters raised in the Report, evidence our adherence to FHA requirements in connection with several cited loans, and set forth our opposition to the to the OIG's recommendations regarding action under PFCRA.

At the outset, we note that, rather than identify fraud or significant infractions of HUD requirements, the majority of the Report's findings identify minor issues or oversights that did not affect the insurability of the loan. For example, in one of the cases in which the Report asserts that the borrower's qualifying ratio exceeded HUD guidelines, the Report references a back-end ratio that only slightly exceeded HUD guidelines, and in which the loan file documented compensating factors. See HUD Handbooks 4155.1, REV-5, ¶¶ 2-12, 2-13.² It appears that inclusion of such minor

² While the Department has issued a new online version of Mortgage Credit Analysis Handbook, 4155.1, the new Handbook became effective for loans originated on or after May 11, 2009, after the cited loans were originated and closed. We therefore rely on the prior Handbook, 4155.1 REV-5, and accompanying Mortgage Letters in this response.

LENDER COMMENTS AND OIG's EVALUATION

Ref to OIG Evaluation

Lender Comments

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issues in the Report serves only as an attempt to justify the costs of the audit of this Company and the public nature of the "Operation Watchdog" probe that led to this memorandum report. Moreover, as demonstrated below, Dell Franklin properly interpreted and adhered to HUD guidelines in underwriting several of the loans at issue and, in all cases, maintains that the borrowers qualified for FHA financing. For these reasons, we believe that most of the Report's allegations are unwarranted and should be removed from the final report.

In addition, we note that, in one of the three loans at issue in the Report [REDACTED] – **FHA Case No. 241-7768099**, the Department's Processing and Underwriting Division previously examined this loan in a Post-Endorsement Technical Review ("PETR"). In that case, the Department initially raised the same issues regarding the borrower's liabilities identified in the Report. After reviewing the Company's response, however, HUD closed its file in this case. We request that the OIG do the same and remove the allegation HUD has already considered resolved from the final report.

A. DELL FRANKLIN GENERALLY COMPLIED WITH HUD'S UNDERWRITING GUIDELINES

In the "Results of the Review" and Appendix B, the Report alleges that Dell Franklin did not underwrite three of the twenty FHA loans reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) income documentation; (2) assessment of borrower liabilities; (3) excessive qualifying ratios; and (4) documenting borrower assets. We address each of these individual allegations in turn below.

1. Income Documentation

In one loan, [REDACTED] – **FHA Case No. 241-7744658**, the Report alleges that the borrowers' income was overstated, as the qualifying income included overtime for the borrower and co-borrower, but the Verifications of Employment ("VOE") did not confirm the expected continuance of the income.

With regard to income documentation, Dell Franklin understands and appreciates that a lender must verify the borrower's employment for the most recent two full years and analyze the income to determine whether it can reasonably be expected to continue through at least the first three years of the mortgage. See HUD Handbook 4155.1 REV-5, ¶¶ 2-6, 2-7. Dell Franklin complied with these requirements in the [REDACTED] loan. Dell Franklin obtained a telephone VOE (**Exhibit B-1**), pay stubs (**Exhibit B-2**), and W-2 forms (**Exhibit B-3**) evidencing that the borrower had been employed by [REDACTED]. See HUD Handbook 4155.1 REV-5, ¶ 3-1(E).

Comment 1

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The loan file contained a VOE (**Exhibit B-4**) and pay stubs (**Exhibit B-5**) confirming the co-borrower's employment with [REDACTED]. The loan file also contained documentation evidencing the co-borrower's receipt of \$1,029 in monthly Social Security benefits (**Exhibit B-5**).

With regard to the borrower's overtime earnings, Dell Franklin respectfully disagrees with the Report's allegation. HUD guidelines generally permit the use of overtime income to qualify a borrower when these earnings can be documented for the past two years. See HUD Handbook 4155.1 REV-5, ¶ 2-7(A). While the loan file does not document a two-year history of overtime income in this case, HUD guidelines permit lenders to consider overtime income earned for periods of less than two years, provided that the underwriter adequately justifies and documents his or her reason for using the income for qualifying purposes. *Id.* Here, the borrower's pay stubs clearly indicated that he earned regular overtime income (**Exhibit B-2**). Thus, the underwriter used this information to develop average monthly earnings for the borrower as reflected on both the pay stubs (**Exhibit B-2**) and the Mortgage Credit Analysis Worksheet ("MCAW") (**Exhibit B-6**). Moreover, as required by HUD guidelines to evidence likelihood of continuance, the VOE did not state that the overtime income was unlikely to continue (**Exhibit B-1**). Contrary to the allegation in the Report, no further verification was necessary. In addition, we note that employers often, as a policy, do not provide information regarding the likelihood of continuance of overtime on the VOE. Thus, HUD merely requires that lenders ensure that there is no indication that such income will cease in the immediate future. Here, nothing in the loan file suggested that the borrower would not continue to earn overtime income, and the fact that the borrower earned consistent overtime indicated that such earnings were likely to continue. In accordance with HUD guidelines, Dell Franklin properly verified the borrower's consistent overtime income and its likelihood of continuance. Thus, the underwriter included these earnings in the qualifying income. The most recent pay stub indicated that the borrower had earned total income of \$19,929.21 as of June 10, 2010, reflecting \$3,690 in monthly earnings ($\$19,929 / 5.4 \text{ months} = \$3,690$), which was slightly more than the \$3,674.71 used on the MCAW (**Exhibit B-6**).

With regard to the co-borrower's overtime earnings, Dell Franklin acknowledges that, although the co-borrower's pay stubs reflected overtime earnings, the VOE from her employer indicated that overtime was not likely to continue and, thus, the underwriter should not have included these earnings in the borrowers' effective income. That said, any oversight with regard to the co-borrower's overtime constituted, at worst, harmless error. Using the borrower's earnings of \$3,674, the co-borrower's earnings of \$3,466, as calculated in the Report, and the co-borrower's additional Social Security income of \$1,029, the borrowers' monthly earnings were \$8,169. This monthly income

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amount would have increased the borrowers' ratios slightly, to 28%/46.6%. While the back-end ratio was slightly higher than the Department's benchmark guideline, see Mortgagee Letter 2005-16, the loan file evidenced significant compensating factors that would have offset these higher qualifying ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13. Importantly, the borrowers made a substantial downpayment of almost \$100,000 to complete this transaction (**Exhibit B-7**), which they obtained through the sale of another property (**Exhibit B-8**). This fact alone would have offset the slightly higher-than-average back-end ratio. In addition, the borrowers had substantial cash reserves after closing (**Exhibit B-6**), and the borrower had an excellent payment history on his previous real estate mortgage loan (**Exhibit B-9**). HUD guidelines expressly recognize that these factors offset higher-than-average qualifying ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(A)(B), and (G). Moreover, the loan file documented that the co-borrower in fact earned additional overtime income (**Exhibit B-5**), which also would have constituted a compensating factor in this case. See id. ¶ 2-13(E).

In summary, Dell Franklin maintains that it properly included the borrower's overtime earnings in the qualifying income in this case and, with regard to the co-borrower's income, any oversight with regard to overtime did not affect the borrower's qualification for FHA financing in this case. As discussed above, even if the co-borrower's overtime earnings had not been included, while the borrowers' qualifying ratios would have slightly increased, significant compensating factors were present that justified loan approval in this instance. For these reasons, we believe that the request for administrative action should be removed from the final report.

As a final matter, we note that the Report acknowledges that the borrowers made 24 mortgage payments before defaulting on this loan. Moreover, a review of the property records evidences that the borrower's relative, [REDACTED], now owns this property (**Exhibit B-10**). This documentation suggests therefore that reasons other than the Company's origination or underwriting practices caused the default in this instance two years after the loan closed.

2. Assessment of Liabilities

In one case, [REDACTED] – FHA Case No. 241-7768099, the Report asserts that the qualifying ratios did not include all of the borrowers' liabilities listed on the September 20, 2006 credit report, as that credit report listed \$1,620 in monthly payments, while the MCAW considered only \$1,220 in monthly obligations.

As indicated in the Report, HUD raised this issue in connection with a PETR of the [REDACTED] case. As the loan closed in October of 2006, and HUD guidelines require lenders to retain such documents for a period of two years, the Company no longer has

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documentation regarding the PETR. See HUD Handbook 4000.2 REV-3, ¶ 5-8. The Company requested that the OIG provide Dell Franklin with the documentation it reviewed in connection with the PETR, but at the time of this response, the Company has not received these documents. That said, the Report itself states that the Department closed its file on this case after reviewing an earlier credit report, dated August 23, 2006, used by the underwriter to calculate the borrower's liabilities, which did not reference the additional \$400 in monthly obligations.

Dell Franklin nevertheless understands and appreciates that HUD guidelines state that lenders "must include the monthly housing expense and all other additional recurring charges ... including payments on installment accounts." HUD Handbook 4155.1 REV-5, ¶ 2-11(A). It was the Company's policy and practice to utilize the most current credit account information and include all installment debts evidenced in the loan file in the calculation of a borrower's qualifying ratios. In this case, the Company acknowledges that the underwriter should have included the additional debts referenced on the September 20, 2006 credit report in the qualifying ratio calculation. In any event, any oversight in the [REDACTED] case regarding the exclusion of the additional debts constituted, at worst, harmless error. As noted in the Report, inclusion of this debt would have increased the borrower's back-end ratio in excess of HUD's benchmark guideline of 43%. See HUD Handbook 4155.1 REV-5, ¶ 2-12; Mortgagee Letter 2005-16. The loan file, however, evidenced compensating factors that would have offset this higher-than-average ratio. Specifically, the loan file documented the borrowers' stable employment history. The borrower had been employed by her current employer for seven years (Exhibit C-1), and the co-borrower had a four-year history of employment as a superintendent (Exhibit C-2). Based on these compensating factors, and the fact that HUD has already closed its file in connection with this case, we believe that administrative action would be inappropriate, and ask that this allegation be removed from the final report.

3. Qualifying Ratios

In two loans, the Report asserts that the borrowers exceeded HUD's recommended debt-to-income ratios without documented, valid compensating factors in the "Remarks" section of the MCAW.

The Department has acknowledged that "[u]nderwriting is more of an art than a science and requires the careful weighing of circumstances that affect the borrower's ability and willingness to make timely mortgage payments." Mortgagee Letter 00-24; see also Mortgagee Letter 95-07. Underwriting requires the subjective evaluation of information based on experience in determining whether a potential borrower is creditworthy. An underwriter must carefully weigh all aspects of an individual's case

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and, were two underwriters to review the same file, one might approve a loan where the other would deny a loan. Significantly, each underwriter may have made a reasonable and prudent underwriting decision.

Furthermore, the Department expressly permits a mortgagee to approve FHA financing to a borrower with qualifying ratios that exceed the benchmark guidelines of 31% and 43% where significant compensating factors justify loan approval. See, e.g., HUD Handbook 4155.1, REV-5, ¶¶ 2-12, 2-13; Mortgagee Letter 2005-16. The Department has professed that the “FHA does not set an arbitrary percent by which ratios may be exceeded but rather FHA relies on the underwriter to judge the overall merits of the loan application and to determine what compensating factors apply and the extent to which those factors justify exceeding the ratios.” Mortgagee Letter 00-24 (emphasis added). Thus, where a potential borrower’s qualifying ratios are high, an underwriter has to consider all relevant circumstances and exercise discretion in deciding whether to approve or reject a loan. With different standards for varying types of underwriting, the Department must rely on underwriters to adequately analyze a borrower’s financial circumstances and take into account all relevant factors, including the range of acceptable levels in qualifying ratios.

It was Dell Franklin’s policy to carefully consider each borrower’s circumstances and document significant compensating factors in the “Remarks” section of the MCAW in compliance with HUD guidelines. Contrary to the allegations in this sub-finding, when compensating factors or other justifications were required, Dell Franklin obtained the necessary documentation to demonstrate these factors, and either included the documentation in the loan file or noted these factors in the “Remarks” section of the MCAW. We address the allegations raised in each of the two cited loans below.

a. [REDACTED] – FHA Case No. 241-7744658

In this case, the Report asserts that utilizing recomputed income that does not include overtime earnings by the borrower or co-borrower increased the borrowers’ ratios to an unacceptable level.

As discussed in detail above, the Company respectfully disagrees with the Report’s recalculation of the borrowers’ income in this instance. Although we acknowledge that the co-borrower’s income should not have reflected overtime earnings, Dell Franklin maintains that it properly included overtime earnings for the borrower. As indicated above, recalculating the borrowers’ effective income based on the loan documentation would have resulted in qualifying ratios of 28%/46.6%. While the back-end ratio would have been slightly higher than the Department’s benchmark guideline, see Mortgagee Letter 2005-16, the loan file evidenced significant

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compensating factors that would have offset this higher ratio. See HUD Handbook 4155.1 REV-5, ¶ 2-13. Importantly, the borrowers made a substantial downpayment of almost \$100,000 to complete this transaction (Exhibit B-7), which they obtained through the sale of another property (Exhibit B-8). This fact alone would have offset the higher ratios. In addition, the borrowers had substantial cash reserves after closing (Exhibit B-6), and the borrower had an excellent payment history on his previous real estate mortgage loan (Exhibit B-9). HUD guidelines expressly recognize that these factors offset higher-than-average qualifying ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(A)(B), and (G). Moreover, the loan file documented that the co-borrower in fact earned additional overtime income (Exhibit B-5), which also would have constituted a compensating factor in this case. See *id.* ¶ 2-13(E). These factors demonstrate that, even with the higher back-end ratio, the borrowers would have qualified for the FHA-insured loan in this case. For this reason, we maintain that administrative action would be inappropriate and request that this allegation be removed from the final report.

Comment 4

b. [REDACTED] – FHA Case No. 483-3658679

In the [REDACTED] loan, the Report alleges that the borrower's fixed payment-to-income ratio of 45.7% exceeded HUD guidelines without adequate compensating factors.

As discussed above, Dell Franklin understands and appreciates that, at the time the [REDACTED] loan was originated, HUD guidelines provided benchmark ratios for front-end and back-end qualifying ratios of 31% and 43%. See HUD Handbook 4155.1 REV-5, ¶ 2-12; Mortgagee Letter 05-16. Based on these benchmark guidelines, the borrower's front-end qualifying ratio of 28.8% was within HUD guidelines, and the borrower's back-end ratio of 45.7%, with which the Report takes issue, only slightly exceeded HUD's benchmark guideline (Exhibit D-1). In addition, contrary to the assertion in the Report, the loan file evidenced sufficient compensating factors to offset this slightly higher-than-average ratio, which the underwriter reasonably determined justified loan approval in this case. See HUD Handbook 4155.1 REV-5, ¶ 2-13. Importantly, as noted in the Report, the underwriter explained on the MCAW that the borrower's credit history showed that the borrower had the ability to devote a greater portion of income to housing expenses (Exhibit D-1). The underwriter derived this conclusion from the fact that the borrower's non-purchasing spouse would reside in the subject property and would have income to contribute to household costs, allowing the borrower to devote a greater portion of her income to her housing obligation. This conclusion was supported by a letter from the non-purchasing spouse indicating that he had satisfied certain of the borrower's outstanding credit obligations prior to closing (Exhibit D-2).

The underwriter also noted on the MCAW that the borrower had the potential for increased earnings based on job training in the borrower's profession (Exhibit D-1).

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The loan file documented that the borrower had been employed with [REDACTED] for 1.5 years (**Exhibit D-3**). Though the Company would not provide written evidence of its training programs, the underwriter was informed during the origination of this loan that the borrower's employer enrolled its new employees into on-the-job training programs during the first five years of employment, which resulted in pay increases with tenure and training. Based on this information, the underwriter properly noted the borrower's potential for increased earnings based on this job training. Finally, although not noted on the MCAW, the loan file documented that the borrower had cash reserves in a retirement account after closing (**Exhibit D-4**). Dell Franklin maintains that the loan file contained evidence of compensating factors that supported loan approval even with a slightly higher-than-average back-end ratio. For these reasons, Dell Franklin believes that administrative action in this case is unwarranted and requests that this allegation be removed from the final report.

Comment 5

4. Borrower Assets

Finally, in one case, [REDACTED] - **FHA Case No. 241-7768099**, the Report asserts that the Company did not confirm the source of the assets entered into the automated underwriting system, as the borrowers opened a savings account on September 15, 2006, 32 days before closing, with a deposit of \$9,904 but did not document the source of these funds. The Report also alleges that the loan file did not evidence redemption of the \$2,894 in retirement account funds listed as assets on the automated underwriting statement.

As an initial matter, as indicated in the Report, HUD performed a PETR in this case. While Dell Franklin did not retain documentation related to the PETR and, thus, did not review this information in preparation of this response, we note that it appears from the Report that HUD raised no issues with regard to the Company's documentation of the borrowers' assets in this case.

With regard to the borrower's savings account, Dell Franklin understands and appreciates that an FHA lender must verify all funds used for the borrower's investment in the property. See HUD Handbook 4155.1 REV-5, ¶ 2-10. Where funds in a borrower's savings or checking account are used to cover the borrower's investment, HUD guidelines require that, if there is a large increase in an account, or the account was opened recently, the lender must obtain a credible explanation of the source of those funds. Id. Dell Franklin maintains that it did so in this case. Contrary to the allegation in the Report, the savings account was not opened with a \$9,904 deposit. This amount consisted of the \$4,103.76 in available funds, plus a \$5,801.21 memo credit listed on the bank statement (**Exhibit E-1**). The \$4,103.76 current balance in the savings account, which was listed in the assets reflected on the automated underwriting

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report (**Exhibit E-2**), was derived from a \$4,299 deposit into the borrowers' savings account on September 26, 2006 (**Exhibit E-1**). To document the source of this deposit, the Company obtained a copy of a check in the amount of \$4,299.62, dated September 13, 2006, from the borrower's retirement account (**Exhibit E-3**). This documentation evidences the source of the \$4,103 in assets considered in the underwriting of this loan in compliance with HUD guidelines.

With regard to the retirement account funds, the loan file contained a copy of the borrower's retirement account to evidence the existence of this asset (**Exhibit E-4**). As the borrower did not use the \$2,894 in available retirement funds to meet her investment in the property, Dell Franklin was not required to obtain documentation regarding the redemption of these funds from the retirement account. The Company complied with HUD guidelines in verifying the borrowers' assets in this case and, therefore, we request that this finding be removed from the final report.

B. DELL FRANKLIN STRONGLY OPPOSES THE RECOMMENDATION THAT PFCRA PENALTIES ARE APPROPRIATE IN THIS CASE

1. Dell Franklin Exercised Due Diligence in Underwriting the Loans at Issue

In addition to the underwriting deficiencies discussed above, the Report asserts that, in the three loans at issue, the underwriter's certification on page 3 of the Addendum to the Uniform Residential Loan Application ("URLA"), Form HUD-92900-A ("Addendum") was incorrect, as the underwriter certified to using due diligence in underwriting these cases but did not do so. We understand that this allegation is predicated on the OIG's determination that these three cases contained underwriting deficiencies. The Report alleges that these underlying oversights demonstrate that the underwriter did not exercise due diligence in examining the loan file and, as a result, the certification on the Addendum in these cases was incorrectly signed. The Report recommends in connection with these allegations that HUD's Associate General Counsel for Program Enforcement determine the legal sufficiency of and, if sufficient, pursue remedies under the PFCRA for the inaccurate certifications in these cases. As discussed in detail above, Dell Franklin takes exception to the allegations that these loans contained underlying origination deficiencies, as well as the inflammatory recommendation to impose PFCRA penalties made in connection with this finding.

HUD is authorized to impose civil penalties under PFCRA against persons who "make, submit, or present, or cause to be made, submitted, or presented, false, fictitious, or fraudulent claims or written statements to Federal authorities or to their agents." 24 C.F.R. § 28.1. The Report suggests that, because the OIG identified

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underwriting deficiencies in these three cases, the underwriters' certifications that due diligence was used in underwriting these loans are inaccurate. As demonstrated in the above discussion, however, in the three cases cited, Dell Franklin substantially complied with HUD requirements and the underwriter made a reasonable decision to approve the loan after exercising due diligence in examining each of the files at issue. For these reasons, Dell Franklin disagrees with the recommendation of any penalty in connection with these loans, let alone the harsh sanction of PFCRA penalties recommended in the Report.

Additionally, the Report does not allege, and there is no evidence to suggest, that Dell Franklin or its employees intended to circumvent HUD underwriting guidelines in these cases. Rather, the certifications in these three cases were executed by the underwriters after diligent review of the loan files in which these individuals made every effort to comply with FHA requirements. The certifications in these cases were executed in the belief that the borrowers qualified for FHA financing, which in fact they did in each case, rather than in an attempt to mislead the Department. The Report does not allege that Dell Franklin or its underwriters knowingly misrepresented facts to the Department or intentionally provided false information in the cases at issue. Before imposing penalties on FHA-approved lenders, HUD weighs a number of factors. While intentional violations or a disregard for HUD requirements can lead to severe sanction, such as PFCRA penalties, HUD traditionally imposes less severe consequences for deficiencies caused by unintentional error. Additionally, Dell Franklin maintains that the borrowers in the cited cases qualified for FHA financing. At worst, certain of these loans contained minor errors that did not affect the insurability of the loans. As indicated above, Dell Franklin believes that the final report should omit recommendations of administrative action in connection with these cases, making the recommendation of PFCRA penalties all the more severe under these circumstances.

We also note that, rather than cite new allegations, the PFCRA recommendation appears to be an attempt to pile on the allegations made against Dell Franklin's underwriting practices in this Report. Typically, OIG audit reports allege certain deficiencies in a company's FHA operations, and the company is given an opportunity to address the materiality and accuracy of the allegations. By also adding an incorrect certification allegation to these underwriting assertions, the OIG has created a situation where every misunderstanding of FHA requirements or oversight of a detail or document in a FHA loan could give rise to allegations of a false certification claim. Considering the sensationalizing of the "Operation Watchdog" probe, and the devastating effects this matter has and will continue to have on the targeted lenders, such actions will create a chilling effect on lenders who want to participate in the FHA Program. Enforcement actions are meant to reinforce HUD's rules and regulations,

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rather than discourage broad participation in FHA lending. For the sake of the Program, therefore, we believe the OIG should reconsider its approach to alleging false certifications and focus on the compliance with FHA rules and regulations.

2. **The PFCRA Allegations Constitute a Recommendation to HUD, Rather than a Final Action By the Department**

As noted above, the Report merely recommends that the Department determine the legal sufficiency of pursuing PFCRA remedies in the cited cases. Upon receiving the final report, the Department will have an opportunity to independently examine the review findings and make an independent determination of whether such penalties are appropriate in these three cases. As discussed at length earlier in this response, Dell Franklin disagrees that the Report's assertions warrant administrative action or PFCRA remedies. HUD may also disagree with the Report's assertions and decide not to pursue PFCRA penalties in this instance.

In addition, while the review process is still ongoing at the time the OIG issues its "final" report, the Report and the OIG's recommendations typically are made public on the OIG website. As a result, a lender's investors and peers are able to access the preliminary recommendations of the OIG before a final assessment as to their merit can be made by the Department. These entities often misinterpret the OIG's recommendations to be final actions by the Department. Under these circumstances, making these preliminary recommendations public and including inflammatory allegation that HUD pursue PFCRA remedies with the suggestion that the loans identified involve misrepresentations will have a material, adverse effect on the Company's business. This would be especially detrimental in this circumstance, as the public nature of the "Operation Watchdog" probe has already resulted in the loss of investors and customers to the point where Dell Franklin was forced to cease loan originations and wind down its operations.

If the OIG's goal is to present the reader with a full and accurate disclosure of this review and its implications to the Company, the Report should include the following disclosure on the first page in bold, capitalized lettering:

THE REPORT FINDINGS REFLECT THE VIEWS OF THE OFFICE OF INSPECTOR GENERAL AND DO NOT CONSTITUTE A FINAL DETERMINATION OF THE MATTERS RAISED HEREIN BY THE U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT. THE FINAL DETERMINATION IN THIS MATTER WILL BE MADE BY THE REPORT'S ADDRESSEE, THE HUD ASSISTANT SECRETARY FOR HOUSING – FEDERAL HOUSING COMMISSIONER, WHO WILL ULTIMATELY

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DECIDE WHETHER TO ACCEPT THE REPORT'S RECOMMENDATIONS IN WHOLE OR IN PART OR REJECT THEM.

Such a disclosure would more accurately convey the status of the OIG's "final" report to the Company's investors, customers, and the public.

III. CONCLUSION

Dell Franklin takes the matters raised in the draft Report seriously. Because FHA lending comprised a significant portion of Dell Franklin's overall business operations throughout its existence, the Company was committed to educating and training its employees on issues regarding FHA compliance and to assuring their adherence to HUD's rules and regulations. Although the publication of the Department's scrutiny of the Company in the press release announcing the "Operation Watchdog" probe has effectively put the Company out of business, Dell Franklin nevertheless has conducted a thorough review of the issues identified in the Report. As discussed above, Dell Franklin's review indicated that the Report's findings are at variance with the facts, do not constitute violations of HUD/FHA requirements on the part of Dell Franklin, or do not affect the underlying loans' insurability. The Company substantially complied with FHA underwriting requirements in several of the loans identified in the Report and made loans to qualified FHA borrowers. Accordingly, we respectfully request that the OIG revise the allegations cited in the Report based on the information and documentation provided in this response and remove allegations for which Dell Franklin has demonstrated its compliance with HUD requirements.

Finally, Dell Franklin believes that the recommendations involving PFCRA penalties are unwarranted, as they suggest an intent to circumvent HUD requirements when the OIG knows full well that no such intention existed in these cases. Dell Franklin values its relationship with the Department and did not, in any manner, seek to misrepresent any information to HUD. Dell Franklin believes that the various remedies available to HUD, short of the severe sanctions under PFCRA, are commensurate to resolve any deficiency identified in the Report. We believe, and we hope the OIG will agree, that this response and accompanying exhibits demonstrate that including these recommendations in the Report is unnecessary, inappropriate, and will further damage Dell Franklin's reputation, which has already suffered as a result of the public nature of the "Operation Watchdog" probe. We respectfully request that the OIG revise its recommendations to fit the facts of this case.

If you have any additional questions, or if you need additional information, please do not hesitate to contact our Washington counsel, Phillip Schulman, at (202) 778-9027.

Ref to OIG Evaluation

Lender Comments

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Thank you for your kind consideration.

Sincerely,



Richard Reese
President

cc: Heath Wolfe, Regional Inspector General for Audit, Region V
Phillip L. Schulman, Esq., K&L Gates LLP

OIG's Evaluation of Lender Comments

- Comment 1** For loan number 241-7744658, Dell disagreed with our report and asserted that its underwriter was correct in including the borrower's overtime income of \$1,101. Dell based its assertion on the borrower's earnings for the most recent 5.4 months. Dell's response did not include any additional information than what was already in the loan file and we had reviewed. As stated in our draft report, the overtime income should not have been included because the borrower's employment history did not support the consistency of monthly earnings remaining the same or increasing. Further, the verification of employment also did not document that the overtime income was likely to continue. Based on Dell's response, we did not change our conclusion and recommendation.
- Comment 2** Dell acknowledged that its underwriter should have included the additional debts referenced in the latest credit report and stated that it was an oversight. However, Dell stated that the compensating factors, like stable employment, would have offset the higher than average ratio. We disagree. Had Dell's underwriter included the actual liabilities, the total payment-to-income ratio would have increased to 51.85 percent, well above HUD's allowable ratio of 43 percent. Further, stable employment is not an allowable compensating factor under HUD regulations. Based on Dell's response, we did not change our conclusion and recommendation.
- Comment 3** Dell acknowledged that the coborrower's income should not have included overtime earnings; but maintained that it properly included the borrower's overtime earnings. However Dell; did not provide any additional documentation to support its assertion. We stated in our draft report that the verification of employment in the loan file did not document that the overtime income was likely to continue. We also said that the borrower's employment history did not support the consistency of monthly earnings remaining the same or increasing. Dell did not provide additional information or documentation to clarify or support changing the analysis of the stated issues in our report. Therefore, we did not change our conclusion that Dell overstated the borrowers' income by \$1,386 by including unsupported overtime income. By using the recomputed income without the overtime earnings, the mortgage payment-to-income ratio would be 32.183 percent and the total fixed payment-to-income ratio would be 51.916 percent, above HUD's allowable ratios of 31 and 43 percents, respectively.

We agree with Dell's statement that a downpayment of nearly \$100,000 is significant along with a substantial cash reserve. Dell stated that these factors would have compensated for higher ratios. We considered these factors when we analyzed Dell's underwriting. After considering Dell's response, we did not change our conclusion in the final report because: (1) the total payment-to-income ratio would be 51.916 percent, substantially above HUD's allowable ratio; (2) the borrower's monthly mortgage payment were more than 300 percent greater than the previous payment, a very substantial increase. According to the mortgage

credit analysis worksheet, the current housing expense was \$659 per month compared to the future mortgage payments of \$2,275, an increase of \$1,616 per month.

Comment 4 Dell agreed that the total payment-to-income ratio exceeded HUD's allowable ratio, but stated that the borrower had the potential for increased earnings through job training. However, there was no documentation to support this compensating factor in the loan file. Further, Dell did not provide any written evidence or any statement from the borrower's employer that the borrower had received any kind of training or potential of any future training that would increase the earnings.

Dell stated that its underwriter noted on the mortgage credit analysis worksheet a compensating factor that the borrower had the ability to devote a greater portion of income to housing expenses. Dell explained that the underwriter derived this conclusion from the fact that the borrower's non-purchasing spouse would reside in the subject property and would have income to contribute for household expenses. However, Dell did not provide any documentation to support that the spouse had income to contribute.

Although not noted on the mortgage credit analysis worksheet, Dell stated in its response the loan file documented that the borrower had cash reserves in a retirement account after closing. We determined that the borrower had a cash reserve of two months in mortgage payments. However, HUD requires three months of cash reserves. After evaluating Dell's comments, we did not change our conclusion and recommendation in this report.

Comment 5 We agree with Dell's assertion that the savings account was not opened with a deposit of \$9,904 on September 15, 2006, and we adjusted our memorandum report. The loan file contained a savings account inquiry, dated October 10, 2006, which showed an available balance of \$9,904. It also showed deposits of \$4,203, \$4,299, and a memo credit of \$5,801.

In our draft report, we stated that the loan file did not contain documentation to support the source of funds in the savings account and there was no evidence of redemption of the retirement funds. Dell's underwriter listed available assets of \$13,614 that comprised of \$4,104 in a savings account, \$6,616 in a checking account, and \$2,894 in a retirement account. Dell stated that \$4,104 was part of the \$4,299 deposit which came from the borrower's retirement account. Dell also asserted that the loan file contained evidence that the borrower's retirement account had available funds. However, Dell did not provide the required redemption documentation if the funds were obtained from the retirement account. After evaluating Dell's comments, we did not change our conclusion and recommendation in this report.

Comment 6 Dell disagreed with our recommendation and asserted that its underwriters made a reasonable decision to approve the loans after exercising due diligence. The two

underwriters involved with the three materially deficient loans did not use due diligence in underwriting these loans. Appendix B of this report provides detailed descriptions of the material underwriting deficiencies. We did not change our recommendation as this recommendation is appropriate based on the issues cited in this report. Violations of FHA rules are subject to administrative and civil action. The appropriateness of civil money penalties will be determined by HUD.