



U. S. Department of Housing and Urban Development
Office of Inspector General
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New York, NY 10278 0068

MEMORANDUM NO: 2010-NY-1805

September 1, 2010

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

Dane M. Narode, Associate General Counsel for Program Enforcement, CACC

Edgar Moore

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

SUBJECT: Webster Bank, Cheshire, CT, Did Not Properly Underwrite a Selection of FHA Loans

INTRODUCTION

We conducted a review of Federal Housing Administration (FHA) loans underwritten by Webster Bank (Webster), an FHA direct endorsement lender. This review was conducted as part of our "Operation Watchdog" 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. The objective of the review was to determine whether Webster underwrote 20 loans in accordance with U.S. Department of Housing and Urban Development (HUD)/FHA requirements.

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

The draft memorandum report was provided to Webster officials on July 22, 2010 and Webster officials provided a written response on August 6, 2010. Webster officials disagreed with our findings and recommendations. The complete text of Webster officials' response, along with our evaluation of that response, can be found in appendix C of this memorandum, except for the exhibits, which were too voluminous to be included within the report.

METHODOLOGY AND SCOPE

Webster Bank is 1 of 15 direct endorsement lenders we selected from HUD's publicly available Neighborhood Watch¹ system for a review of underwriting quality. These direct endorsement

¹ Neighborhood Watch is a Web-based data processing, automated query, reporting, and analysis system designed to highlight exceptions to lending practices to high-risk mortgages so that potential problems are readily identifiable.

lenders all had a compare ratio² in excess of 200 percent of the national average as listed in the system for loans endorsed between November 1, 2007, and October 31, 2009. We selected loans that had gone into claims status. We selected 20 loans underwritten by Webster that had gone into claims status within 30 months of the loan's endorsement date. The sample of 20 loans consisted of 17 purchases and 3 refinances. The selected loans did not include streamline refinances. To accomplish our objectives, we reviewed applicable HUD handbooks, mortgagee letters, and reports from HUD's Quality Assurance Division.

We performed our work from March³ through June 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 Webster Bank, consider the results of previous audits, or communicate with Webster's management in advance. We did not follow standards in these areas because our goal was to aid HUD in identifying material underwriting deficiencies and/or potential wrongdoing on the part of poor performing lenders that contributed to a high rate of default and claims against the FHA insurance fund. To meet our objectives, it was not necessary to fully comply with standards, nor did our approach negatively affect our review results.

BACKGROUND

Webster Bank is a HUD-approved Title II supervised mortgagee located in Cheshire, CT. A supervised mortgagee is a HUD/FHA approved financial institution that is a member of the Federal Reserve System or an institution whose accounts are insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration, which is not required to have mortgage lending as its principal source of revenue and may be approved to originate, sell, purchase, hold, and/or service HUD/FHA insured mortgages, depending on its wishes and qualifications. FHA approved Webster on November 14, 1935. Webster is approved to participate in the Lender's Insurance (LI) program effective February 2, 2006. The LI program enables high-performing mortgagees pursuant to section 256 of the National Housing Act, to endorse FHA mortgage loans without a pre-endorsement review⁴ being conducted by FHA. Under the LI program, the approved mortgagee performs its own pre-endorsement review and enters mortgage loan level data to FHA via the FHA Connection⁵. The FHA Connection will perform an automated verification process to check the data for accuracy and completeness, and the mortgagee then will be able to endorse the mortgage loan automatically.

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.

³ On January 12, 2010, OIG served a subpoena on Webster requesting all documents related to 20 FHA loans, however, our work did not begin until March 2010.

⁴ A pre-endorsement review is conducted by HUD's Homeownership Center staff on the FHA case binder to ensure that FHA documentation requirements have been met, forms and certifications are properly executed, and FHA Connection and Automated Underwriting System data have integrity.

⁵ FHA Connection is an interactive system available through the Internet that gives approved FHA lenders real-time access to FHA systems for the purpose of conducting official FHA business in an electronic fashion.

The goal of Operation Watchdog is to determine why the selected lenders had such a high rate of defaults and claims. We selected up to 20 loans in claims status from each of 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, Webster endorsed 6,808 loans valued at more than \$921 million and submitted 201 claims worth more than \$29.7 million.

The objective of this review was to determine whether Webster underwrote the 20 selected loans in accordance with HUD/FHA requirements, and if not, whether patterns of underwriting deficiencies reflected systemic problems.

RESULTS OF REVIEW

Webster Bank officials did not underwrite 6 of 20 loans reviewed in accordance with HUD/FHA regulations. As a result, the FHA insurance fund suffered actual losses of \$456,854 on five loans and faces potential loss of \$60,136 on one loan for a total of \$516,990 as shown in the below table.

FHA/loan number	Closing date	Number of payments before first default	Acquisition Cost	Unpaid Balance	Original mortgage amount	Actual loss to HUD ⁶	Potential Loss to HUD (60% of Unpaid Balance)	TOTAL Actual and Potential Loss to HUD
105-3302961	12/04/07	2	111,199	100,227	101,900		60,136	60,136
132-1827919	07/28/05	1	80,653	69,709	72,055	34,419		34,419
197-3647194	04/16/07	4	331,584	309,559	315,056	191,105		191,105
461-4133646	05/31/07	2	130,487	120,351	123,068	61,257		61,257
481-2619404	07/06/07	9	152,603	140,521	143,103	93,911		93,911
562-2061518	06/25/07	6	168,513	149,724	153,265	76,162		76,162
					\$908,447	\$456,854	\$60,136	\$516,990

The below table summarizes the material underwriting deficiencies that we identified in the six loans.

Area where underwriting deficiencies were found	Number of loans ⁷
Income	2
Liabilities	1
Excessive Ratios	1
Gift documentation	2
Borrower investment in property not verified	3

⁶ The loss amount was obtained from HUD's Single Family Acquired Asset Management System (SAMS). SAMS tracks properties from acquisition to final sales closing and maintains all accounting data associated with the case records.

⁷ The deficiencies noted are not independent of one another, as one loan may have contained more than one deficiency.

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

Specific examples of these underwriting deficiencies follow.

Unsupported Income or Questionable Employment History

Webster officials incorrectly calculated borrower income or did not verify employment stability for two loans. For example, for loan number 105-3302961, Webster officials calculated the borrower's monthly effective income as \$2,720 using a letter dated October 25, 2007, from the borrower's current employer that was faxed from an unknown source. The letter stated that the borrower received an internal transfer effective November 26, 2007. The letter also stated that the borrower will be paid a monthly salary of \$2,720 payable monthly in arrears. Based on this letter, the borrower had to work from November 26, 2007 through December 26, 2007 to receive this new salary in January 2008. Since this loan closed on December 4, 2007, Webster officials should have used the borrower's current salary. In addition, Webster's file contained copies of the borrower's pay stubs for two weeks and not the required 30 days and these pay stubs only showed that the borrower worked 20 hours per week at an hourly rate of \$11.06. Using the income documented by the borrower's pay stubs, we calculate the borrower's monthly effective income to be \$958.53 by multiplying the hourly rate by the number of hours worked ($\$11.06 \times 20 \text{ hours per week} \times 52 \text{ weeks} / 12 \text{ months}$) instead of the \$2,720 used by the lender.

Underreported Liabilities

Webster officials underreported liabilities for one loan. Specifically, for loan number 481-2619404, Webster officials incorrectly calculated the borrower's back ratio⁸ because it underreported the borrower's liabilities by excluding monthly child support payments totaling \$500. The mortgage credit analysis worksheet⁹ listed the borrower's total monthly payments as \$30 and a back ratio of 39.99 percent. However, Webster's file contained an "Order of Divorce" and a "Property Settlement Agreement," which showed that the borrower had to pay \$500 in monthly child support beginning November 1, 2003. Webster officials did not include this in the borrower's back ratio because of an email from the borrower's former wife, which stated that the borrower does not pay \$500 a month in child support. However, this email does not relieve the borrower of his legal and financial responsibilities for his minor child and without legal documents stating otherwise, the borrower is legally responsible for the child support. Therefore, Webster officials should have included the \$500 child support debt in calculating the borrower's back ratio. Including the \$500 in monthly child support increases the borrower's back ratio from 39.99 to 58.17 percent requiring significant compensating factors to justify mortgage approval.

⁸ The front ratio is the mortgage payment-to-income ratio, and the back ratio is the fixed payment-to-income ratio; HUD's benchmarks are 31 percent and 43 percent, as set forth in Mortgagee Letter 2005-16.

⁹ The mortgage credit analysis worksheet is used to analyze and document mortgage approval.

Excessive Ratio(s) without Adequate Compensating Factors

Webster officials approved one loan that had excessive ratios without adequate compensating factors. For loan number 562-2061518, without documenting acceptable compensating factors, Webster officials approved the loan for the borrower that had a front ratio of 44.50 percent and a back ratio of 48.10 percent, which exceeded HUD's benchmarks of 31 percent and 43 percent as set forth in Mortgagee letter 2005-16. The underwriter listed the following compensating factors: 8 years on the job, had good credit history until joining a credit counseling service then later occurred and he cancelled, and good on mortgage-FHA. Regarding the compensating factor related to 8 years on the job, FHA requires stable employment as a basis for mortgage approval; therefore, it should not be used as a compensating factor. While good mortgage history is a valid compensating factor, the borrower's monthly payments increased from \$769.61 to \$968.74; and the factor regarding the borrower joining a credit consolidating company and subsequently cancelling is not an acceptable compensating factor, but is indicative of the borrower's previous credit problems. Therefore, the underwriter did not present and document compensating factors that were significant enough to justify mortgage approval for this loan in which the ratios exceeded HUD's benchmarks.

Insufficient Gift Documentation

Webster officials did not properly verify the transfer of gift funds for two loans. For loan number 461-4133646, Webster officials did not adequately verify the transfer of a \$3,750 gift; therefore, the borrower's investment in the property was not verified. The mortgage credit analysis worksheet showed that the borrower's statutory cash investment requirement was \$3,750 and Webster's file contained a gift letter dated May 22, 2007 from a public charity for a \$3,750 gift to the borrower to assist with the home purchase. The gift letter stated that once the closing office has all of the signed and completed documents required, the closing office will disburse the gift funds at the loan closing for the purchase of the home. The HUD-1 settlement statement shows that this loan closed on May 31, 2007 and lists gift funds of \$3,750; however, Webster's file did not contain any documentation to verify that these gift funds were provided to the closing agent. Without any documentation verifying that the closing agent received these funds, Webster officials did not verify and document the gift funds or the borrower's investment in the property.

Borrower Investment in Property Not Verified

Webster officials did not verify the borrower's investment in the property for three loans. For two of the three loans, Webster officials did not verify the transfer of gift funds; therefore, the borrowers' investment in the property was not verified. For the third loan, FHA number 197-3647194, Webster officials did not verify and document the cash sales proceeds from the sale of the borrower's prior residence. Webster's file only contained two pages of the HUD-1 settlement statement from the sale of this home and not the fully executed HUD-1 settlement statement; therefore, Webster did not document the actual sale and the sufficiency of the net proceeds required for settlement. In addition, the HUD-1 settlement statement for this purchase listed an earnest money deposit of \$14,537.92; however, there was no documentation in the file to verify the source of funds or that the funds were received by either the closing agent or the

seller. Without this documentation, Webster officials did not verify and document the borrower's investment in the property.

Incorrect Underwriter's Certifications Submitted to HUD

We reviewed the certifications for the six loans with material underwriting deficiencies for accuracy, Webster's direct endorsement underwriters incorrectly certified that due diligence was used in underwriting these six 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.

Applicable Statutes

The Program Fraud Civil Remedies Act of 1986 (31 U.S.C. (United States Code) 3801-3812) and (24 C.F.R. Part 28) provides Federal agencies, which are the victims of false, fictitious, and fraudulent claims and statements, with an administrative remedy to (1) recompense such agencies for losses resulting from such claims and statements; (2) permit administrative proceedings to be brought against persons who make, present, or submit such claims and statements; and (3) deter the making, presenting, and submitting of such claims and statements in the future; up to \$7,500 for each violation and double the amount of paid claims (recovery limited to claims of \$150,000 or less).

Civil Money Penalties (24 C.F.R. Part 30.35) provides that the Mortgage Review Board may initiate a civil money penalty action against any mortgagee or lender who knowingly violates any of the listed 14 different violations; up to \$7,500 for each violation, but not to exceed \$1,375,000.

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 (31 U.S.C Section 3801-3812) and/or, Civil Money Penalties (24 C.F.R. Part 30.35) against Webster and/or its principals for incorrectly certifying to the integrity of the data or that due diligence was exercised during the underwriting of six loans that resulted in actual losses of \$456,854 on five loans and potential loss of \$60,136 on one loan, which could result in affirmative civil enforcement action of approximately \$1,078,980.¹⁰

We also recommend that HUD's Deputy Assistant Secretary for Single Family

- 1B. Take appropriate administrative action against Webster 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.

¹⁰ Double damages for actual loss amounts related to five loans and potential loss related to one loan ($\$516,990 \times 2 = \$1,033,980$) plus \$45,000, which is a \$7,500 fine for each of the six loans with material underwriting deficiencies.

**SCHEDULE OF INELIGIBLE COSTS AND
FUNDS TO BE PUT TO BETTER USE**

Recommendation number	Ineligible 1/
1A	\$516,990
Totals	\$516,990

- 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 5 properties (\$456,854) and potential loss related to 1 property (\$60,136).

Appendix A

SUMMARY OF MATERIAL UNDERWRITING DEFICIENCIES

FHA Number	Unsupported Income or Questionable Employment History	Underreported Liabilities	Excessive Ratio(s) without Adequate Compensating Factors	Insufficient gift documentation	Borrower investment in property not verified
105-3302961*	X				
132-1827919	X				
197-3647194*					X
461-4133646*				X	X
481-2619404*		X		X	X
562-2061518*			X		
TOTALS	2	1	1	2	3

* Loan was originated under the Lender's Insurance Program, therefore, lender self insures the FHA loan and only submits those case binders (paper or electronic) when requested for review by HUD.

Appendix B

LOANS WITH MATERIAL UNDERWRITING DEFICIENCIES

Loan number: 105-3302961

Mortgage amount: \$101,900

Section of Housing Act: 203 (b)

Loan purpose: Purchase

Date of loan closing: December 4, 2007

Status as of February 28, 2010: Claim

Payments before first default reported: 2

Potential Loss to HUD: \$60,136

Summary:

We found a material underwriting deficiency relating to income, which resulted in excessive ratios.

Incorrect Calculation of Borrower Income Resulting in Excessive Ratios

Webster officials incorrectly calculated the borrower's monthly effective income. Webster officials calculated the borrower's monthly effective income as \$2,720 using a letter dated October 25, 2007 from the borrower's current employer that was faxed from an unknown source. The letter stated that the borrower received an internal transfer effective November 26, 2007. The letter also stated that the borrower will be paid a monthly salary of \$2,720 payable monthly in arrears. Based on this letter, the borrower had to work from November 26, 2007 through December 26, 2007 to receive this new salary in January 2008. Since this loan closed on December 4, 2007, Webster should have used the borrower's current salary. Webster's file contained copies of the borrower's pay stubs for two weeks and not the required 30 days and these pay stubs only showed that the borrower worked 20 hours per week. Specifically, the borrower's paystub dated October 19, 2007 related to the pay period from 10/06/2007 to 10/12/2007, showed the borrower's hourly rate as \$11.06 and showed 20.03 hours worked. The borrower's paystub dated October 26, 2007 related to the pay period from 10/13/2007 to 10/19/2007 showed the borrower's hourly rate as \$11.06 and showed 20 hours worked. Using the income documented by the borrower's pay stubs, we calculate the borrower's monthly effective income to be \$958.53 by multiplying the weekly rate by the number of hours worked (\$11.06 per hour x 20 hours per week x 52 weeks /12 months) instead of the \$2,720 used by the

Lender; accordingly, the income used by the Webster official is questionable. Using the income documented by the borrower's paystubs increases the borrower's front ratio (mortgage payment-to-income) from 30.16 to 85.64 percent and increases the back ratio (fixed payment-to-income) from 33.10 to 93.99 percent requiring compensating factors. The mortgage credit analysis worksheet documented compensating factors of manual approval; ratios are in line; and good reserves. Manual approval and ratios are in line are not acceptable compensating factors. Good reserves is an acceptable compensating factor if Webster officials had documented that the borrower has cash reserves equal to three months of principal, interest, taxes and insurance. The mortgage credit analysis worksheet shows principal, interest, taxes, and insurance as \$820, therefore, Webster should have documented borrower cash reserves totaling \$2,460. Copies of the borrower's bank statements showed a savings balance of \$5 and an ending checking balance of \$1,668. The beginning checking balance was \$25 and included a large deposit of \$1,632 that the borrower explained as an overage from his student grant; therefore, Webster officials did not document cash reserves as a significant compensating factor. Additionally, the file contained a verification of employment conducted on February 22, 2008 using the Work Number of the Employer, which showed that the borrower was hired 9/10/2007 and was inactive as of 1/7/2008. Also, Neighborhood Watch showed that the borrower defaulted after only making two payments.

HUD/FHA Requirements:

Chapter 2 of HUD Handbook 4155.1 REV-5 provides that the anticipated amount of income, and the likelihood of its continuance, must be established to determine a borrower's capacity to repay mortgage debt, and income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue.

Mortgagee Letter 2005-16 dated April 13, 2006 states that for manually underwritten mortgages, the qualifying ratios are raised to 31% and 43% and if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval.

Chapter 2-13 of HUD Handbook 4155.1, REV-5, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed HUD benchmark guidelines; however, underwriters must note in the "remarks" section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation. Chapter 2-13 G states that an acceptable compensating factor is that the borrower has substantial documented cash reserves (at least three months' worth of principal, interest, taxes, and insurance) after closing.

Loan number: 132-1827919

Mortgage amount: \$72,055

Section of Housing Act: 203 (b)

Loan purpose: Purchase

Date of loan closing: July 28, 2005

Status as of February 28, 2010: Claim

Payments before first default reported: 1

Loss to HUD: \$34,419

Summary:

We found material underwriting deficiencies relating to income.

Income Stability Not Established

Webster officials did not verify the borrower's employment for the most recent two-full years; therefore, income stability was not established. Review of the FHA case binder and Webster's file determined that the borrower worked for 5 months beginning on December 14, 2004 at his current employer, worked six months from January 1, 2004 to July 4, 2004 at a previous employer, but the borrower did not explain the five month gap between July 4, 2004 and December 14, 2004. Webster officials obtained a verification of employment dated 6/17/05 from the borrower's current employer and obtained W-2s for 2003 and 2004 from the borrower's previous employers; however, Webster officials did not obtain an explanation from the borrower for the five month gap in employment from July 4, 2004 to December 14, 2004. Therefore, Webster officials only documented an eleven month employment history rather than the required two-year period.

HUD/FHA Requirements:

Chapter 2-6 of HUD Handbook 4155.1 REV-5 states that the lender must verify the borrower's employment for the most recent two full years and the borrower must explain any gaps in employment spanning one month or more.

Incorrect Calculation of Borrower Income but Ratios Are Not Excessive

Webster officials improperly calculated the borrower's income because they did not document that overtime income used had been received for the past two years, or was likely to continue. Webster officials included \$96 in overtime payments in calculating the borrower's monthly effective income; however, the borrower only worked at his current employer for 7 months. Further, Webster officials did not justify or document the reasons for using this overtime income

for qualifying purposes. Since Webster officials did not verify that the borrower had received overtime for the past 2 years and did not justify or document the reasons for using the overtime income for qualifying purposes, the overtime income should not have been included in the calculation of the borrower income. Using the borrower's most recent paystub, we calculate the monthly effective income to be \$1,880 instead of the \$1,976 used by Webster officials. This increases both the mortgage payment to income ratio and the fixed payment to income ratio from 36.80 to 38.68 percent; however, these ratios are not excessive.

HUD/FHA Requirements:

Chapter 2-7 A of HUD Handbook 4155.1 REV-5, provides that overtime income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue; however, the overtime income must be averaged for the past 2 years, and the employment verification must not state that such income is unlikely to continue. In addition, periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes.

Loan number: 197-3647194

Mortgage amount: \$315,056

Section of Housing Act: 203 (b)

Loan purpose: Purchase

Date of loan closing: April 16, 2007

Status as of February 28, 2010: Claim

Payments before first default reported: 4

Loss to HUD: \$191,105

Summary:

We found material underwriting deficiencies relating to verification of proceeds from the sale of the borrower's prior residence and the borrower's investment.

**Inadequate Verification of Proceeds from Sale of Prior Residence
Borrower Investment in Property Not Verified**

Webster officials did not verify and document the cash sales proceeds from the sale of the borrower's prior residence; therefore, the borrower's cash investment in the property was not verified and documented. Review of the uniform residential loan application in Webster's file determined that the borrower was using proceeds from the sale of his home in Oregon to purchase this home located in California. Webster's file only contained two pages of the HUD-1 settlement statement from the sale of this home and not the fully executed HUD-1 settlement statement; therefore, Webster officials did not document the actual sale and the sufficiency of the net proceeds required for settlement. The HUD-1 settlement statement for this purchase listed an earnest money deposit of \$14,537.92; however, there was no documentation in the file to verify the source of funds or that the funds were received by either the closing agent or the seller. Without this documentation Webster officials did not verify and document the borrower's investment in the property.

HUD/FHA Requirements:

Chapter 2-10 of HUD Handbook 41551.1, REV-5 states that all funds for the borrower's investment in the property must be verified and documented. Chapter 2-10 E states that the net proceeds from an arms-length sale of a currently owned property may be used for the cash investment on a new house, but a fully executed HUD-1 Settlement Statement must be provided as satisfactory evidence of the cash sales proceeds accruing to the borrower, and the lender must document both the actual sale and the sufficiency of the net proceeds required for settlement.

Loan number: 461-4133646

Mortgage amount: \$123,068

Section of Housing Act: 203 (b)

Loan purpose: Purchase

Date of loan closing: May 31, 2007

Status as of February 28, 2010: Claim

Payments before first default reported: 2

Loss to HUD: \$61,257

Summary:

We found material underwriting deficiencies relating to gift funds and the borrower's investment.

Inadequate Verification of transfer of gift funds:
Borrower Investment Not Verified and Documented

Webster officials did not adequately verify the transfer of a \$3,750 gift; therefore, the borrower's investment in the property was not verified. The mortgage credit analysis worksheet showed that the borrower's statutory cash investment requirement was \$3,750 and Webster's file contained a gift letter dated May 22, 2007 from a public charity, for a \$3,750 gift to the borrower to assist with the home purchase. The gift letter stated that once the closing office has all of the signed and completed documents required by the Preferred Program,¹¹ the closing office will disburse the gift funds at the loan closing for the purchase of the home. The HUD-1 settlement statement shows that this loan closed on May 31, 2007 and lists gift funds of \$3,750; however, Webster's file did not contain any documentation to verify that these gift funds were provided to the closing agent. Without any documentation verifying that the closing agent received these funds, Webster officials did not verify and document the gift funds or the borrower's investment in the property.

HUD/FHA Requirements:

Chapter 2-10 of HUD Handbook 4155.1 REV-5 states that all funds for the borrower's investment in the property must be verified and documented and the lender must be able to determine that the gift funds ultimately were not provided from an unacceptable source and were indeed the donor's own funds. When the transfer occurs at closing, the lender remains responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source.

¹¹ The Non-profit provides down payment assistance through its products, Preferred Program and Hope Funds Program.

Loan number: 481-2619404

Mortgage amount: \$143,103

Section of Housing Act: 203 (b)

Loan purpose: Purchase

Date of loan closing: July 6, 2007

Status as of February 28, 2010: Claim

Payments before first default reported: 9

Loss to HUD: \$93,911

Summary:

We found material underwriting deficiencies relating to underreported liabilities, gift funds, and the borrower's investment.

Incorrectly Calculated Ratio Due to Underreported liabilities

Webster officials incorrectly calculated the borrower's back ratio because it underreported the borrower's liability for child support payments totaling \$500. The mortgage credit analysis worksheet listed the borrower's total monthly payments as \$30 and a back ratio of 39.99 percent. However, Webster's file contained an "Order of Divorce" and a "Property Settlement Agreement," which showed that the borrower had to pay \$500 in monthly child support beginning November 1, 2003. Webster officials did not include this in the borrower's back ratio because of an email from the borrower's former wife, which stated that the borrower does not pay \$500 a month in child support. Specifically, the email stated that the borrower does not pay \$500 per month in child support because subsequent to the divorce; the borrower and his ex-wife agreed that the borrower would help out with the child's daily needs without going through the court system. However, this email does not relieve the borrower of his legal and financial responsibilities for his minor child and without legal documents stating otherwise, the borrower is legally responsible for the child support. Therefore, Webster officials should have included the \$500 in child support debt in calculating the borrower's back ratio. Including the \$500 in monthly child support increases the back ratio from 39.99 to 58.17 percent requiring significant compensating factors to justify mortgage approval. The mortgage credit analysis worksheet listed the following as compensating factors: the borrower receives a substantial amount of commission income not used in qualifying; he is a limited user of credit, and he has been with his current employer for over three years. The borrower's credit report shows various credit accounts and does not support that the borrower is a limited user of credit. Regarding the borrower being with his current employer for over three years, job stability is a requirement of mortgage approval and not a compensating factor. The factor related to substantial amount of commission income not used in qualifying was supported by the borrower's pay stubs for five pay periods in 2007, which showed commission income earned through April 29, 2007 of

\$5,133. However, this compensating factor is not significant enough to justify mortgage approval with a back ratio of 58.17 percent after including the child support in the borrower's back ratio.

HUD/FHA Requirements:

Chapter 2-11 of HUD Handbook 4155.1, REV-5, states that the lender must include the monthly housing expenses and all additional recurring charges extending 10 months or more, including payments on installment accounts, child support, or separate maintenance payments in computing the debt-to-income ratios.

Mortgagee Letter 2005-16 dated April 13, 2006 states that for manually underwritten mortgages, the qualifying ratios are raised to 31% and 43% and if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval.

Chapter 2-13 of HUD Handbook 4155.1, REV-5, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed HUD benchmark guidelines; however, underwriters must note in the "remarks" section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation.

Inadequate Verification of transfer of gift funds
Borrower Investment in Property Not Verified

Webster officials did not adequately verify and document a \$3,360 gift; therefore, the borrower's investment in the property was not verified and documented. Webster's file contained a gift letter from the borrower's father for a \$3,360 gift to the borrower to be used for the home purchase; however; Webster's file did not contain a withdrawal document showing that the withdrawal was from the donor's account. Additionally, Webster's file contained an illegible copy of the borrower's deposit slip and did not contain the borrower's bank statement showing deposit of the gift funds. Without this documentation, Webster officials did not verify and document the gift funds or the borrower's investment in the property.

HUD/FHA Requirements:

Chapter 2-10 C of HUD Handbook 4155-1 REV-5 states that all funds for the borrower's investment in the property must be verified and documented and the lender must be able to determine that gift funds were not provided from an unacceptable source, were the donor's own funds, and the lender must obtain the withdrawal document showing that the withdrawal is from the donor's account, as well as the homebuyer's deposit slip and bank statement that shows the deposit.

Loan number: 562-2061518

Mortgage amount: \$153,265

Section of Housing Act: 203 (b)

Loan purpose: Cash-out Refinance

Date of loan closing: June 25, 2007

Status as of February 28, 2010: Claim

Payments before first default reported: 6

Loss to HUD: \$76,162

Summary:

We found a material underwriting deficiency relating to excessive ratios without adequate compensating factors.

Excessive Ratios without Documentation of Acceptable Compensating Factors to Justify Mortgage Approval

Webster officials approved the mortgage with a front ratio of 44.50 percent and a back ratio of 48.10 percent, which exceeded HUD's benchmarks (31 percent and 43 percent as set forth in Mortgagee letter 2005-16) without documenting acceptable compensating factors. The mortgage credit analysis worksheet showed 44.50 percent as the mortgage payment-to-income (front) and 48.10 percent as the fixed payment-to-income (back) ratios, and the underwriter listed the following compensating factors: 8 years on the job, had a good credit history until joining a credit counseling service then later occurred and he cancelled, good on mortgage-FHA. Regarding the compensating factor related to 8 years on the job, stability of income/employment is a requirement for mortgage approval and should not be used as a compensating factor to justify approving the mortgage with ratios above HUD's benchmarks. While good mortgage history is a valid compensating factor, the borrower's monthly payments increased from \$769.61 to \$968.74 and Webster's file did not contain a mortgage payoff statement, therefore we are unable to determine whether or not the borrower made the last mortgage payment due. Additionally, the factor regarding the borrower joining a credit consolidating company and subsequently cancelling is not an acceptable compensating factor, but is indicative of the borrower's previous credit problems. In fact, the HUD-1 settlement statement showed that the cash out refinance was used to pay off borrower credit debts totaling \$16,876. Therefore, the underwriter did not present and document compensating factors that were significant enough to justify mortgage approval for this loan in which the ratios exceeded HUD's benchmarks.

HUD/FHA Requirements:

Mortgagee Letter 2005-16 dated April 13, 2006 states that for manually underwritten mortgages, the qualifying ratios are raised to 31% and 43% and if either or both ratios are exceeded on a manually underwritten mortgage, the lender must describe the compensating factors used to justify mortgage approval.

Chapter 2-13 of HUD Handbook 4155.1, REV-5, provides that compensating factors may be used to justify approval of mortgage loans with ratios that exceed HUD benchmark guidelines; however, underwriters must note in the “remarks” section of the mortgage credit analysis worksheet any compensating factor used and provide supporting documentation.

Chapter 2-6 Stability of Income states that the lender must verify the borrower’s employment for the most recent two full years.

Chapter 1 of HUD Handbook 4155.1, REV-5, cautions that cash-out refinances for debt consolidation represent a considerable risk, especially if the borrower has not had an attendant increase in income, and such transactions must be carefully evaluated.

APPENDIX C

LENDER COMMENTS AND OIG's EVALUATION

Ref to OIG Evaluation

Lender Comments



Webster Bank, N.A.
145 Bank Street
Waterbury, CT 06702

WebsterOnline.com

August 4, 2010

VIA FEDERAL EXPRESS

Mr. Edgar Moore
Regional Inspector General for Audit
U.S. Department of Housing
and Urban Development
Office of the Inspector General
New York/New Jersey, 2AGA
26 Federal Plaza
Room 3430
New York, New York 10278-0068

**RE: Webster Bank, N.A.
HUD OIG Draft Memorandum Report**

Dear Mr. Moore:

Webster Bank, N.A. ("Webster" or "Bank") is in receipt of the revised Draft Memorandum Report ("Report"), dated July 22, 2010, from the U.S. Department of Housing and Urban Development's ("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 were endorsed for FHA insurance between November 1, 2007 and October 31, 2009, defaulted within the first 30 months, and have since gone into claim status.

The Report states that its objective was to determine whether the Bank 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 eight of the twenty loans contained underwriting deficiencies and, in each of these eight cases, the underwriters incorrectly certified that due diligence was used in underwriting the loans. Based on these assertions, the Report recommends that HUD: (1) in connection with the underwriting certifications, 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") and/or civil money penalties under HUD regulations; and (2) take appropriate administrative action with regard to the

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underwriting deficiencies. Webster strongly disagrees with the Report's findings and recommendations.

The OIG provided Webster with an opportunity to submit written comments for inclusion in the final report. This response summarizes Webster'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 lender 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. WEBSTER BANK, N.A.

Webster was founded in 1935 and has been approved to participate in the FHA program since November 14, 1935. Headquartered in Waterbury, Connecticut, Webster employs approximately 3,109 individuals throughout its offices and branch network. Webster operates one FHA-approved branch located in Cheshire, Connecticut. The Bank currently sells most FHA loans that it originates into the secondary market on a servicing-released basis, and its primary investors include Bank of America and Wells Fargo Home Mortgage. Webster's employees consistently produce high quality loans in compliance with HUD/FHA standards.

FHA lending constitutes approximately 20.89% (2007) and 7.11% (2010) of Webster's mortgage business. The Bank takes its responsibilities under the FHA program seriously because FHA lending represents the Bank's commitment to affordable lending in the communities we serve. We strive to comply with applicable rules and regulations and are committed to educating and training our employees on issues of FHA compliance. Since 1935 Webster has endeavored to help people achieve the dream of home ownership. Through dependable and professional service we have repeatedly demonstrated our commitment to borrowers and allegiance to the FHA Program.

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We also note that the review covered loans originated between July 28, 2005 and December 4, 2007. As you know, during and immediately following this period, the United States experienced a dramatic financial crisis that resulted in record-breaking unemployment, declining home values, loan default and foreclosure activity. Many of the borrowers in the cases at issue defaulted after making multiple mortgage payments. This payment activity suggests that these borrowers defaulted as a result of unforeseen economic or personal setbacks as a result of this crisis, rather than because of poor origination or underwriting decisions. In fact, loan servicing data for the loans reviewed demonstrates that at least eleven of these borrowers reported curtailment of income, illness or death, which often results in income loss, as the reason for the default.

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 Bank's internal or information systems controls or the results of previous audits, and did not communicate with Webster's management in advance of issuing the Report. Moreover, instead of reviewing a statistically random sample of loans originated by Webster 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 Bank provide information and loan files in the cases reviewed, which Webster would have promptly supplied, the OIG subpoenaed loan file documentation simultaneously from fifteen FHA-approved lenders, including Webster, in connection with the "Operation Watchdog" probe. While HUD and the OIG expressly stated that there was "no evidence of wrongdoing" on the part of Webster 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 Webster, 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 Bank 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. The Bank is one of several of the identified lenders whose reputations suffered as a result of the public announcement of the "probe." Webster has always been committed to complying with HUD requirements and originating quality FHA-

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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 concerns identified in the Report below.

II. RESPONSE TO RESULTS OF REVIEW

As previously noted, the Report alleges noncompliance with HUD requirements in eight loans and recommends action by HUD and the Departmental Enforcement Center regarding these assertions. Upon receipt of the draft Report, Webster performed its own stringent analysis of the loans subject to the OIG's review. Based on Webster's diligent examination, the Bank disagrees with a number of the assertions in the Report and takes strong exception to certain of the recommendations made in the Report, including the suggestion that the Department consider pursuing remedies under PFCRA and/or civil money penalties. 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 Bank intentionally disregard HUD guidelines or knowingly misrepresent information to the Department. We are of the opinion and believe the OIG will agree that this response and accompanying exhibits demonstrate Webster's 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.

A. WEBSTER COMPLIED WITH HUD's UNDERWRITING GUIDELINES

In the "Results of the Review" and Appendix B, the Report alleges that Webster did not underwrite eight of the twenty FHA loans reviewed in compliance with HUD requirements. Specifically, the Report asserts that these loans involved deficiencies in: (1) income verification; (2) assessment of borrower liabilities; (3) excessive qualifying ratios; (4) documenting the source of gift funds; and (5) documenting the source of funds to close. We address each of these individual allegations in turn below.

1. Income Verification

In two of the loans reviewed by the OIG, the Report contends that the Bank did not properly calculate the borrower's income and/or did not obtain adequate support for the borrower's employment. Webster respectfully disagrees with the allegations in the cited loans, and our individual responses to these cases are set forth below.

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a. ██████ – FHA Case No. 105-3302961

In the ██████ loan, the Report alleges that Webster should not have used the monthly effective income reflected on an October 25, 2007 letter from the borrower's employer to qualify the borrower for the loan. Specifically, the Report claims that because Ms. ██████ was to be paid \$2,720 in monthly income in arrears, the borrower did not receive this higher income until after the loan closed, which required the use of the borrower's current salary to calculate qualifying income. Accordingly, using the pay stubs contained in the loan file, the Report asserts that the Bank should have qualified the borrower with \$958.53 in monthly income, which would have increased the debt-to-income ratios to an unacceptable level.

Webster understands and appreciates that FHA guidelines generally require a lender to review a borrower's income, evaluate its likelihood of continuance, and use only those sources of income that can be verified in calculating the monthly income used to qualify a borrower. See HUD Handbook 4155.1 REV-5, ¶¶ 2-6, 2-7.¹ The Bank complied with these requirements in the ██████ loan. Notably, Webster obtained a copy of an internal transfer letter, which was signed by the employer's Human Resource Manager and acknowledged by the borrower, confirming the borrower's \$2,720 monthly salary as of November 26, 2007 (**Exhibit B-1**). The Bank also verbally verified the borrower's current employment and start date of September 11, 2007 (**Exhibit B-2**) and obtained the borrower's two most recent pay stubs (**Exhibit B-3**), which together covered the requisite 30-day period. While the borrower may have previously been paid by the employer on an hourly basis and worked part-time hours after completing her college education (**Exhibit B-4**), the letter from Bank of America confirms that the borrower was earning a \$2,720 monthly salary as of November 26, 2007 (**Exhibit B-1**), which was prior to the date of closing (**Exhibit B-5**). The letter also confirms the borrower's receipt of a promotion and notifies Ms. ██████ that her salary will be reviewed on an annual basis. As these documents clearly evidenced the borrower's current income and likelihood of continuance, the underwriter reasonably used a \$2,720 monthly salary to calculate the borrower's effective income on the Mortgage Credit Analysis Worksheet ("MCAW") (**Exhibit B-6**).

Nevertheless, the Report contends that Ms. ██████ would have needed to work from November 26, 2007 through December 26, 2007 to receive the new salary in January 2008, and since the loan closed on December 4, 2007, the borrower's hourly,

¹ 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.

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part-time income should have been used to qualify the borrower. Webster respectfully disagrees. We are not aware of, and the Report does not reference, any requirement in FHA guidelines requiring a lender to exclude a borrower's current income from its qualifying calculation because this income is paid in arrears and not received prior to closing. Rather, FHA guidelines require a lender to exclude income from its calculations only if the income cannot be verified, is not stable, or will not continue. Even projected income from a new job that will begin within 60 days of closing may be used to qualify a borrower for an FHA loan. See HUD Handbook 4155.1, REV-5, ¶ 2-7(R). These requirements, therefore, confirm that actual receipt of current, verified income is not necessary in order to include the income as part of the lender's qualifying calculation. In this case, because Webster obtained a copy of the letter from Bank of America, which verified the borrower's full-time employment with a monthly income of \$2,720 earned prior to closing, the Bank properly used this amount to qualify the borrower for FHA financing. Accordingly, we request the OIG to remove this allegation from the final report.

b. [REDACTED] – FHA Case No. 132-1827919

In the [REDACTED] loan, the Report asserts that Webster did not document a full two-year employment history for the borrower and improperly calculated the borrower's qualifying income with \$96 in monthly overtime. More specifically, the Report claims the Bank did not obtain an explanation from the borrower for a five-month gap in employment between his current and previous employers, which suggests income stability was not established. In addition, the Report alleges that Webster did not document that the borrower's overtime income had been received for the past two years or was likely to continue when the borrower had been employed at his current job for seven months. Without this documentation, the Report states that Webster should have used \$1,880 in monthly income to qualify the borrower, as opposed to total income, including overtime, of \$1,976.

With regard to income stability, Webster understands and appreciates that a lender must verify the borrower's employment for the most recent two full years. However, HUD guidelines expressly state that the Department does not impose a minimum length of time a borrower must have held a position of employment to be eligible for FHA financing. See HUD Handbook 4155.1 REV-5, ¶ 2-6. In this case, even with an alleged five-month gap in employment, Webster obtained documentation from the borrower to verify a total of 25 months of the borrower's past employment, including 2003 and 2004 W-2 statements (Exhibit C-1) and a Verification of Employment ("VOE") from the borrower's current employer, dated June 20, 2005 (Exhibit C-2). Moreover, although the borrower had not been employed at his current position for a full two-years prior to closing, the loan file documented that he had

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consistently been employed during the past two years and had been working for Porta-Fab Corporation for the past seven months. The VOE also identified the borrower as a member of the Carpenter's Union, which the underwriter understood to be a favorable indicator of the probability of the borrower's continued employment. Thus, based on the borrower's consistent employment as documented since 2003, the fact that he had been employed at his current job for seven months, and the likelihood of his continued employment as a union member, the underwriter reasonably determined that the borrower had demonstrated sufficient employment and income stability to warrant loan approval.

The Bank also properly calculated the borrower's income using overtime. The fact that the borrower had been working for the current employer for only seven months did not require the underwriter to exclude overtime income altogether, as suggested in the Report. FHA guidelines provide that, with respect to the inclusion of overtime in qualifying income, "[p]eriods of less than two years may be acceptable provided the underwriter adequately justifies and documents his or her reason for using the income for qualifying purposes." HUD Handbook 4155.1 REV-5, ¶ 2-7(A). Thus, the inclusion of overtime in the borrower's effective income was proper based on the FHA guidelines. In this case, the underwriter relied on the borrower's pay stubs and VOE to justify the Bank's calculation of the borrower's income, which indicated that the borrower had consistently earned overtime income since his current employment began (**Exhibits C-2 and C-3**). In fact, as of April 3, 2005, the borrower had earned a total of \$748.65 in overtime income, which increased to \$2,018.10 by July 9, 2005 (**Exhibit C-3**). Moreover, the VOE expressly stated that the borrower's overtime income was likely to continue (**Exhibit C-2**), and the underwriter documented the borrower's potential for increased earnings on the MCAW (**Exhibit C-4**). Because overtime was an integral component of the borrower's job, the inclusion of overtime in the borrower's qualifying monthly income was appropriate.

Yet, even if the Bank had excluded the \$96 in overtime from the borrower's qualifying monthly income, the Report acknowledges that the borrower still qualified for FHA financing. In this case, \$96 less in qualifying income would have resulted in 38.68% front-end and back-end qualifying ratios, which the Report expressly acknowledges "are not excessive." And, although the Bank was not required to document compensating factors in light of these ratios, the MCAW explicitly listed a number of reasons to justify approval of this loan, including a good rental history, a minimum increase in the borrower's housing obligation, no debts, and the borrower's ability to devote all income to his mortgage payment (**Exhibit C-4**). Webster, therefore, complied with HUD guidelines in documenting and analyzing the borrower's income in this loan and this allegation should be removed from the final report.

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2. Assessment of Liabilities

In one loan, [REDACTED] – FHA Case No. 481-2619404, the Report contends that the Bank did not properly assess the borrowers' liabilities, as the borrower was legally obligated to make child support payments of \$500; however, this liability was excluded from the calculation of the borrower's qualifying ratios. The Report asserts that including the child support debt would have increased the borrower's back-end ratio to 58%, which would have required significant compensating factors.

With regard to liabilities, Webster understands and appreciates that, in calculating a borrower's qualifying ratios, FHA-approved lenders must include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations extending ten months or more. See HUD Handbook 4155.1 REV-5, ¶ 2-11(A). It is the Bank's policy and practice to do so in each FHA-insured loan it originates. In the [REDACTED] case, although the borrower's divorce documentation indicated that he was obligated to pay \$500 per month in child support, the loan file also contained a letter from the borrower's ex-wife, in which she expressly stated that, per an agreement between the borrower and her, the borrower was not making the \$500 monthly payment, as they had made alternate financial arrangements (Exhibit D-1). Although the loan file referenced a \$500 obligation, the file clearly evidenced that the borrower was not making this payment and was not being held responsible for the payment by the intended recipient of the funds. Therefore, the underwriting reasonably excluded this \$500 payment from the borrower's liabilities on the MCAW (Exhibit D-2).

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Nevertheless, even if the underwriter had included the child support payment in the calculation of the borrower's ratios, the borrower would have qualified for FHA financing. As acknowledged in the Report, inclusion of this debt would have increased the back-end ratio and required significant compensating factors. Both the MCAW and the loan file in this case demonstrated several significant compensating factors that would have offset the higher-than-average back-end ratio. As acknowledged in the Report, the borrower received significant commission income that was not included in the qualifying income in this case (Exhibit D-3). The loan file documented \$4,026 in commission income in 2006 (Exhibit D-4), and \$5,132 in commission income for the first four months of 2007 (Exhibit D-3). This documentation reflected that the borrower earned a monthly average of \$572 in commission income in the sixteen months prior to closing ($\$9,158/16 = \572). Had the underwriter included this conservative estimate of \$572 in commission income in the qualifying ratios along with the \$500 child support obligation, the income would have offset the liability and the borrower's back-end ratio would have been 48.5%, which would have only slightly exceeded HUD's guidelines. Moreover, as the loan file clearly evidenced that the borrower was not paying the \$500

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child support obligation (Exhibit D-1), this fact would have also constituted a significant compensating factor that would have offset this higher ratio.

In addition to the documented commission income, the loan file referenced additional compensating factors in this case. The loan file documented that the borrower had accumulated over \$5,000 in his retirement account (Exhibit D-5), which evidenced his ability to save. HUD guidelines expressly state that a "demonstrated ability to accumulate savings" and cash reserves after closing compensate against higher-than-average ratios. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C), (G). Furthermore, contrary to the assertion in the Report, the loan file documented that the borrower was a limited user of credit. Though the borrower had some past financial issues, at the time of loan application, he had only two open credit cards with a combined balance of only \$100 (Exhibit D-6), and had only \$30 in recurring monthly payments (Exhibits D-2, D-6).² Finally, the borrower had good job stability, as he had been with the same employer for over three years (Exhibits D-3, D-4), and had the potential for increased earnings due to his position and ability to earn commission income (Exhibit D-3). See HUD Handbook 4155.1 REV-5, ¶ 2-13(I).

In summary, Webster maintains that, based on the loan file documentation, the underwriter made a reasonable decision to omit the \$500 child support payment, as the borrower and the recipient of the funds had made alternative payment arrangements. Moreover, the above discussion and attached documentation demonstrates that, even if the underwriter had included the \$500 in the qualifying ratios, the borrower would have qualified for the FHA-insured loan, as additional significant compensating factors would have offset the higher ratios. For these reasons, administrative action in this case is unwarranted and this allegation should be removed from the final report.

3. Qualifying Ratios

In one loan, ██████ – FHA Case No. 562-2061518, the Report alleges that the borrower's qualifying ratios of 44%/48% exceeded HUD's recommended debt-to-income ratios without documented, valid compensating factors in the "Remarks" section of the MCAW. The Bank respectfully disagrees with this assertion.

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

² Other debts were medical collection accounts which do not have to be paid off or used in the qualifying ratios. Borrower's letter of explanation was in the file. See HUD Handbook 4155.1 REV-5, ¶ 2-3.

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information based on experience in determining whether a potential borrower is creditworthy. An underwriter must carefully weigh all aspects of an individual's case 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. We note that the borrower's ratios in this case were 44%/48%, which exceeded HUD's benchmarks by only a few percentage points. 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. This discretion is particularly important when the same loans underwritten manually could be submitted through an automated underwriting system and approved with much higher qualifying ratios. 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. The standard for compliance with FHA requirements is not whether another underwriter or the OIG would have made a different underwriting determination. The standard is whether the Bank's underwriter made a reasonable underwriting decision in light of the facts in each case.

It is Webster'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 Report's allegation, the loan file in the [REDACTED] case documented significant compensating factors that justified approval of this borrower for FHA financing. Importantly, the underwriter noted on the MCAW that the borrower had an excellent payment history on his prior FHA-insured mortgage (**Exhibit E-1**). The credit report evidenced the borrower's thirty-three month history of timely mortgage payments on this loan (**Exhibit E-2**) and, contrary to the allegation in the Report, the file also contained a payoff statement evidencing that the borrower made the last payment on this loan (**Exhibit E-3**). HUD guidelines expressly state that a borrower's successful demonstration of his or her ability to make timely payments of pay housing expenses over a 12-24 month period compensates for higher-than-average ratios. HUD Handbook 4155.1 REV-5, ¶ 2-13(A). In addition, the borrower's housing

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payment minimally increased by approximately \$200 (**Exhibit E-1**). HUD guidelines expressly state that a minimal increase in housing expenses offsets higher ratios. *Id.* ¶ 2-13(F). Furthermore, although the borrower's mortgage payment increased, the borrower realized a total savings of approximately \$650 per month and a net increase in disposable income of \$450 per month as a result of his debt consolidation at closing (**Exhibit E-4**). The FHA-insured loan at issue created a net benefit to the borrower in reducing his monthly debt obligations, which also compensated against the higher ratios in this case. As indicated on the MCAW, the borrower had explored credit counseling, but determined that refinancing his loan was more beneficial to his overall credit standing (**Exhibit E-1**). The borrower intended to use credit counseling as a debt consolidation mechanism before understanding that it would negatively affect his credit and, contrary to the Report's allegation, did not suggest that the borrower had previous credit problems.

The loan file also documented that the borrower had accumulated over \$3,000 in his retirement account (**Exhibit E-5**), and was making discretionary contribution of \$191.67 per month into this account (**Exhibit E-6**). These documents evidence that the borrower had the ability to accumulate savings, which HUD guidelines expressly recognize as a compensating factor. See HUD Handbook 4155.1 REV-5, ¶ 2-13(C). The MCAW also demonstrated that the loan-to-value ratio in this instance was only 91.5% (**Exhibit E-1**), and the underwriter noted that the borrower had excellent job stability (**Exhibit E-1**), as the loan file evidenced that the borrower had been with the same employer for the past eight years (**Exhibit E-7**). While Webster appreciates that, as noted in the Report, HUD guidelines require job stability, lenders are required to document a borrower's employment for only two years prior to closing, and do not require that a borrower hold the same position for that two-year period. See HUD Handbook 4155.1 REV-5, ¶ 2-6. Based on these guidelines, an eight-year history with the same employer demonstrates job stability above and beyond what is required by the Department's guidelines, and does compensate for higher-than-average ratios.

The above discussion demonstrates that both the MCAW and the loan file documentation supported numerous significant compensating factors in the [REDACTED] loan – factors that HUD guidelines expressly state compensate against higher debt-to-income ratios. The underwriter reasonably determined that these valid compensating factors offset the higher ratios in this case and properly noted several of these factors in the Remarks section of the MCAW. We maintain that the Bank complied with HUD guidelines in this loan and, as a result, this allegation should be removed from the final report.

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4. Gift Fund Documentation

In five cases, the Report asserts that the loan files did not contain proper verification that gift funds had been provided by the borrowers to the closing agents. Four of the loans at issue involved funds from non-profit downpayment assistance organizations, and one loan involved gift funds provided by a relative. We address each of these cases in turn below.

a. Gifts from Downpayment Assistance Organizations

As you know, FHA guidelines require a lender to verify and document the transfer of gift funds used by a borrower. See HUD Handbook 4155.1 REV-5, ¶ 2-10(C). In four of the five cases referenced in this sub-finding, the borrowers obtained "gifts" in the form of downpayment assistance. While the Department no longer permits such assistance in FHA-insured loans, see P. Law 110-289, Section 2113, at the time the loans at issue were originated HUD permitted borrowers to obtain gift funds from non-profit entities providing downpayment assistance. Until 2004, Page 2-11 of HUD's Single Family Reference Guide ("Guide") expressly stated that, with respect to gifts provided by a nonprofit or municipality through a downpayment assistance program, "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." In each of the loans cited in the Report in which downpayment assistance was provided, the HUD-1 Settlement Statement ("HUD-1") documents the transfer of the funds, and the settlement agents certified to the accuracy of the information reflected on the HUD-1. It was not until HUD issued Mortgagee Letter 2004-28 that the Department's guidelines expressly required lenders to obtain and keep the documentation of the wire transfer in its mortgage loan application binder in connection with downpayment assistance gift transfers. After issuance of Mortgagee Letter 2004-28, it was Webster's policy and procedure to obtain evidence of the wire transfer of gift funds provided by downpayment assistance companies in all FHA-insured loans involving such assistance.

At the time the four loans at issue were originated, Webster understands and appreciates that it was required to obtain and retain evidence of the wire transfer of gift funds from the downpayment assistance provider in its loan file. In one of the cases cited, ██████████ – FHA Case No. 137-3707930, contrary to the Report's allegation, the loan file in fact contained evidence of the wire transfer of downpayment assistance funds. In the remaining three cases, in preparation of this response, the Bank contacted each settlement agent and obtained evidence that the funds identified on the HUD-1s were in fact transferred by the non-profit assistance provider to the agent at settlement. To document the borrowers' receipt of downpayment assistance in these four cases, we have attached: (1) the gift letter from the downpayment assistance organization; (2) the HUD-1 evidencing the gift funds; and (3) the wire transfer

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documentation confirming that the settlement agent received these funds at or before closing. This documentation is attached as follows:

<u>Borrower</u>	<u>FHA Case No.</u>	<u>Gift Letter</u>	<u>HUD-1</u>	<u>Wire Transfer Confirmation</u>
██████	105-3258296	F-1	F-2	F-3
██████	132-1827919	G-1	G-2 ³	G-3
██████	137-3707930	H-1	H-2	H-3
██████	461-4133646	I-1	I-2	I-3

Comment 7

Comment 8
Comment 7
Comment 9

The attached documentation demonstrates, in addition to the HUD-1 reference to the gift funds, that each of the four borrowers at issue in the Report in fact received the downpayment assistance gift from the nonprofit provider. While the wire transfer documentation was inadvertently omitted from the loan files in a few isolated cases, any oversight constituted, at worst, harmless error. The attached documents evidence that the borrowers in all four of the cited cases in fact received the downpayment assistance funds at the time of closing and qualified for FHA financing.

For these reasons, this allegation and any requests for administrative action in connection with these cases should be removed from the final report.

b. Gift Funds from Relatives

In one loan, ██████ – FHA Case No. 481-2619404, the Report alleges that the loan file did not document a \$3,360 gift the borrower received from his father, as the file did not contain documentation of the withdrawal of funds from the donor's account and the copy of the borrower's deposit slip was illegible.

Comment 10

³ Please note that, in this case, the borrowers did not need the full \$3,654.75 in downpayment assistance funds to close the loan. Therefore, the borrowers used only \$2,861.35 of the funds, as indicated on the HUD-1 (Exhibit G-2), and returned the remaining \$793.40 to the downpayment assistance organization.

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Comment 10

With regard to gift funds obtained from a relative, HUD guidelines require a lender to obtain: (1) a gift letter specifying, among other items, the dollar amount given, the donor's name, address, telephone number, and relationship to the borrower, and stating that no repayment is required; (2) a copy of the bank statement showing the withdrawal from the donor's personal account; and (3) evidence that funds have been deposited into a borrower's account before closing or a verification of receipt of the funds from the settlement agent. See HUD Handbook 4155.1, REV-5, ¶12-10(C); Mortgagee Letter 00-28. As stated in the Report, the borrower received a \$3,360 gift to cover the funds needed to close this loan from his father. To evidence the gift, Webster obtained a gift letter dated June 27, 2007 from the borrower's father in which he indicated his intent to provide a \$3,360 gift to the borrower (**Exhibit J-1**). Contrary to the Report's allegation, the loan file also contained a copy of the donor's account statement from Wachovia and a Wachovia withdrawal slip, both dated June 28, 2007, evidencing his withdrawal of \$3,360 (**Exhibit J-2**). The loan file also contained a copy of the deposit slip evidencing that the borrower deposited \$3,360 into his Bank of America checking account on June 28, 2007 (**Exhibit J-3**). Contrary to the Report's assertion, the deposit slip, while somewhat hard to read, is not illegible, and clearly documents the borrower's deposit of the gift funds into his Bank of America account (**Exhibit J-3**). Moreover, the loan file contained copies of the borrower's Bank of America account statements (**Exhibit J-4**), which evidenced that he had an account with this institution, and the checking account number on the bank statement matched the redacted account number on the deposit slip (**Exhibits J-3, J-4**). The attached documentation demonstrates that Webster properly evidenced the source of the borrower's gift funds in this case. Webster adhered to FHA requirements in documenting the gift funds in this loan and, as a result, this assertion should be removed from the final report.

5. Source of Funds to Close

Comment 11

Finally, in six cases, the Report asserts that the borrowers' source of funds to close the loans was not verified, as the loan files did not contain gift fund documentation or a fully executed HUD-1 evidencing the sale of a prior residence. We address each of these assertions below.

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a. Gift Fund Documentation

In five of the six cases cited in this sub-finding,⁴ rather than cite new allegations regarding the source of the borrowers funds to close, the Report merely repeats the assertions made in the section regarding gift fund documentation, and concludes that, without proper documentation of the transfer of gift funds, Webster did not verify the borrowers' investment in the property.

Webster strongly objects to the inclusion of these allegations in the final report. The assertions made in this section of the Report merely reiterate allegations already made in the Report's sub-finding regarding gift fund documentation. As you know, HUD guidelines at the time these loans were originated set forth the information the Department requires to document the source of funds used for the borrower's investment in the property in Section 2-10(C) of HUD Handbook 4155.1 REV-5. The Report cites the same section of the same provision in both its allegations regarding gift fund documentation and verification of the borrowers' investment in the properties at issue. These are not separate allegations, but merely a different way of stating the same alleged deficiency in each of these cases. Thus, this section of the Report is unnecessarily repetitive and needlessly inflammatory. It appears that inclusion of such repetitive and inflammatory claims in the final report serves only as an attempt to justify the "Operation Watchdog" probe.

Moreover, as demonstrated above, the Bank obtained the required documentation, either at the time of loan closing or in preparation of this response, to document the borrowers' investments in these properties through the use of gift funds from relatives or downpayment assistance organizations. Webster maintains that it conformed to HUD requirements regarding documenting the funds the borrowers used to cover their required investment in the properties and that each of these five borrowers qualified for the FHA-insured loan. For these reasons, these repetitive and unnecessary allegations are unwarranted and should be removed from the final report.

b. Sale of Prior Residence

In one additional loan, [REDACTED] - FHA Case No. 197-3647194, the Report asserts that the loan file did not document the source of the borrower's funds to close, as the funds were derived from the borrower's sale of a prior residence, but the loan file did not contain a fully executed HUD-1 regarding that sale.

Comment 12

⁴ These five cases are: (1) [REDACTED] - FHA Case No. 105-3258296; (2) [REDACTED] - FHA Case No. 132-1827919; (3) [REDACTED] - FHA Case No. 137-3707930; (4) [REDACTED] - FHA Case No. 461-4133646; and (5) [REDACTED] - FHA Case No. 481-2619404.

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Webster understands and appreciates that all funds for the borrower's investment in the property must be verified and documented. See HUD Handbook 4155.1 REV-5, ¶ 2-10. When a borrower's minimum investment will be derived from the sale of real property, FHA guidelines require lenders to obtain a fully executed HUD-1. Id. ¶ 2-10(E). In the [REDACTED] loan, both the initial and final loan applications indicated that the source of the borrower's downpayment would be the sale of his prior residence, [REDACTED] Tierra Drive, in [REDACTED], Oregon (**Exhibit K-1**). To document the source of this downpayment, Webster obtained a copy of the HUD-1 evidencing the borrower's sale of this property, from which he received \$30,730.20 in proceeds (**Exhibit K-2**). While the copy of the HUD-1 located in the Bank's loan file inadvertently omitted the signature page for this document, any oversight in this regard constituted, at worst, harmless error. As confirmed by the Title History Report for the [REDACTED] Tierra Drive property which evidences that the borrower in fact sold this property to the individual listed on the HUD-1 on March 30, 2007, the same date listed on the HUD-1, for the \$149,000 sales price reflected on the HUD-1 (**Exhibit K-3**).

Comment 12

Based on the borrower's proceeds from this sale, the borrower had more than sufficient funds to cover the \$14,537.92 needed to close this loan (**Exhibit K-4**). As evidenced by the attached receipts from the settlement agent, the borrower provided these funds in two installments: (1) an earnest money deposit of \$1,000 on March 28, 2007 (**Exhibit K-5**); and (2) a \$13,537.92 deposit with the settlement agent on April 13, 2007 (**Exhibit K-6**).⁵ The above discussion and attached documentation demonstrates that the borrower in fact sold his prior residence and used proceeds from that sale to cover the downpayment in this case. For these reasons, administrative action in connection with this case would be unwarranted. We therefore request that this loan be removed from the final report.

Comment 13

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

1. Webster Exercised Due Diligence in Underwriting the Loans at Issue

In addition to the underwriting deficiencies discussed above, the Report asserts that, in the eight loans at issue, the underwriter's certification on page 3 of the Addendum to the Uniform Residential Loan Application ("URLA"), Form HUD-92900-A

⁵ We note that, as the borrower provided all funds prior to closing, the settlement agent listed the \$14,527.92 in total funds as an Earnest Money Deposit ("EMD") on the HUD-1 (**Exhibit K-4**). The EMD in this case, however, was the \$1,000 provided on March 28, 2007 (**Exhibit K-5**). As this amount was less than two percent of the sales price, the Bank was not required to document the source of these funds. See HUD Handbook 4155.1 REV-5, ¶ 2-10(A).

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("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 eight 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 civil money penalties and/or remedies under the PFCRA for the inaccurate certifications in these cases.

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

Additionally, the Report does not allege, and there is no evidence to suggest, that Webster or its employees intended to circumvent HUD underwriting guidelines in these cases. Rather, the certifications in these eight 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 Webster 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, Webster maintains that the borrowers in the

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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, Webster believes that the final report should omit recommendations of administrative action in connection with many of 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 Webster'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, 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.

Comment 13

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 and/or civil money penalties 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 eight cases. As discussed at length earlier in this response, Webster disagrees that the Report's assertions warrant administrative action, civil money penalties, or PFCRA remedies. HUD may also disagree with the Report's assertions and decide not to pursue PFCRA or civil money 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

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that HUD pursue PFCRA remedies with the suggestion that the loans identified involve misrepresentations will have a material, adverse effect on the Bank's business.

If the OIG's goal is to present the reader with a full and accurate disclosure of this review and its implications to the Bank, 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 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 Bank's investors, customers, and the public.

Comment 13

III. CONCLUSION

Webster takes the matters raised in the draft Report seriously. Because FHA lending comprises a significant portion of Webster's overall business operations, the Bank is committed to educating and training its employees on issues regarding FHA compliance and to assuring their adherence to HUD's rules and regulations. As discussed above, Webster's review of the loan files at issue indicated that the Report's findings are, for the most part, at variance with the facts, do not constitute violations of HUD/FHA requirements on the part of Webster, or do not affect the underlying loans' insurability. The Bank 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 Webster has demonstrated its compliance with HUD requirements.

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Finally, Webster 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. Webster values its relationship with the Department and did not, in any manner, seek to misrepresent any information to HUD. The various remedies available to HUD, short of the severe sanctions under PFCRA, are commensurate to resolve any deficiency identified in the Report. We are of the opinion and believe the OIG will agree, that this response and accompanying exhibits demonstrate that including these recommendations in the Report is unnecessary, inappropriate, and may further damage Webster's reputation. Webster is committed to the dream of home ownership and the FHA Program is instrumental in our endeavor to assist people in achieving that dream. 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.

Thank you for your kind consideration.

Sincerely,


Nitin J. Mhatre 8/4/2010
Executive Vice President, Consumer Finance Division

Attachments

cc: Phillip L. Schulman, Esq., K&L Gates LLP
Jennifer L. Harris, Esq. Webster Bank, N.A.

OIG's Evaluation of Lender Comments

- Comment 1** Webster officials question the methodology used to select the 20 loan files reviewed. However, we want to point out that the loan sample was not intended to be statistical or random. The sample was the result of targeted analysis to specifically identify loans that had gone into claim status. Further, the review does not project results to Webster's universe of FHA loans, and the conclusions only relate to the now six FHA loans identified as having material underwriting deficiencies.
- Comment 2** Webster officials have taken issue with the press release announcing OIG's Operation Watchdog initiative, however, the January 12, 2010 HUD press release does not make any accusations or presumptions of fraud. The goal of the initiative was to determine why there was such a high rate of defaults and claims with the 15 lenders and whether there may have been wrongdoing involved. The detection and investigation of fraud is the responsibility of the Office of Inspector General in each of its audits and reviews. As such, the reviews are proactive in trying to identify systemic problems that HUD needs to address.
- Comment 3** We agree that projected income can be used to qualify if a borrower is about to start a new job, however, Chapter 2-7 R of HUD Handbook 4155.1 REV-5 provides that a guaranteed, non-revocable contract for employment is needed for qualifying purposes. In this case, the internal transfer letter did not indicate that it was a guaranteed, non-revocable contract; therefore, the income should not have been used for qualifying purposes. Accordingly, since there was no guaranteed, non-revocable contract and the borrower defaulted on this loan after making only two payments, OIG will not remove this case from the report.
- Comment 4** Without a written explanation for the five month gap in the borrower's employment, Webster officials did not establish income stability for the borrower. While HUD allows overtime income received for periods of less than two years to be used to qualify (See Chapter 2-6 of HUD Handbook 4155.1 REV-5), we do not believe that overtime income received for seven months is sufficient for qualifying purposes. Additionally, the borrower defaulted after only making one payment; therefore, this case will remain in the report.
- Comment 5** Webster officials contend that the underwriter reasonably excluded a \$500 child support payment from the borrower's liabilities, however, it is not reasonable to exclude court ordered child support as indicated in legal documents because of an email from the borrower's former wife. Additionally, we do not believe that significant compensating factors were presented to justify mortgage approval; therefore, this case will remain in the report.
- Comment 6** Webster officials state that although the borrower's ratios exceeded HUD's thresholds by a few percentage points the compensating factors presented justify approving this loan. However, the factors of job stability, an excellent credit

history, making the last payment on a previous mortgage and incurring a minimal increase in the refinanced mortgage payment are not significant compensating factors for this case. FHA cautions that cash-out refinances for debt consolidation represent a considerable risk, especially if the borrower has not had a corresponding increase in earned income. While the borrower did realize a monthly savings of \$650 through debt consolidation, the borrower's refinanced mortgage payment increased \$200 per month and the monthly income increased minimally (\$35 a month). However, given the minimal increase in earned income, the borrower's history of an inability to save, as evidenced by accumulating only \$54 per month (\$649/12) in retirement savings, and incurrence of large amounts of debt, approval of the loan represents a significant risk, especially since the ratios, even after debt consolidation, exceeded HUD's guidelines. Consequently, the loan should not have been approved with these insignificant compensating factors. Furthermore, since the borrower defaulted on this loan after making only six payments and filed for chapter 7 bankruptcy, this case will remain in the report.

- Comment 7** For FHA numbers 105-3258296 and 137-3707930, Webster officials provided the wire transfers showing that the gift funds were received by the closing agent; therefore, the material deficiencies and both loans have been removed from the report.
- Comment 8** For FHA number 132-1827919, Webster officials provided the wire transfer showing that the \$3,654.75 was received by the closing agent; therefore, the material deficiency related to the gift has been removed.
- Comment 9** For FHA Loan 461-4133646, Webster officials provided a fax from the nonprofit to the closing agent stating that the gift funds were wired; however, there is no documentation from the closing agent confirming that the closing agent received the gift funds; therefore, this case will remain in the report.
- Comment 10** For FHA Loan 481-2619404, Webster officials provided a deposit search inquiry and an account detail inquiry for the donor's account, as well as a copy of the donor's withdrawal document; but none of these documents showed a beginning or ending balance for the donor's account. Without evidence of the donor's beginning or ending balances, there is no documentation showing that the funds were the donor's, and that the funds did not come from an unacceptable source.
- Comment 11** At the cornerstone of FHA is the 3 percent minimum required cash investment to be made by borrowers. While FHA allows the entire 3 percent investment to come from gift funds, it is imperative that the lender document that the gift funds were actually received, were from an acceptable source, and the borrower's investment in the property is verified and documented (see Chapters 1-7 and 2-10 of HUD Handbook 4155.1 REV-5)

Webster officials state that rather than cite new allegations regarding the borrower's source of funds to close, the report merely repeats the assertion made

regarding gift funds. However, the report states that the borrowers' investment in the property was not verified or documented. The loan files indicated that the gift funds would be provided as part of the borrower's investment in the property. Nevertheless, if the gift funds were not adequately verified, then Webster officials did not verify the gift or the borrower's investment in the property. Thus, this is not a repeat allegation, nor is it inflammatory to report that this is a dual violation of HUD/FHA regulations.

Comment 12 For FHA Loan 197-3647194, Webster officials stated that the HUD-1 signature page was inadvertently omitted for the sale of the borrower's prior residence; however, Webster officials still did not provide the signature page for the HUD-1 in its response. Although Webster officials provided copies of receipts from the title company for a \$1,000 initial deposit dated 3/28/2007 and a \$13,537.92 deposit for funds for closing dated 4/13/2007; the HUD-1 settlement statement shows that the earnest money deposit was \$14,537.92. In addition, since Chapter 2-10 E of HUD Handbook 4155.1 REV-5 specifically requires a fully executed HUD-1; without the signed HUD-1, we still question the proceeds from the sale of the prior residence.

Comment 13 Webster officials believe that the recommendations for remedies under Program Fraud Civil Remedies Act, Civil Money Penalties, and/or administrative action are not appropriate and should be removed from the report. However, we did not change the recommendations because violations of FHA rules are subject to civil and administrative action. Nevertheless, the report does recommend that HUD make determinations of the legal sufficiency of the deficiencies cited and pursue remedies under the Program Fraud Civil Remedies Act, Civil Money Penalties, and/or administrative actions, if necessary.