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Audit Report Number 2005-LA-1011

TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing Commissioner, H

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: KB Home Mortgage Company Did Not Follow HUD Requirements When Originating Insured Loans

HIGHLIGHTS

What We Audited and Why

We audited KB Home Mortgage Company (KB) insured loan originations in the Phoenix, Arizona, metropolitan area because the KB default and claim rate under the Department of Housing and Urban Development's (HUD) Phoenix office jurisdiction was almost triple the average for that office. Our primary audit objective was to determine whether KB originated HUD-insured loans in accordance with prudent lending practices and HUD requirements.

What We Found

KB did not originate the 19 loans in our sample in compliance with HUD requirements or prudent lending practices. All 19 loans involved origination deficiencies that should have precluded their approval. The deficiencies included false employment data, overstated income, understated liabilities, unacceptable credit histories, improper treatment of downpayment gifts and/or interest rate buydowns resulting in overinsured mortgages, inaccurate or excessive qualifying ratios without compensating factors, and borrower overcharges for unsupported or unallowable fees. We attribute the problems to inadequate internal controls over

the loan origination process and, according to former KB underwriting staff, KB's emphasis on production over prudent lending practices. As a result, KB placed HUD's single family insurance fund at risk for 19 unacceptable loans with original mortgages totaling \$2,509,576, and borrowers were overcharged \$9,400. HUD remains at risk and/or has incurred losses totaling \$1,218,681 related to 15 of the 19 loans.

What We Recommend

We recommend that HUD take appropriate administrative action against KB under Mortgagee Review Board and/or other authority. At a minimum, this should include seeking appropriate monetary sanctions for 15 of the loans totaling \$1,218,681 and requiring KB to reimburse the borrowers or HUD for \$9,400 in unearned, unallowable, or excessive fees.

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

Auditee's Response

We provided KB with the discussion draft report on July 15, 2005, and held an exit conference with KB on July 25, 2005. KB provided preliminary summary comments pertaining to the discussion draft on July 29, 2005. These summary comments, and the information exchanged during the exit conference, were incorporated where appropriate in the final draft report delivered to KB on August 2, 2005. KB's formal written response to the final draft report was received on August 17, 2005. KB disagreed with most of the report.

The complete text of KB's formal response, along with our evaluation of that response, can be found in appendix B of this report. We have also expanded and updated the body of the report, as well as some of the case summaries, to address KB's preliminary and formal responses.

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BACKGROUND AND OBJECTIVES

The National Housing Act, as amended, established the Federal Housing Administration, an organizational unit within the U.S. Department of Housing and Urban Development (HUD). The Federal Housing Administration provides approved mortgage lenders with insurance against losses on mortgage loans to qualifying homebuyers. The mortgage insurance program is authorized under Title II, section 203(b), of the National Housing Act, and is governed by regulations in 24 *Code of Federal Regulations*, Part 203. Most loans are insured under HUD's Direct Endorsement Program¹, which authorizes lenders to underwrite and close loans without prior HUD review or approval.

KB Home Mortgage Company (KB) is a wholly owned subsidiary of the builder/developer KB Home. KB originates Federal Housing Administration, Department of Veterans Affairs, and conventional loans primarily for customers purchasing newly constructed homes from its parent company. Until recently, KB operated 11 branch offices in nine states. KB has a corporate office located at 10990 Wilshire Boulevard, Los Angeles, California, and Regional Operations Centers (for processing and underwriting) in Las Vegas, Nevada, and San Antonio, Texas. KB has been a HUD-approved lender since April 15, 1965, with approved branch office operations in Arizona since 1993, and is authorized to originate loans under HUD's Direct Endorsement Program. At the July 25, 2005 exit conference KB officials advised us of a pending sale of all KB assets and the transfer of all KB Home loan origination business to Countrywide Financial Corporation.

Our primary audit objective was to determine whether KB originated HUD-insured loans in accordance with prudent lending practices and HUD requirements.

¹ 24 CFR 203.5

RESULTS OF AUDIT

Finding 1: KB Did Not Originate Loans in Compliance with HUD Requirements and Prudent Lending Practices

KB did not originate the 19 loans in our sample in compliance with HUD requirements or prudent lending practices. All 19 loans involved origination deficiencies that subjected HUD to unacceptable insurance risk totaling \$2,509,576. HUD has incurred losses or remains at risk for losses on 15 of the loans totaling \$1,218,681. The improper loan originations also resulted in inappropriate charges to borrowers on all 19 loans totaling \$9,400. We attribute the problems to an inadequate internal control environment and, according to former KB underwriting staff, KB's emphasis on production over prudent lending practices.

HUD Requirements

Regulations at 24 *Code of Federal Regulations*, Section 202.5(j)(4) require HUD-approved lenders, officers, directors, and employees to conform with generally accepted prudent and responsible lending practices. Section 202.5(h) provides that lenders shall implement written quality control plans that assure compliance with HUD regulations and other issuances regarding loan origination. The specific requirements for HUD-insured loan originations are principally described in HUD Handbooks 4000.2, 4000.4 and 4155.1, the HUD Homeownership Center Reference Guide, and various Mortgagee Letters.

KB Did Not Have Adequate Control Over Loan Originations

KB deviated from HUD requirements and prudent lending practices in originating all 19 loans in our sample. Although KB provided us with current and predecessor quality control plans that meet HUD requirements, the controls intended in the plans were not applied or implemented in the origination of these loans. Rather, in originating these 19 loans, KB apparently acceded to the interests of the parent builder/seller (KB Home) or their own bottom line. KB Home is in the business of building and selling homes, and the sales cannot be consummated unless its prospective buyers are approved for home mortgage loans. Similarly, KB does not earn origination or other fees on loans that are not approved, and KB Home is the source of virtually all KB loans. Three former KB underwriters told us that if the builder wanted a loan approved, it would be approved.

In our opinion, KB unduly emphasized approval of these loans over quality control and prudent lending practices to meet its corporate production objectives. KB procedures inhibited proper underwriting of all 19 loans in our sample, and in four cases (023-1063809, 023-1107968, 023-1135453, and 023-1357024), KB or KB Home employees may have been aware of or involved in the falsification of employment documentation.

KB Procedures Precluded Proper Underwriting

KB's procedures precluded proper underwriting of all 19 loans we reviewed. Three former underwriters claimed KB policy discouraged the disapproval of any loans and that underwriters were instructed to "condition" rather than disapprove loans. If the underwriters suggested that loans be denied, they would be referred to a KB supervisor who would normally approve them. When loans were conditionally approved, both the conditional and final underwriter approvals were based on incomplete borrower qualification documentation. These underwriter assertions are supported by documentary evidence in KB and HUD case files for all 19 loans.

The underwriter conditionally approved all 19 loans we reviewed, with provisions that additional documentation be obtained and/or conditions be met. Conditions imposed by the underwriter were detailed on internal KB condition sheets. In two cases (023-1013299 and 023-1104448), the conditional approvals were based on qualification packages that only included the preliminary loan applications and credit reports. For the other 17 cases, the underwriter said some additional qualification documentation would have been reviewed at the time of conditional approvals, but the qualification packages were not complete for any of these loans, as evidenced by the condition sheets.

In addition, for all 19 cases, loan processors and loan counselors (not the underwriter) signed off on the condition sheets, indicating the underwriter conditions were satisfied. Although KB claims loan processors and loan counselors did not receive traditional loan commissions, both job classifications did receive case specific "incentive payments" based on their individual overall retention or capture rates.² These incentive payments constitute improper commission payments under the spirit and intent of the Mortgage Approval Handbook³, which prohibits commissioned employees from performing any underwriting activities.

² Percentage of loan applications approved.

³ HUD Handbook 4060.1 REV-1, paragraph 2-17.

When loan processing was complete, the underwriter was only provided with the Mortgage Credit Analysis Worksheets (form HUD-92900-PUR) and Direct Endorsement Approvals (form HUD-92900-A) for signature. The underwriter was not provided with the complete borrower qualification package or the condition sheet for any of the loans to verify that the underwriting conditions had been satisfied. Therefore, in all 19 cases, KB procedures resulted in the underwriter falsely certifying to having personally reviewed all documents associated with the credit application.

In one of our sample cases (023-1063809), the form HUD-92900-A certification was signed by a KB underwriter other than the one who underwrote the loan, and was signed before it was completely filled out. Another underwriter, who was still employed by KB during our audit, admitted to signing six other underwriter certifications for loans⁴ she did not underwrite. She said she had been requested to sign the false underwriter certifications by her KB supervisor.

Inappropriate KB origination procedures and emphasis on production over prudent lending practices precluded proper underwriting of all 19 loans we reviewed. Prudent impartial origination, underwriting, and internal control procedures should have identified or prevented most of the problems we found including (among others) false employment data, overstated income, understated liabilities, negative credit histories, improper treatment of downpayment gifts or interest buydowns resulting in overinsured mortgages, inaccurate or excessive qualifying ratios without compensating factors, and borrower overcharges for unsupported or unallowable fees. None of the 19 loans in our sample should have been approved by KB for HUD insurance.

False Employment Data (4 of 19 Cases)

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 5-3, classifies the misrepresentation of the borrower's financial capacity by the lender as the highest level of deficiency. HUD Handbook 4000.2, REV-2, paragraph 1-21, requires lenders to immediately report the detection of any violations of law or regulation, false statements, or program abuses to HUD.

We determined that 4 of 19 cases in our sample contained false employment documents. The false documentation included pay stubs, Internal Revenue Service W-2 forms, and verifications of employment. We confirmed the false employment data by interviewing the borrowers and/or the employers and through wage reports from the state of Arizona Department of Economic Security.

In one case (023-1063809), the loan file contained a false telephone verification of employment. The document indicated the loan processor contacted the

⁴ Six loans not included in our sample.

employer by phone on March 22, 2002, and verified that the coborrower was an active employee as of that date. However, the employer told us that the coborrower separated from the company on March 8, 2002. Therefore, at the time of KB's telephone verification, the loan processor should have been told the coborrower's employment was terminated. However, the telephone verification form incorrectly stated that the coborrower was still continuously employed as of March 22, 2002.

In the second case (023-1357024), false employment documents found in the loan file included a pay stub, a W-2 form, and a verification of employment. HUD Handbook 4000.2, REV-2, paragraph 3-6, prohibits the handling of verification forms by loan applicants and real estate agents. Nonetheless, KB did not question the authenticity of these documents although they were faxed from the real estate agent, whom we later found to be the primary borrower's mother. When we showed these documents to the employer, he stated that although the borrower was employed at the business, the employer did not issue the pay stub and W-2 form in the loan file. The employer explained that both the borrower and the realtor were also his relatives. Therefore, when the borrower hand carried the blank verification form to him, the employer signed it blank because he assumed the borrower would fill in the correct wage information. The employer stated he later became aware of the false verification of employment during a KB reverification process and immediately reported it to KB personnel. However, KB failed to report the detection of this violation to HUD as required.

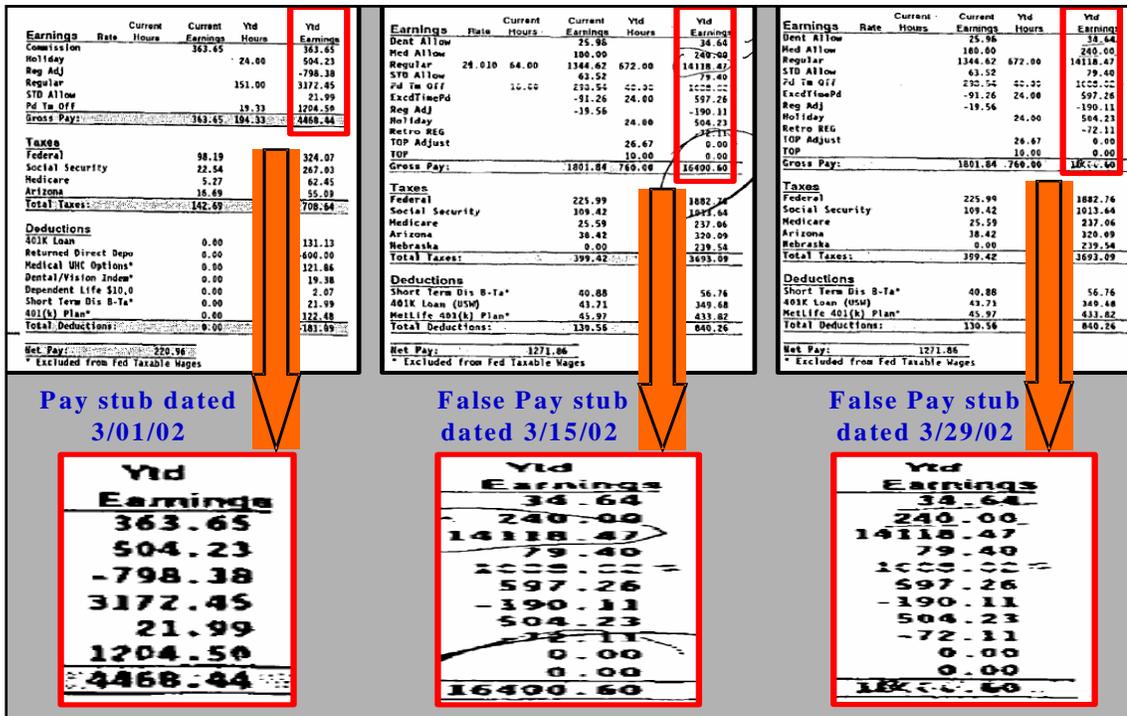
The third case (023-1107968), includes another false telephone employment verification form. The telephone verification indicated that Air One Transport reported the borrower to be currently employed as of March 28, 2002, and explained a discrepancy in the name of the business (Air One Transport versus Express Parcel Services). We interviewed representatives of both Air One Transport and Express Parcel Services and determined that the borrower was not employed by Air One Transport on March 28, 2002, that the business name explanation was untrue, and that the person reportedly contacted by the KB processor to verify the borrower's stated employment with Express Parcel Services did not work for that firm. In this case and two other cases (023-0876050 and 023-110448), KB also did not obtain sufficient documentation, as required by HUD Handbook 4155.1, REV-4, paragraph 3-1E, to support borrower or coborrower income. For one borrower, concurrent/part-time income was not verified, and for the other two, pay stubs were not obtained covering 30 days of current employment.

In the fourth false employment case (023-1135453), the loan file contained two false pay stubs, a false W-2 form, and a false online verification of employment. The borrower told us her last date of employment was January 24, 2002, and her

final pay stub was dated March 1, 2002. The borrower stated she expressed her concern to the loan counselor that she might not be able to afford the mortgage because she was laid off. However, the loan counselor reassured her that she would still qualify based on the income documentation she had previously provided. When we showed the income documents to the borrower, she confirmed the two pay stubs, dated March 15 and 29, 2002, and one of the two W-2 forms in the loan file were never issued to her and that she never submitted these items to KB. These pay stubs, showing the same amounts for the year-to-date earnings and deductions, together with an unexplained switch from commissioned to salaried earnings, were clear indications that these documents were fabricated. In addition, the online verification KB ostensibly obtained on March 12, 2002,⁵ indicated the borrower was an active employee as of April 23, 2002.⁶ The discrepancy between the online verification date and employment status date suggested the verification was altered. Finally, wage reports from the Department of Economic Security, and our reverification with the same online employment verification service, confirmed the two pay stubs, W-2 form, and original online verification of employment were all false documents.

Figure 1: False Employment Example, Case 023-1135453

The pay stub, dated March 1, 2002, is the only authentic document submitted by the borrower. The second and third pay stubs show an unrealistic increase in earnings and depict a salaried rather than commissioned employee. The second and third pay stubs are virtually identical, although the third should have shown increased year-to-date earnings.



⁵ Form shows Internet web address and online access date as March 12, 2002.

⁶ The "active as of" date is later than the date the online verification was supposedly obtained.

Overstated Income (14 of 19 Cases)

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-7, states for most cases, borrower income will be limited to salaries and wages. However, several other types of income may be treated as effective income. To include other types of income as effective income, the lender must obtain additional documentation to support its determination that these other sources of income can be expected to continue for the first three years of the mortgage loan. For example, for overtime/bonus income or part-time income to be included as effective income, an earnings trend needs to be established. To do so, the lender must document the income for the past two years and determine the income can reasonably be expected to continue.

KB overstated the borrower income for 14 of the 19 cases. While the false employment data contributed to the overstated income in four of the cases already discussed, most of the 14 cases contained overstated income because KB inappropriately included overtime/bonus income, part-time income, child support, or a combination thereof in its calculation. In seven of the cases, KB included overtime/bonus or part-time income in the calculations without verifying such income for the previous two years and/or justifying the likelihood of continuance.

Understated Liabilities (4 of 19 Cases)

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-11, requires lenders to consider all recurring obligations, contingent liabilities, and projected obligations that meet HUD's specific guidelines when evaluating a loan application. In computing debt-to-income ratios, the lender must include all borrower liabilities extending 10 months or more. Debts lasting less than 10 months must be counted if the amount of the debt affects the borrower's ability to pay immediately after loan closing.

KB did not consider all outstanding liabilities when approving 4 of the 19 loans we reviewed. KB failed to include education loans, revolving credit accounts, and credit cards. For example, in case 023-1043232, the borrower's recurring liabilities of \$711 were understated by \$194 because KB failed to include an open credit card account, and in case 023-1135453, the borrower's recurring liabilities of \$519 were understated by \$697 because KB failed to include three education loans and two credit cards.

Unacceptable Credit Histories (15 of 19 Cases)

HUD Handbook 4155.1, REV-4, paragraph 2-3, says the most useful guide in determining the attitude toward credit obligations is past credit performance. The handbook requires lenders to provide strong offsetting factors to approve loans in which the credit histories reflect continuous slow payments, judgments, and delinquent accounts, despite adequate income to support the obligations. Accordingly, sufficiency of income is not considered a valid compensating factor for a negative credit history.

In 15 of 19 cases, the borrower credit histories demonstrated significant disregard toward credit obligations. Credit reports for these borrowers included adverse information such as bankruptcy, poor credit ratings, and numerous charge-off or collection accounts. In most instances, KB obtained “explanation letters” from the borrowers but did not provide offsetting or compensating factors.

Overinsured Mortgages and Improper Treatment of Downpayment Gifts or Buydowns (9 of 19 Cases)

We determined that 9 of the 19 cases involved overinsured mortgage loans. In eight of the cases, the overinsured mortgages resulted (in part) from improper treatment of downpayment “gift” funds that were derived from the borrowers but routed through the seller (KB Home) and nonprofit gift providers. In these cases, the sources of the gifts were actually the borrowers, who were required to agree to increased sales prices to accommodate the gifts. Sales prices were increased by the amount of the gifts plus the nonprofit agency administrative fees.

HUD Handbook 4155.1, REV-4, paragraph 2-10, states that no repayment of a gift may be expected or implied. Since the gifts were funded via increased sales prices, the borrowers were repaying the gifts over the life of the loans. Therefore, they were not eligible gifts, and the loans were overinsured by the amount of the gifts plus the administrative fees.

Furthermore, although HUD does not approve or disapprove individual nonprofit agency downpayment gift programs, Mortgagee Letter 96-18 clarifies HUD’s position as to the unacceptability of programs involving *quid pro quo* arrangements. Unacceptable arrangements are described as those whereby the assistance is only available if the buyer obtains financing with a particular lender or buys a particular builder’s property. KB Home’s requirement that the buyer

execute an amendment/addendum increasing the price of an existing sales contract, to accommodate the nonprofit gift, clearly constitutes an inappropriate quid pro quo arrangement.

In three of the nine cases, the sales prices were also increased to accommodate interest rate buydowns. In these cases, the mortgage was also overinsured because the borrowers financed the interest rate buydowns through increased sales prices.

Figure 2: Sales Price Increase, Case 023-1211310

The sales price was increased \$1,341 for the gift (\$841) plus the nonprofit administrative fee (\$500).

Table 1: Price Change Summary

PRICE	CHANGE	NEW PRICE
\$ 150,990.	\$ 1,341	\$ 152,331
\$ -0-	\$ 0-	\$ 2
\$ 5,918	\$ -	\$ 5,918
\$ 4,951	\$ -	\$ 4,951
\$ 10,500.7	\$ -	\$ 10,500.7
\$,	\$,	\$,

Table 2: Addendum Price Change Table

DESCRIPTION	PRICE	CHANGE	NEW PRICE
BASE PRICE	\$ 150,990.	\$ 1,341	\$ 152,331
LOT PREMIUM	\$ -0-	\$ 0-	\$ 2
TOTAL OPTIONS	\$ 5,918	\$ -	\$ 5,918
TOTAL FLOORING	\$ 4,951	\$ -	\$ 4,951
Incentive	\$ 10,500.7	\$ -	\$ 10,500.7

TERMS, CONDITIONS AND/OR EXPLANATION OF CHANGE: Buyer is requesting participation in the Homegrant Program. Buyer agrees the Base Price is now \$152,331 and the Seller Contribution will not exceed \$1,341. Seller's contribution is subject to Management acceptance and financing of terms. Buyer can utilize contribution towards their downpayment and closing costs. Buyer agrees the administrative costs associated with the program will be identified within the closing statement provided to Buyer prior to closing.

TERMS, CONDITIONS AND/OR EXPLANATION OF CHANGE: Buyer is requesting participation in the Homegrant Program. Buyer agrees the Base Price is now \$152,331 and the Seller Contribution will not exceed \$1,341. Seller's contribution is subject to Management acceptance and financing of terms. Buyer can utilize contribution towards their downpayment and closing costs. Buyer agrees the administrative costs associated with the program will be identified within the closing statement provided to Buyer prior to closing.

Inaccurate/Excessive Qualifying Ratios without Compensating Factors (15 of 19 Cases)

HUD Handbook 4155.1, REV-4, paragraphs 2-12 and 2-13, specified that the ratio of mortgage payment to effective income (front ratio) generally may not exceed 29 percent, and the ratio of total fixed payments to effective income (back ratio) may not exceed 41 percent, unless significant compensating factors are

presented. The handbook allows greater latitude in considering compensating factors for the front ratio than the back ratio.

In 10 of the 19 cases in our sample, the borrower(s)' debt-to-income ratios calculated by KB exceeded the handbook guidelines, yet KB approved the loans and submitted them for insurance endorsement without presenting compensating factors. For 5 of the 10 cases, compensating factors were added to the Mortgage Credit Analysis Worksheets in the KB loan files before the files were provided for our review. These (potential) compensating factors were not included on the Mortgage Credit Analysis Worksheets in the HUD case binders, so they do not appear to have been considered in approving the loans.

Moreover, after adjusting for overstated income and understated liabilities as discussed above, borrower debt-to-income ratios exceeded HUD guidelines for 15 of the 19 loans in our sample. Compensating factors were not presented by KB for any of the 15 loans at the time they were approved. The following table depicts these excessive qualifying ratios.

Figure 3: Qualifying Ratios

HUD Case No.		KB Calculated		OIG Calculated	
		Mortgage Payment-to-Income Ratio	Total Fixed Payment-to-Income Ratio	Mortgage Payment-to-Income Ratio	Total Fixed Payment-to-Income Ratio
HUD Requirement		29.00%	41.00%	29.00%	41.00%
1	023-0876050	35.19	41.62	39.36	46.55
2	023-1013299	31.86	45.97	36.19	52.22
3	023-1043232	25.99	46.56	35.77	71.89
4	023-1052683	34.99	49.46	38.99	55.12
5	023-1063809	27.43	38.49	40.81	57.27
6	023-1104448	34.75	44.92	61.48	79.46
7	023-1107968	23.15	47.53	23.95	49.18
8	023-1113441	24.70	32.33	32.75	49.45
9	023-1135453	20.63	30.17	28.89	60.19
10	023-1145205	30.29	45.00	30.29	44.70
11	023-1185414	31.45	44.47	31.45	44.47
12	023-1211310	34.72	45.99	40.12	53.15
13	023-1234810	39.30	40.38	39.30	40.38
14	023-1254460	29.87	29.87	53.30	76.06
15	023-1357024	24.60	40.94	47.27	79.14
Cases With Excessive Individual Ratios		8	9	13	14
Cases With Excessive Front or Back Ratios		10		15	

Unsupported or Unallowable Fees (19 of 19 Cases)

HUD Handbook 4000.2, REV-2, provides guidance as to what customary and reasonable closing costs and fees can be collected by the lender from the borrower. Chapter 2-15 of the HUD Homeownership Center Reference Guide provides a more detailed description of closing costs and fees. Whenever “actual costs” are permitted, it is expected that they will not exceed reasonable and customary costs for the area.

An unallowable fee is one that has been identified by the local HUD office as not being a necessary/normal part of the loan origination process. An unearned fee is a closing cost for which there is no actual service or thing of value attached to it. An excessive fee is a closing cost charged to the borrower beyond the amount allowed by HUD.

On all 19 of the loans in our sample, we determined that KB failed to ensure that the borrower was not charged excessive, unallowable, or unearned fees. The improper fees were not accompanied by supporting documentation or justification for any of the 19 loans. As a result, KB allowed a total of \$9,400 in excessive, unallowable, or unearned fees (ranging from \$240 to \$1,757 per case) to be charged to the borrowers. The following schedule illustrates the improper charges for each loan:

Figure 4: Unallowable/Unearned/ Excessive Fees

	023-0687906	023-0876050	023-1013299	023-1028162	023-1043232	023-1052683	023-1063809	023-1104448	023-1107968	023-1113441	023-1135453	023-1145205	023-1185414	023-1186721	023-1211310	023-1234810	023-1254460	023-1322842	023-1357024	Totals
Unallowable/unearned fees																				
Premium	\$20	\$21	\$25	\$14	\$20	\$21	\$24	\$38	\$17	\$20		\$39	\$20	\$20	\$21	\$42	\$18	\$18	\$19	\$416
Association					53		20			24						24	24			145
Additional escrow fee																50				50
Additional check fee											20									20
Courtesy signing (signing)	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50	900
Working capital		56	60		74		60	84		96	60	44	56		113	63	75	56	96	993
Payoff fee		60			30				20			10		30						150
Bond loan fee			100				50					50	50						50	300
Statement/transfer fee		75	75		75		75	75		75		25	75		75	75		75	75	850
Check processing								20												20
Bond escrow fee									50											50
contract/transaction	250	250	250	250	250	250	250	250	250	250	250	250	250	250	250	250	250	250	250	4,000
Discount point (unearned)														1,506						1,506
Total unallowable/unearned fees charged per loan	\$ 320	\$ 512	\$ 560	\$ 314	\$ 552	\$ 321	\$ 529	\$ 517	\$ 387	\$ 515	\$ 380	\$ 468	\$ 1,757	\$ 350	\$ 583	\$ 504	\$ 343	\$ 249	\$ 240	\$ 9,400

Although 17 of the 19 loans included a \$250 charge to the borrower for a contract or transaction coordination fee paid to HomeSafe, Inc., in one case (023-1185414), KB has already reimbursed the borrower for the unearned/unallowable HomeSafe fee in response to a post-endorsement review by the Santa Ana Homeownership Center Quality Assurance Division.

Prohibited Involvement by Interested Third Party (19 of 19 Cases)

HUD Handbook 4000.2, REV-2, paragraph 3-6, and HUD Handbook 4155.1, REV-4, CHG-1, paragraph 3-1, prohibit the handling of verification items by an interested third party. Documents relating to income/employment verification and verification of deposit must not pass through the hands of the applicant or an interested third party. Also, HUD Handbook 4060.1, REV-1, paragraph 2-17, prohibits commissioned employees from performing any underwriting activities.

KB allowed KB Home (builder/seller) sales representatives to collect pay stubs, W-2 forms, and bank statements from the borrowers. Loan processors and loan counselors, who were paid incentives based on their retention or capture rates, also certified to underwriter conditions in all 19 cases, as evidenced by the internal KB condition sheets. As discussed earlier, KB procedures effectively transferred the ultimate underwriting eligibility determinations from the underwriters to commissioned loan processors and loan counselors. In one case (023-1135453), the loan counselor knew of and may have created false employment documentation.

Inappropriate Use of Buydown Rate (5 of 19 Cases)

HUD Handbook 4155.1, REV-4, paragraph 2-14, provides underwriting requirements that must be met in order for a HUD loan to qualify at the buydown rate. A buydown not meeting all the handbook criteria may only be considered as a compensating factor. In addition, the lender must establish that the eventual increase in mortgage payments will not adversely affect the borrower and chance of default.

For 5 of the 19 loans, KB qualified the borrowers using the buydown rate but failed to show that the scheduled mortgage payment increase would not adversely affect the borrowers or the chance of default. On all five loans, one or both (front/back) qualifying ratios exceeded the HUD maximums.

Debt Paid by Interested Third-Party (4 of 19 Cases)

According to Mortgagee Letter 2002-02, it is not acceptable underwriting to use debt-to-income qualifying ratios which are reduced through payments made by property sellers or nonprofit agencies. HUD deems such payment of consumer debt by third parties to be an inducement to purchase, which should result in a dollar-for-dollar reduction in the sales price.

On 4 of the 19 loans, KB allowed third parties to pay off the borrowers' consumer debts. For all four loans, the borrowers provided little or no money at closing. The source(s) of funds to close the loans were primarily nonprofit gifts, secondary financing loans, and seller loan proceeds. Since the consumer debts were all paid at closing, it is clear that they were paid using either the seller's funds or the nonprofit gift/loan funds.

Downpayment Unverified or Provided by Interested Third-Party (4 of 19 Cases)

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-10, requires the lender to verify all funds for the borrower's investment in the property. The funds may come from the borrowers' savings or checking account, but if there is a large increase in an account, the lender must obtain an explanation and evidence of the source of funds. Interested third parties are not allowed to provide funds toward the borrower's minimum required investment.

For 4 of the 19 sample loans, the downpayment was unverified or was provided by an interested third party. In three of the cases, KB failed to obtain an explanation and evidence for the source of funds, although large and unusual deposits are shown on the bank statements. In one of the cases, the borrower told us he borrowed funds from the real estate agent because he did not have sufficient funds to close.

Recommendations

We recommend that HUD's Assistant Secretary for Housing-Federal Housing Commissioner

- 1A. Initiate settlement negotiations with KB, requesting reimbursement and/or indemnification for HUD's actual and potential losses on 15 of the 19 loans, detailed in appendix A, totaling \$1,218,681.⁷
- 1B. Require KB to reimburse the borrowers or HUD \$9,400 for unearned and unallowable fees.

⁷ Since overinsured case number 023-1052683 is still active, indemnification should include requiring KB to pay the servicing lender \$20,346 toward any arrearages and to principal.

SCOPE AND METHODOLOGY

KB was selected for review due to high default and claim rates, both nationally and under the Phoenix, Arizona, HUD field office jurisdiction. At the time of the selection, KB had the highest default and claim rate nationally of the largest 28 lenders (253 percent of average). It also had the highest default and claim comparison ratio (282 percent) of the 22 largest lenders originating loans under the Phoenix office jurisdiction.

Using HUD's Neighborhood Watch early warning system, we made a nonrepresentative selection of 19 loans from a listing of 129 early default⁸ loans originated under the Tempe, Arizona, branch office identification number. Loans originated under the KB Phoenix branch office identification number were not selected, because that branch had recently been reviewed by HUD's Quality Assurance Division. However, KB performed all loan processing and underwriting for all Arizona loans from its Las Vegas, Nevada, Regional Operations Center, so the branch office identification numbers associated with any Arizona loans are immaterial.

To accomplish our objective, we

- ❑ Reviewed relevant HUD rules, regulations, and guidance.
- ❑ Reviewed KB and HUD case files for the 19 sample loans and First American Title escrow files for 18 of the sample loans.⁹
- ❑ Obtained Arizona Department of Economic Security wage reports on the borrowers for all 19 loans.
- ❑ Interviewed 10 borrowers.
- ❑ Interviewed 33 current and former employers.
- ❑ Obtained six employment verifications from an online verification service.
- ❑ Interviewed the former KB employee who underwrote all 19 of the loans and interviewed three other former KB underwriters.¹⁰

We relied upon computer-processed data contained in HUD's Neighborhood Watch system and Single Family Data Warehouse system. The reliability of data in the Single Family Data Warehouse system has been assessed by an independent contractor and the HUD Office of Inspector General (OIG) and has been found to be adequate. The assessment included relevant general and application controls. Since the data in the Neighborhood Watch system are derived

⁸ Loans that went into default within three years of closing.

⁹ First American Title could not locate its escrow file for one of the loans.

¹⁰ KB would not allow us to interview any current employees without a manager present.

from the Single Family Data Warehouse system, the data in both systems were considered sufficiently reliable to be used in meeting our objectives. During the audit, we did not note any discrepancies between information in the 19 loan files and the data in these two automated HUD systems.

All of the loans included in our sample were Arizona early default loans closed in 2002, so the problems identified in these loans should not necessarily be construed as extending to KB's more recent or national production. However, since some issues identified during this loan origination audit do have possible systemic implications, we plan to conduct a followup review and provide updated conclusions in a later report. It should be noted that as of April 30, 2005, KB's national and Phoenix office default and claim comparison ratios had improved to 146 percent and 164 percent respectively. While these ratios are still high, they represent significant improvements.

The audit fieldwork was performed between December 15, 2004, and April 20, 2005. The audit was conducted in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Policies, procedures, and controls that management has in place to reasonably ensure that the loan origination process complies with HUD's requirements and prudent lending practices.

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

Significant Weaknesses

Based on our review, we believe the following issue is a significant weakness:

- KB did not have adequate internal controls to reasonably ensure that loan originations complied with HUD requirements and prudent lending practices (see finding).

FOLLOWUP ON PRIOR AUDITS

This audit was coordinated with a concurrent HUD-OIG audit of KB late endorsements. The results of the late endorsement audit are included in Audit Report Number 2005-LA-1007. These two concurrent audits were the first HUD-OIG audits of KB.

We obtained and reviewed three independent auditors' reports on KB that encompassed four fiscal years ending November 30, 2000, 2001, 2002, and 2003. None of these reports contained any findings.

From July 2002 through June 2004, HUD's Quality Assurance Division performed multiple reviews of KB branches in California, Texas, Nevada, Arizona, and Florida. On June 16, 2005, KB signed a \$3.2 million settlement agreement with HUD relating to one of these reviews conducted in May of 2004. The settlement was to resolve HUD's January 26, 2005, notice of violation to KB for loan origination improprieties involving 373 (primarily Texas) loan originations.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible <u>1/</u>	Unsupported <u>2/</u>	Funds to be put to better use <u>3/</u>
1A (tabulation below)	\$145,625	\$291,974	\$781,082
1B (tabulation page 14)	\$9,400		

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 polices or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when an eligibility determination cannot be made at the time of the audit. A legal opinion or administrative determination may be needed on these costs.

3/ Funds to be put to better use are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

HUD case no.	Mortgage amount	Claim amount	Additional expenses	Recovered amount (resale)	Net loss (ineligible)	Claim paid not yet resold (unsupported)	Indemnification amount (funds put to better use)
023-0687906	\$ 117,394.00	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 117,394.00
023-0876050	Claim	129,671.47	10,799.07	128,000.00	12,470.54	-	-
023-1013299	Claim	148,774.43	10,946.24	141,000.00	18,720.67	-	-
023-1028162	92,689.00	-	-	-	-	-	92,689.00
023-1043232	Claim	118,838.09	5,828.67	95,555.00	29,111.76	-	-
023-1052683	147,520.00	-	8,834.16	-	-	-	156,354.16
023-1063809	Claim	147,194.74	19,396.61	147,700.00	18,891.35	-	-
023-1104448	121,570.00	-	750.00	-	-	-	122,320.00
023-1113441	137,564.00	-	-	-	-	-	137,564.00
023-1145205	Claim	148,315.33	14,478.91	141,332.00	21,462.24	-	-
023-1186721	Claim	136,705.62	9,440.74	114,000.00	32,146.36	-	-
023-1211310	Claim	154,378.09	1,969.46	-	-	156,347.55	-
023-1254460	Claim	135,626.91	-	-	-	135,626.91	-
023-1322842	150,128.00	-	4,633.00	-	-	-	154,761.00
023-1357024	Claim	140,727.91	15,093.98	143,000.00	12,821.89	-	-
Totals	\$ 766,865.00	\$1,260,232.59	\$ 102,170.84	\$ 910,587.00	\$ 145,624.81	\$ 291,974.46	\$ 781,082.16
Recommendation 1A sanction total					\$1,218,681.43		

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments


August 17, 2005
<u>VIA FEDERAL EXPRESS</u>
Ms. Joan S. Hobbs Regional Inspector General for Audit U.S. Department of Housing and Urban Development Office of the Inspector General Region IX, 9DGA 611 West 6th Street Suite 1160 Los Angeles, CA 90017-3101
RE: KB Home Mortgage Company HUD OIG Draft Audit Report
Dear Ms. Hobbs:
KB Home Mortgage Company ("KBHMC" or "Company") is in receipt of the Draft Audit Report ("Report"), dated August XX, 2005, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of the Inspector General ("OIG"). The Report is based on a review of the Company's former Tempe, Arizona branch office conducted between December 15, 2004 and April 20, 2005, and covers loans originated by that branch in 2002.
The Report states that its primary objective was to determine whether KBHMC originated HUD-insured loans in accordance with prudent lending practices and HUD requirements. The Report contains one finding, alleging underwriting deficiencies in 19 Federal Housing Administration ("FHA") insured mortgage loans. Based on this finding, the Report recommends that HUD: (1) initiate settlement negotiations with KBHMC, requesting reimbursement and/or indemnification for HUD's actual and potential losses on 15 of the 19 loans; and (2) require the Company to reimburse the borrowers or HUD for unearned and/or unallowable fees.
The OIG provided the Company with an opportunity to submit written comments for inclusion in the final report. This response summarizes KBHMC's history and operations, including the extensive improvements KBHMC has implemented since the loans in question were originated, and addresses the individual findings in the Report.
<small>KB HOME MORTGAGE COMPANY 10990 WILSHIRE BLVD, 9TH FLOOR LOS ANGELES, CA 90024 DC 737808 v1 0307048.0100</small>

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We appreciate this opportunity to comment on the OIG's findings and recommendations.

I. INTRODUCTION

Before KBHMC responds to each of the individual findings in the Report, we believe that it is necessary in this case to address the tenor of the Report, with which the Company takes strong exception. The Report is written in a manner that gives the reader the impression that the Company engages in a pattern and practice of disregarding HUD requirements. Nothing could be further from the truth. As discussed throughout this response:

- **The Report's findings are based on a review of only 19 FHA-insured loans, which represent less than one half of one percent of the FHA loans originated by KBHMC during the relevant period.**
- **All 19 of these loans were underwritten by a single underwriter.**
- **KBHMC terminated this rogue underwriter for poor performance in December of 2002, nearly two years before the OIG initiated its audit.**
- **From this adversely selected sample, the Report concludes that KBHMC had a company-wide practice of disregarding FHA requirements and ignores that inconsistencies were limited to one office, one errant underwriter and one small group of loans.**
- **The sample of loans reviewed, however, is too small to make any generalizations about KBHMC's policies and practices.**
- **In fact, the Report relies on two disgruntled former employees as the sole basis for the assertions that KBHMC emphasized production over loan quality and conditioned, but did not reject, loans from the parent company. However, both underwriters routinely rejected loans during the relevant audit period, as evidenced by declined loan files subsequently provided to the OIG as well as a signed statement provided by the Company's Assistant Vice President of Underwriting.**
- **Contrary to these unverified assertions, KBHMC's policies and practices complied with HUD requirements.**

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- **Furthermore, KBHMC disagrees with many of the Report's specific allegations, which largely involve subjective underwriting decisions. Many of the Report's allegations are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability.**
- **Moreover, years before this audit was initiated, KBHMC implemented numerous reforms, including tightened underwriting guidelines, enhanced quality control and focused staff training, to ensure that the types of deficiencies identified in the Report did not recur. As a result, the Company's default/claim rate has improved dramatically.**

Contrary to the extensive and often repetitive allegations in the Report, the above summary points make clear that any noted deficiencies were isolated exceptions to KBHMC's policies and procedures. Importantly, the OIG's review focused on a mere 19 loans originated in a former branch in 2002. These 19 loans represent less than one half of one percent of the FHA-insured loans originated by KBHMC during 2002. By the OIG's own admission, these 19 loans constituted an adverse sample. While the Report may identify deficiencies in a handful of loans, it does not necessarily follow that these issues were present on a Company-wide basis. Nevertheless, the Report uses findings from a minute adverse sampling of 19 loans to draw conclusions regarding the Company's overall policies and procedures.

To further underscore the limited nature of this review, it should be noted that one individual underwrote all 19 of the loans at issue in the Report. The alleged deficiencies identified in the Report were not the result of four or five underwriters, or even a pair of underwriters. Rather, the Report's findings are based on the performance of a single errant underwriter who acted contrary to both KBHMC policy and FHA requirements. This underwriter, in fact, was terminated by KBHMC two years before the OIG undertook their review of the Company. What troubles us is that the OIG was aware of these circumstances and chose to bury the information in the Scope and Methodology section at the end of the Report. By doing so, the findings are distorted; in order to put them in the proper context, the reader should be informed up front that all of the deficiencies are attributed to a single former employee who was dismissed by KBHMC for poor performance.

We appreciate that the Scope and Methodology section of the Report finally acknowledges that "[a]ll of the loans included in the review sample were Arizona loans closed in 2002, so the problems identified in these loans should not necessarily be construed as extending to KB's more recent or national production." Notwithstanding

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that comment, the substantive sections of the Report ignore that any inconsistencies were limited to one office, one underwriter, and one small group of loans, as well as the Company's responsible behavior in this instance, and instead extrapolate the findings to the entire Company. Moreover, for the most part, the Report's findings focus on subjective underwriting analysis. As discussed below, KBHMC disagrees with many of the allegations regarding the underwriting in the 19 cases at issue.

We also note that several of the findings and statements included in the Report are based on the OIG's interviews of the underwriter responsible for approving all 19 loans in question and an additional underwriter whom the Company recently terminated for cause. Based on these interviews, the OIG drew conclusions about the Company's policies, determined that the underwriters' statements reflected the overall policies and procedures of the Company, and relied on these statements to support several allegations suggesting that the Company had a breakdown in procedural controls. KBHMC takes strong exception to such audit techniques. Audits should not draw conclusions about a company's policies and procedures solely from statements made by former, disgruntled employees. Such a practice risks drawing the wrong conclusions, as was done in this case. Moreover, we object to a footnote in the Report indicating that KBHMC would not permit the OIG to interview any current employees without a manager present, suggesting somehow that this limitation was improper. Contrary to this implication, it is common practice for corporate entities to require that managers be present during interviews of their employees by governmental agencies. In fact, were the OIG's or the Department's employees subject to interviews, these agencies would also require that supervisors be present during questioning. KBHMC's actions suggest no impropriety. Accordingly, this footnote should be removed from the Report.

In summary, the results of the OIG's audit indicate that a rogue employee terminated two years prior to the review violated both KBHMC's policies and FHA requirements. Rather than focus on the fact that the findings involve isolated instances of non-compliance by this individual, the Report generalizes its findings and fails to consider fully the substantial changes that have occurred at the Company, including the enhancements to its underwriting and Quality Control/compliance procedures and its improved default/claim rates. The Report attempts to justify an eighteen-week review by putting a handful of loans in the worst possible light and extending findings involving the subjective underwriting decisions made by one individual to the Company's entire operations. We note that the allegations in the Report are merely findings and recommendations by the OIG, and do not constitute determinations or a final action by the Department. KBHMC is confident that, when the Department reviews the Report and this response, it will recognize that KBHMC has demonstrated a commitment to

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FHA compliance and, to the extent that deficiencies existed, they were limited to the actions of a single underwriter.

A. KB HOME MORTGAGE COMPANY

At the time of the OIG's review, KBHMC was a wholly-owned subsidiary of KB Home, one of the nation's largest homebuilders and a publicly held Delaware corporation. KBHMC operated through its home office in Los Angeles, California and eleven additional registered branch offices, and employed over 500 individuals. The Company has been an approved Federal Housing Administration ("FHA") lender for nearly 40 years and received Direct Endorsement ("DE") authority when the DE program was initiated almost 20 years ago. KBHMC, which has been originating about 8,000 to 10,000 FHA loans per year, is also an approved lender for Fannie Mae, Freddie Mac, Ginnie Mae, and the Veterans Administration. The Company's primary investors included Washington Mutual, CitiMortgage, Countrywide Home Loans, Inc., and Chase Manhattan Mortgage Corporation.

On June 20, 2005, the Company announced that it had entered into an agreement with Countrywide Home Loans under which Countrywide will purchase substantially all of KBHMC's assets. Shortly, the Company will close its doors and cease to exist as a mortgage banking entity. Since this announcement, the Company has focused on winding down its operations. To that end, KBHMC has released employees and is in the process of transferring files to Countrywide and consolidating our permanent storage. These efforts have hampered our ability to locate files and prepare a response to the Report.

KBHMC is a sizeable lender committed to achieving the goals of the FHA program, while placing a premium on FHA compliance. KBHMC would never knowingly violate FHA guidelines or endanger the reputation of the Company or its employees. KBHMC takes its Quality Control functions seriously and is dedicated to customer service. Over the past few years, the Company underwent substantial changes in senior management, which included the hiring of a new General Counsel and Chief Compliance Officer with several years of management experience, who is dedicated to full compliance with FHA requirements, as well as improving training opportunities and underwriting quality.

B. THE FORMER TEMPE, ARIZONA BRANCH OFFICE

The OIG's review focused on loans originated from the Company's Tempe, Arizona office in 2002. Two years prior to the OIG's review, the Company's Quality Control and compliance efforts uncovered issues regarding the origination of loans at

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that location. Based on its findings, the Company made a business decision to close its Tempe office. Thus, on December 30, 2002, the Company shut down operations in Tempe and terminated its FHA approval. While the Report suggests otherwise, KBHMC's actions in connection with the Tempe office evidence KBHMC's commitment to monitor its locations, identify problems, and resolve them in a manner that protects its investors and the FHA Insurance Fund.

Comment 5

Furthermore, as indicated above, several of the findings are based on the OIG's interviews of two former underwriters, including the underwriter who underwrote all 19 of the cited loans. The Company independently identified deficiencies in the underwriting performance of both individuals and terminated their employment. The underwriter responsible for the 19 loans at issue, [REDACTED] was terminated for poor performance on December 9, 2002. The additional underwriter referenced in the Report, [REDACTED], was terminated for poor performance in April of 2005. Furthermore, the Department agreed with KBHMC's determination regarding these individuals' underwriting skills, and placed both underwriters on the Limited Denial of Participation ("LDP") List. [REDACTED] was included on the LDP List from May 28, 2003 to February 27, 2004 (Exhibit A-1), and [REDACTED] is currently on the LDP list (Exhibit A-2). While not acknowledged in the Report, KBHMC identified deficiencies in these individuals' performance and terminated their employment with the Company. We trust that the Department will take these actions into consideration when reviewing the findings in this case.

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Finally, we note that the Department has reviewed loans originated by the Company's Arizona offices in at least two other instances and has satisfied itself that KBHMC resolved any outstanding issues at that location. We hope that, after the Department's review of this response, it will again determine that any deficiencies in the loans cited occurred as a result of two former underwriters acting against Company policy and procedures and that KBHMC has adequately addressed any remaining concerns regarding that location.

C. BUSINESS CHANGES

In addition to the actions discussed above, and since the loans at issue were originated, KBHMC made a number of changes to its Underwriting and Quality Control Departments in an effort to improve underwriting performance and enhance its Quality Control and compliance functions. KBHMC's considerable efforts resulted in strengthened underwriting and compliance programs and also caused the Company to identify many of the issues cited in the Report and take steps internally prior to the OIG's review to remedy any issues. In fact, the Report points out that, since its audit, the Company's national and Phoenix office default/claim ratios have decreased and

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represent significant improvements. We believe it is important to summarize these improvements below.

1. Underwriting Improvements

Improving the Company's underwriting standards, and thereby the quality and performance of its loans, has been the driving force behind the managerial and procedural changes KBHMC has made in the past few years. To that end, in 2002, the Company terminated poorly performing underwriters and hired a Chief Credit Officer ("CCO") to address the Company's high percentage of poor underwriting ratings and high default/claim rates. During his tenure, the CCO significantly tightened the Company's procedures. The new General Counsel/Chief Compliance Officer continued efforts to strengthen the Company's underwriting procedures and performance.

In addition, KBHMC positioned senior underwriting managers in its processing centers. These senior underwriting managers are in direct contact with the loan counselors and processors in the field, which permits these individuals to mentor Company employees on proper origination procedures and quickly communicate new HUD requirements. These managers report to the Chief Compliance Officer and conduct monthly meetings focused on file quality. The managers also meet with Quality Control personnel on a regular basis to discuss trends identified in Quality Control reviews, as well as strategies to continue KBHMC's loan quality and performance. Moreover, the Company has hired former underwriters in the Quality Control Department. Specifically, two of the employees in KBHMC's Quality Control staff are DE-approved underwriters. These individuals do not underwrite loans on behalf of the Company, but rather conduct Quality Control reviews and training to ensure that KBHMC's underwriters properly analyze and approve FHA loans in compliance with HUD guidelines.

Finally, the Company tightened its overall underwriting standards. KBHMC has reevaluated its credit standards and requires the evaluation of all layers of credit risk involved in each loan transaction. The Company is more sensitive to the increased risk associated with loans involving downpayment assistance, and makes additional efforts to ensure that each borrower is qualified for FHA financing in those cases. Underwriters regularly review traditional or telephone VOEs or tax returns to confirm borrowers' employment histories and are required to document all compensating factors in the loan file and in the "Remarks" section of the Mortgage Credit Analysis Worksheet ("MCAW"). KBHMC provides underwriting guidelines to all branch offices and, as discussed below, engages in stringent Quality Control to ensure that all offices of the Company comply with FHA and KBHMC's underwriting standards. KBHMC scrutinizes each applicant's

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credit record to determine the applicant's creditworthiness. As always, KBHMC's underwriters are required to evaluate every loan application on its merits and to make an underwriting decision based on the applicant's qualifications.

2. Quality Control and Compliance Enhancements

In addition to tightening its underwriting procedures, KBHMC's management focused its attention on revitalizing the Company's Quality Control and training programs to ensure compliance with FHA guidelines and to monitor employees' underwriting practices. To accomplish this goal, in November of 2002, KBHMC transferred the management of the Quality Control Department from the Company's corporate offices to ██████████ Senior Vice President, Investor Relations and Quality Control, who immediately focused on increasing the number and experience level of the Quality Control staff. Prior to the asset sale, the Company employed ten individuals in the Quality Control department who had extensive experience in the mortgage banking industry, specifically in the origination of FHA-insured loans. KBHMC stationed Quality Control personnel in each of its processing centers, and these individuals are available to answer questions and resolve issues raised by loan officers, processors, and underwriters. KBHMC also makes use of the tools provided by HUD to monitor its performance and improve its loan quality. For example, KBHMC uses HUD's Neighborhood Watch System to monitor closely its default/claim rates and investigates fluctuations in its performance to identify and resolve the underlying causes for any increases. Similarly, the Quality Control Department also reviews the Post-Endorsement Technical Reviews ("PETR") KBHMC receives and isolates issues and trends identified by HUD in these reports. Quality Control staff members communicate these findings to KBHMC's staff, along with suggestions on how to avoid any identified issues in the future.

In addition to internal Quality Control enhancements, the Company also began outsourcing Quality Control reviews during the time period at issue in the OIG's review. In the Fall of 2002, the Company began using a third-party provider, Adfitech, to conduct its Quality Control reviews. In March of 2004, the Company retained TENA Companies, Inc. ("TENA") to conduct these reviews. TENA reviews a statistically random sample of the Company's FHA-insured loans that provides a 95% confidence level with 2% precision, which constitutes approximately 150 loans per month. TENA prepares reports of its review findings for ██████████ who furnishes relevant portions to division managers and provides a written summary of the report to senior management. ██████████ along with senior management, works to develop and implement any necessary corrective action plans based on TENA's findings.

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Finally, the Company substantially increased staff training on issues of FHA compliance. The Company conducts FHA training sessions at its processing centers for all production and underwriting staff. KBHMC also retained outside companies to conduct training sessions on properly documenting borrower income and employment in FHA-insured cases. Just prior to the asset sale, KBHMC had started a new program, called "Quick Quality," to communicate and reiterate HUD requirements. On a regular basis, the Quality Control department sent "Quick Quality" emails to all employees that identified issues and provided guidance to employees on proper practices. We believe that the above improvements in management, underwriting guidelines and Quality Control efforts have contributed to KBHMC's improvement in default/claim rates over the past few years.

II. RESPONSES TO THE FINDING

The Report contains one finding, including 13 sub-findings, in which it alleges that KBHMC did not originate the 19 loans in compliance with HUD requirements or prudent lending practices. As discussed above, the tone of the Report suggests that, at the time the loans in question were originated, the Company had a pattern and practice of disregarding HUD guidelines. KBHMC takes strong exception to this suggestion, as well as to several of the individual allegations in the Report. After receiving the Report, KBHMC conducted a thorough review of the findings and loan files, as well as examined applicable HUD/FHA guidelines and internal Company procedures at the time these loans were originated in an effort to provide pertinent information and documentation with this response. Our review indicated that several of the findings in the Report are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not affect the underlying loans' insurability. While we recognize that there is always room for improvement, at no time did the Company intentionally disregard HUD guidelines or knowingly misrepresent information to the Department. Where a deficiency existed, we have acknowledged the deficiency, strengthened our policies and procedures to assure compliance with HUD's requirements, and would agree to cooperate with the Department to ensure that all concerns in these cases are resolved. We also would agree to refund the fees referenced in the Report. We believe, and we hope the Department will agree, that this response and accompanying exhibits demonstrate KBHMC's general compliance with HUD/FHA requirements and adherence to prudent lending standards. We address each assertion in Finding 1 in turn below.

A. CONTROL OVER LOAN ORIGINATIONS

The first sub-finding in the Report generally alleges that, at the time the loans at issue were originated, KBHMC had inadequate internal controls and apparently emphasized loan production over prudent lending practices to meet its corporate

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production objectives. The Report states that, although KBHMC had a Quality Control Plan in place that met HUD requirements, the controls intended in the Plan were not applied or implemented in the origination of the 19 loans at issue. Rather, the Report asserts that, in the 19 loans, the Company apparently acceded to the interests of the parent builder/seller (i.e., KB Home) or its own bottom line. The Report justifies this allegation by indicating that the builder's sales could not be consummated, and the Company would not earn origination or other fees, without loan approval. To support these allegations, the Report expressly relies on interviews of two former KBHMC underwriters.

These allegations are unfounded. Contrary to the allegations regarding KBHMC's Quality Control, at the time the loans cited in the Report were originated, the Company had in place and adhered to a Quality Control Plan that complied with HUD guidelines and required its employees and underwriters to do the same. KBHMC's policies required all underwriters to examine thoroughly all loans and ensure compliance with HUD guidelines prior to approval. No written or oral directives of the Company emphasized production over loan quality or encouraged employees to succumb to outside influences or customer demands. As expressly acknowledged in the Report, these assertions are based on statements made by two former underwriters, [REDACTED] and [REDACTED]. As explained above, KBHMC terminated the employment of both of these individuals, and HUD has placed each underwriter on the LDP List in connection with their poor underwriting performance. To the extent that the underwriters making these assertions acted contrary to HUD requirements or determined that loan production superseded loan quality, they did so in contravention of Company policy.

Moreover, these allegations are based on a review of 19 loans originated by one former employee. Rather than acknowledge the isolated nature of any deficiencies identified in these 19 loans, the Report suggests that the findings are symptomatic of the Company's practices. Examining the full set of facts in this case, however, demonstrates that any oversights noted in the 19 subject loans resulted from the isolated actions of one former employee. Moreover, the OIG repeats the assertion that the oversights identified in the loans at issue resulted from inadequate controls and an emphasis on production over loan quality in four different places in the Report. This repetition is unfair, unnecessary, and appears to be an attempt to discredit KBHMC and its reputation. KBHMC believes that this allegation inaccurately portrays the Company, both now and during the period it originated the subject loans. As described above, the Company's policies and procedures conformed to HUD guidelines and required underwriters to examine all aspects of a loan file to ensure that the borrower qualified for FHA financing and that all documentation requirements were satisfied prior to

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closing. The Company did not encourage its underwriters to approve FHA-insured loans to unqualified individuals in any instance, regardless of whether the property securing the loan was being sold by a KBHMC affiliate. To the extent that the underwriters cited in this sub-finding did so, such action was clearly contrary to KBHMC's requirements and practices.

Nevertheless, as described above, KBHMC has tightened its underwriting standards to improve overall loan quality and strengthened its Quality Control Department to ensure that all employees conform to proper underwriting standards. As a result of these underwriting changes, the percentage of loans secured by KB Home's properties has plummeted from well over 80% in 2002 to less than 50% today. As a result of tightening its underwriting standards, KBHMC's default rate has substantially improved.

In summary, the Company vehemently disagrees with the repetitive and conclusory allegations in this sub-finding. Although based on statements made by two former underwriters and the actions of one former individual responsible for underwriting all of the loans at issue, the Report ignores these facts and attributes the deficiencies to non-existent, so-called KBHMC corporate philosophies. To the contrary, the issues identified in this section were isolated occurrences and KBHMC has resolved any outstanding issues by terminating the underwriter's employment, closing the Tempe office, and tightening its underwriting standards.

B. UNDERWRITING PROCEDURES

The Report generally alleges that KBHMC's procedures precluded proper underwriting of all 19 loans reviewed and makes several specific allegations in this regard. We respond individually to each of the specific assertions below.

1. KBHMC's Overall Underwriting Policy

As an initial matter, the Report includes two statements regarding KBHMC's overall underwriting policy that the Company finds particularly offensive. The Report cites interviews of two former underwriters who "claimed that KBHMC policy discouraged the disapproval of any loans and that underwriters were instructed to 'condition' rather than disapprove loans." The Report further asserts that these underwriters stated that "if the builder wanted a loan approved, it would be approved."

These cheap shots are contrary to the facts. At all times during the Company's existence, KBHMC's policies and procedures have dictated that underwriters were only to approve a loan if it met HUD requirements. At the July 25th exit conference, OIG

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officials indicated that [REDACTED] and [REDACTED] were the two underwriters who made the statements cited above. Under separate cover, KBHMC provided the OIG with twenty-two loan files that were declined by six different underwriters, including [REDACTED], [REDACTED], and [REDACTED]. These files demonstrate that, contrary to their statements to the OIG, these two underwriters in fact declined loans. Moreover, in a signed statement, the Company's Assistant Vice President of Underwriting, [REDACTED], indicated that the Company never gave a written or oral directive to condition, rather than to reject loans from KB Home (**Exhibit B**). According to [REDACTED], numerous files were declined by all underwriters employed by KBHMC, including the two individuals who made the statements included in the Report, during the time period referenced in these statements (**Exhibit B**). These declined files and [REDACTED] statements demonstrate that, contrary to the allegations made by two former terminated employees, KBHMC did not have a policy, written or oral, discouraging the rejection of loans, regardless of the source, and in fact rejected loans in numerous cases.

2. Circumstances Underlying the Loan Approval in the Nineteen Cases Reviewed

With regard to the 19 cases at issue, the Report alleges that the conditional and final underwriter approvals were based on incomplete borrower qualification documentation, as the responsible underwriter in all 19 cases: (1) initially approved these loans without reviewing complete documentation; (2) conditioned final approval on additional documentation; and (3) permitted loan processors and/or loan counselors to sign off on the outstanding conditions. The Report further states that, although loan processors and loan counselors did not receive traditional loan commissions, both positions received case-specific "incentive payments" based on their individual percentages of loan applications approved. Taken together with these employees' signing off on loan conditions, the Report concludes that these "incentive payments" constituted improper commission payments under the spirit and intent of HUD requirements prohibiting commissioned employees from performing underwriting activities. The Report indicates that the individual responsible for underwriting all 19 loans was provided with only the MCAW and Addendum to the Uniform Residential Loan Application ("URLA"), Form HUD-92900-A ("Addendum"), and was not provided with the complete borrower qualification package or condition sheet for the 19 loans to verify that the conditions had been satisfied. Based on this information, the Report concludes that KBHMC's procedures resulted in the underwriter falsely certifying to having personally reviewed all documents associated with the credit application. Finally, with regard to certifications, the Report alleges that, in one of the 19 cases reviewed, the Addendum was signed by an underwriter other than the individual who underwrote the loan before the form was completed and another former underwriter

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admitted to signing the Addendum in six cases that she did not underwrite at the request of her supervisor. These six cases, however, are not included in the 19 loans reviewed by the OIG. KBHMC responds to each of these allegations below.

a. KBHMC's Procedures Complied with FHA Requirements

Contrary to the allegations in this sub-finding, KBHMC's procedures complied with HUD guidelines. At all times during its operation, the Company required its underwriters to thoroughly review all employment and credit documents, as well as the appraisal and any documentation verifying the source of funds necessary to close the loan. To the extent these documents are not available during an underwriter's initial review, the underwriter is required to fill out a condition sheet and place an asterisk next to the critical missing items. The underwriter must ensure that the item is obtained and that the underwriter reviews the document prior to final approval. This asterisk serves as an indicator to the underwriter and the processing team that these crucial documents remain outstanding and must be reviewed by the underwriter to ensure that HUD guidelines are met in each case. Underwriters must sign off on conditions that are marked with an asterisk. While the loan processors and/or loan counselors are responsible for gathering this documentation and resolving minor issues in documents already reviewed by the underwriter, such as missing signatures, KBHMC has consistently required its underwriters to review all credit, employment, and source of funds documentation prior to final loan approval. The Company requires this thorough review and analysis by the underwriter prior to his or her signing of the MCAW or the relevant portions of the Addendum in all cases.

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The statements made by ██████████ demonstrate her contravention of Company policy as well as HUD requirements. For example, KBHMC required this underwriter to review all employment, credit and source of funds documentation prior to loan approval. To the extent that ██████████ did not receive such documentation in the cited cases, this underwriter should have, according to KBHMC requirements, placed an asterisk next to the missing items on the condition sheets in these cases. These sheets, however, demonstrate that, in 13 of the 19 cases, ██████████ placed an asterisk only next to the appraisal. This practice violated Company procedure and inaccurately indicated to her managers and the loan processing staff that she had reviewed documentation when, based on her admissions, she had not.

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Moreover, the Report states that the underwriter indicated she was not "provided with" the complete loan package or condition sheet prior to loan approval, and merely was "provided with" the MCAW and Addendum to sign. These comments suggest that some other individual was responsible for assuring that ██████████ received all relevant information regarding the loan before she signed any approval documents.

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This is not the case. Rather, as the Direct Endorsement underwriter, per HUD's express guidelines, [REDACTED] was responsible for "the decisions relating to the acceptability of the appraisal, the inspections, the buyer's capacity to repay the mortgage and the overall acceptability of the mortgage loan for HUD insurance." HUD Handbook 4000.4 REV-1, CHG-2, ¶ 2-4. Based on FHA guidelines, therefore, [REDACTED] was accountable for reviewing the documents necessary to make a sound underwriting decision. If this individual was not "provided with" all documentation necessary to do so, it was her duty to ensure that she received and reviewed those documents and verified that all outstanding conditions had been satisfied prior to making her approval decision. To the extent this underwriter failed to complete these steps, she violated KBHMC's procedures and HUD guidelines.

With regard to the allegations concerning false certifications, we strongly disagree with the conclusion that these certifications resulted from KBHMC's procedures. Rather, the underwriter violated Company policy to the extent that she signed the MCAW or the Addendum without ensuring that she reviewed all critical documentation before approving any borrower for FHA financing. The underwriter should not have signed either the MCAW or the Addendum without performing this review. To the extent that she did not conduct a review, the underwriter's individual decisions, rather than KBHMC's procedures, resulted in the erroneous certifications.

Finally, to the extent that any underwriter signed a MCAW or Addendum in connection with a loan underwritten by another individual, that underwriter should have, at a minimum, reviewed all critical file documentation in compliance with Company policy. We understand that the statement regarding the six loans that are not the subject of the OIG's review was made by [REDACTED]. As discussed above, KBHMC terminated [REDACTED] employment and she is currently on the LDP List as a result of her poor underwriting performance. Thus, we believe that any concern in connection with this statement effectively has been resolved. We also note that all six of these loans were underwritten by [REDACTED], who was terminated in 2002. Moreover, as to the allegation that this individual's supervisor encouraged such inaccurate certifications, KBHMC policy does not permit management personnel to request that any underwriter violate HUD requirements or the Company procedures. We have interviewed the referenced supervisor, who denies this underwriter's statement.

In summary, in each of the 19 cases, [REDACTED] had the opportunity to (i) require that all crucial documentation necessary to make a sound underwriting decision be obtained, and (ii) review such information prior to signing the MCAW or Addendum. In each of these cases, she chose to abdicate her responsibilities as a Direct

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Endorsement underwriter by ignoring her obligation to review all relevant documentation and make a reasoned, objective decision prior to signing the MCAW and Addendum in these cases. These decisions were contrary to both Company policy and FHA guidelines. The full picture of the circumstances in this case demonstrate a particular underwriter's lack of regard for KBHMC's and HUD's requirements, rather than deficiencies in the whole Company's procedures. As discussed above, KBHMC identified this underwriter's sub-standard performance and lack of responsibility in executing her employment duties, and relieved her of her position with the Company in December of 2002. Thus, KBHMC responsibly identified and handled the circumstances surrounding the loans cited in the Report and we believe that all such concerns in this regard have been effectively resolved. As such, we believe that the Report should be substantially revised to remove allegations concerning KBHMC's overall underwriting procedures.

b. KBHMC's Procedures Did Not Permit Commissioned Employees to Underwrite Loans

With regard to the allegation concerning the loan processors' activities in this sub-finding, KBHMC strongly disagrees with the Report's conclusions. The Report asserts that KBHMC permitted loan processors and/or loan counselors to sign off on outstanding conditions involving employment, credit or source of funds documentation, which resulted in commissioned employees performing underwriting activities. Later, the Report repeats this allegation and concludes that KBHMC's procedures effectively transferred the ultimate underwriting eligibility determinations from the underwriters to commissioned loan processors and loan counselors.

Contrary to this allegation, KBHMC's policies did not permit such behavior. The Company understands and appreciates that employees who perform underwriting and loan servicing activities may not receive commissions. See HUD Handbook 4060.1 REV-1, ¶ 2-17. As discussed above, KBHMC's procedures are designed to ensure that loan processors and counselors do not engage in such activity. To do so, KBHMC requires underwriters to place an asterisk on loan condition sheets next to all credit, employment and funds documents required to make an underwriting decision. Only underwriters are permitted to sign off on those "starred" conditions. Loan processors may initial only those minor outstanding conditions not "starred." In many of the 19 cases at issue, however, the responsible underwriter violated this requirement and neglected to place an asterisk next to outstanding critical documentation or, based on her statements in the Report, review these documents prior to approval. While loan processors may have initialed certain conditions, these notations signified merely that the documents had been obtained, not that these processors were somehow

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responsible for underwriting duties in these cases. It was the underwriter's responsibility to review these documents and ensure compliance with HUD guidelines. Thus, any deficiency in this regard resulted from the underwriter's violation of Company policy, rather than KBHMC's procedures. We also note that, while the loan processors and loan counselors employed by the Company during the time period in question did receive bonuses, these bonuses were based on customer service as well as loan production, and were determined on a Division-wide basis. Thus, the suggestion that these individuals received "incentive payments" based on their individual percentages of loan applications approved is simply not true.

In any event, to the extent that critical loan documentation was gathered by loan processors or loan counselors and not reviewed by the underwriter, the underwriter violated her employment duties by not placing an asterisk by these items on the condition sheets or reviewing them to ensure compliance with HUD guidelines prior to loan approval. Therefore, the allegation that KBHMC's procedures regarding loan processors violated HUD requirements should be removed from the final Report.

C. EMPLOYMENT DOCUMENTATION

The Report alleges that four loan files contained false employment documents, including pay stubs, Internal Revenue Service ("IRS") W-2 forms, and Verifications of Employment ("VOE"), and indicates that the OIG confirmed the false information by interviewing the borrowers and/or the employers during post-endorsement reviews.

KBHMC consistently has required its underwriters to review thoroughly all employment documentation and ensure that all employment documents are consistent and accurate prior to closing. Where underwriters identify inconsistencies in a borrower's employment history or income documents, KBHMC has always required underwriters to resolve these discrepancies prior to closing or halt the loan transaction in the event that false or fraudulent information is discovered. The Company's policy for underwriters, as well as processing staff, requires these individuals to report any potential fraud or false information to management, who then forwards the loan file to KBHMC's Quality Control Department for further investigation. To the extent that the Company uncovers or is informed of false or fraudulent information through its Quality Control reviews or other channels, KBHMC's policy and procedure, currently and at the time the loans at issue were originated, is to promptly report the deficiency to the Department pursuant to its obligations under HUD Handbooks 4060.1 REV-1 and 4000.2 REV-2.

To the extent that Company employees participated in providing inaccurate employment information or were informed of inaccurate information by employers but

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failed to report this information to the Company's management or the Department, such activity was clearly contrary to KBHMC's policies and procedures. The Company does not tolerate such behavior and takes prompt action to discipline or terminate, if necessary, employees who engage in such action. KBHMC did so here. The underwriter responsible for the loans in question was terminated in 2002, and the Company has closed the office in which the activities cited allegedly took place. We believe that these actions effectively resolve any concerns that may have arisen in connection with the four loans cited in this sub-finding. In addition, to ensure that similar problems do not develop in other KBHMC offices, the Company has taken several steps to tighten its underwriting and improve its Quality Control and loan monitoring efforts on a Company-wide basis. As discussed above, KBHMC provides ongoing training to its employees regarding fraud detection and prevention. Moreover, the Company has significantly improved its Quality Control efforts by employing experienced individuals to manage the Company's Quality Control reviews, as well as placing Quality Control employees with underwriting experience in KBHMC's processing centers to be more readily available to answer questions during the origination process. These improvements permit us to discover and remedy any irregularities or deficiencies and will prevent the issues that arose in these cases from recurring elsewhere in the Company. Finally, in response to the Report's findings, we have again trained all employees of the importance of monitoring loan files for potentially false information and to investigate and remedy all file irregularities prior to closing.

While no mortgage company can guarantee that future employees and business partners will not attempt to manipulate the system, KBHMC proactively initiated new controls to cure potential abuses and improve its loan origination process, terminated business relationships with affected employees, and ultimately closed the branch office that is the subject of the Report. Although KBHMC conveyed these actions to the OIG throughout the audit and during the July 25th exit conference, the OIG found it necessary to repeat the same allegations in these four cases in several instances without acknowledging that any deficiencies were isolated or to note the Company's significant efforts to prevent reoccurrence. The Report seems to ignore facts that do not conveniently fit predetermined conclusions.

In any event, although the Company acknowledges that discrepancies in employment documentation should have been resolved in two cases prior to closing,¹ in the two remaining loans, as demonstrated in the individual responses below, the false

¹ We note that two of the loans in question, [REDACTED] – FHA Case No. 023-1107968 and [REDACTED] – FHA Case No. 023-1135453, have been paid in full or sold by HUD at a profit and, thus, are not included in the Report's recommendation for indemnification.

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nature of the information may have been provided to KBHMC's employees and, if so, would not have been evident to the Company at the time of origination, approval, or closing. In these two cases, while the OIG's re-verification process determined that the employment information on telephone verifications was inaccurate, nothing on the face of the documentation contained in the loan files in these cases suggest impropriety. There is no evidence in these loan files to demonstrate the source of the inaccurate information included in these verifications. Thus, while KBHMC has implemented new controls in an effort to strengthen its lending practices and assure its continued adherence to HUD/FHA guidelines, and although we recognize in two of the cases cited in this sub-finding that conflicting file documentation should have been questioned prior to closing, KBHMC generally complied with applicable requirements in the remaining cases.

1. ██████████ – FHA Case No. 023-1063809

In this loan, the Report alleges that the loan file contained a false telephone VOE. Specifically, the Report asserts that the loan processor contacted the employer by phone on March 22, 2002 and verified that the co-borrower was an active employee at that time; however, the employer told the OIG during its re-verification that the co-borrower separated from the company on March 8, 2002. The Report concludes that, at the time of the Company's telephone verification, the loan processor should have been told that the co-borrower's employment had been terminated; however, the telephone VOE incorrectly stated that the co-borrower was still continuously employed as of March 22, 2002.

At the time of underwriting and approval, the loan file contained a telephone VOE from The Picture People (**Exhibit C-1**), a 2001 W-2 form from The Picture People (**Exhibit C-2**), and several pay stubs from The Picture People ranging from October of 2001 through March 22, 2002 (**Exhibit C-3**). These documents complied with HUD requirements for alternative documentation, see HUD Handbook 4155.1 REV-4, CHG-1, ¶ 3-1(E),² and nothing on the face of the items received was suspicious. The Report suggests that, because its re-verification efforts determined that the borrower's end date was before the March 22, 2002 telephone verification, that the individual with whom the KBHMC loan processor spoke "should have" informed the Company employee that the borrower had been terminated. The Report, however, contains no information indicating that the loan processor actually received any information from the individual with whom

² HUD Handbook 4155.1 REV-4, CHG-1 was applicable at the time the subject loans were originated and closed. KBHMC therefore relies on the then-current Handbook and accompanying Mortgage Letters throughout this response.

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she spoke other than the information that was reflected on the telephone VOE. The Report does not indicate that, during re-verification, the OIG contacted either the loan processor or the specific individual at The Picture People with whom the loan processor spoke at the time of the telephone VOE. The OIG's re-verification procedures identified inaccurate information; however, one cannot determine from this information whether it was provided by the employer or the loan processor. Thus, it is possible that, among other explanations, at the time of the telephone verification, The Picture People employee was unaware of the co-borrower's employment status or mistakenly conveyed that the co-borrower was still employed. Without further evidence, however, it is impossible to determine the source of the incorrect information included on the telephone VOE.

Furthermore, additional documentation in the loan file indicated that the co-borrower was employed by The Picture People past March 8, 2002, and as of loan closing. For instance, the loan file contained a pay stub covering the period of March 3, 2002 through March 16, 2002, which was issued on March 22, 2002 (**Exhibit C-3**). Moreover, the co-borrower certified on the URLA that she was employed by The Picture People as of April 25, 2002 (**Exhibit C-4**). Thus, based on the documentation contained in the loan file, the underwriter had no reason to question the information set forth in the telephone verification.

In summary, although the OIG identified inaccuracies with the telephone VOE through its re-verification procedures, the information obtained during that process does not evidence that KBHMC's loan processor was responsible for the inaccuracies included on the telephone VOE. Furthermore, to the extent the borrower's employment documentation was false, the co-borrower should not have certified otherwise on the loan application. The OIG's re-verification does not confirm that KBHMC or its employees in fact engaged in fraud in originating, processing, underwriting, closing, or submitting the subject loan for endorsement. Therefore, indemnification is not warranted and this loan should be removed from this section of the Report.

2. [REDACTED] – FHA Case No. 023-1107968

In the [REDACTED] loan, the Report also alleges, based on information obtained during a re-verification process, that the telephone verification contained inaccurate information. The Report asserts that, while the telephone VOE indicated that, as of March 28, 2002, the co-borrower was employed and explained a business name discrepancy between Air One Transport versus Express Parcel Services, interviews of representatives of both Air One Transport and Express Parcel Services uncovered that the co-borrower was not employed by either company on March 28, 2002, that the

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business name explanation was untrue, and that the person reportedly contacted by the loan processor at Express Parcel Services did not work for that entity.

In this case, at the time of underwriting and approval, the loan file contained a telephone VOE indicating that the co-borrower had been employed by Air One Transport, and that this entity had purchased Express Parcel Services (**Exhibit D-1**), 2000 and 2001 W-2 forms for the co-borrower from both Express Parcel Services and Air One Transport (**Exhibit D-2**), and pay stubs for the co-borrower from both entities (**Exhibit D-3**). These documents complied with HUD requirements for alternative documentation. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 3-1(E). While the co-borrower's income indicated employment with two different entities, the loan processor's certification included what appears on its face to be a reasonable explanation for the name differences. Moreover, none of the loan file documents appeared suspicious.

As in the prior case, the Report contains no indication that the loan processor actually received any information other than the information regarding the co-borrower's employment reflected on the telephone VOE. The Report does not indicate that, during re-verification, the OIG contacted either the loan processor or the specific individual at the employer with whom the loan processor spoke at the time of the telephone VOE. While the Report asserts that the individual listed on the VOE was not an employee of the entity listed, the loan processor would not have known this at the time the telephone VOE was taken, and was not required to verify that individual's employment status. Rather, the processor was responsible for verifying the telephone number of the employer and obtaining information from the employer regarding the loan applicant's employment. Nothing on the face of the telephone VOE suggests that the loan processor did not take these steps in this case. The OIG's re-verification procedures identified inaccurate information; however, one cannot determine from this information whether that information was provided by the employer or the loan processor. Without further evidence, it is impossible to determine the source of the incorrect information included on the telephone VOE. Moreover, the co-borrower certified on the URLA that he was employed by the entity reflected in the employment documentation as of March 28, 2002 (**Exhibit D-4**). Thus, based on the documentation contained in the loan file, the underwriter had no reason to question the information set forth in the telephone verification.

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In summary, although the OIG identified inaccuracies with the telephone VOE through its re-verification procedures, the information obtained during that process does not evidence that KBHMC's loan processor was responsible for these inaccuracies. Furthermore, to the extent the borrower's employment documentation was false, the co-borrower should not have certified otherwise on the loan application. The OIG's re-

verification does not confirm that KBHMC or its employees in fact engaged in fraud in originating, processing, underwriting, closing, or submitting the subject loan for endorsement. Thus, this loan should be removed from this section of the Report.

D. CALCULATION OF BORROWER INCOME

In 10 of the 19 cases,³ the Report asserts that the Company's calculations of the borrowers' incomes were overstated, as overtime/bonus income, part-time income, rental income, or a combination thereof was inappropriately included in the calculation. In 7 cases, the Report alleges that overtime income was included; however, such income was not verified for the previous two years and/or the underwriter did not justify the likelihood of continuance.

KBHMC understands and appreciates that, when using income in addition to a borrower's salary and wages to qualify him or her for FHA financing, a lender must obtain additional documentation to determine that such income can be expected to continue for the first three years of the mortgage loan. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-7. With regard to overtime and bonus income, where such wages are included in a borrower's effective income, KBHMC obtains evidence that the borrower has received such income for approximately the past two years, or a justification from the underwriter regarding the reason for using such income earned for less than two years, and that there are reasonable prospects of the continuance of such additional income. See id. ¶ 2-7(A). In addition, the Company's policy consistently has required its employees to establish an earnings trend for overtime/bonus income and, to the extent that such income shows a continual decline, a sound rationalization for including the funds in the effective income. Id. KBHMC underwriters must review a borrower's income in each FHA transaction, ensure that any income used to qualify the borrower is documented in compliance with FHA guidelines, and determine that such income can rationally be included in the effective income based on the borrower's earnings history.

These policies and procedures were in place during 2002, when the loans in question were originated, and remain KBHMC policy and practice today. To the extent that any deficiencies regarding overstated income occurred in the loans reviewed, such overstatements resulted from one underwriter's contravention of KBHMC policy and her obligations to review, document, and justify the inclusion of additional income in the

³ While the Report cites 14 cases in this sub-finding, that total includes the 4 cases discussed above in which the Report takes issue with the accuracy of the employment documentation. As we have addressed this issue in a prior section, we limit this discussion to the remaining cases.

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earnings calculations. As indicated above, this underwriter was terminated in December of 2002. Nevertheless, we have provided training to our current employees regarding proper calculation of borrower income and FHA guidelines regarding the inclusion of additional income in the qualification determination. Furthermore, we disagree with the Report's allegations regarding certain cases cited in this sub-finding. We discuss two cases in which we take issue with the Report below.

1. ~~REDACTED~~ FHA Case No. 023-1043232

In this loan, the Report alleges that the borrowers' monthly income of \$3,199 on the MCAW is overstated by \$688, as the base salary calculation included overtime income without adhering to HUD requirements and the loan file did not contain adequate documentation to justify the receipt of child support income.

The borrower's total effective income in this case included base pay, child support income, and rental income. With regard to the borrower's base pay, KBHMC maintains that the income reflected on the MCAW was calculated correctly based on loan file documentation. Contrary to the allegation, the borrower's base salary did not reflect overtime income. Rather, the income of \$2,967 listed on the MCAW (**Exhibit E-1**) includes the borrower's base salary, plus child support income. The Company is unaware of any express requirement regarding what information a lender must use to calculate income. In this case, the underwriter reasonably calculated the borrower's monthly base earnings of \$2,750 by using the income reflected on the borrower's most recent pay stub and confirmed by her 2001 W-2 form (**Exhibit E-2**). This amount, plus the \$232 in documented child support, equals \$2,982 in monthly income, which is slightly more than the \$2,967 in income used to qualify the borrower on the MCAW.

With regard to the child support income, KBHMC maintains that these funds were adequately documented in the loan file. FHA guidelines require lenders to document such income by obtaining: (1) a copy of the divorce decree, legal separation agreement or voluntary payment agreement; and (2) evidence that the payments have been received during the last twelve months. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-7(F). HUD requirements further provide that periods of less than twelve months may be acceptable, provided the lender adequately documents the payor's ability and willingness to make timely payments. See *id.* In this case, the loan file contained a copy of the court order requiring the payor to make a monthly child support payment of \$232 to the borrower (**Exhibit E-3**), as well as bank statements demonstrating that the payor in fact had made such payments for the past seven months (**Exhibit E-4**). While these bank statements covered less than a twelve-month period, the seven months' of timely payments evidenced the payor's ability and willingness to make the child support payments in this case. Thus, it was reasonable and within HUD requirements to include

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this income in the borrower's effective income. The \$232 in child support income, along with the borrower's base salary of \$2,750 and verified rental income of \$257 per month (**Exhibit E-5**), totaled \$3,199 in effective income in this case (**Exhibit E-1**). KBHMC thus complied with HUD requirements in calculating and documenting this borrower's income.

2. ████████ – FHA Case No. 023-1186721

In the ████████ loan, the report alleges that the borrower's monthly income of \$7,620 reflected on the MCAW is overstated by \$3,810, as this unsubstantiated amount was added to the borrower's verified income of \$3,810.

In this case, the borrower and her spouse initially applied together for FHA financing. The borrower earned \$3,516 per month (**Exhibit F-1**) and the borrower earned \$3,203 per month in disability payments (**Exhibit F-2**). Ultimately, the borrower's spouse was removed from this transaction, and only the borrower obtained FHA financing. Nevertheless, the spouse's income was inadvertently included on the MCAW. In any event, when considering only the borrower's verified income, she qualified for this loan. Had the MCAW reflected only the borrower's income, the qualifying ratios in this case would have been higher than those listed on the MCAW (**Exhibit F-3**). While the borrower's back-end ratio would have been slightly over the 41% benchmark, see HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-12(B), the loan file indicated that the home was energy-efficient, and that borrower's spouse was receiving a substantial monthly disability payment, which was a significant compensating factor in this case. See id. ¶ 2-13(E). As the borrower ultimately would have qualified for financing in this case, we believe that inclusion of this allegation in the Report is unwarranted.

E. CALCULATION OF LIABILITIES

The Report alleges that, in 4 loans, all outstanding liabilities, such as education loans, revolving credit accounts, and credit cards, were not considered prior to loan approval.

The Company's policies and procedures consistently have required underwriters to examine all of a borrower's outstanding liabilities, such as installment loans, revolving charge accounts, child support and student loans, extending ten months or more from closing when determining whether a particular borrower qualifies for FHA financing. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-11. In all but one of the cases cited in the Report, loan file documentation evidences KBHMC's strict adherence to this policy. While the Company appreciates that, in one case, certain liabilities were inadvertently

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excluded from consideration, any oversight in this case constituted an isolated incident contrary to Company policy. Furthermore, the responsible underwriter is no longer employed by the Company. In any event, KBHMC respectfully disagrees with the allegations in three of the four cases included in this sub-finding. Our individual responses to these three cases are set forth below.

1. **██████ – FHA Case No. 023-1043232**

In the ██████ loan, this sub-finding alleges that the borrowers' recurring liabilities of \$711 on the MCAW are understated by \$196, as the total liability calculation did not include an unpaid American Express account with a \$196 monthly payment. Contrary to this allegation, KBHMC properly excluded the American Express account referenced in the Report. The divorce decree contained in the loan file demonstrated that this account, number ██████ (Exhibit G-1), was the borrower's ex-spouse's responsibility (Exhibit G-2). Thus, the Company properly excluded this debt from consideration on the MCAW (Exhibit G-3). KBHMC complied with HUD requirements in this case and, therefore, objects to the inclusion of this allegation in the Report.

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2. **██████ – FHA Case No. 023-1113441**

In the ██████ case, the Report alleges that the following two education loans were excluded improperly from the total liabilities reflected on the MCAW: (1) Fst Nat-Lub for \$2,750 at \$138 per month; and (2) Fst Nat-Lub for \$1,826 with a monthly payment of \$91. Contrary to the allegation in this case, KBHMC properly excluded both of these accounts from the liabilities calculation when qualifying this borrower. The borrower's February 19, 2002 credit report indicates that these two accounts were student loans not in repayment (Exhibit H-1). Furthermore, the most recent credit report in the loan file, dated March 12, 2002, indicates that both of these accounts had been transferred (Exhibit H-2). As the borrower had transferred the accounts and the monthly obligations no longer appeared on the credit report, the Company properly excluded these student loans from consideration on the MCAW (Exhibit H-3). Thus, the allegation in this case is inappropriate.

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3. **██████ – FHA Case No. 023-1254460**

In the ██████ loan, the Report alleges that the borrower's absence of recurring liabilities was incorrect, as the MCAW should have reflected a monthly payment of \$355 on an automobile loan with a balance of \$4,329.

Contrary to the allegation in this case, the Company properly excluded the referenced loan from consideration in qualifying this borrower for financing. As

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acknowledged in the summary portion of the Report, FHA guidelines require lenders to include monthly payment amounts for debts extending ten months or more after closing. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-11(A). In this case, the loan closed on August 30, 2002 (Exhibit I-1). While the borrower's credit report indicated that, as of April 15, 2002, the outstanding balance on the account in question was \$4,329 (Exhibit I-2), the borrower would have made four payments of \$355, totaling \$1,420, between the date of the credit report and the settlement date. Thus, as of the date of closing, the outstanding balance on this account would have been \$2,909 with only eight payments remaining ($\$4,329 - \$1,420 = 2,909 / \$355 = 8.1$) (Exhibit I-2). As this debt would not extend ten months or more past closing, KBHMC complied with HUD requirements in this case. Inclusion of this allegation in the Report is therefore unwarranted.

F. UNACCEPTABLE CREDIT HISTORIES

In 15 cases, the Report asserts that the borrowers' credit histories demonstrated significant disregard toward credit obligations, as the histories reflected adverse information such as bankruptcy, poor credit ratings, numerous charge-offs, or collection accounts. While the Report acknowledges that KBHMC obtained explanation letters from the borrowers in most cases, it takes the position that the borrowers did not provide offsetting or compensating factors.

KBHMC respects the importance of analyzing a borrower's credit performance and examining his or her attitude towards credit obligations. It is KBHMC's policy, with respect to every FHA applicant, to scrutinize the applicant's credit record and reasonably determine the applicant's creditworthiness. Given the potential risks not only to the Department, but to the Company, of making a poor credit decision, the Company's management, since KBHMC's inception, has endeavored to monitor underwriting performance and provide ongoing training to employees on the issue of credit analysis. KBHMC's employees take their underwriting responsibilities seriously and understand that they will face severe consequences for unsatisfactory analysis of borrower credit. KBHMC never would knowingly jeopardize the Company's stability or its relationship with the Department. Despite the Company's policies and its efforts to train and educate its underwriters on the importance of prudent credit analysis, it appears that one underwriter circumvented Company policy and approved certain borrowers with credit problems and inadequate offsetting factors. As discussed above, in December of 2002, KBHMC terminated the underwriter responsible for approving all of the loans at issue in this sub-finding after discovering poor underwriting techniques on the part of this individual.

That being said, in reviewing the loans cited in this sub-finding, KBHMC determined that five of the borrowers had demonstrated sufficient creditworthiness to

justify loan approval. In evaluating these five cases, we hope the Department will consider that HUD delegated to FHA lenders the responsibility for analyzing borrower credit and determining an individual's creditworthiness. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3. While HUD has established specific guidelines, credit analysis remains largely subjective. Underwriting is an art, not a science, and requires careful weighing of the circumstances. See Mortgagee Letters 00-24 and 95-07. Where derogatory items are present, lenders have discretion to consider the borrower's unique circumstances and determine whether financing is appropriate. As HUD directed, in the cases discussed below, KBHMC examined the overall pattern of credit behavior and determined whether financial difficulties in the past reflected an unacceptable risk or failed to reflect the borrower's current situation. The Company properly considered each borrower's previous housing obligations, recent and/or undisclosed debts, collections, judgments, and bankruptcies. The Company required each borrower to provide a written explanation of past credit issues to ensure that it reviewed the totality of the borrowers' circumstances, rather than focus on isolated occurrences of delinquent credit or slow payments. In these cases, KBHMC reasonably determined that late payments were not due to the borrower's disregard for financial obligations and at times resulted from factors beyond the borrower's control. As discussed below, the borrowers were generally hard-working individuals who took responsibility for their financial obligations. KBHMC adhered to FHA requirements in these loans and reasonably determined that the borrowers qualified for FHA financing. We address each of these cases in turn below.

1. ██████████ – FHA Case No. 023-0687906

In the ██████████ loan, the Report alleges that both borrowers' credit histories were unacceptable because: (1) the loan file did not contain alternative credit accounts from the borrower to supplement her limited credit history; and (2) the co-borrower's account indicated 13 accounts, 8 of which were collections or charge-offs.

With regard to the borrower's credit history, while the credit report dated January 10, 2002 indicated an open collection account (**Exhibit J-1**), the loan file also contained a statement from the borrower dated January 3, 2002 indicating her intent to pay this account in full (**Exhibit J-2**), as well as a supplement to the credit report dated March 25, 2002, indicating that the collection account had been paid in full (**Exhibit J-3**). Thus, the credit report evidences that, prior to loan closing, the borrower had taken responsibility for her credit obligations and had satisfied her outstanding debt. Furthermore, contrary to the allegation in the Report, the loan file also contained a letter from an alternative creditor indicating that the borrower had remained current on her electric bill for at least 12 months prior to closing (**Exhibit J-4**). This information

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supplemented her credit report and indicated that the borrower was a responsible individual willing to make timely payments on utility expenses.

With regard to the co-borrower's credit history, the credit report dated December 26, 2001 lists 13 accounts (**Exhibit J-5**). Four of these entries were installment accounts that the borrower was paying as agreed (**Exhibit J-5**). Two of these accounts had timely payment histories for over 12 months (**Exhibit J-5**). While the credit report reflected a number of collection accounts, all of these accounts were over two years old, and two of the accounts were over four years old (**Exhibit J-5**). The fact that these accounts were so dated demonstrated that the borrower's credit issues occurred in the past and that his more current credit history demonstrated an acceptance of his obligations and willingness to make timely payments. Moreover, although not indicated in the Report, the borrower paid all collection accounts in full prior to closing, as evidenced by: (1) supplemental credit reports dated January 10, 2002 and April 19, 2002 (**Exhibit J-6**); (2) a letter from the borrower (**Exhibit J-7**); and (3) receipts indicating payment of the accounts at issue (**Exhibit J-8**). The co-borrower's satisfaction of all outstanding accounts demonstrates that he had taken responsibility for his credit obligations and had satisfied all of his derogatory accounts prior to closing. Thus, after closing, the borrowers had only one installment debt with a monthly payment of \$469 in addition to their mortgage payment, which was considered by the underwriter on the MCAW (**Exhibits J-5 and J-9**).

Furthermore, in addition to the borrowers' credit documentation, the loan file also contained letters of explanation indicating that the borrowers' past credit issues arose because of unforeseen medical problems during a period when the co-borrower did not have medical insurance and a period of unemployment by the borrower over three years prior to loan application (**Exhibit J-10**). The underwriter in this case examined these letters and reasonably determined that the borrowers' past credit issues resulted from circumstances beyond their control and that both individuals had accepted responsibility for their credit obligations and worked to improve their credit standing. In addition, both borrowers' credit reports verified an excellent twenty-four month rental history (**Exhibits J-3 and J-6**). FHA guidelines state:

The basic hierarchy of credit evaluation is the manner of payments made on previous housing expenses, including utilities, followed by the payment history of installment debts, then revolving accounts. Generally, an individual with no late housing or installment debt payments should be considered as having an acceptable credit history unless there is major derogatory credit on his or her revolving accounts.

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HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3. Here, the borrowers demonstrated a consistent commitment to meet their monthly housing expenses over a two-year period prior to closing. While the borrowers' credit reports contained some derogatory items, the borrowers had paid these accounts in full prior to closing.

In addition to the fact that the borrowers paid off all outstanding accounts prior to or at closing, and had a demonstrated history of making housing payments in a timely manner, the loan file contained other evidence to offset the borrower's past credit problems. The underwriter documented on the MCAW that the borrowers had moderate debt-to-income ratios of 27%/40% (**Exhibit J-9**). Furthermore, the co-borrower had been employed at his current job for two years prior to closing (**Exhibit J-11**). While these factors should have been noted on the MCAW in compliance with Company policy and FHA guidelines, the Department expressly has acknowledged that such factors are significant in analyzing a borrower's creditworthiness. See, e.g., HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13. The underwriter in this case properly examined all of the information in the loan file and determined that the borrowers had made a concerted effort to improve their credit by paying off half of all collection accounts prior to closing and that, contrary to the Department's allegation, the loan file contained sufficient factors, such as timely rental payments and stable employment, to offset the borrower's past credit history. Thus, the underwriter exercised reasonable discretion in this case and we respectfully maintain that indemnification in connection with this sub-finding is unwarranted.

2. █████ – FHA Case No. 023-1028162

In this case, the Report alleges that the loan file contained alternative credit sources to supplement the borrower's limited credit history; however, the alternate credit showed a pattern of late and past due payments.

The credit report in this case reflects only two collection accounts (**Exhibit K-1**). Both accounts had been incurred over 24 months prior to loan closing, and one was over 36 months old (**Exhibit K-1**). The age of these accounts evidenced the borrower's willingness to accept responsibility for his credit and ability to avoid further derogatory items in the recent past. Nevertheless, to determine the borrower's overall credit history, the underwriter required documentation of alternative credit sources to fully evaluate this borrower. The loan file contains evidence of several of the borrower's alternative credit accounts (**Exhibit K-2**). While some of these documents indicate a few late payments by the borrower, none of these payments were more than 30 days late (**Exhibit K-2**). Finally, the underwriter required the borrower to provide an explanation of his past derogatory credit, in which he indicated that past accounts resulted from his mistaken belief that accounts had been paid in full or were covered by

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insurance programs, rather than a disregard for his credit obligations (**Exhibit K-3**). Based on this documentation, the underwriter reasonably determined that the borrower had resolved his past credit issues and had demonstrated a satisfactory history of payments on alternative credit that indicated his willingness and ability to make timely mortgage payments.

In addition to the borrower's explanation and improved credit performance, the MCAW indicated that the borrower had moderate debt-to-income ratios of 25%/25% and no recurring expenses other than his mortgage payment (**Exhibit K-4**). The Department expressly has acknowledged that such factors are significant in analyzing a borrower's creditworthiness. See, e.g., HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13. The underwriter in this instance analyzed all of these factors and reasonably determined, based on the totality of the circumstances, that the borrower presented a reasonable credit risk. Thus, we believe that this allegation should be removed from the Report.

3. **██████ – FHA Case No. 023-1186721**

In the ██████ case, the Report alleges that the credit report indicated that the borrower filed for Chapter 7 bankruptcy on April 3, 1998, which was discharged on July 22, 1998; however, after the bankruptcy discharge, the borrower had one late payment past 30 days, two charge-offs totaling \$8,275, two collection accounts totaling \$334, and one civil judgment in an amount of \$424. The Report concludes that the loan file did not contain additional documentation to mitigate the borrower's continued poor credit history.

With regard to cases involving Chapter 7 bankruptcies, HUD guidelines state that a Chapter 7 liquidation will not disqualify the borrower if at least two years have passed since the bankruptcy was discharged and the borrower has reestablished good credit and demonstrated an ability to manage financial affairs. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3(E). In this instance, the loan closed on June 14, 2002, which was approximately four years after the borrower's bankruptcy had been discharged (**Exhibit L-1**). In addition, while the borrower's credit report reflected certain derogatory items incurred after the discharge date, all credit accounts were open at least three years prior to loan closing (**Exhibit L-2**). The age of the derogatory items indicates that, while the borrower may have incurred some residual credit problems shortly after the bankruptcy, she had taken responsibility for her credit obligations and had refrained from incurring new credit accounts in the three years prior to closing. Furthermore, of the accounts listed on the credit report, the borrower was paying four as agreed (**Exhibit L-2**). Thus, while the credit report reflected derogatory items in the past, the underwriter analyzed the totality of the circumstances in this case and reasonably determined that the

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borrower had accepted responsibility for her credit obligations and taken control of her finances.

In addition to the borrower's improved credit performance, additional factors present in the loan file counseled toward extending FHA financing in this case. As pointed out in the Report, the borrower's accurate qualifying ratios in this case were 27%/41.72% (**Exhibit F-3**). While the borrower's back-end ratio would have been slightly over the 41% benchmark, see HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-12(B), the loan file indicated that home was energy-efficient, and that the borrower's non-purchasing spouse was receiving a considerable monthly disability payment, which constituted a significant compensating factor in this case. See id. ¶ 2-13(E). Based on these factors, the underwriter exercised the discretion imparted by the Department and made a reasonable judgment that this borrower presented an acceptable risk. Thus, this allegation should be removed from the Report.

4. **██████ – FHA Case No. 023-1211310**

The Report alleges in this case that the credit report for the primary borrower and his non-purchasing spouse showed numerous charge-offs and adverse ratings, including: (1) four charge-offs; (2) six collections, with four outstanding; (3) two accounts with two 30-day late payments; and (4) a paid collection representing a government fine from Maricopa County.

In this case, the underwriter analyzed the totality of the borrower's credit history in accordance with HUD guidelines and the discretion afforded in such cases. While the borrower's credit report evidenced some derogatory credit accounts, most of the credit accounts were opened more than two years prior to loan application, and the majority of the borrower's credit problems occurred prior to 2000 (**Exhibit M-1**). The credit report demonstrates that, in the two years prior to closing, the borrower and his non-purchasing spouse had four accounts with good ratings and, overall, their credit reports indicated eight satisfactory credit accounts (**Exhibits M-1 and M-2**). The age of the derogatory credit, as well as the borrower's ability to reestablish good credit in his recent accounts, counseled toward loan approval in this case.

Furthermore, the loan file contained other evidence to offset the borrower's past credit issues. For instance, the borrower's employment documentation indicated that he had been employed at his current job for ten years prior to closing and that his continued employment was "probable" (**Exhibit M-3**). Additionally, the borrower's credit report indicated that he had made timely rental payments for the past eleven years (**Exhibit M-4**). While these factors should have been noted on the MCAW in compliance with Company policy and FHA guidelines, the Department expressly has

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acknowledged that such factors are significant in analyzing a borrower's creditworthiness. See, e.g., HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13. In fact, FHA requirements expressly state that, "if a borrower over the past 12-24 months has met his or her housing obligation as well as other debts, there should be little reason to doubt the borrower's ability to continue to do so." Id. ¶ 2-13(A). Here, the underwriter properly examined all of the information in the loan file and determined that the borrower's past derogatory credit did not affect the borrower's current attitude toward credit obligations and that the loan file contained sufficient factors, such as an excellent rental and employment history, to offset the borrower's past credit history. Thus, the underwriter exercised reasonable discretion in this case and we respectfully maintain that indemnification is unwarranted in connection with this sub-finding.

5. [REDACTED] – FHA Case No. 023-1322842

In the [REDACTED] loan, the Report alleges that the credit report included the following items, but the loan file did not contain additional documentation to mitigate the borrowers' derogatory credit: (1) nine paid collection accounts; (2) two collection accounts paid during the loan process; (3) three accounts with late payments; and (4) a judgment from a previous landlord satisfied two months prior to settlement.

In this case, the underwriter reviewed the totality of the items listed on the borrowers' credit report. While the report included derogatory accounts, the borrowers had incurred a majority of these items over 12 months prior to loan application (**Exhibit N-1**). Furthermore, as acknowledged in the Report, 11 of the accounts were paid in full prior to loan closing. These payments evidenced the borrowers' acceptance of responsibility for their past credit issues and a willingness to satisfy outstanding obligations. The borrowers also provided a detailed explanation for each credit item, which evidenced their efforts to resolve accounts and improve their credit performance (**Exhibit N-2**). With regard to the past judgment, for example, the borrowers' explanation evidenced that this item did not result from the borrower's disregard for his housing obligation, but rather arose out of a dispute with the landlord regarding the early rental termination fee (**Exhibit N-2**). Moreover, while the Report identifies only the derogatory credit, the credit report lists four accounts that the borrowers paid as agreed (**Exhibit N-1**). These accounts also indicated their ability and willingness to satisfy debts.

In addition to the fact that the borrowers' had demonstrated acceptance of responsibility for their credit accounts and efforts to satisfy outstanding obligations prior to closing, additional factors present in the loan file counseled toward extending FHA financing in this case. For example, the borrower's qualifying ratios in this case were 24%/35% (**Exhibit N-3**), which were well within HUD's benchmark guidelines. See

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HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-12. The borrowers' also had stable employment histories. Each had been employed by the current employer for at least two years prior to closing on October 28, 2002 (**Exhibit N-4**), and the co-borrower had held the same position for four years prior to that date (**Exhibit N-5**). Finally, the co-borrower's credit report indicated an excellent rental history for the four years prior to closing (**Exhibit N-6**). The Department expressly has acknowledged that such factors are significant in analyzing a borrower's creditworthiness. See, e.g., HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13. Based on the complete loan file, the underwriter exercised the discretion imparted by the Department and made a reasonable judgment that this borrower presented an acceptable risk. Thus, this allegation should be removed from the Report.

G. OVER-INSURED MORTGAGES

The Report alleges that, based on the Company's treatment of downpayment assistance gifts and/or interest rate buy-downs, nine loans were over-insured. Specifically, the Report asserts that, in eight cases, the builder, KB Home, increased the property sales price in the amount of a downpayment assistance grant and the assistance provider's administrative fees. The Report asserts that the gift funds and fees were financed and repaid by the borrowers over the life of the loans, and thus, the downpayment assistance in these cases was not an eligible gift and the loans were over-insured by the amount of the gifts and administrative fees. The Report also alleges that this practice constituted a *quid pro quo* arrangement, as KB Home required buyers to execute an amendment/addendum increasing the property sales price to accommodate the nonprofit assistance. Finally, in the cases, the Report asserts that the sales prices were also increased to accommodate interest rate buy-downs and, as the borrowers financed the buy-downs through increased sales prices, these loans also were over-insured. We address each of these allegations in turn below.

1. KBHMC Complied with the Department's Downpayment Assistance Grants

In connection with downpayment assistance gifts, HUD guidelines require lenders to document the transfer of the gifts from the non-profit agency to the borrower. Specifically, lenders must obtain evidence from the agency of the amount of the funds being provided, as well as evidence that no repayment by the borrower is required. See HUD Single Family Reference Guide, Page 2-11. KBHMC complied with these requirements in this case and the Report does not question the Company's adherence to its obligations in this regard. In each of the eight loans cited, the borrowers received downpayment assistance from an independent, non-profit downpayment assistance provider. The actual funds received by the borrowers were not provided by the builder.

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While the builder may have made donations to the nonprofit assistance agency in the amount of the assistance gifts received by these borrowers, HUD requirements expressly state that such circumstances are permissible under FHA guidelines, provided that the nonprofit organization receives the contribution from the seller/builder outside of closing of the particular transaction. See Mortgagee Letter 02-22(E). Although KBHMC is an independent company from KB Home, KBHMC understands that the nonprofit agencies wired the funds used for the downpayment assistance in these cases to the settlement agent at or before closing. Thus, the downpayment assistance gifts in these loans came from the nonprofit entities' funds, not KB Home's sales proceeds in these cases, even though KB Home routinely donated funds to the nonprofit entities. Moreover, the gift letters from the downpayment assistance providers expressly state that no repayment of the assistance gift is required. An example of one such letter is attached as **Exhibit O-1**. Therefore, the downpayment assistance grants in the eight cases complied fully with all HUD requirements of which KBHMC is aware.

The Report nevertheless takes issue with the builder's increase of the property sales price in the amount of the assistance grant and the borrowers' increased loan amounts to include the price increases. While the OIG may dislike this practice on the part of builders/sellers, such action by these entities does not violate HUD guidelines. HUD requirements govern only the practices of FHA-approved lenders and require that they follow guidelines to ensure that borrowers qualify for financing and the value of the underlying property for which financing is obtained is supported. We are not aware of any HUD guideline that dictates what considerations a seller/builder must use to determine property value, nor are we aware of any restriction on the increase of the property value in an amount of downpayment assistance gifts. As discussed above, provided that the builder makes contributions to the nonprofit entities after closing, which the Report does not question in this case, HUD guidelines do not govern whether a builder or seller increases a property's sales price in the amount of that future contribution.

Moreover, KBHMC cannot control what factors any builder, including its parent company, uses to set the price of its properties. With regard to property value, a lender can only satisfy itself that the value of the real property securing the loan is supported and is not less than the sales price agreed upon by the buyer and seller. To do so, HUD guidelines require lenders to obtain an appraisal of the property to establish an estimated value for mortgage insurance purposes. See HUD Handbook 4000.2 REV-3, ¶ 2-3. Moreover, HUD requirements expressly state that, rather than any considerations made by the buyers and/or sellers in determining the sales price, "the [appraised] value serves as the basis for determining the maximum insurable mortgage loan." HUD Handbook 4150.1 REV-1, ¶ 1-1. Thus, provided the appraised value

supports the sale price, HUD requirements permit lenders to calculate the maximum mortgage amount based on that value, regardless of how the parties to the sales transaction determine the ultimate sale price. In each of the cases cited in this sub-finding, a third-party appraiser conducted an independent analysis of the property and determined that the value of each property supported the final sale price. The Report does not take issue with the appraisals in this case; rather it suggests that KBHMC somehow could control the builder's decision to increase the sale price based on a downpayment assistance gift. This is not the case. Such determinations by the builder were outside of KBHMC's control and HUD's jurisdiction.

With regard to the allegation that the builder's sales price increase constituted a *quid pro quo* arrangement, KBHMC respectfully disagrees. The Report cited Mortgagee Letter 96-18 to support this allegation. While that Mortgagee Letter expresses concern with nonprofit agencies that receive contributions from builders, it does not prohibit such arrangements. The Mortgagee Letter merely clarifies that arrangements in which assistance from the nonprofit agency is only available if the buyer obtains financing with a particular lender or buys a particular builder's property, or whereby the nonprofit entity compels the recipient to purchase properties owned by the donor of the funds, are inappropriate. Mortgagee Letter 96-18. In the eight cases cited in the Report, we are not aware that the nonprofit agencies in question compelled the borrowers to obtain financing from KBHMC or purchase a property from KB Home. According to the grant award letters, the borrowers received the gift funds from independent nonprofit assistance agencies that expressly stated that the assistance funds were in no way made available to the donor from any person or entity with an interest in the property sale, including the builder or loan officer (**Exhibit O-1**). To the extent that the builder increased the sales price after the borrowers qualified for these assistance grants, it does not follow that such negotiations constituted *quid pro quo* arrangements between the nonprofit entities and the builder, as suggested in the Report. Rather, as discussed above, to the best of KBHMC's knowledge, any contributions made by KB Home to the nonprofit entities were made after the settlements in the eight cases at issue, in compliance with Mortgagee Letter 02-22, which was issued several years after Mortgagee Letter 96-18. Therefore, we maintain that the facts cited in this sub-finding do not constitute violations of FHA guidelines.

We also note that, in several of the cases cited in this sub-finding, while the builder may have increased the sales price based on the purchaser's receipt of downpayment assistance, the builder also provided the purchaser with upgrades at no cost well in excess of the increased purchase price. For example, in the case used as

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an example in the Report,⁴ while the graphic indicates that the sales price was increased \$1,341, which reflected the amount of the non-profit downpayment assistance gift, the Report ignores the \$10,507 in free upgrades the builder provided to the purchase in this sales transaction (**Exhibit O-2**). Though not required to offset the increased purchase price or comply with HUD requirements, this case demonstrates that the borrower ultimately benefited from the builder's price adjustments in this case.

In summary, KBHMC maintains that it satisfied its obligations with regard to documenting and justifying the borrowers' receipt of downpayment assistance gifts in the eight cases at issue. While the OIG may dislike a builder's or seller's increase of a property's purchase price in an amount of such assistance, this practice is not prohibited by HUD requirements, is outside the control of FHA-approved lenders, and does not result in over-insured mortgages. In the cases at issue, in compliance with HUD requirements, KBHMC obtained appraisals to ensure that the sales prices were supported and properly documented the receipt of downpayment assistance funds. As the allegations set forth in this sub-finding do not constitute violations of FHA requirements, and as KBHMC complied with all applicable requirements in connection with downpayment assistance grants, these allegations should be removed from the Report.

2. KBHMC Complied with HUD's Interest Rate Buy-Down Requirements

With regard to buy-down rates, HUD guidelines expressly state that buy-down funds may come from the seller/builder. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14. Provided that these buy-down funds, as well as any other permissible contributions from interested third-parties, do not exceed six percent of the property's sales price, FHA guidelines do not require a dollar-for-dollar reduction in the sales price. See *id.* ¶ 1-7(A). In each of the three cases cited in the Report, KBHMC ensured that any buy-down funds provided by the builder were included in the seller contributions, and that this total amount did not exceed six percent of the sales price. The Company complied with these HUD guidelines regarding buy-down funds, and the Report does not allege otherwise.⁵

⁴ The case cited is ██████ – FHA Case No. 023-1211310.

⁵ While the Report contains allegations regarding the appropriateness of certain borrowers' receipt of interest rate buy-downs, we address these assertions later in this response.

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The Report nevertheless takes issue with the builder's increase of the property sales price in the amount of the buy-down funds and the borrowers' increased loan amounts to include the price increase. While the OIG may dislike this practice on the part of builders/sellers, such actions on the part of these entities is outside of the Department's jurisdiction. As stated above, HUD requirements govern only the practices of FHA-approved lenders and require that they follow guidelines to ensure that borrowers qualify for financing and the value of the underlying property for which financing is obtained is supported. We are not aware of any HUD guideline that dictates what considerations a seller/builder must use to determine property value, nor are we aware of any restriction on the increase of the property value in an amount of buy-down funds. Moreover, KBHMC cannot control what factors any builder, including its parent company, uses to set the price of its properties. With regard to property value, a lender can only satisfy itself that the value of the real property securing the loan is supported and is not less than the sales price agreed upon by the buyer and seller. KBHMC did so in the three cases at issue by obtaining an independent appraisal that supported the ultimate value. The Report does not take issue with the appraisals in this case; rather it suggests that KBHMC somehow could control the builder's decision to increase the sales price based on the builder's provision of buy-down funds. Such determinations by the builder, however, were outside of KBHMC's control and HUD's jurisdiction.

In the three cases at issue, KBHMC maintains that it satisfied its obligations with regard to the borrower's receipt of an interest rate buy-down and properly included those funds in the six-percent seller contribution calculation. While the OIG may dislike a builder's or seller's increase of a property's purchase price in an amount of those buy-down funds, this practice is not prohibited by HUD requirements, is outside the control of FHA-approved lenders, and does not result in over-insured mortgages. As the allegations set forth in this sub-finding do not constitute violations of FHA requirements, and as KBHMC complied with all applicable requirements in connection with buy-down funds in these cases, the allegations in this sub-finding should be removed from the Report.

H. QUALIFYING RATIOS

In 10 cases, the Report contends that the borrowers' debt-to-income ratios exceeded FHA guidelines, and adequate compensating factors were not present. In five of these cases, the Report suggests that compensating factors were added to the MCAW in the Company's loan files before these files were presented to the OIG for review and, as these "potential" compensating factors were not included on the MCAWs

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included in the case binders submitted to HUD, these factors do not appear to have been considered during loan approval.⁶

The Report references Paragraphs 2-12 and 2-13 of the former Mortgage Credit Analysis Handbook, 4155.1 REV-4, CHG-1, which was applicable at the time the subject loans were originated and closed. As stated in Paragraph 2-12, lenders rely on a borrower's qualifying ratios to determine whether the borrower can be expected to meet his or her housing expenses. The Department established benchmark guidelines of 29% and 41% for a borrower's mortgage payment-to-income and total fixed payment-to-income ratios, respectively, and noted that greater latitude is permissible on the front-end ratio. As explained in Paragraph 2-13, the Department permitted an underwriter to rely on compensating factors to approve a loan to a borrower with qualifying ratios that exceed the benchmark guidelines of 29% and 41%. Under such circumstances, Paragraph 2-13 required an underwriter to list compensating factors in the remarks section of the MCAW, and it referenced several compensating factors that could be considered. Prior to the issuance of the new Mortgage Credit Analysis Handbook (4155.1 REV-5), however, which was not effective at the time the subject loans were originated and closed, HUD did not dictate which compensating factors were acceptable, the number of compensating factors that must exist, or the extent to which the benchmark guidelines could be exceeded. HUD delegated all such decisions to the mortgage lender.

As discussed above, the Department has recognized 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. It requires the subjective evaluation of information based on experience in determining whether a potential borrower is creditworthy. An underwriter must carefully weigh all aspects of an individual's case. 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.

⁶ The Report also asserts that, after adjusting for overstated income and understated liabilities, debt-to-income ratios exceeded HUD guidelines for 16 of the loans reviewed; however, compensating factors were not presented by the Company at the time of approval. We have addressed the Department's allegations regarding overstated income and understated liabilities elsewhere in this response. As set forth in those sections, KBHMC respectfully disagrees with many of the allegations regarding income and liability calculations and, in those cases in which it believes such calculations complied with HUD requirements, the Company maintains that the MCAWs accurately reflected the borrowers' qualifying ratios.

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Furthermore, as previously noted, the Department permits a mortgagee to approve a borrower with ratios exceeding the benchmark guidelines of 29% and 41% where significant compensating factors justify loan approval. *See, e.g.*, HUD Handbook 4155.1 REV-4, CHG-1 ¶¶ 2-12, 2-13. Here, while the borrowers' front-end ratios may be higher than HUD's benchmark guidelines, the back-end ratios in several of the loans cited are within HUD's 41% benchmark ratio. As noted above, HUD has indicated that the back-end ratio is the more important of the two, as it reflects the borrower's total funds to total debt. *See id.* Additionally, the Department expressly delegated to lenders the authority to determine what compensating factors exist and the extent to which the benchmark ratios may be exceeded. It did not limit the acceptable compensating factors to any particular items.⁷ 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; *see also* Mortgagee Letter 95-07. Thus, where a potential borrower's ratios are high, an underwriter must consider all relevant circumstances and exercise discretion in deciding whether to approve or reject a loan. Nevertheless, in this sub-finding, the Report second-guesses the Company's underwriting decisions.

The Department enumerated several compensating factors that it will accept, including, among others: (1) a good credit history or conservative attitude towards the use of credit; (2) a minimal increase in housing expense; (3) the potential for increased earnings; (4) the receipt of income not included in effective income; (5) high credit bureau scores; (6) the ability to accumulate savings; and (7) substantial cash reserves after closing. *See* HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgagee Letter 97-26. Notably, the Department did not define these factors. For instance, it did not explain what type of credit history would be considered "good," what amount of increase in housing expenses would be considered "minimal," or what credit bureau scores would be deemed "high." Rather, it left such determinations to individual lenders. Furthermore, while FHA guidelines specifically identify the aforementioned, and other, compensating factors, the Department has recognized that "each loan is a separate and

⁷ The new Mortgage Credit Analysis Handbook, HUD Handbook 4155.1 REV-5, ¶ 2-13, specifies that the 10 compensating factors enumerated in the Handbook are the only compensating factors that will justify approval of a loan to a borrower with qualifying ratios that exceed the benchmark guidelines. This Handbook, however, did not become mandatory until January 1, 2004. HUD Handbook 4155.1 REV-4, CHG-1 was applicable at the time the subject loans were originated and closed. KBHMC therefore had discretion to determine what compensating factors existed.

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unique transaction and that there may be other factors [besides those identified in the FHA guidelines] that demonstrate the borrower's ability and willingness to make timely mortgage payments." Mortgage Letter 95-07.

The Department's concern with respect to compensating factors, as expressed in the above-referenced Handbook provisions and Mortgage Letters, is that lenders too often fail to address which compensating factors justify their approval of a particular mortgage. The guidelines remind lenders of their responsibility to explain why they believe a mortgage is an acceptable risk. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgage Letter 95-07. In compliance with these requirements, KBHMC requires its underwriters to obtain the relevant credit information and documentation. Upon careful consideration of each borrower's unique situation, the underwriter must reasonably determine whether significant compensating factors support approval of a loan. It is KBHMC's underwriting policy to consider the totality of each borrower's circumstances and approve or reject a loan application based upon all available information. Moreover, KBHMC requires its underwriters to note the compensating factors on which they rely in the "Remarks" section of the MCAW. To the extent the underwriter neglected to note every compensating factor in the referenced cases, the Company's files clearly evidence the underwriter's rationale.

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Given that HUD had not yet limited the acceptable compensating factors to those enumerated in the Handbook and had delegated authority to lenders to determine whether compensating factors existed and the extent to which the benchmark ratios could be exceeded, KBHMC adhered to FHA requirements in the cited cases. While the Report questions KBHMC's underwriting decisions in these cases, they do not identify a violation of any particular FHA requirement(s). Rather, they express disagreement with the underwriter's decisions that the compensating factors present in the loan file offset the higher ratios. While we understand and appreciate the OIG's position, HUD delegated to lenders the decision as to whether particular compensating factors are present and sufficient to offset higher qualifying ratios. The Company properly exercised this authority and complied with FHA requirements in the cited cases. There was no cap on permissible qualifying ratios and the compensating factors that KBHMC considered were expressly recognized in the FHA guidelines. The underwriters' decisions were both permissible and reasonable and, thus, indemnification under these circumstances would be inappropriate.

1. **Additional Compensating Factors in Certain Cases**

As stated above, in five of the loans cited in this sub-finding, the Report states that compensating factors were added to the MCAWs in connection with this review, but are not present on the MCAWs included in HUD's case binders.

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KBHMC objects to the inclusion of this allegation in the Report. The tone of the assertion suggests that the Company altered loan documents in an effort to comply with HUD requirements after the fact. To the contrary, the additional factors indicated on the MCAW resulted from the post-closing system in place at the time these loans were originated. As KBHMC clearly explained during the exit interview on July 25, 2005, at that time, the Company was in the process of converting its system to image all documents. It appears that, in some cases, the incomplete MCAW was imaged and submitted in the case binder to HUD for insurance endorsement; however, the more complete MCAW was retained in the "original" hard copy file at KBHMC. During this review, the OIG requested the "original" files and, thus, KBHMC provided these hard copy files. To the extent that the MCAWs in these files contain additional compensating factors not reflected on the imaged MCAWs, this discrepancy resulted from an oversight by the post-insuring Department at the time of closing and case binder submission rather than an attempt by the Company to bolster the compensating factors in any case after the fact.

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Moreover, to the extent that the underwriter inadvertently omitted any compensating factors from the MCAWs in the imaged case binders, it does not follow that the underwriter did not consider these compensating factors in loan approval, as the Report suggests. As pointed out above, to the extent the underwriter neglected to note compensating factors in the referenced cases, the Company's files clearly evidence the underwriter's rationale and all factors were considered in the determination of whether each individual borrower qualified for FHA financing. As the loan files document the additional compensating factors, the Company considered these factors at the time of underwriting, and any differences in the MCAWs resulted from the inadvertent imaging of an incomplete MCAW, KBHMC requests that this allegation be removed from the final Report.

2. Examples of Compliance with HUD Requirements

As discussed above, KBHMC maintains that it complied with HUD requirements regarding qualifying ratios and compensating factors in several of the cases cited in the Report. Below, we summarize the Company's adherence to FHA guidelines in two of these loans.

a. [REDACTED] – FHA Case No. 023-1043232

In the [REDACTED] case, the Report alleges that, after recalculating the qualifying ratios using the correct effective income and recurring liabilities, the borrower's ratios were 35%/71%; however, the loan file did not contain adequate compensating factors to support approval of the loan.

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As discussed earlier in this response, KBHMC disagrees with the allegations regarding the borrower's income and liability calculations in this case. The Company maintains that the income and liabilities indicated on the MCAW were supported by loan file documentation and correctly determined by the underwriter in this instance. Therefore, contrary to the allegation in this sub-finding, the qualifying ratios were 25%/46% (**Exhibit E-1**). While KBHMC understands and appreciates that the underwriter should have listed the compensating factors justifying this higher-than-average back-end ratio on the MCAW, any oversight was harmless in this case. The loan file clearly documents compensating factors in this instance. First, the borrowers purchased an energy-efficient home, which would decrease their utility costs and allow more income to be directed toward housing payments. Moreover, the borrower had enrolled in courses at the University of Phoenix to further her education, which would increase her potential earnings (**Exhibit P**). HUD requirements expressly state that the potential for increased earnings is a compensating factor that may be used in justifying approval where higher qualifying ratios. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13(l). KBHMC therefore complied with HUD guidelines in this instance.

b. [REDACTED] – FHA Case No. 023-1186721

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In the [REDACTED] case, the Report alleges that, based on its recalculation of the borrower's qualifying ratios using the correct effective income and monthly liabilities, the borrower's ratios are 27.02%/41.72%. While the Report acknowledges that the front-end ratio is within HUD guidelines, it alleges that the back-end ratio exceeds HUD's benchmark guideline of 0.72% and, given the borrower's negative credit history, the loan file should have included some "serious" compensating factors.

As discussed above, KBHMC acknowledges that the income reflected on the MCAW inadvertently reflected the non-purchasing spouse's income and that the ratios in this case were higher than those indicated on the MCAW. Nevertheless, when using the accurate income and liabilities to calculate the ratios, the Report acknowledges that HUD's benchmark guidelines are exceeded by less than one percent. Contrary to the suggestion in the Report, the loan file included evidence of significant compensating factors to justify this slightly higher back-end ratio. As discussed earlier, although the borrower had derogatory items in his credit history, all such issues had occurred more than three years prior to loan closing (**Exhibit L-2**), indicating that the borrower had taken responsibility for her credit obligations and refrained from incurring new credit accounts. Furthermore, the loan file indicated that the home was energy-efficient, and that borrower's non-purchasing spouse was receiving a significant monthly disability payment, which was not reflected in the effective income used to calculate the accurate ratio and would be used to assist the borrower in meeting housing costs. See *id.* ¶ 2-

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13(E). Although the underwriter did not state these factors expressly on the MCAW, they were documented in the file and significantly more than compensated for a back-end ratio only 0.72% above HUD's benchmark ratio. Thus, this allegation should be removed from the Report.

I. FEES

In this sub-finding, the Report alleges that, in 19 cases, the borrowers paid excessive, unallowable, or unearned fees.

KBHMC's policy consistently has been to charge only those fees permitted by HUD requirements. See HUD Handbook 4000.2 REV-2, ¶ 5-2. Nevertheless, the Company recognizes that the fees cited in the Report should not have been charged to the borrowers. Please note that the Company discontinued charging the referenced fees prior to the OIG's review. The Company currently scrutinizes all fees charged to borrowers to ensure that it charges only those fees permissible under HUD guidelines in FHA-insured transactions. Moreover, KBHMC has trained all staff that only those fees permitted by FHA guidelines may be passed onto the borrower in FHA loans. We are confident that the fees identified in the Notice are not currently charged to borrowers in FHA transactions originated by the Company. Nevertheless, KBHMC would agree to refund these fees should the Department deem such refunds appropriate.⁸

J. INTERESTED THIRD PARTY INVOLVEMENT

In this sub-finding, the Report generally alleges that the Company permitted the builder's sales representatives to collect pay stubs, W-2 forms, and bank statements from the borrowers. The Report further alleges that loan processors and loan counselors, who were paid incentives based on their retention rates, also certified to underwriter conditions in all 19 cases, as evidenced by the internal KBHMC condition sheets. The Report concludes that KBHMC's procedures effectively transferred the ultimate underwriting eligibility determinations from the underwriters to commissioned loan processors and loan counselors. Finally, in one case, ██████ – FHA Case No. 023-1135453, the Report repeats its allegation that the loan counselor knew of and may have created false employment documentation.

⁸ As the Report indicates, the Company has already agreed to refund one of the fees cited in one case, ██████ – FHA Case No. 023-1185414, in response to a post-endorsement technical review conducted by the Santa Ana Homeownership Center's Quality Assurance Division.

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With regard to the allegations concerning the loan processor certifications and the Bell loan, the Report sets forth these identical allegations earlier in the Report, and this response addressed these allegations above. We believe that it is unnecessarily repetitive to include the identical allegations in this section of the Report and that such repetition merely furthers the Report's apparent attempt to discredit the Company.

With regard to the assertion regarding the documentation received from the builder's sales representatives, KBHMC objects to the inclusion of this finding in the Report, as the Company maintains that this activity does not constitute a violation of FHA requirements. KBHMC understands and appreciates HUD's requirement that "credit reports" and "[v]erification forms must pass directly between lender and provider without being handled by any third party" and that faxed documents should be verified. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 3-1; Mortgagee Letter 01-01. It is KBHMC's policy and practice to obtain credit reports and verifications directly from the providers and to ensure that faxed documentation is accurate and complete.

KBHMC, however, is unaware of any prohibition in place at the time the loans cited in the Report were originated against a borrower furnishing pay stubs, W-2 forms, or bank statements, or against a borrower's use of a third party's facilities to do so. Paragraph 3-6 of the Mortgagees' Handbook Application Through Insurance (Single-Family), cited in the Report as the basis of Finding 3, states: "The credit report and verification forms must not pass through the hands of the applicant, a real estate agent, or other interested third party." (emphasis added). The Handbook references credit reports and verification forms, not bank statements, pay stubs, or W-2 forms. In fact, the Handbook expressly states that the "applicant must provide a copy of his/her most recent pay stub." HUD Handbook 4000.2 REV-2, ¶ 3-6(B)(2) (emphasis added). The Mortgage Credit Analysis Handbook further states that, regarding employment documentation, a lender may obtain pay stubs and W-2 forms "from the borrower," and, regarding verifications of deposit, a lender may obtain bank statements "from the borrower." HUD Handbook 4155.1 REV-4, CHG-1, ¶ 3-1(E) and (F). The HUD guidelines cited in the Report as the basis of the allegations in Finding 3 only address the provision of verifications of deposit and employment, and do not restrict lenders from accepting faxed copies of other required documentation from borrowers. In compliance with these requirements in the cited cases, KBHMC obtained credit reports and verification forms directly from the credit bureaus, banks, and employers, and it obtained pay stubs, bank statements, and other documents from the borrowers.

Furthermore, as you know, borrowers often meet with loan officers outside of a lender's office in order to accommodate a borrower's work schedule, and borrowers often use fax machines made available by real estate agents or builder representatives,

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to which the borrowers would not otherwise have access, in order to deliver documents to the lender. Here, the borrowers made use of the builder's facilities for this purpose. Whether the borrowers personally faxed the documents to the Company or handed the documents to a representative of the builder, the borrowers themselves would have brought most of the documents to the builder's sales office for delivery to KBHMC.

Therefore, contrary to the allegations in the Report, FHA requirements do not prohibit lenders from obtaining bank statements, pay stubs, or W-2 forms from the borrowers. As the borrowers in these subject cases frequently visited the builder's sales offices to complete documentation in connection with these transactions, they provided KBHMC with these documents by using the builder's facilities. This practice complied with FHA requirements in effect at the time these loans were originated. As no violation of HUD/FHA requirements exists in this regard, this allegation should be removed from the final Report.

K. BUY-DOWN RATES

In five loans involving temporary interest rate buy-downs, the Report contends that the loan files did not demonstrate that the scheduled mortgage payment increase would not adversely affect the borrowers' risk of default and that, on all five loans, the qualifying ratios exceeded HUD maximum amounts.

KBHMC's policy regarding interest rate buy-downs consistently has required underwriters to establish that the eventual increase in mortgage payments will not adversely affect the borrower and lead to default. To do so, FHA guidelines provide that the borrower must have the potential for increased income that would offset the scheduled payment increases, a demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expenses, substantial assets available to cushion the increased payments, or a cash investment in the property that substantially exceeds the minimum required. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). In the cases cited in the Report, to the extent that the loan files did not evidence one of these four factors, the absence of such documentation was against Company policy. As discussed above, all of the loans at issue in the Report, including those cited in this sub-finding, were underwritten by one individual. As discussed above, this individual violated Company policy in addition to HUD requirements in certain of her underwriting decisions. KBHMC discovered these issues in 2002, and promptly terminated her employment. Thus, we believe that any issues identified in the Report regarding this individual's underwriting performance have been effectively resolved.

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Nevertheless, KBHMC disagrees with the Report's assertions in two cases cited in this sub-finding. In these two cases, the files documented that the borrowers had, among other things, the potential for increased earnings, and would be able to handle the increased mortgage payments. KBHMC adhered strictly to FHA requirements in these cases, and the allegations regarding these loans are inappropriately included in the Report. We address each loan in turn below.

1. [REDACTED] - FHA Case No. 023-1052683

In the [REDACTED] loan, contrary to the allegation in the Report, the loan file did contain evidence indicating that the scheduled mortgage payment increase would not adversely affect the borrowers and likely lead to default. While KBHMC acknowledges that the compensating factors present in this case should have been noted on the MCAW, and has reminded its current employees of their obligation in that regard, loan file documents supported the borrower's potential for increased income that would offset the scheduled payment increases, one of the express criteria set forth by the Department. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). Specifically, the borrower's income documentation indicated that his overtime had increased during the few months prior to closing (**Exhibit Q-1**). Furthermore, the loan file indicated that the co-borrower had recently been hired as a salesperson, and was expected to increase his earnings to between \$2,500 and \$3,000 per month (**Exhibit Q-2**). Neither the borrower's overtime income, nor the co-borrower's potential increased earnings as a salesperson were included in the borrowers' effective income. Thus, this income demonstrated the potential for increased income that would offset the borrowers' scheduled payment increases in this case.

We note that the OIG suggested in correspondence in connection with this review that, as such income had not been verified in accordance with HUD requirements for effective income, that such earnings increases would not constitute appropriate documentation to determine a borrower's ability to handle future payment increases in buy-down transactions. KBHMC respectfully disagrees. While the Company appreciates that the loan file documentation did not cover the requisite period necessary to use the income to qualify the borrowers (and, therefore, the Company did not include these earnings in that calculation), the requirements regarding buy-down considerations instruct lenders to determine the "potential for increased income that would offset the scheduled payment increases." See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). Here, the borrower's recent increase in overtime and the co-borrower's new employment clearly indicated that both borrowers had the potential for increased earnings, and these factors established the borrower's ability to meet the

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increased future payments. KBHMC complied with HUD requirements in this case and this loan should be removed from consideration in this sub-finding.

2. [REDACTED] – FHA Case No. 023-1254460

In this case, contrary to the allegation in the Report, the loan file documentation indicated that the scheduled mortgage payment increase would not adversely affect the borrowers and likely lead to default. While KBHMC acknowledges that the compensating factors present in this case should have been noted on the MCAW, and has reminded its current employees of their obligation in that regard, loan file documents supported the borrower's potential for increased income that would offset the scheduled payment increases, one of the express criteria set forth by the Department. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). Specifically, the borrower was employed at two separate Denny's restaurants; however, only his income from one of these positions was included in the effective income in this case. The loan file contained two separate letters from each restaurant's manager demonstrating his length of employment and pay rate (Exhibit R-1). Moreover, the borrower had recently begun working for another restaurant, Abuelo's, at the time of origination (Exhibit R-2). As the borrower had only been employed by this restaurant for a few months, the income he earned in this position was not included in effective income. Thus, both the additional Denny's position and the recent Abuelo's job indicated that the borrower had the potential for increased earnings above those wages reflected in his effective income. These additional earnings evidenced the borrower's ability to manage the scheduled payment increases in connection with the interest rate buy-down. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-14(A)(4). Thus, this allegation should not be included in the Report.

L. PAYMENT OF DEBTS

The Report asserts that, in four loans, third parties paid off borrowers' consumer debts. The Report reaches this conclusion by alleging that the debts were paid using either the seller's funds or a nonprofit downpayment assistance gift/loan, because: (1) the borrowers provided little or no money at closing; (2) the source of funds used to close primarily consisted of a nonprofit downpayment assistance gift, secondary financing, or seller loan proceeds; and (3) the consumer debts were paid at closing.

KBHMC takes exception to the Report's analysis in one of the loans cited, [REDACTED] – FHA Case No. 023-1107968, and maintains that the payment of the borrower's debts at closing in this case did not constitute a violation of FHA requirements. The Report references Mortgagee Letter 02-02 to support its allegations in this case. As discussed during the exit conference on July 25, 2005, that Mortgagee Letter clarified

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that the FHA was concerned with the "[e]limination of consumer debt ... prior to obtaining FHA insured mortgage financing in order to have a favorable debt to income ratio." Mortgagee Letter 02-02 (emphasis added). The Department therefore stated that, "[w]hen a property seller or nonprofit has paid a homebuyer's consumer debts in order to meet debt to income ratios, the mortgage credit approval of such a borrower would not be considered by FHA to be acceptable underwriting." Id. (emphasis added). KBHMC requires its underwriting staff to comply with the directive set forth in Mortgagee Letter 02-02, and prohibits the use of downpayment assistance gifts to satisfy a loan applicant's debts prior to loan approval in an effort to improve the applicant's qualifying ratios. The Company requires its underwriters to include all outstanding debts at the time of application into the borrower's ratios to ensure that the underwriter accurately analyzes the borrower's credit situation independent of any non-profit assistance.

In the [REDACTED] loan, the debts were paid at closing, and not prior to underwriting or loan approval. The debts referenced in the Report were considered by the underwriter in analyzing and approving this loan and were not satisfied in order to meet HUD requirements regarding debt-to-income ratios. The MCAW indicates that the underwriter considered \$1,088 in debts to qualify this borrower for FHA financing (**Exhibit R-3**). After loan approval, the borrower decided to satisfy certain outstanding debts at closing, which totaled approximately \$200. The debts paid off at closing, which are reflected on the HUD-1 (**Exhibit R-4**), were included in the total liability payment of \$1,088 used to qualify the borrower on the MCAW, but were not included in the borrower's total debts of \$888 referenced on the final URLA (**Exhibit D-4**). While the borrower also received a downpayment assistance gift from a non-profit entity, we do not believe that this transaction contravened the directive set forth in Mortgagee Letter 02-02. As the debts in this case were considered in the underwriting analysis and were not paid prior to closing in order to qualify the borrower for the FHA-insured loan, we are not aware that the facts in this case constituted a violation of FHA requirements. Therefore, the allegation regarding the [REDACTED] loan should be removed from the final Report.

M. DOWNPAYMENT VERIFICATION

Finally, the Report alleges that, in 4 loans, the downpayment was unverified or provided by an interested third party. Specifically, the Report asserts that, in 3 cases, the loan file did not contain evidence of the source of large, unusual deposits shown on bank statements. Additionally, in one loan, the Report indicates that the borrower stated during an interview that he used a real estate agent's funds to close because he did not have sufficient funds.

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KBHMC understands and appreciates that a lender must verify all funds used for the borrower's investment in the property. It is the Company's policy and procedure to verify all sources of funds used to close to ensure that borrowers derive all funds from acceptable sources. With regard to deposits into borrower accounts, KBHMC requires its underwriters to examine the borrower's bank statements and, to the extent that any deposits constitute a large increase in the account, obtain evidence of the source of the deposit. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-10(B). The underwriter responsible for analyzing and approving the loans at issue in this sub-finding was subject to these policies and procedures. To the extent that large deposits or sources of closing funds were not documented or were derived from unacceptable sources, this underwriter violated Company policy, as well as FHA requirements, in these cases. We note that KBHMC identified this underwriter's performance issues two years prior to the OIG's review and terminated her employment with the Company. Thus, we believe that any outstanding issues regarding this allegation have been resolved. Nevertheless, KBHMC respectfully disagrees with the allegations in two of the cases cited.

1. ██████ – FHA Case No. 023-0687906

In the ██████ loan, the Report alleges that the loan file did not verify that the borrowers had the \$2,421 paid into the escrow account for closing, as KBHMC was required to obtain two bank statements to establish sufficient funds; however, the Company obtained only one bank statement.

Contrary to the allegation in the Report, the loan file contained bank statements evidencing two-months of transactions. The bank statement included in the loan file covered the period between March 8, 2002 and May 8, 2002 (**Exhibit S**). This statement evidenced regular deposits into the borrower's account, did not indicate any large, unexplained deposits, and demonstrated that the borrower had sufficient funds in the account from which to derive the \$2,421 placed into escrow as part of their cash investment (**Exhibit S**). KBHMC complied with HUD requirements in this case and this allegation should be omitted from the final Report.

2. ██████ – FHA Case No. 023-1028162

In the ██████ case, the Report asserts that the source of the borrowers' \$4,700 cash investment paid into escrow was not verified, as the bank statement shows an unusual deposit of \$2,500 into the borrowers' bank account before the cash investment was made.

Contrary to the allegation in this case, the referenced \$2,500 deposit was not unusual under the circumstances and was verified. The borrowers provided a

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statement indicating that the funds used for the escrow deposit were derived from their income and the borrower's recent overtime earnings (**Exhibit T-1**). The loan file evidenced that the borrowers earned income of over \$2,500 per month (**Exhibit K-4**). Based on their earnings and their explanation letter regarding additional overtime payments and their savings regarding personal items, the underwriter reasonably determined that the borrowers had sufficient funds in their own account to make the escrow deposit, and documented both the deposit (**Exhibit T-2**) and their ability to accumulate the funds used for the deposit (**Exhibit T-1**). As this deposit was not large or unusual, the underwriter had no reason to verify the source of these funds. KBHMC complied with HUD guidelines in this loan, and this allegation should therefore be removed from the final Report.

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III. CONCLUSION

The Report portrays KBHMC as having inadequate controls and suggests a pattern and practice of disregarding underwriting requirements. This characterization is untrue and unsupported by the Report's findings.

To the contrary, as discussed throughout this response, all nineteen of the cases reviewed were underwritten by one individual. At the time the loans at issue were originated, KBHMC's policies and procedures complied with FHA guidelines; however, this underwriter acted contrary to both Company policy and FHA requirements. The Company discovered this individual's errant behavior and terminated her employment in December of 2002 (more than two years before the OIG began its review). Moreover, in many of the cases cited, the Report's allegations are at variance with the facts, do not constitute violations of FHA requirements, or constituted harmless errors that do not justify the penalties recommended by the OIG. Many of the specific underwriting deficiencies alleged in the Report focus largely on subjective decision-making, and many allegations tend to second-guess the underwriter's decisions without identifying actual violations of FHA requirements.

As discussed throughout the Report, KBHMC generally complied with FHA underwriting requirements, made loans to qualified FHA borrowers, and established effective management supervision and controls. All of the loans cited in the Report were originated in 2002. Since then, KBHMC has made several management changes, and has continued to enhance its underwriting practices and Quality Control and Compliance Departments. The Company identified and responded to operational and underwriting concerns, and it has exercised responsible management supervision. The Company's success in this area is demonstrated by its improved default/claim rate, and the concerns identified in the Report are no longer an issue at KBHMC. Stringent controls are in place to ensure that Company personnel adhere to both KBHMC's and HUD's requirements.

We hope the OIG will consider this response and supporting documentation. We trust that, after reviewing these materials, you will agree that KBHMC's policies and practices complied with FHA requirements, that any deficiencies identified in the nineteen loans cited in the Report resulted from the actions of one individual, and that the Company properly handled the dismissal of this individual and strengthened its underwriting and Quality Control efforts to ensure that all employees strictly comply with Company policy and FHA guidelines. Based on these facts, we request that the final Report be revised to reflect the precise circumstances surrounding the loans. At a

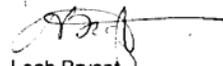
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minimum, the Report should clarify that one individual underwrote all nineteen loans at issue and that KBHMC terminated all underwriters interviewed by the OIG for cause. We also ask that the statements currently included in the Report that are inaccurate, repetitive, overstate the deficiencies identified, or do not constitute violations of FHA requirements be removed from the final Report. Including these inaccurate or overstated conclusions in the Report will adversely affect a publicly-traded company as well as unnecessarily damage KBHMC's reputation. We respectfully request that the OIG revise its recommendations to fit the facts of this case.

If you have any questions concerning the matters discussed herein, please contact our in-house counsel, Donald Bundy, at (310) 893-7315, or KBHMC's Washington counsel, Phillip L. Schulman, at (202) 778-9027.

Thank you for your consideration.

Sincerely,



Leah Bryant
President

Enclosures

cc: Phillip L. Schulman, Esq.

OIG Evaluation of Auditee Comments

- Comment 1** In our opinion, many of the problems identified in the 19 loans we reviewed occurred because KB procedures during 2002, at the very least permitted, and (based on the evidence) prescribed that underwriters certify loans that they had not adequately determined met HUD requirements. This was a systemic issue resulting from undue actual or perceived corporate pressure to approve loans. It cannot reasonably be attributed to one “rogue” underwriter. KB’s poor national default/claim loan performance and the company wide remedial actions KB implemented (as repeatedly mentioned in KB’s comments) are clear evidence and acknowledgement that problem loans were not isolated to one office or to one underwriter. We do recognize that KB has taken positive actions in an attempt to address deficiencies in the loan origination process. Where appropriate, we have made revisions to this final report to address the overall and specific concerns expressed in KB’s response.
- Comment 2** We interviewed four former KB underwriters including one underwriter who was terminated in 2005, after HUD formally notified her of her Limited Denial of Participation. We do not normally conduct interviews with only former employees, however, at the entrance conference KB’s attorney told us we could only speak with current employees if their supervisor was present. We felt that under those circumstances, employees would not provide candid responses.
- Comment 3** KB makes electronic images of loan files, so their ability to locate files should not have been greatly encumbered by the transfer of business to Countrywide Home Loans.
- Comment 4** KB contends they addressed the problem of poor Phoenix area loans by closing the Tempe branch office on December 30, 2002. They do not mention that they had just obtained approval for a new branch office serving the same metropolitan Phoenix area on December 18, 2002, or that all Arizona loan underwriting was handled out of their Las Vegas Regional Operations Center. In fact, little if any business was ever likely conducted in the Tempe branch since preliminary applications, as well as bank statements, pay stubs and W-2 forms were routinely collected at the builder sales offices. In addition, many of the loan counselors and loan processors involved in the 19 loans we reviewed appear to have been physically located in the Las Vegas Regional Operations Center, not in Tempe. Although we asked KB for home addresses and work locations for their then current and former employees, we were only provided with employee listings showing their geographic and/or programmatic areas of responsibility.
- Comment 5** KB’s portrayal of their supposed proactive termination of this underwriter is inaccurate. HUD affirmed her Limited Denial of Participation on March 29, 2005, and KB terminated her employment effective on April 25, 2005. Her KB separation notice states that she was terminated because of the HUD sanctions, not due to “poor performance.”

- Comment 6** Resolution of the issues cited in the two prior HUD Quality Assurance Division reviews of Tucson (July 2002) and Phoenix (March 2004) branch office originations were case specific remedies, not procedural changes or improvements relating to the operation of either branch. Resolution for the Tucson branch review included indemnification agreements for 7 of 19 loans. The Phoenix branch review was resolved with indemnification agreements on 6 of 15 loans
- Comment 7** We interviewed four former KB underwriters.
- Comment 8** We interviewed three former underwriters that said KB strongly discouraged the disapproval of any loans; that they were told to condition rather than disapprove loans; and that if the builder wanted a loan approved, it would be approved. The fourth former KB employee we interviewed only worked as an underwriter for three months during 2003 and never underwrote any HUD loans. This underwriter could neither confirm nor deny the statements made by the other three underwriters.
- Comment 9** Subsequent to the exit conference, KB provided us with an extensive listing of cases they claim pertained to loan applications that were denied by 21 different underwriters or by an automated underwriting system. We requested that KB provide us with the actual case files for 30 cases we selected from KB's listing so that we could confirm they did in fact represent legitimate underwriter denials. KB provided us with 7 of the 30 case files we requested and 15 additional case files that they selected. The former underwriters told us that the vast majority of these cases would have been pre-screening denials, not underwriter decisions to deny applications. That is, loan counselors requested that underwriters deny the applications in KB's automated loan origination system because the loan counselors had determined during pre-screening that it would be a waste of time trying to get the applicants qualified. Loan counselors did not have user access or authority to deny loans in KB's computer system, so underwriters were asked to deny the applications to free up the related properties for sale to other prospective buyers. Although several of the 22 case files KB provided do include some evidence of underwriter evaluation of the cases, most of the cases, including many of those selected by KB, show no evidence of underwriter evaluation but do include notes indicating the loan counselors or KB managers instructed the underwriters to deny the loans.
- Comment 10** During the audit, we requested copies of all KB loan origination policy and procedure statements. KB provided us with only those policy and procedure statements they deemed pertinent to our review. They did not provide any policy or procedure statement describing the preparation or use of their internal underwriter condition sheet.
- Comment 11** Here KB acknowledges that the underwriter would not have seen critical credit, employment, and source of funds documents for the loans we reviewed, although

they attribute this fact to the underwriter's noncompliance with KB's (undocumented) policy relative to the use of asterisks on the underwriter condition sheet. Nevertheless, they state repeatedly in responses to individual cases that the underwriter "...had no reason to question..."; "...exercised reasonable discretion..."; "...properly examined..."; "...made a reasonable judgment..."; or "...analyzed the totality of the circumstances..." in approving the loans. The acknowledgement by KB that the underwriter did not see the complete qualification packages subsequent to conditional approval invalidates all arguments as to proper "underwriter" determinations.

Comment 12 The problem with KB underwriters signing the HUD-92900-A certifications and Mortgage Credit Analysis Worksheets for loans which they did not underwrite does not appear to be limited to just six loans. We have identified 549 cases where the KB loan origination database shows the loan as underwritten by a different underwriter than is shown in the HUD Single Family Data Warehouse system. We plan on addressing this issue during our followup review.

Comment 13 As stated in Comment 10 above, KB did not provide us with any policy or procedure statement relating to the underwriter condition sheets or the implications of an asterisk next to any underwriter conditions. KB does acknowledge that loan processors and loan counselors signed off on underwriter conditions relating to credit, employment, and funds documents which should have been verified by the underwriter. They again concede that these critical qualification documents would not have been provided to the underwriter for review absent the asterisk. Therefore, their attributing these occurrences to a single underwriter's violation of KB's thus far unsubstantiated "policy" regarding the underwriter condition sheets is unjustified.

Comment 14 Per the examples KB provided of their incentive compensation programs, loan counselors could receive payments of a flat \$200 per loan for all loans closed during a given month. Loan counselors could also receive an additional payment of up to \$200 per loan based on their individual overall retention rate. A retention rate of 80 percent or more would qualify for the full \$200 per loan payment. Similarly, the loan processors incentive compensation program specifies that processors were eligible for incentive payments of up to \$10 per loan based on their individual overall retention rate. The KB incentive compensation programs for loan counselors and processors provided for other additional compensation based on community or division customer satisfaction scores. However, the initial \$200 per closed loan payments to loan counselors, and the retention based payments to both loan counselors and processors constitute unallowable commission payments by any definition.

Comment 15 KB employees who would have been involved in or at least aware of the false employment documents would have primarily been loan counselors and loan processors. Terminating the underwriter and closing the Tempe branch did not address or resolve the problem (see Comment 4).

Comment 16 Case No. 023-1063809 – Employment Documentation The underwriter had no reason to question the information set forth in the telephone verification of employment for the coborrower only because, as indicated by the initials on the underwriter condition sheet, the underwriter never saw the telephone verification. If the underwriter had seen the telephone verification, there would have been reason to question its authenticity. The loan file contained several pay stubs from The Picture People ranging from October 2001 through March 22, 2002. The pay stubs show the coborrower had been working between 53 to 88 hours each pay period between October 2001 and January 2002. Pay stubs for February and March 2002 indicate the coborrower worked significantly fewer hours. The final pay stub, dated March 22, 2002, covering a two-week period from March 2, 2002 to March 16, 2002 shows the coborrower only worked 10 hours and cashed-out her vacation time. The pay stubs depict the final days of the coborrower's employment in clear contrast with the subsequent false telephone verification.

Comment 17 Case No. 023-1107968 – Employment Documentation As in the previous case, the underwriter condition sheet indicates that the underwriter would not have seen the false telephone verification. If the underwriter had reviewed the telephone verification as required by HUD and KB's stated policy, there would have been several reasons to question its authenticity. There were also other very apparent discrepancies in the loan application and employment documents for the coborrower. Notably, the W-2s in the loan file contradict the telephone verification statement that Air One Transport bought Express Parcel. KB also improperly used a pay stub from Air One Transport to supplement the pay stub from Express Parcel to meet the 30-day pay stub requirement. Lastly, the Universal Residential Loan Application only showed employment from Express Parcel and not Air One Transport.

Comment 18 Case No. 023-1043232 – Income Calculation There are no documents in the file to support KB's contention that the borrower was salaried versus an hourly employee. In fact, the single bi-weekly pay stub KB used to project monthly earnings shows overtime earnings, which is atypical of salaried employees. This same pay stub dated March 15, 2002, shows identical amounts earned for the pay period as well as for the year-to-date. There was no explanation in the loan file for this anomaly. It was not reasonable to calculate the borrowers income as a salaried employee based entirely on the one questionable pay stub. Regarding child support, HUD Handbook 4155.1 REV-4 Paragraph 2-7 F requires evidence of actual receipt of the child support payment for the previous twelve months. This is in addition to a copy of the divorce decree. The banks statements show recurring deposits in irregular amounts over a period of only seven months and do not constitute acceptable evidence according to the handbook. The divorce decree provided for the child support payments to be processed through the court, so deposits of any payments from the court should have been in consistent recurring amounts. The loan file does not include copies of cancelled checks or other acceptable evidence of the purported child support payments, and the bank

statements (which do not constitute acceptable evidence) cover only seven months.

- Comment 19** Case No. 023-1186721 – Income Calculation By KB’s own admission, the non-purchasing spouse’s income was erroneously included on the Mortgage Credit Analysis Worksheet. This resulted in a significant understatement of the qualifying ratios that were used in the underwriting decision and illustrates a pattern of serious underwriting deficiencies related to this case.
- Comment 20** Case No. 023-1043232 – Liabilities Calculation The credit report shows two separate American Express accounts of approximately the same amounts (\$3,937 at \$196 per month and \$3,892 at \$194 per month). We excluded the first account from our calculation of borrower liabilities since it was the responsibility of the ex-husband per the divorce decree. The second account was the responsibility of the borrower, and KB should not have excluded that account from the calculation of borrower liabilities.
- Comment 21** Case No. 023-1113441 – Liabilities Calculation HUD Handbook 4155.1 REV-4, Paragraph 2-11.C, requires that student loans be included in borrower monthly obligation calculations unless the borrower can provide evidence that the debt may be deferred beyond twelve months of closing. The most recent credit report shows nine student loans outstanding and totaling nearly \$24,000. The two Fst Nat-Lub accounts are included in the nine open accounts under a new creditor (Panhandle). KB did not obtain evidence that any of the student loans were deferred beyond twelve months of closing as required. Neither is there any evidence in the loan file suggesting the borrower was still enrolled in school. The credit report shows four of the student loan accounts as having been active within the previous year with adverse ratings.
- Comment 22** Case No. 023-1254460 – Liabilities Calculation The borrower’s \$4,329 debt should not have been excluded from the qualifying ratio calculation. KB inappropriately assumed that the borrower would have paid four \$355 payments on the \$4,329 loan between April 15 and August 30, 2002. HUD Handbook 4000.2 REV-2, Paragraph 3-6 stipulates that credit documents must be no more than 90 days old at the time of underwriting. KB relied on a credit report that was 137 days old. In order to exclude the debt, a new credit report should have been obtained to substantiate that there were less than ten months of payments remaining on this account.
- Comment 23** Case No. 023-0687906 – Credit History According to HUD Handbook 4155.1 REV-4 Paragraph 2-4, alternative or nontraditional credit accounts may be used to supplement a traditional credit report having an insufficient number of trade items reported, but may not be used to offset derogatory references in the traditional credit report. Also, prior collection accounts must be given due consideration in evaluating the borrower’s credit worthiness regardless whether they are paid off prior to closing or not. The credit reports demonstrate that the coborrower

allowed several accounts to remain in collection during the two years prior to the loan application, all while continuously employed and earning income KB considered viable for use in the mortgage loan qualification. Finally, neither of the two letters purportedly from the borrower and coborrower explaining prior credit problems and numerous recent credit inquiries are signed or dated. Unsigned attestation or certification documents are not valid for any real estate transaction. The underwriter conditionally approved the loan subject to satisfactory letters explaining the prior delinquent credit and recent inquiries. The loan counselor's initials on the underwriter condition sheet relative to these conditions demonstrate that the underwriter never saw the explanation letters.

Comment 24 Case No. 023-1028162 – Credit History The most recent credit report only showed two derogatory accounts. However, these were two of only three total credit accounts, and one of the derogatory accounts was a collection account still owing. The only other account shown on the credit report was a child support obligation reported by the Arizona Department of Economic Security. Documentation of alternative credit included: statements from Cox Cable (for both basic and expanded service); a four month old statement from Arizona Public Service indicating the borrower had past due payments in three of the preceding seven months; an undated statement from Southwest Gas reporting four late payments in twelve months of service; and an auto insurance coverage certificate. Other than the cable company obligation, the only credit documented for this borrower was bad credit. The underwriter did not analyze the totality of the circumstances and reasonably determine that the borrower presented a reasonable credit risk as claimed by KB. The underwriter condition sheet shows that the loan counselor signed off on all but 3 of 36 conditions imposed for loan approval. The underwriter never saw any of the documentation she deemed necessary to resolve the unacceptable credit history.

Comment 25 Case No. 023-1186721 – Credit History HUD Handbook 4155.1 REV-4, CHG-1, Paragraph 2-3E provides that Chapter 7 liquidation will not disqualify the borrower if at least two years have passed since the bankruptcy was discharged and the borrower has reestablished good credit and demonstrated an ability to manage financial affairs. However, the borrower had not reestablished good credit. In fact, the borrower had derogatory debts on her credit report that were incurred after the bankruptcy, some of which were not paid until loan closing. The debts included an almost \$8,000 charge off (remained outstanding after loan closing), a civil judgment for an unpaid debt, and other collection/charge off accounts. The underwriter did not analyze the totality of the circumstances and reasonably determine that the borrower had accepted responsibility for her credit obligations and presented an acceptable risk. As evidenced by the underwriter condition sheet, the loan counselor signed off on all but 2 of 20 conditions imposed for loan approval. The underwriter never saw any of the documentation she deemed necessary to resolve the unacceptable credit history.

Comment 26 Case No. 023-1211310 – Credit History HUD Handbook 4155.1 REV-4, CHG-1, Paragraph 2-3 states that while *minor* derogatory information occurring two or more years in the past does not require explanation, *major* indications of derogatory credit, including judgments and collections, and any other recent credit problems, require sufficient written explanation from the borrower. Although the original debts for many of the derogatory credit accounts were incurred more than two years prior to the credit report date, at least three of these accounts had missed or late payments within one year of the credit report. One of the collection accounts remained outstanding for over two years, and seven charge off or collection accounts were not paid prior to or at closing. KB points to the stability and longevity of the borrower’s employment as offsetting the past poor credit performance. In reality, the disregard of credit obligations during periods of stable employment is a more serious impediment to credit qualification than poor credit performance during periods of unemployment. The loan file does not include any explanation for the unacceptable credit history. Contrary to KB’s assertion, the underwriter did not analyze the totality of the borrower’s credit history, did not examine all the information in the loan file, and did not determine that the past derogatory credit did not affect the borrower’s current attitude toward credit obligations. The underwriter did not verify even one of the 37 conditions she imposed for loan approval per the condition sheet.

Comment 27 Case No. 023-1322842 – Credit History The underwriter did not review the “totality” of the borrower credit history. This is evidenced by the fact that someone other than the underwriter signed off on several credit related condition sheet items. Actually, the totality of the credit qualification documents for this loan clearly depicts an unacceptable credit risk. Although the collection and charge off accounts are excluded from the total debt qualifying ratio calculation, the handbook does require that they be considered in the overall credit qualification decision. In this case, over \$10,000 in chargeoff and collection accounts were not paid off prior to closing and several had been referred to collection agencies or attorneys. Although some of the accounts with derogatory histories were opened twelve or more months prior to loan application, two collection accounts and one of the delinquent accounts were opened within four months preceding the original loan application. Finally, the stability of both borrowers’ employment is not a compensating factor for their poor credit. A pattern of credit abuse and disregard for financial obligations during periods of stable employment is actually an even greater impediment to proper credit qualification than credit problems attributable to periods of unemployment.

Comment 28 Mortgagee Letter 96-18 provides that it is inappropriate to approve “quid pro quo arrangements whereby assistance is only available if the buyer obtains financing with a particular lender or buys a particular builder’s property.” The mortgagee letter also states “the source of funds for the gift to the borrower must be totally unrelated to the loan transaction.” The nonprofit gift program utilized by KB Home (builder/seller) for the loans we reviewed was clearly in violation of the

mortgagee letter as well as HUD Handbook 4155.1, which states that no repayment of a gift may be expected or implied. The purchase agreement addendums wherein buyers were required to agree to increased sales prices in order to receive the gift funds were definitely tied to the purchase of the specific KB Home properties to which the purchase agreements applied. The example of a purchase agreement addendum (shown in Figure 2 of the report and referenced as Exhibit O-2 b in KB's response) also specifies that the gift was conditioned upon the buyers obtaining financing through KB Home Mortgage Company. By requiring buyers to agree to an increased sales price to accommodate the gift amount plus the nonprofit administrative fee, KB Home as seller was obtaining repayment of the gift funds from the buyer. Any other seller "incentive" contributions to these transactions were irrelevant to the inappropriate treatment of the gift funds.

Comment 29 Normally, interest rate buydown funds are provided by the seller, and any such seller contributions in excess of the allowable six percent maximum must result in dollar-for-dollar reductions in the sales price as well as proportionate reductions in the maximum insurable mortgage. In the three cases cited in the report, the actual sources of the buydowns funds were the homebuyers since they were required to agree to increases in sales prices to accommodate the buydowns. HUD does allow buyers to pay traditional discount points to reduce the (30 year) mortgage interest rate, but those buyer contributions cannot be financed through the insured mortgage. Similarly, buyer contributions toward short-term (1 to 3 year) interest reductions (buydowns) would not be eligible for financing through the insured mortgage. KB is correct that current HUD requirements do not specifically address the scenario of sellers recovering buydown funds through increased sales prices. However, KB's logic that the practice is acceptable since it is not specifically precluded is both flawed and less than prudent.

Comment 30 As discussed in Comment 11, KB has acknowledged that the underwriter would not have seen all critical credit qualification documents for any of the loans we reviewed. The absence of any compensating factors on Mortgage Credit Analysis worksheets in the official HUD case files where KB's own calculations of qualifying ratios exceeded HUD benchmarks was not just a negligent omission by the underwriter. The underwriter did not and could not have considered the potential compensating factors that KB now retrospectively wishes to raise.

Comment 31 For each case included in our review, we showed the underwriter the Mortgage Credit Analysis Worksheets as included in both the HUD and KB case files. The underwriter said the handwriting on every one of the KB case file worksheets specifying compensating factors was not hers.

Comment 32 See Comments 30 and 31.

Comment 33 Case No. 023-1043232 – Excessive Ratios without Compensating Factors This case involved several loan origination deficiencies apart from the excessive ratios

without specification of any compensating factors. Although there is evidence in the case file of the borrower enrolling in college level courses, this was not considered by the underwriter and would be a questionable application of compensating factors anyway. The borrower was paying for the college courses by incurring additional student loan debt and was not projected to graduate until September 2005, or over three and one half years after the March 2002 loan application. See Comments 30 and 31.

Comment 34 Case No. 023-1186721 – Excessive Ratios without Compensating Factors We removed this case from Figure 3 and eliminated the excessive ratio deficiency from Appendix C as well as from the Narrative Case Summary since the total debt ratio only minimally exceeded the HUD benchmark.

Comment 35 KB incorrectly interprets the HUD Handbook restrictions on third party handling of credit and verification documents as only applying to the credit report and the actual employment and deposit verification forms. KB also incorrectly assumes that we took exception to the borrowers' handling of pay stubs, bank statements, and W-2 forms. Our position is that HUD's concern relates to the unnecessary handling of any income, asset or credit qualification documents by the seller agents, realtors, or commissioned lender staff. Case No. 023-1357024 included a false pay stub and a false W-2 form that were faxed from the real estate agent's office. Case No. 023-1135453 included two false pay stubs and a false W-2 form. Based on our interview with the borrower, the KB commissioned loan counselor may have been involved in creating these documents. Critical income, asset, and credit qualification documents were routinely collected and transmitted by KB Home (seller) sales representatives for most if not all of the cases we reviewed.

Comment 36 Case No. 023-1052683 – Buydown Rates Handbook 4155.1 REV-4, CHG-1, Paragraph 2-14 requires the lender to show the eventual increase in mortgage payments will not adversely affect the borrower and likely lead to default. Otherwise, the buydown interest rate may only be used as a compensating factor. The handbook requires that the underwriter specifically state which of four criteria the borrower meets, and for the criteria involving potential for increased income, the handbook requires documentation of job training or education in the borrower's profession or a history of the borrower's career advancement along with increases in earnings. Neither the primary borrower's recent overtime earnings nor the co-borrower's newly found employment meet the handbook criteria. Furthermore, the underwriter did not specify that the borrowers met any of the four handbook criteria, and based on the underwriter condition sheet, does not appear to have reviewed any employment documentation for either borrower. We disagree with KB's retrospective evaluation of the borrowers' potential for increased earnings.

Comment 37 Case No. 023-1254460 – Buydown Rates As in the previous case, the underwriter did not specify that the borrower met the handbook criteria relative to

potential increased income, and we disagree with KB's retrospective evaluation thereof. Although the borrower kept one Denny's job throughout the loan origination, he replaced the second Denny's job (making \$8 per hour) with a job at Abuelo's Mexican Restaurant, still making only \$8 per hour. Clearly the borrower did not exhibit a potential for increased earnings. None of the credit, asset, or employment conditions imposed by the underwriter were signed off (verified) by the underwriter.

Comment 38 Case No. 023-1107968 – Payment of Debts KB is correct that Mortgagee Letter 02-02 does specifically preclude third party payment of the homebuyer's consumer debt in order to meet debt to income ratio requirements. However, the mortgagee letter also addresses third party payment of consumer debt apart from the qualifying ratio calculation. The mortgagee letter makes it clear that HUD considers the payment of consumer debt by third parties to be an inducement to purchase that must result in a dollar-for-dollar reduction to the sales price, as well as a commensurate reduction in the maximum insurable mortgage calculation. There were no reductions in the sales price or maximum insurable mortgage calculation for this loan associated with the third party payment of consumer debt.

Comment 39 Case No. 023-0687906 – Downpayment Verification The bank records KB refers to are not bank statements. They only provide account activity information but do not show account balances. Therefore, they do not demonstrate that the borrower had sufficient funds in the account to make the \$2,421 payment into escrow. Neither do they cover the required three month time period. The one actual bank statement in the file dated February 25, 2002, shows a beginning balance in the savings account of \$25 and a single deposit of \$3,537. The source of this large and unusual deposit was not verified as required. Whereas the underwriter condition sheet specified the need to obtain satisfactory proof of the borrower's downpayment, closing costs and payoffs, these documents were not obtained, and no KB employee signed off on this condition.

Comment 40 Case No. 023-1028162 – Downpayment Verification The borrowers' statement relative to the source of funds is inadequate evidence that the downpayment was not derived from unallowable sources. The bank statements did not support a pattern of savings and the borrowers did not claim to have saved the cash at home. Also, HUD Handbook 4155.1 REV-4, Paragraph 2-10 cautions that borrowers with bank accounts are less likely to save money at home than individuals with no history of bank accounts. The unusual \$2,500 bank deposit represented more than half of the amount required to close and was deposited only one month prior to closing. It definitely required verification as per the HUD handbook, and was also one of the conditions imposed by the underwriter but signed off by the commissioned loan counselor.

Appendix C

SCHEDULE OF LOAN DEFICIENCIES

	023-0687906	023-0876050	023-1013299	023-1028162	023-1043232	023-1052683	023-1063809	023-1104448	023-1107968	023-1113441	023-1135453	023-1145205	023-1185414	023-1186721	023-1211310	023-1234810	023-1254460	023-1322842	023-1357024	Total Loans with Stated Deficiency	Percentage of 19 Loans	
Fraud Indicators																						
False Underwriter Certification	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	19	100%	
False Employment Data								x		x		x								x	4	21%
False/Invalid Social Security Number																x					1	5%
Income/Credit Qualifying																						
Inaccurate/Excessive Qualifying Ratios w/o Compensating Factors		x	x		x	x	x	x	x	x	x	x	x			x	x	x		x	15	79%
Unacceptable Credit History	x	x	x	x		x	x	x	x	x	x	x			x	x				x	15	79%
Overstated Income		x	x		x	x	x	x	x	x	x				x	x				x	14	74%
Understated Liabilities					x						x	x								x	4	21%
Inappropriate Use of Buydown Rate		x			x	x														x	5	26%
Insufficient Employment Documentation		x								x	x										3	16%
Loan Processing																						
Third-Party Loan Processing	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	19	100%
Unearned/Unallowable Fees	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	19	100%
Overinsured Mortgage & Improper Treatment of Gift Funds		x					x				x		x		x	x	x	x		x	9	47%
Debt Paid by Interested Third Party			x				x			x					x						4	21%
Downpayment Unverified or Provided by Interested Third Party	x			x	x									x							4	21%
Loan Approved w/o Supporting Documentation			x						x												2	11%
Total Deficiencies Per Loan	5	9	8	5	8	9	7	8	9	8	8	6	5	7	8	6	8	5	8			

Appendix D

NARRATIVE CASE SUMMARIES

HUD case number: 023-0687906
Loan amount: \$117,394
Settlement date: August 29, 2002
Status: Borrowers retain ownership; not currently in default
Indemnification: \$117,394

KB underwrote and approved the mortgage based on unacceptable credit history. It failed to verify the borrowers' downpayment came from a legitimate source. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrowers met HUD qualifying guidelines. Additionally, KB overcharged the borrowers \$320. KB also allowed interested third parties to handle vital loan documents.

A. Unacceptable credit history

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-3, 2-4. Both borrowers' credit histories were unacceptable. KB failed to obtain alternative credit accounts from the borrower to supplement her limited credit history. The only credit account on her credit report was a collection account. At the same time, the coborrower's credit report shows 13 accounts, of which eight (62 percent) were collections or charge-offs.

B. Third-party loan processing

HUD Handbook 4000.2, REV-2, paragraph 3-6; 4155.1, REV-4, CHG-1, paragraph 3-1. KB allowed commissioned loan counselors and loan processors to sign off on underwriter conditions and allowed KB Homes sales representatives to complete loan processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

C. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrowers \$20 in excess hazard insurance (unallowable), a \$50 signing fee (unallowable), and a \$250 HomeSafe "coordinator fee" (unearned/unallowable).

D. Unverified source of downpayment

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-10. The borrowers ostensibly paid \$2,421 into escrow as part of their cash investment. However, KB did not verify the borrowers had sufficient funds to close. To establish that the borrowers had sufficient funds, KB was required to obtain two bank statements, but KB only obtained one bank statement.

Recommendations

- ❑ Indemnify HUD for mortgage amount of \$117,394.
- ❑ Refund \$320 in overcharges to the borrowers or to HUD.

HUD case number: 023-0876050
Loan amount: \$124,690
Settlement date: January 9, 2002
Status: Resold by HUD at net loss
Loss on resale: \$12,471

KB underwrote and approved the mortgage based on overstated income, insufficient employment documentation, inappropriate use of the buydown rate, no compensating factors, and the borrower's unacceptable credit history. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrower met HUD qualifying guidelines. Additionally, KB overcharged the borrower \$512, overinsured the HUD mortgage by \$3,636, and allowed interested third parties to handle vital loan documents.

A. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgagee Letter 97-26. KB failed to include compensating factors on the Mortgage Credit Analysis Worksheet submitted to HUD for excessive front and back ratios of 35.19 percent and 41.62 percent. We recalculated the qualifying ratios using the correct gross monthly income and recurring liabilities discussed below. The recalculated mortgage payment-to-income ratio of 39.36 percent exceeds the HUD requirement by 10.36 percent. The total fixed payment-to-income ratio of 46.55 percent exceeds the HUD requirement by 5.55 percent. KB did not provide compensating factors on the Mortgage Credit Analysis Worksheet submitted to HUD.

B. Unacceptable credit history

HUD Handbook 4155.1, REV-4, paragraph 2-3, 2-5; 24 CFR 203.5(c). The borrower's credit history was unsatisfactory. The credit report indicated the borrower had three charge-off accounts still owing (\$1,694 total outstanding), five collection accounts still owing, and eight federal student loans with twenty-eight 90-day late payments, one outstanding civil judgment, and two accounts with a combined twenty-two 30-day lates, five 60-day lates, and six 90-day lates. Although three of the five collection accounts and the civil judgment were paid, KB did not obtain bank statements to show the payoffs came from the borrower's funds. The borrower's credit history indicates a history of abuse and debt mismanagement. Although the borrower did submit an all-encompassing explanation letter, KB did not obtain additional documentation to mitigate the borrower's poor credit history.

C. Overstated income

HUD Handbook 4155.1, REV-4, paragraph 2-7. The borrower's monthly income of \$2,876 on the Mortgage Credit Analysis Worksheet is overstated by \$304. KB calculated the borrower's income year-to-date earnings up to May 31, 2001, including overtime and a bonus. However, KB did not fulfill the overtime/bonus requirements. KB did not obtain documentation or verification from the employer stating overtime was likely to continue. The KB loan file does not provide evidence to show that KB performed an earnings trend. The documents in the loan file indicate a negative earnings trend.

D. Inappropriate use of buydown rate

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-14. KB qualified the borrower using the buydown interest rate but failed to show that the scheduled mortgage payment increase would not adversely affect the borrower and likely lead to default. To use the buydown interest rate to qualify, the underwriter must document the borrower's ability to handle the scheduled mortgage payment increase.

E. Insufficient employment documentation

HUD Handbook 4155.1, REV-4, paragraph 3-1E. KB did not obtain a 30-day period of pay stubs to show the borrower's current earnings. The loan file only contained one biweekly pay stub, covering a 15-day period. The 30-day period is required because KB only executed a telephone employment verification.

F. Third-party loan processing

HUD Handbook 4155.1, REV-4, paragraph 3-1; 4000.2, REV-2, paragraph 3-6. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and allowed KB Home sales representatives to handle vital loan documents.

G. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrower \$21 in excess hazard insurance (unallowable), a \$50 signing fee (unallowable), a \$60 payoff fee (unallowable), a \$56 working capital fee (unallowable), a \$75 statement fee (unallowable), and a \$250 HomeSafe "coordinator fee" (unearned/unallowable).

H. Overinsured mortgage

HUD Handbook 4155.1 REV-4, Paragraph 1-6, 1-7. KB overinsured the HUD mortgage by \$3,636. KB increased the sales price from \$117,990 to \$121,677, a difference of \$3,687, to accommodate a 2:1 buydown received by the borrower and paid by the seller. By increasing the sales price, KB allowed the seller to be reimbursed for the buydown by financing the buydown through the borrower.

Recommendations

- ❑ Reimburse HUD for loss of \$12,471.
- ❑ Refund \$512 in overcharges to the borrower or to HUD.

HUD case number: 023-1013299
Loan amount: \$143,806
Settlement date: January 31, 2002
Status: Resold by HUD at net loss
Loss on resale: \$18,721

KB underwrote and approved the mortgage based on overstated income, no compensating factors, an unacceptable credit history, and insufficient loan documentation. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrower met HUD qualifying guidelines. Additionally, KB overcharged the borrowers \$560, allowed the payment of consumer debts by an interested third party, and allowed interested third parties to handle vital loan documents.

A. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgagee Letter 97-26. KB did not provide compensating factors on the Mortgage Credit Analysis Worksheet submitted to HUD to overcome a mortgage payment-to-income ratio of 31.86 percent and a total fixed payment-to-income ratio of 45.97 percent. We recalculated the qualifying ratios using the correct gross monthly income discussed below. The recalculated mortgage payment-to-income ratio of 36.19 percent exceeds the HUD requirement by 7.19 percent. The total fixed payment-to-income ratio of 52.22 percent exceeds the HUD requirement by 11.22 percent.

B. Unacceptable credit history

HUD Handbook 4155.1, REV-4, paragraph 2-3, 2-5; 24 CFR 203.5(c). The borrower's credit history was unsatisfactory. The credit report indicated the borrower had six collection accounts (one still outstanding and inappropriately paid at closing), one open charge-off account, two paid charge-off accounts, two accounts with a combined two 30-day late payments, three 60-day late payments, and one 90-day late payment. KB did not obtain additional documentation to mitigate the borrower's poor credit history.

C. Overstated income

HUD Handbook 4155.1, REV-4, paragraph 2-7. The primary borrower's monthly income of \$3,052 on the Mortgage Credit Analysis Worksheet is overstated by \$550. The pay stubs, dated January 25, 2002, and January 11, 2002, show overtime of one and eleven hours, respectively. In contrast, the 2001 pay stubs, dated June 29, 2001, and June 15, 2001, show overtime hours of 96 and 77, respectively. The pay stubs indicate a negative earnings trend. KB did not obtain documentation or verification from the employer stating overtime was likely to continue. The KB loan file does not provide evidence to show that KB performed an earnings trend analysis.

D. Third-party loan processing

HUD Handbook 4155.1, REV-4, paragraph 3-1; 4000.2, REV-2, paragraph 3-6. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing

functions. Sales representatives obtained earnings documents, bank statements, and signatures on the Uniform Residential Loan Application.

E. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrower \$25 in excess hazard insurance (unallowable), a \$50 signing fee (unallowable), a second bond and additional check fee \$100 (unallowable), a \$60 working capital fee (unallowable), a \$75 statement fee (unallowable), and a \$250 HomeSafe “coordinator fee” (unearned/unallowable).

F. Inducement to purchase

Mortgagee Letter 2002-02. KB allowed a third party to pay off the borrower’s consumer debts. The HUD-1 Settlement Statement lists five accounts paid at closing: four Master Financial Group accounts for \$963 and a Fingerhut account for \$244. Outside of a nonprofit bond loan for \$8,700, the borrower deposited only \$137.41 into escrow. Since the debts were paid out of the settlement escrow account, and the borrower did not deposit enough to cover the consumer debts paid off, the debts were paid using portions of the seller’s sales proceeds or using the nonprofit bond loan.

G. Loan approved without supporting documentation

HUD Handbook 4155.1, REV-4, paragraph 3-1. An internal underwriting conditions sheet states, “file approved on stated income only, borrowers to provide income documentation to support monthly earnings of \$4,160.” The underwriter stated that the condition meant she underwrote the loan based only on the credit report and loan application. The underwriter did not have the pay stubs, verifications of employment, W-2 forms, bank statements, etc., when approving the loan.

Recommendations

- ❑ Reimburse HUD for loss of \$18,721.
- ❑ Refund \$560 in overcharges to the borrower or to HUD.

HUD case number: 023-1028162
Loan amount: \$92,689
Settlement date: January 31, 2002
Status: Currently in default (as of April 1, 2005)
Indemnification: \$92,689

KB underwrote and approved the mortgage for borrowers with unacceptable credit history. KB failed to verify the borrowers' downpayment came from a legitimate source. This resulted in HUD insuring the loan for borrowers who did not meet HUD qualifying guidelines. Additionally, KB overcharged the borrowers \$314 and allowed interested third parties to handle vital loan documents.

A. Unacceptable credit history

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-3, 2-4. The borrowers' credit history was unacceptable. KB used alternative credit sources to supplement the borrowers' limited credit history. However, alternative credit accounts used were unacceptable because they too showed a pattern of late payments and past dues.

B. Third-party loan processing

HUD Handbook 4000.2, REV-2, paragraph 3-6; 4155.1, REV-4, CHG-1, paragraph 3-1. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents and signatures on the Uniform Residential Loan Application.

C. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrowers \$14 in excess hazard insurance (unallowable), a \$50 signing fee (unallowable), and a \$250 HomeSafe "coordinator fee" (unearned/unallowable).

D. Unverified source of downpayment

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-10. KB did not verify the source of the borrowers' \$4,700 cash investment paid into escrow. The bank statement shows an unusual deposit of \$2,500 into the borrowers' bank account before the cash investment was made. Although KB did obtain a letter of explanation from the borrowers, describing their ability to save, KB did not verify the source of this deposit.

Recommendations

- ❑ Indemnify HUD for mortgage amount of \$92,689.
- ❑ Refund \$314 in overcharges to the borrowers or to HUD.

HUD case number: 023-1043232
Loan amount: \$116,520
Settlement date: April 5, 2002
Status: Foreclosed and resold by HUD at net loss
Loss on sale: \$29,112

KB submitted the loan for endorsement without compensating factors to justify approval of the loan with a ratio exceeding HUD requirements. KB underwrote and approved the mortgage based on overstated income, understated liabilities, and an inappropriate buydown interest rate. It failed to verify the borrower's downpayment came from a legitimate source. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrower met HUD qualifying guidelines. Additionally, KB overcharged the borrowers \$552 and allowed interested third parties to handle vital loan documents.

A. No compensating factors

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgage Letter 97-26. KB did not provide compensating factors in the Mortgage Credit Analysis Worksheet submitted to HUD to support the approval for a loan with a total fixed payment-to-income ratio of 46.56 percent. This underwriter-calculated ratio exceeded HUD requirements by 5.56 percent.

B. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-12, 13. We recalculated the qualifying ratios using the correct gross monthly income and recurring liabilities discussed below. The recalculated mortgage payment-to-income ratio of 35.77 percent exceeds the HUD requirement by 6.77 percent, and the total fixed payment-to-income ratio of 71.81 percent exceeds the HUD requirement by 30.81 percent.

C. Overstated income

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-7. The borrowers' monthly income of \$3,199 on the Mortgage Credit Analysis Worksheet is overstated by \$688. KB and HUD loan files do not have sufficient evidence to justify the receipt of child support income. Moreover, KB included overtime earned in the base income calculation without following HUD requirements. The correct gross monthly income should be \$2,511.

D. Understated liabilities

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-11. The borrowers' recurring liabilities of \$711 on the Mortgage Credit Analysis Worksheet are understated by \$194. KB failed to include one account: American Express for \$3,892 at \$194 per month.

E. Inappropriate use of buydown interest rate to qualify

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-14. KB qualified the borrower using the buydown interest rate but failed to show that the scheduled mortgage payment increase would not adversely affect the borrower and likely lead to default. To use the

buydown interest rate to qualify, the underwriter must document the borrower's ability to handle the scheduled mortgage payment increase.

F. Third-party loan processing

HUD Handbook 4000.2, REV-2, paragraph 3-6; 4155.1, REV-4, CHG-1, paragraph 3-1. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained bank statements and signatures on the Uniform Residential Loan Application.

G. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrowers \$20 in excess hazard insurance (unallowable), \$53 in excess homeowners association dues (unallowable), a \$50 signing fee (unallowable), a \$30 payoff fee (unallowable), \$74 in working capital (unallowable), a \$75 transfer fee (unallowable), and a \$250 HomeSafe "coordinator fee" (unearned/ unallowable).

H. Unverified source of downpayment

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-10. KB did not verify the source of the borrowers' \$2,963 cash investment paid into escrow. The bank statement shows two unusual deposits of \$1,626 and \$1,560 into the borrowers' bank account a few days before the cash investment was made. KB did not verify the source of these deposits.

Recommendations

- ❑ Reimburse HUD \$29,112 for the loss on sale.
- ❑ Refund \$552 in overcharges to the borrowers or to HUD.

HUD case number: 023-1052683
Loan amount: \$147,520
Settlement date: March 19, 2002
Status: Borrowers retain ownership; not currently in default; partial claims
Indemnification: \$156,354 (\$147,520 + \$8,834 partial claims)

KB submitted the loan for endorsement without compensating factors to justify approval of the loan with a ratio exceeding HUD requirements. KB underwrote and approved the mortgage based on overstated income and an inappropriate buydown interest rate. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrowers met HUD qualifying guidelines. Additionally, KB overcharged the borrowers \$321, allowed payoff of consumer debts by an interested third party, overinsured the HUD mortgage by \$20,346, and allowed interested third parties to handle vital loan documents.

A. No compensating factors

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgagee Letter 97-26. KB did not provide compensating factors in the Mortgage Credit Analysis Worksheet submitted to HUD to support the approval for a loan with a mortgage payment-to-income ratio of 34.99 percent and a total fixed payment-to-income ratio of 49.46 percent. These underwriter-calculated ratios exceeded HUD requirements by 5.99 percent and 8.46 percent, respectively.

B. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-12, 13. We recalculated the qualifying ratios using the correct gross monthly income discussed below. The recalculated mortgage payment-to-income ratio of 38.99 percent exceeds HUD requirement by 9.99 percent, and the total fixed payment-to-income ratio of 55.12 percent exceeds the HUD requirement by 14.12 percent.

C. Unacceptable credit history

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-3, 2-4. The borrowers' credit history was unacceptable. Four of seven accounts (57 percent) on the credit report were collection accounts.

D. Overstated income

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-7. The borrowers' monthly income of \$2,799 on the Mortgage Credit Analysis Worksheet is overstated by \$287. The correct gross monthly income should be \$2,512.

E. Inappropriate use of buydown interest rate to qualify

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-14. KB qualified the borrowers using the buydown interest rate but failed to show that the scheduled mortgage payment increase would not adversely affect the borrowers and likely lead to default. To use the buydown interest rate to qualify, the underwriter must document the borrowers' ability to handle the scheduled mortgage payment increase.

Third-party loan processing

HUD Handbook 4000.2, REV-2, paragraph 3-6; 4155.1, REV-4, CHG-1, paragraph 3-1. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

F. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrowers \$21 in excess hazard insurance (unallowable), a \$50 signing fee (unallowable), and a \$250 HomeSafe “coordinator fee” (unearned/unallowable).

G. Overinsured mortgage

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 1-6, 1-7; Mortgagee Letter 96-18. KB overinsured the HUD mortgage by \$20,346. KB increased the sales price from \$126,690 to \$142,324, a difference of \$15,634, to cover the nonprofit gift, seller-paid loan discount, and seller-paid buydown. By increasing the sales price, KB converted the nonprofit gift and seller-paid incentives into a loan that became part of the mortgage. Also, KB did not decrease the sales price as consideration for the payoff of consumer debts by a third party.

H. Inducements to purchase

Mortgagee Letter 2002-02. KB allowed a third party to pay off the borrowers’ consumer debts. The HUD-1 Settlement Statement lists two accounts paid at closing: 1st Investors for \$4,549 and RMA for \$457. Outside of an \$11,277 nonprofit gift, the borrowers brought a total of only \$500 to closing. Since the debts were paid out of the settlement escrow account and the borrowers did not deposit enough to cover the consumer debts paid off, the debts were paid using portions of the seller’s sale proceeds or using the nonprofit gift funds.

Recommendations

- ❑ Pay \$20,346 to the servicing lender to reduce loan amount.
- ❑ Indemnify HUD for \$136,008 for the reduced mortgage amount (\$127,174) and partial claims paid (\$8,834).
- ❑ Refund \$321 in overcharges to the borrowers or to HUD.

HUD case number: 023-1063809
Loan amount: \$140,641
Settlement date: April 30, 2002
Status: Foreclosed and resold by HUD at net loss
Loss on sale: \$18,891

KB underwrote and approved the mortgage using a falsified employment verification document and overstated income. Further, the KB underwriter made false certifications to HUD stating the mortgage was underwritten with due diligence. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrowers met HUD qualifying guidelines. Additionally, KB overcharged the borrowers \$529 and allowed interested third parties to handle vital loan documents.

A. False certifications

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 3-16; Mortgagee Letter 95-31.

KB's underwriter falsely certified that the loan was underwritten through having personally reviewed the pertinent loan documents. However, the underwriter, whose signature appears on the direct endorsement approval (HUD-92900-A) that was submitted to HUD, did not underwrite the mortgage. This mortgage was underwritten, approved, and insured without the underwriter's due diligence.

B. Falsified verification of employment

HUD Handbook 4000.4, REV-1, CHG-2, paragraph 5-3. KB used a falsified verification of employment form to qualify the borrowers for the mortgage. The coborrower separated from her employer on March 8, 2002. However, KB's telephone verification of employment, dated March 22, 2002, falsely stated the coborrower was still employed as of the date of the verification.

C. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-12, 13; Mortgagee Letter 97-26. We recalculated the qualifying ratios using the correct gross monthly income discussed below. The recalculated mortgage payment-to-income ratio of 40.81 percent exceeds HUD requirement by 11.81 percent, and the total fixed payment-to-income ratio of 57.27 percent exceeds the HUD requirement by 16.27 percent.

D. Unacceptable credit history

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-3, 2-4. The borrowers' credit history was unacceptable. The borrowers did not establish good credit after their bankruptcy was discharged in 1994. Three of four accounts (75 percent) opened since then went into collection.

E. Overstated income

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-7. The borrowers' monthly income of \$4,567 on the Mortgage Credit Analysis Worksheet is overstated by \$1,499. Since the coborrower's employment was false, the correct gross monthly income should only include the borrower's verified income of \$3,068.

Third-party loan processing

HUD Handbook 4000.2, REV-2, paragraph 3-6; 4155.1, REV-4, CHG-1, paragraph 3-1. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

F. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrowers \$24 in excess hazard insurance (unallowable), \$20 in excess homeowners association dues (unallowable), a \$100 signing fee and bond loan fee (unallowable), a \$60 working capital fee (unallowable), a \$75 statement fee (unallowable), and a \$250 HomeSafe “coordinator fee” (unearned/ unallowable).

Recommendations

- ❑ Reimburse HUD \$18,891 for the loss on sale.
- ❑ Refund \$529 in overcharges to the borrowers or to HUD.

HUD case number: 023-1104448
Loan amount: \$121,570
Settlement date: March 29, 2002
Status: Current, reinstated by borrower
Indemnification: \$122,320 (\$121,570 + \$750 expenses)

KB underwrote and approved the mortgage based on overstated income, insufficient employment documentation, an unacceptable credit history, excessive qualifying ratios with no compensating factors, and insufficient loan documentation. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrower met HUD qualifying guidelines. Additionally, KB overcharged the borrower \$517, allowed the payment of consumer debts by an interested third party, and allowed interested third parties to handle vital loan documents.

A. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgagee Letter 97-26. KB did not provide compensating factors in the Mortgage Credit Analysis Worksheet submitted to HUD to overcome a mortgage payment-to-income ratio of 34.75 percent and a total fixed payment-to-income ratio of 44.92 percent. We recalculated the qualifying ratios using the correct gross monthly income discussed below. The recalculated mortgage payment-to-income ratio of 61.48 percent exceeds the HUD requirement by 32.48 percent. The total fixed payment-to-income ratio of 79.46 percent exceeds the HUD requirement by 38.46 percent.

B. Unacceptable credit history

HUD Handbook 4155.1, REV-4, paragraph 2-3, 2-5; 24 CFR 203.5(c). The borrowers' credit history was unsatisfactory. The credit report indicated the primary borrower had five open accounts with three of the accounts as unpaid collections (60 percent). Two of the collections were inappropriately paid at closing (see below), and one account remained outstanding. The coborrower did not have a credit history.

C. Overstated income

HUD Handbook 4155.1, REV-4, paragraph 2-7. The borrower's monthly income of \$2,990 on the Mortgage Credit Analysis Worksheet is overstated by \$1,300. KB added \$1,300 of concurrent/part-time employment of less than two years without justifying its likelihood of continuance. The KB and HUD loan files do not contain documents to conclude that the income's continuance is likely.

D. Insufficient employment documentation

HUD Handbook 4155.1, REV-4, paragraph 3-1E. KB did not obtain a 2001 W-2 form or complete a verification of employment for the primary borrower's concurrent/part-time employment. Without the required documentation, KB would not have been in a position to determine the income stability or likelihood of income continuance.

Third-party loan processing

HUD Handbook 4155.1, REV-4, paragraph 3-1; 4000.2, REV-2, paragraph 3-6. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained earnings documents, bank statements, and signatures on the Uniform Residential Loan Application.

E. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrower \$38 in excess hazard insurance (unallowable), a \$50 signing fee (unallowable), a \$20 check processing fee (unallowable), a \$75 statement fee (unallowable), \$84 in working capital to Central and Dobbins homeownership association (unallowable), and a \$250 HomeSafe “coordinator fee” (unearned/unallowable).

F. Loan approved without supporting documents

HUD Handbook 4155.1, REV-4, paragraph 3-1. An internal underwriting conditions sheet states, “file approved on stated income only, borrowers to provide income documentation to support monthly earnings of \$3,290.” The underwriter stated that the condition meant she underwrote the loan based only on the credit report and loan application. The underwriter did not have the pay stubs, verifications of employment, W-2 forms, bank statements, etc., when approving the loan.

Recommendations

- ❑ Indemnify HUD for the \$121,570 loan amount plus \$750 partial payment totaling \$122,320.
- ❑ Refund \$517 in overcharges to the borrower or to HUD.

HUD case number: 023-1107968
Loan amount: \$115,568
Settlement date: March 29, 2002
Status: Property resold by HUD at net profit
Indemnification: None

KB underwrote and approved the mortgage based on false employment data, overstated income, insufficient employment documentation, an unacceptable credit history, and no compensating factors. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrower met HUD qualifying guidelines. Additionally, KB overcharged the borrower \$387, allowed the payment of consumer debts by an interested third-party, and allowed interested third parties to handle vital loan documents.

A. False employment data and insufficient employment documentation

HUD Handbook 4000.2, REV-2, paragraph 1-21; 4000.4, REV-1, paragraph 5-3; 4155.1, REV-4, paragraph 3-1E; Mortgage Letter 97-26. KB used a false telephone employment verification for the coborrower's employment. The telephone verification was executed on March 20, 2002, by a loan processor, even though the coborrower stopped working on November 15, 2001. Also, KB did not obtain a 30-day period of pay stubs to show the coborrower's current earnings. The loan file only contained one 15-day pay stub. The 30-day period is required because KB executed a telephone employment verification.

B. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgage Letter 97-26. KB failed to include compensating factors on the Mortgage Credit Analysis Worksheet submitted to HUD for an excessive total fixed payment-to-income ratio of 47.53 percent. We recalculated the qualifying ratios using the correct gross monthly income and recurring liabilities discussed below. The recalculated mortgage payment-to-income ratio of 23.95 percent does not exceed the HUD requirement, but the total fixed payment-to-income ratio of 49.18 percent exceeds the HUD requirement by 8.18 percent.

C. Unacceptable credit history

HUD Handbook 4155.1, REV-4, paragraph 2-3, 2-5; 24 CFR 203.5(c). The borrowers' credit history was unsatisfactory. The credit report indicated the borrowers had four collection accounts (one outstanding, one paid, and two paid at closing), two open charge-off accounts (\$1,953 outstanding), two accounts with combined sixteen 30-day lates, one 60-day late, and two accounts with adverse ratings. KB did not obtain additional documentation to mitigate the borrowers' poor credit history.

D. Overstated income

HUD Handbook 4155.1, REV-4, paragraph 2-7. The borrower's monthly income of \$4,462 on the Mortgage Credit Analysis Worksheet is overstated by \$150. KB calculated the coborrower's gross monthly income of \$2,100 from earnings at a previous employer.

KB should have used the current employer when calculating the coborrower's gross monthly income.

E. Third-party loan processing

HUD Handbook 4155.1, REV-4, paragraph 3-1; 4000.2, REV-2, paragraph 3-6. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

F. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrower \$17 in excess hazard insurance (unallowable), a \$50 signing fee (unallowable), a \$50 bond escrow fee (unallowable), a \$20 payoff fee (unallowable), and a \$250 HomeSafe "coordinator fee" (unearned/ unallowable).

G. Inducement to purchase

Mortgagee Letter 2002-02. KB allowed a third party to pay off the borrower's consumer debts. The HUD-1 Settlement Statement lists two accounts paid at closing: Kenneth Eisen & Atuc. for \$173 and NCO Financial System for \$64. Outside of a nonprofit bond loan for \$7,000, the borrowers did not bring any money to closing. Since the debts were paid out of the settlement escrow account and the borrower did not deposit enough to cover the consumer debts paid off, the debts were paid using the seller's funds or using the nonprofit bond loan.

Recommendations

- Refund \$387 in overcharges to the borrower or to HUD.

HUD case number: 023-1113441
Loan amount: \$137,564
Settlement date: July 15, 2002
Status: Foreclosed
Indemnification: \$137,564

KB underwrote and approved the mortgage based on overstated income and understated liabilities. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrowers met HUD qualifying guidelines. Additionally, KB overcharged the borrowers \$515 and overinsured the HUD mortgage by \$7,785. KB also allowed interested third parties to handle vital loan documents.

A. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1 REV-4, CHG-1, Paragraph 2-12, 13; Mortgagee Letter 97-26. We recalculated the qualifying ratios using the correct gross monthly income and recurring liabilities discussed above. The recalculated mortgage payment-to-income ratio of 32.75 percent exceeds HUD requirement by 3.75 percent, and the total fixed payment-to-income ratio of 49.45 percent exceeds the HUD requirement by 8.45 percent.

B. Unacceptable credit history

HUD Handbook 4155.1, REV-4, paragraph 2-3, 2-5; 24 CFR 203.5(c). The borrowers' credit histories were unacceptable. For the primary borrower, 16 of 17 accounts (94 percent) were collection or charged off accounts. Nine of the collection/charged off accounts remained unpaid after settlement (\$8,119 total outstanding charge-offs). For the coborrower, three of five accounts (60 percent) were collection or charged off accounts. All three of these accounts remained unpaid after settlement.

C. Overstated income

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-7. The borrowers' monthly income of \$4,622 on the Mortgage Credit Analysis Worksheet is overstated by \$1,138. KB and HUD loan files do not have sufficient evidence to justify the receipt of child support income. Moreover, KB included overtime earned in the base income calculation without following HUD requirements. The correct gross monthly income should be \$3,484.

D. Understated liabilities

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-11. The borrowers' recurring liabilities of \$353 on the Mortgage Credit Analysis Worksheet are understated by \$229. KB included two accounts: Mercury Finance for \$11,184 at \$333 per month and Capital One Bank for \$210 at \$20 per month. KBHM failed to include two accounts, Fst Nat-Lub for \$2,750 at \$138 per month and Fst Nat-Lub for \$1,826 at \$91 per month.

E. Third-party loan processing

HUD Handbook 4000.2, REV-2, paragraph 3-6; 4155.1, REV-4, CHG-1, paragraph 3-1. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

F. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrowers \$20 in excess hazard insurance (unallowable), \$24 in excess homeowners association dues (unallowable), a \$50 signing fee (unallowable), a \$96 working capital fee (unallowable), a \$75 transfer fee (unallowable), and a \$250 HomeSafe “coordinator fee” (unearned/unallowable).

G. Overinsured mortgage

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 1-6, 1-7; Mortgagee Letter 96-18. KB overinsured the HUD mortgage by \$7,785. KB increased the sales price from \$128,990 to \$136,886, a difference of \$7,896, to cover the nonprofit gift. By increasing the sales price, KB converted a nonprofit gift into a loan that became part of the mortgage.

Recommendations

- ❑ Indemnify HUD for mortgage amount of \$137,564.
- ❑ Refund \$515 in overcharges to the borrowers or to HUD.

HUD case number: 023-1135453
Loan amount: \$138,003
Settlement date: April 19, 2002
Status: Paid in full on March 1, 2005, property sold by borrower
Indemnification: None

KB underwrote and approved the mortgage based on false employment data, overstated income, understated liabilities, and unacceptable credit history. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrower met HUD qualifying guidelines.

Additionally, KB overcharged the borrower \$380, overinsured the HUD mortgage by \$8,883, and allowed interested third parties to handle loan documents.

A. False employment data

HUD Handbook 4000.2, REV-2, paragraph 1-21; 4000.4, REV-1, paragraph 2-5; Mortgagee Letter 97-26. KB knowingly approved the HUD loan using false employment data. The borrower stated her last date of employment was January 24, 2002, as evidenced by her last pay stub, dated March 1, 2002, with earnings of \$4,468. The state of Arizona Department of Economic Security verified the wages earned in 2002 as \$4,305. The loan file contained two false pay stubs, dated March 15, 2002, and March 29, 2002. The borrower confirmed she did not receive pay stubs past March 1, 2002. The loan file also contains a false W-2 form and false online verification of employment. The borrower confirmed she only received one W-2 form in 2001. The KB and HUD loan files include a second (false) 2001 W-2 form for \$25,501. The online verification completed on March 12, 2002, falsely states the borrower was an active employee as of April 23, 2002. However, we completed a verification using the same online service and received a termination date of January 24, 2002. The borrower said she notified the KB loan counselor that she had lost her job, and that the loan counselor assured her she would still qualify based on that employment.

B. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgagee Letter 97-26. We recalculated the qualifying ratios using the correct gross monthly income and recurring liabilities discussed below. The recalculated mortgage payment-to-income ratio of 28.89 percent does not exceed the HUD requirement, but the total fixed payment-to-income ratio of 60.19 percent exceeds the HUD requirement by 19.19 percent.

C. Unacceptable credit history

HUD Handbook 4155.1, REV-4, paragraph 2-3, 2-5; 24 CFR 203.5(c). The borrower's credit history was unsatisfactory. The credit report indicated the borrower had two unpaid collection accounts (both paid at closing), an auto loan with six payments 30 days late, two student loans with a combined two payments 60 days late, and one credit card with a 60-day late payment. The credit report also detailed five civil judgments between June 1996 and January 2002 (all satisfied).

D. Overstated income

HUD Handbook 4155.1, REV-4, paragraph 2-7. Although the income was based on false employment data, we analyzed the income calculations to show that KB did not prudently calculate the borrower's income. The borrower's income of \$5,440 on the Mortgage Credit Analysis Worksheet is overstated by \$1,556. KB did not take into account the borrower's historical earnings.

E. Understated liabilities

HUD Handbook 4155.1, REV-4, paragraph 2-11. The borrower's recurring liabilities of \$519 on the Mortgage Credit Analysis Worksheet are understated by \$697. KB failed to include three education loans and two credit cards: Educaid-TMS for \$11,466 at \$573 per month, U.S Department of Education for \$2,223 at \$25 per month, AES Military Supply for \$981 at \$50 per month, Capital One for \$856 at \$26 per month, and Capital One for \$453 at \$23 per month.

F. Third-party loan processing

HUD Handbook 4155.1, REV-4, paragraph 3-1; 4000.2, REV-2, paragraph 3-6. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions, and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained earnings documents, bank statements, and signatures on the Uniform Residential Loan Application

G. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrower a \$50 signing fee (unallowable), a \$20 additional check fee (unallowable), \$60 in working capital to Mountain Ranch homeowners association (unallowable), and a \$250 HomeSafe "coordination fee" (unearned/ unallowable).

Recommendations

- Refund \$380 in overcharges to the borrower or to HUD.

HUD case number: 023-1145205
Loan amount: \$142,729
Settlement date: August 29, 2002
Status: Foreclosed and resold by HUD at net loss
Loss on sale: \$21,462

KB submitted the loan for endorsement without compensating factors to justify approval of the loan with ratios exceeding HUD requirements. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrowers met HUD qualifying guidelines. Additionally, KB overcharged the borrowers \$468 and overinsured the HUD mortgage by \$1,673. KB also allowed interested third parties to handle vital loan documents.

A. No compensating factors

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgagee Letter 97-26. KB did not provide compensating factors in the Mortgage Credit Analysis Worksheet submitted to HUD to support the approval for a loan with a mortgage payment-to-income ratio of 30.29 percent and a total fixed payment-to-income ratio of 45.00 percent. These underwriter-calculated ratios exceeded HUD requirements by 1.29 percent and 4.00 percent, respectively.

B. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-12, 13. We recalculated the qualifying ratios using the correct recurring liabilities of \$581. The recalculated mortgage payment-to-income ratio of 30.29 percent exceeds HUD requirement by 1.29 percent, and the total fixed payment-to-income ratio of 44.70 percent exceeds the HUD requirement by 3.70 percent.

C. Unacceptable credit history

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-3, 2-4. The borrowers' credit history was unacceptable. Seven of sixteen accounts (44 percent) reported as collection/charge-off accounts. Two of the seven collection/charge-off accounts remained unpaid after settlement in the amount of \$7,821.

D. Third-party loan processing

HUD Handbook 4000.2, REV-2, paragraph 3-6; 4155.1, REV-4, CHG-1, paragraph 3-1. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

E. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrowers \$39 in excess hazard insurance (unallowable), a \$50 bond loan fee (unallowable), a \$50 signing fee (unallowable), a \$10 payoff account fee (unallowable), \$44 in working capital

(unallowable), a \$25 transfer fee (unallowable), and a \$250 HomeSafe “coordinator fee” (unearned/unallowable).

F. Overinsured mortgage

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 1-6, 1-7; Mortgagee Letter 96-18. KB overinsured the HUD mortgage by \$1,673. KB increased the sales price from \$142,790 to \$144,490, a difference of \$1,700, to cover the nonprofit gift. By increasing the sales price, KB converted a nonprofit gift into a loan that became part of the mortgage.

Recommendations

- Reimburse HUD \$21,462 for the loss on sale.
- Refund \$468 in overcharges to the borrowers or to HUD.

HUD case number: 023-1185414
Loan amount: \$150,602
Settlement date: June 25, 2002
Status: Foreclosed and resold by HUD at net profit
Indemnification: None

KB submitted the loan for endorsement without compensating factors to justify approval of the loan with ratios exceeding HUD requirements. KB failed to verify the borrower's downpayment came from a legitimate source. KB charged the borrower \$1,757 for unearned/ unallowable fees. Additionally, KB allowed interested third parties to handle vital loan documents.

A. No compensating factors

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgage Letter 97-26. KB did not provide compensating factors in the Mortgage Credit Analysis Worksheet submitted to HUD to support the approval for a loan with a mortgage payment-to-income ratio of 31.45 percent and a total fixed payment-to-income ratio of 44.47 percent. These underwriter-calculated ratios exceeded HUD requirements by 2.45 percent and 3.47 percent, respectively. KB added compensating factors to the Mortgage Credit Analysis Worksheet and resubmitted it to the HUD's Santa Ana Homeownership Center in response to a post-endorsement technical review.

B. Third-party loan processing

HUD Handbook 4000.2, REV-2, paragraph 3-6; 4155.1, REV-4, CHG-1, paragraph 3-1. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

C. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrowers \$20 in excess hazard insurance (unallowable), a \$50 signing fee (unallowable), \$56 in working capital (unallowable), a \$75 statement fee (unallowable), a \$50 bond loan fee (unallowable), a \$250 HomeSafe "coordinator fee" (unearned/unallowable), and a \$1,506 loan discount (unearned/unallowable). After the Santa Ana Homeownership Center's post-endorsement technical review, which identified the HomeSafe "coordinator fee" as an unallowable fee, KB reimbursed the borrower by applying a reduction to the loan principal.

D. Downpayment provided by interested third party

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-10. The borrower supposedly paid \$4,981 into escrow as part of the cash investment. KB only verified that a portion of these funds came from the borrower's payroll check. According to the borrower, he borrowed funds from the real estate agent the week before closing because he did not have sufficient funds to close. This was evident on the bank statement, which shows a

\$900 deposit three days before closing. Without this deposit, the borrower would not have had sufficient funds to close.

Recommendations

- Refund \$1,757 in overcharges to the borrower or to HUD.

HUD case number: 023-1186721
Loan amount: \$129,614
Settlement date: August 19, 2002
Status: Foreclosed and resold by HUD
Loss on resale: \$32,146

KB underwrote and approved the mortgage based on overstated income and an unacceptable credit history. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrower met HUD qualifying guidelines. Additionally, KB overcharged the borrower \$350, allowed the payment of consumer debts by an interested third party, overinsured the HUD mortgage by \$11,209, and allowed interested third parties to handle vital loan documents.

A. Unacceptable credit history

HUD Handbook 4155.1, REV-4, paragraph 2-3, 2-5; 24 CFR 203.5(c). The borrower's credit history was unsatisfactory. The credit report indicated that the borrower filed for Chapter 7 bankruptcy on April 3, 1998, and that the bankruptcy was discharged on July 22, 1998. After the bankruptcy discharge, the borrower had one payment past 30 days late, two charge-offs totaling \$8,275, two collection accounts totaling \$334, and one civil judgment for \$424. KB did not obtain additional documentation to mitigate the borrower's continued poor credit history.

B. Overstated income

HUD Handbook 4155.1, REV-4, paragraph 2-7. The borrower's monthly income of \$7,620 on the Mortgage Credit Analysis Worksheet is overstated by \$3,810. KB added \$3,810 in unsubstantiated income to the borrower's verified income of \$3,810 to arrive at a grand total of \$7,620. However, the KB and HUD loan files do not support additional borrowers or concurrent employment to justify a \$3,810 increase in gross monthly income.

C. Third-party loan processing

HUD Handbook 4155.1, REV-4, paragraph 3-1; 4000.2, REV-2, paragraph 3-6. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Home sales representatives to handle vital loan documents.

D. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrower \$20 in excess hazard insurance (unallowable), a \$50 signing fee (unallowable), a \$30 pay-off fee (unallowable), and a \$250 HomeSafe "coordinator fee" (unearned/unallowable).

E. Overinsured mortgage

HUD Handbook 4155.1, REV-4, paragraph 1-6, 1-7; Mortgagee Letter 96-18. KB overinsured the HUD mortgage by \$11,209. KB increased the sales price from \$111,590 to \$120,772, a difference of \$9,182, to cover the nonprofit gift. By increasing the sales

price, KB converted a nonprofit gift into a loan that became part of the mortgage. Also, KB did not decrease the sales price as consideration for the payoff of consumer debts by a third party.

F. Inducements to purchase

Mortgagee Letter 2002-2. KB allowed the payment of consumer debts by a third party. The HUD-1 Settlement Statement lists three accounts paid at closing: civil judgment for \$1,866, Surety Acceptance for \$202, and Allied Interstate for \$132. Outside of a \$8,682 nonprofit gift, the borrower only brought a total of \$350 to closing. Therefore, the debts were paid using seller sale proceeds or the nonprofit gift funds.

Recommendations

- Reimburse HUD for loss of \$32,146.
- Refund \$350 in overcharges to the borrower or to HUD.

HUD case number: 023-1211310
Loan amount: \$150,573
Settlement date: July 26, 2002
Status: Foreclosed
Indemnification: \$156,347 (\$154,378 (claim) + \$1,969 (expenses))

KB underwrote and approved the mortgage based on overstated income, an unacceptable credit history, a false social security number, and no compensating factors. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrower met HUD qualifying guidelines. Additionally, KB overcharged the borrower \$583, overinsured the HUD mortgage by \$1,322, and allowed interested third parties to handle vital loan documents.

A. False social security number

HUD Handbook 4155.1, REV-4, paragraph 3-2C; 4000.2, REV-2, paragraph 1-20; 24 CFR 202.5(j)(4). KB approved the HUD mortgage with knowledge that the coborrower was using a false social security number. During the loan process, the coborrower had been in the United States for less than one year. KB performed an online employment verification using the coborrower's reported social security number. The online verification revealed that the social security number was attached to another person other than the coborrower. KB inappropriately continued with the loan approval without obtaining an explanation or resolution of the serious discrepancy.

B. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgagee Letter 97-26. KB failed to include compensating factors on the Mortgage Credit Analysis Worksheet submitted to HUD for excessive front and back ratios of 34.72 percent and 45.99 percent. We recalculated the qualifying ratios using the correct gross monthly income discussed below. The recalculated mortgage payment-to-income ratio of 40.12 percent exceeds the HUD requirement by 11.12 percent. The total fixed payment-to-income ratio of 53.15 percent exceeds the HUD requirement by 12.15 percent.

C. Unacceptable credit history

HUD Handbook 4155.1, REV-4, paragraph 2-3, 2-5; 24 CFR 203.5(c). The borrowers' credit history was unsatisfactory. The credit reports for the primary borrower and his nonpurchasing spouse showed numerous charge-offs and adverse ratings. The borrower had four charge-offs (\$1,654 outstanding), six collections (four outstanding), and two accounts with two 30-day late payments. The borrower had a paid collection that was a government fine from Maricopa County.

D. Overstated income

HUD Handbook 4155.1, REV-4, paragraph 2-7. The borrower's income of \$3,832 on the Mortgage Credit Analysis Worksheet is overstated by \$516. Since the primary borrower, who was an auto detailer, was paid on a per-car rather than hourly basis, KB should have taken an average of the borrower's prior two years' earnings. For the

coborrower, KB used an 80-hour biweekly work schedule; however, the loan file only substantiates a 60 to 70hour work schedule.

E. Third-party loan processing

HUD Handbook 4155.1, REV-4, paragraph 3-1; 4000.2, REV-2, paragraph 3-6. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

F. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; 24 CFR 3500.14; chapter 2-15, HUD Homeownership Reference Guide. KB charged the borrower \$21 in excess hazard insurance (unallowable), a \$50 additional escrow fee (unallowable), a \$50 courtesy signing fee (unallowable), \$24 in excess homeownership association dues (unallowable), a \$75 transfer fee (unallowable), \$113 in working capital to Dynamite homeownership association (unallowable), and a \$250 HomeSafe transaction coordination fee (unearned/unallowable).

G. Overinsured mortgage

HUD Handbook 4155.1, REV-4, paragraph 1-6, 1-7; Mortgagee Letter 96-18. KB overinsured the HUD mortgage by \$1,322. KB increased the sales price from \$150,990 to \$152,331, a difference of \$1,341, to cover the nonprofit gift. By increasing the sales price, KB converted a nonprofit gift into a loan that became part of the mortgage.

Recommendations

- ❑ Reimburse HUD for any losses incurred when the property is resold. The amount of the claim and expenses to date are \$156,347.
- ❑ Refund \$583 in overcharges to the borrower or to HUD.

HUD case number: 023-1234810
Loan amount: \$131,442
Settlement date: August 9, 2002
Status: Paid in full on March 1, 2005, property sold by borrowers
Indemnification: None

KB inappropriately qualified the borrowers at the buydown rate and did not provide compensating factors to overcome a high mortgage payment-to-income ratio. Additionally, KB overcharged the borrower \$504, overinsured the HUD mortgage by \$8,645, and allowed interested third parties to handle vital loan documents

A. Excessive qualifying ratios without compensating factors

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgagee letter 97-26. KB did not provide compensating factors to overcome a mortgage payment-to-income ratio of 39.30 percent. The ratio exceeded HUD requirements by 10.30 percent.

B. Inappropriate use of buydown rate

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-14. KB qualified the borrower using the buydown interest rate but failed to show that the scheduled mortgage payment increase would not adversely affect the borrower and likely lead to default. To use the buydown interest rate to qualify, the underwriter must document the borrower's ability to handle the scheduled mortgage payment increase.

C. Third-party loan processing

HUD Handbook 4155.1, REV-4, paragraph 3-1; 4000.2, REV-2, paragraph 3-6. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

D. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrower \$42 in excess hazard insurance (unallowable), \$24 in excess homeownership association fees, a \$50 courtesy signing fee (unallowable), \$63 in working capital (unallowable), a \$75 statement fee (unallowable), and a \$250 HomeSafe "coordinator fee" (unearned/unallowable).

E. Overinsured mortgage

HUD Handbook 4155.1, REV-4, paragraph 1-6, 1-7; Mortgagee Letter 96-18. KB overinsured the HUD mortgage by \$8,883. KB increased the sales price from \$111,590 to \$120,772, a difference of \$9,182, to cover the nonprofit gift. By increasing the sales price, KB converted a nonprofit gift into a loan that became part of the mortgage.

Recommendations

- ❑ Refund \$504 in overcharges to the borrower or to HUD.

HUD case number: 023-1254460
Loan amount: \$124,863
Settlement date: August 30, 2002
Status: Claim paid
Indemnification: \$135,627

KB underwrote and approved the mortgage based on overstated income, unacceptable concurrent employment, inappropriate use of the buydown rate, and understated liabilities. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrower met HUD qualifying guidelines. Additionally, KB overcharged the borrower \$343, overinsured the HUD mortgage by \$14,298, and allowed interested third parties to handle vital loan documents.

A. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, paragraph 2-12, 13; Mortgagee Letter 97-26. We recalculated the qualifying ratios using the correct gross monthly income and recurring liabilities discussed below. The recalculated mortgage payment-to-income ratio of 53.30 percent exceeds the HUD requirement by 24.30 percent. The total fixed payment-to-income ratio of 76.06 percent exceeds the HUD requirement by 35.06 percent.

B. Overstated income

HUD Handbook 4155.1, REV-4, paragraph 2-7. The borrower's monthly income of \$2,784 on the Mortgage Credit Analysis Worksheet is overstated by \$1,224. KB calculated the borrower's primary income by using year-to-date earnings through April 17, 2002. However, the year-to-date earnings included overtime and did not reflect future and past performance. KB should have used the written verification of employment stating \$9 per hour for 40 hours per week.

C. Unacceptable concurrent employment

HUD Handbook 4155.1, REV-4, paragraph 2-7B. KB used \$817 from concurrent employment. However, the earnings KB included were derived from previous employment and not the actual concurrent employment. Even if calculated correctly, the concurrent employment should have only been included as a compensating factor because of the small timeframe on the job (three months) and the lack of documentation to support the likelihood of employment continuance.

D. Understated liabilities

HUD Handbook 4155.1, REV-4, paragraph 2-11. The borrower's recurring liabilities of \$0 on the Mortgage Credit Analysis Worksheet are understated by \$355. KB failed to include an auto loan with a balance of \$4,329 and a monthly payment of \$355. More than 10 months remained on the payment schedule.

E. Inappropriate use of buydown rate

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-14. KB qualified the borrower using the buydown interest rate but failed to show that the scheduled mortgage payment increase would not adversely affect the borrower and likely lead to default. To use the

buydown interest rate to qualify, the underwriter must document the borrower's ability to handle the scheduled mortgage payment increase

F. Third-party loan processing

HUD Handbook 4155.1, REV-4, paragraph 3-1; 4000.2, REV-2, paragraph 3-6. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Home sales representatives to handle vital loan documents.

G. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrower \$18 in excess hazard insurance (unallowable), \$75 in working capital to a homeowners association (unallowable), and a \$250 HomeSafe "coordinator fee" (unearned/unallowable).

H. Overinsured mortgage

HUD Handbook 4155.1, REV-4, paragraph 1-6, 1-7; Mortgagee Letter 96-18. KB overinsured the HUD mortgage by \$14,298. KB increased the sales price from \$106,390 to \$120,890, a difference of \$14,500, to cover the nonprofit gift (\$4,800), the incentive toward closing costs (\$2,709), and the incentive toward the buydown/discount (\$4,091). By increasing the sales price, KB converted incentives/gift funds into borrower financed items.

Recommendations

- ❑ Reimburse HUD for any losses that may be incurred when the property is sold. The amount of claims paid to date is \$135,627.
- ❑ Refund \$343 in overcharges to the borrower or to HUD.

HUD case number: 023-1322842
Loan amount: \$150,128
Settlement date: October 28, 2002
Status: Currently in default, partial claim paid
Indemnification: \$154,761 (\$150,128 + \$4,633 partial claim)

KB underwrote and approved the mortgage based on overstated income and an unacceptable credit history. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrower met HUD qualifying guidelines. Additionally, KB overcharged the borrower \$249 and allowed interested third parties to handle vital loan documents.

A. Unacceptable credit history

HUD Handbook 4155.1, REV-4, paragraph 2-3, 2-5; 24 CFR 203.5(c). The borrowers' credit history was unsatisfactory. The credit report indicated the borrowers had nine paid collection accounts, two collection accounts outstanding (paid during loan process), three open charge-off accounts (\$9,317 outstanding), one outstanding collection account, three accounts with combined six 30-day lates, two 60-day lates, and one 90-day late. The borrowers also had a judgment, from a previous tenant, satisfied only two months before loan settlement. KB did not obtain additional documentation to mitigate the borrowers' poor credit history.

B. Overstated income

HUD Handbook 4155.1, REV-4, paragraph 2-7. The borrower's monthly income of \$4,888 on the Mortgage Credit Analysis Worksheet is overstated by \$173. KB did not calculate the primary borrower and coborrower's overtime/bonus income, according to HUD requirements. For the primary borrower, KB calculated the income based on current overtime/bonus earnings and did not consider the historical overtime/bonus earnings trend. For the coborrower, KB did not adequately document that overtime had been received the past two years and, therefore, was not able to determine an earnings trend.

C. Third-party loan processing

HUD Handbook 4155.1, REV-4, paragraph 3-1; 4000.2, REV-2, paragraph 3-6. KB allowed commissioned loan processors and loan counselors to sign off on underwriter conditions and also allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

D. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrower \$18 in excess hazard insurance (unallowable), a \$50 bond loan fee (unallowable), a \$50 courtesy signing fee (unallowable), \$56 in working capital to Dynamite homeowners association (unallowable), and a \$75 statement fee (unallowable).

Recommendations

- ❑ Indemnify HUD for \$154,761.
- ❑ Refund \$249 in overcharges to the borrower or to HUD.

HUD case number: 023-1357024
Loan amount: \$133,661
Settlement date: October 28, 2002
Status: Foreclosed and resold by HUD at net loss
Loss on sale: \$12,822

KB underwrote and approved the mortgage using falsified employment and income documents. The use of falsified documents occurred because interested third parties were allowed to handle verification forms and pay documents. Therefore, HUD insured the loan based on KB's inaccurate representation that the borrowers met HUD qualifying guidelines. Additionally, KB overcharged the borrowers \$240 and overinsured the HUD mortgage by \$7,564.

A. Falsified employment

HUD Handbook 4000.2, REV-2, paragraph 1-21; 4000.4, REV-1, CHG-2, paragraph 5-3. KB used falsified employment documents to qualify the borrowers for the mortgage. The false documents include a verification of employment, a W-2 form, and a pay stub. The employer confirmed the W-2 form and pay stub to be false. The manager who signed the false verification of employment admitted to signing the form blank. He confirmed income information on the verification of employment was grossly overstated. He became aware of the false verification of employment and reported it to KB personnel when KB contacted him to re-verify the borrower's employment. However, KB did not report to HUD that it detected false documents in the loan file.

B. Inaccurate/excessive debt-to-income ratios

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-12, 13; Mortgagee Letter 97-26. We recalculated the qualifying ratios using the correct gross monthly discussed below. The recalculated mortgage payment-to-income ratio of 47.27 percent exceeds HUD requirement by 18.27 percent, and the total fixed payment-to-income ratio of 79.14 percent exceeds the HUD requirement by 38.14 percent.

C. Unacceptable credit history

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-3, 2-4. The primary borrower's credit history was unacceptable. Six of six accounts were reported as collection accounts. Two of these six collection accounts remained unpaid after settlement.

D. Overstated income

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 2-7. The borrowers' monthly income of \$4,333 on the Mortgage Credit Analysis Worksheet is overstated by \$2,080. Since the borrower's employment was false, the correct gross monthly income should only include the coborrower's verified income of \$2,253.

E. Third-party loan processing

HUD Handbook 4000.2, REV-2, paragraph 3-6; 4155.1, REV-4, CHG-1, paragraph 3-1. KB permitted interested third parties to handle verification forms and loan documents. KB allowed the borrower to hand-carry a blank verification of employment

to the employer. KB also allowed the completed verification of employment, W-2 forms, and pay stubs to be submitted via the real estate agent. These turned out to be fabricated documents to overstate income. The commissioned loan processor and loan counselor signed off on underwriter conditions and KB allowed KB Homes sales representatives to complete loan-processing functions. Sales representatives obtained pay documents, bank statements, and signatures on the Uniform Residential Loan Application.

F. Unearned/unallowable fees

HUD Handbook 4000.2, REV-2, paragraph 5-3; chapter 2-15, HUD Homeownership Reference Guide; 24 CFR 3500.14. KB charged the borrowers \$19 in excess hazard insurance (unallowable), a \$50 signing fee (unallowable), a \$96 working capital fee (unallowable), and a \$75 statement fee (unallowable).

G. Overinsured mortgage

HUD Handbook 4155.1, REV-4, CHG-1, paragraph 1-6, 1-7; Mortgagee Letter 96-18. KB overinsured the HUD mortgage by \$7,564. KB increased the sales price from \$122,990 to \$130,662, a difference of \$7,672, to cover the nonprofit gift. By increasing the sales price, KB converted a nonprofit gift into a loan that became part of the mortgage.

Recommendations

- ❑ Reimburse HUD \$12,822 for the loss on sale.
- ❑ Refund \$240 in overcharges to the borrowers or to HUD.