



U.S. DEPARTMENT OF
HOUSING AND URBAN DEVELOPMENT
OFFICE OF INSPECTOR GENERAL

September 23, 2013

MEMORANDUM NO:
2013-LA-0803

Memorandum

TO: Charles S. Coulter
Deputy Assistant Secretary for Single Family Housing, HU

Tanya E. Schulze

FROM: Tanya E. Schulze
Regional Inspector General for Audit, Los Angeles Region, 9DGA

SUBJECT: Reviews of Six FHA Lenders Demonstrated That HUD Needs To Strengthen Its Oversight of Prohibited Restrictive Covenants

INTRODUCTION

The U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), conducted a limited review of HUD's oversight of loans underwritten by HUD-approved Federal Housing Administration (FHA) lenders. We conducted the internal review as part of OIG's annual audit plan, prompted by four recent OIG external lender audits reporting that the lenders allowed prohibited restrictive covenant agreements. Generally, the lenders stated they were unaware that the documents violated HUD requirements for FHA insurance. The objective of the internal review was to summarize the recently completed OIG external audits and determine the extent to which HUD had identified and discouraged such agreements.

HUD Handbook 2000.06, REV-4, provides specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the review.

The Inspector General Act, Title 5 United States Code, section 8L, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at <http://www.hudoig.gov>.

METHODOLOGY AND SCOPE

We reviewed seven OIG audit reports and memorandums, issued within the past 5 years, which contained findings in which FHA lenders allowed prohibited restrictive covenants and in many instances, liens corresponding to FHA-insured properties. Our internal review focused on the four most recent audits, highlighted in blue below.

Lender	FHA identification number	Location	OIG audit or memorandum number	Issue date
CTX Mortgage Company, LLC	51358	Dallas, TX	2013-LA-1803	April 18, 2013
Pulte Mortgage, LLC	05369	Englewood, CO	2013-LA-1802	April 18, 2013
Standard Pacific Mortgage, Inc.	11775	Irvine, CA	2013-LA-1801	February 5, 2013
Shea Mortgage, Inc.	78404	Aliso Viejo, CA	2012-LA-1801	September 26, 2012
Universal American Mortgage Company	21490	Las Vegas, NV	2011-LA-1017	September 21, 2011
DHI Mortgage	05424	Scottsdale, AZ	2010-LA-1009	March 19, 2010
DHI Mortgage		Scottsdale, AZ	2009-LA-1018	September 10, 2009

We conducted the audit fieldwork from the OIG Phoenix, AZ, Office of Audit between May and July 2013. To accomplish our objective, we

- Reviewed prior OIG audit reports and memorandums with findings that included lenders' allowing prohibited restrictive covenants as noted above;
- Reviewed relevant FHA requirements set forth in 24 CFR (Code of Federal Regulations) Parts 25, 28, 30, and 203; United States Code (U.S.C.), including 12 U.S.C. 1723i, 12 U.S.C. 1735f-14, 31 U.S.C. 3729-3733, 31 U.S.C. 3801-3812, and 42 U.S.C. 3535(d); HUD Handbooks 4160.1, 4155.1, and 4155.2; and HUD Mortgagee Letters 2009-12 and 2011-22 (including the attached Processing Guide);
- Reviewed an OIG legal opinion pertaining to restrictive covenants;
- Reviewed HUD management decisions discussing prohibited restrictive covenants;
- Reviewed prior reviews conducted by the HUD Quality Assurance Division;
- Discussed the prohibited restrictive covenants with HUD officials; and
- Compiled and summarized the loan data from the seven audits with corresponding prohibited restrictive covenants.

We relied, in part, on and used HUD computer-processed data to select the claim and active loans reviewed for prohibited restrictive covenants in the prior OIG audits. Additionally, we used this data to update the loan status of the selected loans before issuance of the external audits. Although we did not perform a detailed assessment of the reliability of data, we performed a minimal level of testing and determined that the data were sufficiently reliable for our purposes.

We conducted our work in accordance with generally accepted government auditing standards, except that we did not consider the internal controls or information systems controls of HUD. We did not follow standards in these areas because our objective was to summarize prior OIG audit results and determine HUD's identification of similar problems and what it had done to discourage such agreements. To meet our objective, it was not necessary to fully comply with the standards, nor did our approach negatively affect our review results.

BACKGROUND

FHA, created by Congress in 1934, is the largest mortgage insurer in the world aimed at helping low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. It is also the only government agency that operates entirely from its self-generated income from mortgage insurance paid by homeowners and costs the taxpayers nothing. FHA mortgage insurance encourages lenders to approve mortgages for otherwise creditworthy borrowers that might not be able to meet conventional underwriting requirements by protecting the lender against default. At the same time, according to HUD requirements, the lender has the responsibility at loan closing to ensure that any conditions of title to the property are acceptable to FHA and that the mortgaged property will be free and clear of all liens other than the mortgage. Lenders are responsible for complying with all applicable HUD regulations and in turn are protected against default by FHA's Mutual Mortgage Insurance Fund, which is sustained by borrower premiums.

In the event of homeowner default, the FHA fund pays claims to participating lenders. To this end, lenders have a responsibility to ensure that the FHA fund is protected by approving only those loans that meet all eligibility requirements. The FHA fund capital reserve ratio has a congressional mandate of 2 percent. However, based on the 2012 annual report to Congress on the FHA fund,¹ its capital reserve ratio had fallen below zero to a negative 1.44 percent. A U.S. Government Accountability Office report on the FHA fund stated, "If the [capital] reserve account were to be depleted, FHA would need to draw on permanent and indefinite budget authority to cover additional increases in estimated credit subsidy costs."² As a consequence, the FHA fund would no longer run on only self-generated income.

A prohibited restrictive covenant is a legal restriction on conveyance that prevents free assumability of an FHA-insured property.³ HUD has identified various types of prohibited restrictive covenants involving housing finance agencies; affordable housing downpayment

¹ Annual Report to Congress, Fiscal Year 2012 Financial Status, FHA Mutual Mortgage Insurance Fund

² U.S. Government Accountability Office testimony, GAO-12-578T, Mortgage Financing, FHA and Ginnie Mae Face Risk-Management Challenges, issued March 29, 2012

³ See appendix B.

assistance agreements; and condominium covenants, conditions, and restrictions documents. These prohibited restrictions have stipulated income, affordability, or length of stay restrictions. Previous OIG audit reports and memorandums⁴ reported that FHA lenders had allowed their affiliated builders (sellers) to execute covenant agreements with the FHA borrower that contained prohibited restrictions on conveyance.

We issued audit reports on Universal American Mortgage and DHI Mortgage based on general underwriting reviews that also identified prohibited restrictive covenants during the course of each audit. The Universal Mortgage audit reported that 15 loans contained prohibited restrictive covenants, and the two DHI Mortgage audits reported a total of 213 loans in which a prohibited restrictive covenant existed. Prompted by these reviews, we performed an auditability survey of FHA lenders with affiliated builders to determine whether other instances existed in which a lender allowed prohibited restrictive covenants between its builder and the FHA borrowers. This survey led to the additional external lender audits, culminating in this internal review.

The objective of the internal review was to summarize recently completed OIG external audits in which lenders allowed prohibited restrictive covenant agreements and determine the extent to which HUD had identified and discouraged such agreements.

RESULTS OF REVIEW

Our seven audit reviews of six different FHA lenders⁵ demonstrated that HUD needs to strengthen its oversight of prohibited restrictive covenants. HUD has regulations in place to prevent prohibited restrictions on conveyance of FHA-insured properties; however, in the four most recent OIG audits, we found an estimated 2,479 loans with prohibited restrictive covenants. HUD should enhance its efforts to reiterate to the mortgage industry that prohibited restrictive covenants are unacceptable and HUD regulations will be enforced with appropriate penalties. HUD's loan review process did not specifically include a review of restrictions on conveyance and did not track review findings related to restrictive covenants. With the six lenders reviewed, we identified more than \$67 million in potential losses that would not have otherwise occurred, putting the FHA fund at unnecessary risk.

SIX LENDERS ALLOWED PROHIBITED RESTRICTIVE COVENANTS

Reviews of the six FHA lenders demonstrated the prevalence and repeated use of prohibited restrictive covenants in violation of HUD regulations at 24 CFR 203.41(b).⁶ The four lenders most recently targeted and reviewed specifically for this violation showed an estimated 2,479 loans with prohibited restrictive covenant agreements.⁷ Of the 2,479 violating loans, 366 had entered conveyance claim status, resulting in a loss to HUD. These violations generally occurred because the lenders stated they were unaware that the restrictions violated HUD requirements.

⁴ See Methodology and Scope section for a description of each completed audit.

⁵ Four of the seven reviews were recently conducted as part of an OIG effort to target and identify lenders that allowed the recording of prohibited restrictive covenants. Audit resolution on the four external audits is ongoing. OIG and the Office of Housing have held discussions with the HUD Deputy Secretary to determine the appropriate remedies for violations involving restrictive covenants.

⁶ See appendix B.

⁷ The properties identified were located in Arizona, California, Florida, Georgia, Nevada, South Carolina, and Utah.

The insurance of these loans placed the FHA fund at an unnecessary risk of an estimated loss of more than \$49 million.

Reported summary of loans with prohibited restrictive covenants ⁸						
OIG report or memorandum	Total loans	Claim loans	Actual loss to HUD ⁹	Claims paid, loss unknown ¹⁰	Potential loss to HUD ¹¹	Totals
Recent OIG audits completed¹²						
Shea Mortgage, Inc.	600	29	\$ 1,467,611	\$ 2,566,837	\$ 5,092,201	\$ 9,126,649
Standard Pacific Mortgage, Inc.	90	28	1,535,189	1,390,235	544,967	3,470,391
Pulte Mortgage, LLC	1,106	181	9,909,292	11,865,597	1,359,876	23,134,765
CTX Mortgage Company, LLC	683	128	5,285,281	7,975,892	892,032	14,153,205
Subtotal	2,479	366	\$ 18,197,373	\$ 23,798,561	\$ 7,889,076	\$ 49,885,010
Prior OIG reviews completed						
Universal American Mortgage Company	15	1	\$ 118,861	\$ 0	\$1,188,588	\$1,307,449
DHI Mortgage	8	0	0	0	\$789,984	789,984
DHI Mortgage	205	2	219,223	0	15,037,560	15,256,783
Subtotal	228	3	\$ 338,084	\$ 0	\$ 17,016,132	\$ 17,354,216
Totals	2,707	369	\$ 18,535,457	\$ 23,798,561	\$ 24,905,208	\$ 67,239,226

Shea Mortgage, Inc.

We reported that Shea Mortgage did not follow HUD requirements when it underwrote loans that had executed and recorded agreements between Shea Homes and the FHA borrower, containing prohibited restrictive covenants in connection with FHA-insured properties. The audit memorandum reported on 600 loans (29 claim loans and 571 active loans¹²) that did not meet the requirements for FHA insurance. Shea Mortgage’s failure to exercise due diligence allowed prohibited restrictive covenants on the FHA-insured properties, which rendered them uninsurable.

Additionally, we reported that these uninsurable loans placed the FHA fund at unnecessary risk for potential losses because HUD would not otherwise see a loss on loans not insured by the FHA fund. Of the 57 loans (29 claim loans and 28 sampled active loans) identified with prohibited restrictive covenants, 11 resulted in an actual loss to HUD of more than \$1.4 million.

⁸ The loan information provided in the table reflects details reported in the specified OIG audit reports and memorandums cited.

⁹ The actual loss is the calculated amount of loss resulting from the sale of a HUD property. The loss is calculated based on the sales price - [acquisition cost + capital income/expense (rent, repair costs, taxes, sales expenses, and other expenses)].

¹⁰ At the time of the given report, HUD had not posted an actual loss, but a claim had been paid.

¹¹ The potential loss was based on the unpaid mortgage balance for each loan multiplied by the applicable loss rate at the time of the each report.

¹² The total number of loans with prohibited restrictive covenants for the four recently completed audits include estimated amounts derived from statistical sample projections completed for each individual audit.

Another 18 of these loans had conveyance claims paid totaling more than \$2.4 million. One loan was a preforeclosure sale with a \$135,699 claim paid by HUD. The remaining 27 loans found with prohibited restrictive covenants had a total unpaid mortgage balance of more than \$7.7 million with an estimated loss to HUD of more than \$5 million.

Standard Pacific Mortgage, Inc.

We reported that Standard Pacific Mortgage did not follow HUD requirements regarding free assumability and liens when it underwrote loans that had executed and recorded agreements between Standard Pacific Homes and the FHA borrower, containing prohibited restrictive covenants and liens in connection with FHA-insured properties. The audit memorandum reported on 90 loans (28 claim loans and 62 active loans¹²) that did not meet the requirements for FHA insurance, thereby rendering them ineligible for FHA insurance. Standard Pacific Mortgage's failure to exercise due diligence allowed prohibited restrictive covenants with liens on the FHA-insured properties, which rendered them uninsurable.

Additionally, we reported that these uninsurable loans placed the FHA fund at unnecessary risk for potential losses because HUD would not otherwise see a loss on loans not insured by the FHA fund. Of the 33 loans (28 claim loans and 5 sampled active loans) identified with prohibited restrictive covenants, 15 resulted in an actual loss to HUD of more than \$1.53 million. Another 13 of these loans had conveyance claims paid totaling more than \$1.39 million. The remaining five loans found with prohibited restrictive covenants had a total unpaid mortgage balance of more than \$878,000 with an estimated loss to HUD of more than \$544,000.

Pulte Mortgage, LLC

We reported that Pulte Mortgage did not follow HUD requirements regarding free assumability and liens when it underwrote loans that had executed and recorded agreements between sellers and the FHA borrower, containing prohibited restrictive covenants and liens in connection with FHA-insured properties. The audit memorandum reported on 1,106 loans (181 claim loans and 925 active loans¹²) that did not meet the requirements for FHA insurance, thereby rendering them ineligible for FHA insurance. Pulte Mortgage's failure to exercise due diligence allowed prohibited restrictive covenants with the potential for liens on the FHA-insured properties, which rendered the loans uninsurable.

Additionally, we reported that these uninsurable loans placed the FHA fund at unnecessary risk for potential losses because HUD would not otherwise see a loss on loans not insured by the FHA fund. Of the 192 loans (181 claim loans and 11 sampled active loans) identified in which a prohibited restrictive covenant was found, 82 resulted in an actual loss to HUD of more than \$9.9 million. Another 99 of these loans had conveyance claims paid totaling more than \$11.8 million. The remaining 11 loans found with prohibited restrictive covenants had a total unpaid mortgage balance of more than \$2.3 million with an estimated loss to HUD of more than \$1.3 million.

CTX Mortgage Company, LLC

We reported that CTX Mortgage did not follow HUD requirements regarding free assumability and liens when it underwrote loans that had executed and recorded agreements between sellers and the FHA borrower, containing prohibited restrictive covenants and potential liens in connection with FHA-insured properties. The audit memorandum reported on 683 loans (128 claim loans and 555 active loans¹²) that did not meet the requirements for FHA insurance, thereby rendering them ineligible for FHA insurance. CTX Mortgage's failure to exercise due diligence allowed prohibited restrictive covenants with the potential for liens on the FHA-insured properties, which rendered the loans uninsurable.

Additionally, we reported that these uninsurable loans placed the FHA fund at unnecessary risk for potential losses because HUD would not otherwise see a loss on loans not insured by the FHA fund. Of the 136 loans (128 claim loans and 8 sampled active loans) identified in which a prohibited restrictive covenant was found, 51 resulted in an actual loss to HUD of more than \$5.2 million. Another 77 of these loans had conveyance claims paid totaling more than \$7.9 million. The remaining eight loans found with prohibited restrictive covenants had a total unpaid mortgage balance of more than \$1.5 million with an estimated loss to HUD of more than \$892,000.

PROHIBITED RESTRICTIVE COVENANTS WERE MATERIAL VIOLATIONS

The OIG reviews identified in this audit memorandum emphasize the materiality and significance of the violations of HUD regulations and restrictions on conveyance. HUD regulations¹³ at 24 CFR 203.41(b) are clearly defined and state that to be eligible for insurance, the property must not be subject to legal restrictions on conveyance. Further, HUD Handbook 4155.2, paragraph 6.A.1.h, stated that it is the lender's responsibility at loan closing to ensure that any conditions of title to the property are acceptable to FHA. Regardless of intent, a deficiency becomes significant and material when it impacts the insurability of an FHA mortgage loan and when responsibility was on the lender to ensure compliance with the specific HUD regulations. In cases in which FHA properties have a prohibited restrictive covenant, we determined the violations to be material violations that should have precluded the loans from receiving FHA mortgage insurance.

Prior HUD Actions

Our findings and recommendations¹⁴ for each review were made based on how HUD responded and took action when it identified similar types of violations in its own reviews. In its prior reviews of Shea Mortgage,¹⁵ HUD identified unallowable restrictive covenants as a violation of Federal regulations and FHA requirements, considering the violations a material, serious deficiency, stating that loans with prohibited restrictive covenants were ineligible for FHA insurance. Therefore, we followed a similar course in the recent four external OIG reviews and

¹³ See appendix B.

¹⁴ The HUD Office of Single Family Housing and OIG disagreed regarding recommendations concerning indemnification. The HUD Deputy Secretary will determine the appropriate action.

¹⁵ HUD postendorsement technical review results on FHA loans 048-6246440 and 048-5912514

included recommendations that HUD's Associate General Counsel for Program Enforcement pursue civil remedies, civil money penalties, or other administrative action against each lender, if appropriate. We also recommended that HUD's Deputy Assistant Secretary for Single Family Housing require the lenders to (1) reimburse the FHA fund for the actual losses for claims paid, (2) execute an indemnification agreement for claims paid for which the loss was not known, (3) remove all active prohibited restrictions or execute indemnification agreements that prohibited them from submitting claims on those loans identified, and (4) generally ensure that they follow 24 CFR 203.32 and 203.41.

Additionally, members of the United States Congress have illustrated their specific intent of protecting the FHA fund by providing HUD with the appropriate tools and remedies. The pending legislation, the FHA Emergency Fiscal Solvency Act of 2013,¹⁶ states that if the HUD Secretary determines that the lender knew or should have known of a serious or material violation of the requirements established by the Secretary, such that the mortgage loan should not have been approved and endorsed for insurance, and HUD pays an insurance claim with respect to the mortgage, the Secretary may require the lender to indemnify HUD for the loss, regardless of whether the violation caused the mortgage default. This legislation further reinforces the OIG recommendations on the recent four external reviews discussed above by providing the Secretary stronger tools to enforce indemnification.

FHA Fund Exposure

The FHA fund incurred actual and potential unnecessary losses of at least \$67 million due to an estimated 2,707 ineligible loans with prohibited restrictive covenants receiving FHA mortgage insurance. The unnecessary risk stems from the fact that each of these loans should never have received FHA mortgage insurance with the prohibited restrictions in place. Without regulatory reinforcement, FHA is exposed to a higher risk of continued noncompliance and the potential for incurring additional losses. Although we were unable to determine the prevalence of such restrictions associated with FHA-insured loans, because HUD systems do not capture this data, we know that it impacted part of the FHA insurance portfolio. According to HUD, in fiscal year 2012, FHA insured about 1.2 million single-family forward mortgage loans, totaling approximately \$213 billion. With such a large volume and dollar value of loans entering FHA's portfolio annually, it is important for HUD to do what it can to mitigate exposure to the FHA fund to support the continued viability of the fund.

Consumer Protection

While HUD regulations are in place to first protect the FHA mortgage insurance fund, the issue of prohibited restrictive covenants is especially significant as a secondary, but equally significant component of the HUD regulations are to help protect the consumer (the FHA borrowers). Specifically, HUD regulations at 24 CFR 203.41 protect FHA borrowers from prohibited restrictions that carry the potential to impact decision making and impose unnecessary financial burdens. An FHA borrower who is a party to prohibited restrictive covenants could feel pressure

¹⁶ House Resolution 1145, sponsored by Congresswoman Maxine Waters and Congressman Michael E. Capuano on March 13, 2013. It was reintroduced under the 113th Congress after the 112th Congress referred it to the Committee on Banking, Housing, and Urban Affairs.

to defer an attempted conveyance or transfer of his or her property to the detriment of his or her current financial limitations because of perceived payable damages for a breach of contract. In some instances, a waiting period could be the difference between a borrower making good on his or her mortgage and lapsing into foreclosure, which could harm the borrower and ultimately the FHA fund.

HUD NEEDS TO STRENGTHEN ITS OVERSIGHT OF RESTRICTIVE COVENANTS

HUD generally recognized the importance of ensuring that prohibited restrictive covenants were not allowed to be recorded with FHA properties. HUD officials realized that there was a need to inform lenders and reemphasize HUD regulations concerning restrictive covenant agreements. However, HUD needs to do more to strengthen its oversight of prohibited restrictive covenants and its message to lenders that such restrictions will not be tolerated. According to HUD, these prohibited agreements persist due to the builders, with associated lenders, wanting to protect their economic self-interests in the housing developments they built.

Homeownership Center personnel informed us that HUD did not track violations pertaining to prohibited restrictive covenants and had no way of pulling instances of violations without reviewing the data on a loan-by-loan basis. Therefore, we were unable to determine the nationwide extent of prohibited restrictive covenant agreements identified by HUD. Additionally, HUD's loan reviews did not include specific procedures to identify prohibited restrictive covenants, instead it relies on the experience and knowledge of the individual reviewers.

When a violation was found, HUD generally required¹⁷ lenders to (1) remove the restrictions or request indemnification or (2) reconvey the loan to the lender if the loan had already been conveyed to HUD. However, an Office of Single Family Housing official stated that HUD needs to determine the appropriate penalty, describe the penalty, and then communicate that this behavior will not be tolerated.¹⁸ An appropriate remedy, coupled with consistent use of the appropriate penalties, would not only reinforce the materiality of the violations, but would send a message to lenders that such violations will not be tolerated. HUD believed that the use of the Mortgagee Review Board for civil money penalties against lenders would discourage lenders from allowing prohibited restrictive covenants and enforce HUD's requirements, in part, because these actions against a lender are published in the Federal Register. Additionally, HUD Homeownership Center officials suggested that

- An issuance of a mortgagee letter, in plain English, reiterating what are acceptable restrictions and what are not would help in preventing and reducing the risk of these violations.
- A webinar or other training could help reinforce the policy on restrictive covenants.
- Harsher penalties would need to be assessed before lender behavior would change.

¹⁷ OIG disagreed with the Office of Housing regarding the appropriate remedies for cases identified with prohibited restrictive covenant agreements.

¹⁸ OIG was in discussions with the HUD Deputy Secretary to determine appropriate penalties.

We identified some HUD requirements¹⁹ that had been made available to lenders which specified that HUD could and would take action against lenders for violating FHA requirements. These included but are not limited to Mortgagee Letter 2009-12; Mortgagee Letter 2011-22 (including the attached Processing Guide); HUD Handbook 4155.2, paragraph 9.A.1.a; and HUD Handbook 4155.2, paragraph 9.D.1.a, which state, in part, that noncompliance actions vary significantly in their scope and effect. The more serious the scope and effect of the action, the more serious is the sanction that would be applied.

Conclusion

Our reviews of six FHA lenders clearly demonstrate that HUD needs to strengthen its oversight and efforts in identifying prohibited restrictive covenants in connection with FHA-insured properties, prohibited under 24 CFR 203.41(b), which violate FHA requirements for insurability, and take additional action to stop the behavior. We were unable to determine the nationwide extent of the issue as HUD did not specifically look for prohibited restrictive covenants during loan reviews and did not track such violations. However, as stated above, we identified six lenders that allowed the prohibited restrictive covenants. Generally these lenders allowed the agreements because they stated they were unaware that it violated HUD requirements. We agree with HUD that these prohibited agreements persist due to builders, with associated lenders, wanting to protect their economic self-interests in their single family housing developments. We also attribute this condition to HUD's lack of recent public regulatory reinforcement and discouragement of these material violations that impact the insurability of the loans. While HUD did recommend corrective actions as violations were identified, this was done only on a case-by-case basis. As a result, FHA insured ineligible loans and incurred unnecessary losses due to ineligible loans' receiving FHA mortgage insurance. Without regulatory reinforcement, FHA and consumers are exposed to a higher risk of additional losses from the continued noncompliance.

RECOMMENDATIONS

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

- 1A. Reinforce HUD regulatory requirements concerning restrictive covenant agreements to the industry, including lenders and builders. Reinforcement should include efforts such as the issuance of a mortgagee letter, addition of a section to the frequently asked questions, and distribution through LISTSERV. Reinforcement should also include a message to lenders and builders that prohibited restrictive covenant agreements will not be tolerated.
- 1B. Develop and implement specific review procedures to identify prohibited restrictive covenants during Homeownership Center loan reviews and provide education to Homeownership Center personnel to reiterate the importance of identifying the various types of prohibited restrictive covenant agreements.

¹⁹ See appendix B.

- 1C. Develop and implement specific procedures detailing penalties and corrective actions that can be applied consistently to each violating lender and builder. HUD should consider including the various prohibited restrictive covenants known to HUD beyond those identified in this memorandum.


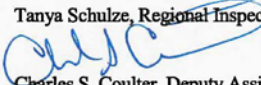
- 1D. Develop and implement procedures for tracking loans identified with prohibited restrictive covenants, including the type of restriction, which would allow HUD and OIG to (1) identify their frequency and emerging trends, (2) determine the impact to FHA, and (3) adequately review of the loans.

Appendix A

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

	 <p>OFFICE OF HOUSING</p>	<p>U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT WASHINGTON, DC 20410-8000</p> <p>SEP 13 2013</p>
	MEMORANDUM FOR:	Tanya Schulze, Regional Inspector General for Audit, 9DGA
	FROM:	 Charles S. Coulter, Deputy Assistant Secretary for Single Family Housing, HU
	SUBJECT:	Discussion Draft Report Review of Six FHA Lenders Demonstrated That HUD Needs to Strengthen Its Oversight of Prohibited Restrictive Covenants
		<p>This is in response to your memorandum of August 12, 2013, transmitting the subject draft audit report. We are providing formal comments to the draft for your consideration.</p> <p>The Office of the Inspector General (OIG) conducted a limited review of the U. S. Department of Housing and Urban Development's (HUD or the Department) oversight of loans underwritten by Federal Housing Administration's (FHA) approved lenders. OIG initiated the audit as part of its 2013 annual audit plan and prompted by four recent OIG external audits reporting that FHA lenders allowed prohibited restrictive covenants.</p> <p>As you know, FHA does not dispute the overall theme of the IG's findings that certain FHA lender's permitted the practice of recording restrictive covenants on FHA loans. FHA offers the following comments to the OIG's draft audit report.</p> <p><u>Results of the OIG Reviews</u></p> <p>OIG determined that six FHA lenders demonstrated prevalent and repeated use of restrictive covenants in violation of HUD regulations at 24 CFR 203.41 (b). The draft report focuses primarily on the four most recent audits in which this practice was uncovered, and for the purpose of this response, FHA's analysis will focus on the audits of Shea Mortgage, Standard Pacific Mortgage, Pulte Mortgage, and CTX Mortgage, herein referred to collectively as the "underlying audit reports". The draft report indicates an estimated 2,479 loans contained prohibited restrictive covenants. FHA notes that this assertion by the OIG is misleading in that this estimation is based on an extrapolation of actual cases reviewed which contained restrictive covenants. Based on FHA's review of the underlying audit reports, 479 cases containing restrictive covenants were identified. This number is reduced further to 451 considering the fact that 28 of the cited restrictive covenants were not legally enforceable and were recorded in error.</p> <p>Of the 451 loans identified which contained a valid restrictive covenant, FHA has paid a claim on 366 loans. FHA determined that the true number of claims paid on loans with restrictive covenants was 339, given that 27 of these claims were on the above referenced loans which contained the</p>
		<p>www.hud.gov espanol.hud.gov</p>

Comment 1

Comment 2

Comment 3

Comment 4

restrictive covenants that were not legally enforceable. FHA examined the performance of these cases within the period covered by the restrictive covenants, which generally corresponded to one year from the date the loans closed, to determine what effect, if any, the covenants had on loan performance. Only 83 loans were determined to have had serious delinquencies within the period covered by a restrictive covenant. None of the default reasons reported by the servicers cited the borrower's inability to sell or rent the property as the reason for the serious delinquency. The borrowers for each of the 83 seriously delinquent cases made an average of 9 payments on their loans before the first 90 day delinquency was reported by the servicer. In addition, a total of only 3 claims were submitted on these cases within the first year from the closing date. This data provides strong evidence that the presence of the restrictive covenants was not a factor in whether the cases went to claim status or in whether the Department suffered insurance claim losses.

Comment 5

Prohibited Restrictive Covenants Were Material Violations

FHA values the OIG's perspective regarding the materiality and significance of the violations of HUD regulations and restrictions on conveyance. FHA agrees with the OIG's finding that that HUD regulations "at 24 CFR 203.41(b) are clearly defined and state that to be eligible for insurance, the property must not be subject to legal restrictions on conveyance." However, FHA notes that there are a myriad of requirements that a loan must meet in order to be eligible for insurance, not all of which are significant and material. Not all violations of FHA regulations warrant one of the harshest financial penalties available to HUD. FHA reiterates its position that it does not believe that the form of restrictive covenants covered in these audits, rise to the level of materiality which would require indemnification.

Comment 6

It is important to note that FHA generally seeks indemnification for material underwriting violations that could negatively impact loan performance and expose the Department to financial loss. In the underlying audits reports, the restrictive covenants, which ranged from 6 months to 12-month periods, were determined not to have such an impact. As mentioned above, only three of the cited loans had a conveyance claim filed during the period of time covered by a restrictive covenant.

Comment 7

The loans containing restrictive covenants reviewed by the OIG all used the standard FHA Deed of Trust which allowed the borrower to be released from the minimum time period of occupancy in the event of the borrower's financial hardship or extenuating circumstances. The restrictive covenants therefore should not have adversely affected the borrowers' ability to repay their loans or prevented borrowers' from seeking an authorized loss mitigation alternative.

In addition, the restrictive covenants covered in this audit would not have prevented FHA from obtaining clear title in the event of a foreclosure and conveyance. The subject restrictions were agreements between borrowers and the sellers to the contract of sale and did not restrict the use of the land or property and thus would not impair FHA's ability to properly dispose of the property through the normal REO process and realize full market value.

Prior HUD Actions

The draft audit report states that “the United States Congress has illustrated its specific intent of protecting the FHA fund by providing HUD the appropriate tools and remedies.” The OIG is referencing the FHA Emergency Fiscal Solvency Act of 2013, a House sponsored bill which was introduced in March 2013 and has not made it out of the House Financial Services Committee for a vote by the full House. FHA is seeking that specific language in order to create a more level playing field between lenders with different FHA authorities, whereby it can require indemnification from Direct Endorsement lenders as it has the authority to do so for lenders with Lender Insuring authority.

HUD Needs To Strengthen Its Oversight of Restrictive Covenants

As the OIG report acknowledged, FHA does recognize the importance of ensuring that prohibited restrictive covenants are not allowed to be recorded with FHA properties. It is important to note that this issue identified in the underlying audit reports is a localized problem associated with builder affiliated mortgage lenders and new home production in certain speculative housing markets across the country. FHA does not have the data available to determine the exact count of FHA approved builder affiliated mortgagees, yet believes that it is a very small segment of FHA new purchase business.

Comment 8

The draft report asserts that the problem of restrictive covenants persists due to HUD’s lack of recent regulatory reinforcement. FHA contends that the problems persist due to the economic self-interests of the builders’ affiliated with the FHA mortgage lenders. In certain speculative housing markets, builders continue to use restrictive covenants to protect anticipated profit margins and prevent speculative investors from artificially driving real estate values. Nonetheless, as was suggested in the separate responses to the underlying audit reports, FHA believes that referral of the lenders committing these violations to the Mortgagee Review Board will have the deterrent effect necessary to curb this practice.

Comment 9

Comment 5

FHA believes that it has adequate controls in place to detect this practice. FHA takes exception to the claim that “HUD’s loan reviews did not include specific procedures to identify prohibited restrictive covenants; instead it relies on the experience and knowledge of the individual reviewers.” FHA’s risk management framework includes a comprehensive review of approximately 10% of all approved lenders on an annual basis and a robust quality control review of a significant number of performing and non-performing loans. The loan reviews performed by Housing’s staff encompass the entire range of program requirements governing the origination, underwriting and servicing of FHA-insured mortgage loans. It is impractical to have specific review procedures for every possible violation of FHA requirements. Rather, restrictive covenants are included as one of many issues examined in Housing’s ongoing reviews of FHA-insured loans to determine compliance with HUD requirements on closing documents. FHA review staff are trained and expected to review all pertinent aspects of an FHA loan, including compliance with closing requirements and legal document sufficiency. FHA continually refines this process to ensure that it is maximizing its opportunity to identify those lenders and loans presenting the greatest risk to the Department.

Comment 10

Conclusion

Housing and FHA continues to refine its loan review criteria and regularly evaluates its materiality standards to ensure violations of FHA policy that demonstrate potential financial harm to the insurance fund are properly mitigated. FHA shares the OIG's ongoing interest in ensuring the robustness of HUD's monitoring and oversight mechanisms for FHA programs. FHA is confident that its continued efforts to strengthen and effectively implement the risk management tools and loan review efforts at its disposal have yielded significant improvements that permit HUD to satisfactorily protect its insurance funds.

OIG Evaluation of Auditee Comments

Comment 1 We disagree with the Office of Single Family Housing's (Housing) statement that the audit memorandum was misleading by reporting on an extrapolation of actual cases. Our methodology and reporting of statistical sample projections is an appropriate use of a statistical sample. For each of the underlying audits, if an unallowable restrictive covenant was found on a statistically selected random sample items (active loan review) these loans were projectable to the universe of the loans. As stated in the New York Law Journal's article The Use of Statistical Sampling as Evidence, by George Bundy Smith and Thomas J. Hall,

Statistical sampling is a scientific methodology by which one draws conclusions about a large population of data by measuring and analyzing a smaller, representative sample of the population. When the sample is randomly selected and of sufficient size so as to achieve statistical significance, statisticians may confidently make inferences about the larger population by reviewing the sample. As such, statistical sampling can provide an efficient way to estimate accurately larger populations of data, and has been utilized across many spectrums outside of the courtroom, including election polling, television ratings, unemployment surveys and analyses of public health issues.

Comment 2 Housing presented an analysis of restrictive covenants and stated that only 339 of 479 cases contained an actual restrictive covenant. As specified in the audit memorandum, the loan data included in the audit finding is a summary of the loan information provided in the individual audit memorandums and reports. As the audit objective stated, in part, was to summarize the previous audit reports and memorandums we did not update the loan information, instead we reported the information as it was published. We added a footnote to the table on page 5 of this audit memorandum for clarification.

Comment 3 We agree with Housing that 27 of the claims identified contained a mitigating document²⁰, rendering the restrictive covenants not enforceable. However, it is important to note that restrictive covenants were still recorded with the applicable counties for each of the 27 loans.

Comment 4 Housing stated that the presence of restrictive covenants was not a factor in whether loans went to claim or in whether the Department suffered insurance claim losses. The audit memorandum and associated external audit reports were completed with an objective of determining the presence of prohibited restrictive covenants. We determined the presence of a prohibited restrictive covenant was a significant, material violation, regardless of whether it was the cause of the loan default. The significance and materiality stems from the fact that loans with a

²⁰ See audit memorandum 2013-LA-1801, Standard Pacific Mortgage, Inc., Irvine, CA, Allowed the Recording of Prohibited Restrictive Covenants.

prohibited restrictive covenant should not have received FHA mortgage insurance.

Comment 5 Housing agreed with the audit memorandum's findings, however, disagreed that indemnification is warranted for the violations explained in this audit memorandum and each of the completed external audit memoranda. At the time of this memorandum, audit resolution for each of the four recently completed audits was still ongoing. OIG and the Office of Single Family Housing were in discussions with the HUD Deputy Secretary to determine appropriate penalties for lenders allowing the recording of prohibited restrictive covenants. We respectfully disagree with the Office of Single Family Housing and believe that indemnification, in addition to a referral to the Mortgagee Review Board, is warranted for the reasons cited in this audit memorandum. We added a footnote to this audit memorandum for clarification.

Comment 6 We disagree with Housing and believe the restrictive covenants did expose HUD to financial loss. Regulations at 24 CFR 203.41(b) states that loans with prohibited restrictive covenants are not eligible for FHA mortgage insurance. In this regard, the loans cited in this audit memorandum should not have received FHA mortgage insurance and associated losses should not have been incurred by HUD.

We would like to clarify that the primary four audit memorandums discussed in the audit finding include prohibited restrictive covenants with a restriction period that ranged from 6 to 24 months (examples are provided in each of the four audit memorandums).

Comment 7 As explained in the audit finding under the "Consumer Protection" section, the prohibited restrictive covenants impact the consumer (FHA borrower) and not just FHA. Additionally, Housing's position regarding clear title in the event of a foreclosure is secondary to the primary basis of this audit memorandum that each loan with a prohibited restrictive covenant was not eligible for FHA mortgage insurance in the first place. See also comments 4 and 5.

Comment 8 We agree with Housing that the issue of prohibited restrictive covenants in association with lenders and associated builders is most likely localized, concentrated in areas with more new construction. However, we would like to clarify that because of the lack of data collected by HUD pertaining to prohibited restrictive covenants, the extent of the problem is unknown and we cannot state the severity of the issue and do not have data indicating which areas have higher concentrations of prohibited restrictive covenants.

During our review, we became aware of other restrictive covenants that potentially make the issue more significant and extend beyond this idea of localization. Interviews with HUD Homeownership Center staff indicated restrictive covenants were present in other situations beyond new construction,

involving housing finance agencies, affordable housing downpayment assistance agreements, and condominium Covenants, Conditions, and Restrictions (CCRs) documents. These prohibited restrictions have stipulated income, affordability, or length of stay restrictions.

Comment 9 We agree with Housing that the issue persists, in part, due to the economic self-interests of the builders affiliated with the FHA mortgage lenders. However, more pertinent to this audit memorandum, we believe HUD can do more to reinforce its regulations regarding prohibited restrictive covenants. We have modified the audit memorandum language discussing the cause to incorporate HUD's belief that this issue continues as a result of the economic self-interests of the builders' affiliated with FHA mortgage lenders.

Comment 10 While we do not disagree with Housing's position that they have a risk management framework in place coupled with trained staff, we do, however, disagree with Housing's statement that it has adequate controls in place with regards to prohibited restrictive covenants. As stated in the audit memorandum, each of the lenders allowed numerous FHA-insured properties to have prohibited restrictive covenants over the course of multiple years. The recommendations in this audit memorandum focus on strengthening HUD's (1) controls in this area and (2) ensuring enforcement is appropriate and consistent.

Appendix B

CRITERIA

The FHA insurance requirements set forth in **24 CFR 203.41(b)** state that to be eligible for insurance, the property must not be subject to legal restrictions on conveyance. Further, 24 CFR 203.41(a)(3) defines legal restrictions on conveyance as “any provision in any legal instrument, law or regulation applicable to the mortgagor or the mortgaged property, including but not limited to a lease, deed, sales contract, declaration of covenants, declaration of condominium, option, right of first refusal, will, or trust agreement, that attempts to cause a conveyance (including a lease) made by the mortgagor to:

- (i) Be void or voidable by a third party;
- (ii) Be the basis of contractual liability of the mortgagor for breach of an agreement not to convey, including rights of first refusal, pre-emptive rights or options related to mortgagor efforts to convey;
- (iii) Terminate or subject to termination all or a part of the interest held by the mortgagor in the mortgaged property if a conveyance is attempted;
- (iv) Be subject to the consent of a third party;
- (v) Be subject to limits on the amount of sales proceeds retainable by the seller; or
- (vi) Be grounds for acceleration of the insured mortgage or increase in the interest rate.”

Regulations at **24 CFR 203.32** state that a “mortgagor must establish that, after the mortgage offered for insurance has been recorded, the mortgaged property will be free and clear of all liens other than such mortgage, and that there will not be outstanding any other unpaid obligations contracted in connection with the mortgage transaction or the purchase of the mortgaged property, except obligations that are secured by property or collateral owned by the mortgagor independently of the mortgaged property.”

HUD Handbook 4155.2, paragraph 6.A.1.h, stated that it is the lender’s responsibility at loan closing to ensure that any conditions of title to the property are acceptable to FHA. In essence, it is the duty of the lender to ensure that FHA loans approved for mortgage insurance are eligible and acceptable according to FHA rules and regulations.

Mortgage Letter 2009-12 warns lenders about appropriate lending practices by stating that HUD must hold lenders accountable for their lending practices to protect the public trust and the FHA fund.

Mortgage Letter 2011-22 in the attached Processing Guide, for the condominium approval process, paragraph 1.8.8, reiterates 24 CFR 203.41 requirements for free assumability. Additionally, it states, “If the conveyance could cause any of these things to occur, the property is considered to be subject to legal restrictions on conveyance and is usually ineligible for FHA mortgage insurance.”

HUD Handbook 4155.2, paragraph 9.A.1.a, states, in part, that the objective of the Homeownership Center action is to reduce the risk of defaults and claims to FHA, improve lender performance, and remove noncomplying lenders from the program.

HUD Handbook 4155.2, paragraph 9.D.1.a, states, in part, that noncompliance actions vary significantly in their scope and effect. The more serious the scope and effect of the action, the more serious is the sanction that would be applied.