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

April 18, 2013

MEMORANDUM NO:
2013-LA-1802

Memorandum

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

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

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

SUBJECT: Pulte Mortgage LLC, Englewood, CO, Allowed the Recording 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 loans underwritten by Pulte Mortgage LLC.[1] We selected the lender based on the results of an auditability survey, which determined that Pulte Mortgage allowed prohibited restrictive covenants to be filed against Federal Housing Administration (FHA)-insured properties. The objective of our review was to determine the extent to which Pulte Mortgage failed to prevent the recording of prohibited restrictive covenants with potential liens in connection with FHA-insured loans closed between January 1, 2008, and December 31, 2011.

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.

[1] FHA identification number 05369

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 332[2] loans underwritten by Pulte Mortgage with closing dates between January 1, 2008, and December 31, 2011. We conducted the audit work from the HUD OIG Phoenix, AZ, Office of Audit between June 2012 and January 2013. To accomplish our objective, we

- Reviewed prior HUD OIG audit reports with findings that included lenders allowing prohibited restrictive covenants;[3]
- Reviewed relevant FHA requirements set forth in 24 CFR (Code of Federal Regulations) Part 203 and HUD Handbooks 4000.2 and 4155.2;
- Reviewed a HUD OIG legal opinion pertaining to restrictive covenants;
- Reviewed a HUD management decision discussing prohibited restrictive covenants;
- Reviewed prior reviews conducted by the HUD Quality Assurance Division;
- Discussed the prohibited restrictive covenants with Pulte Mortgage officials; and
- Obtained and reviewed FHA loan data downloaded from HUD's Single Family Data Warehouse[4] and Neighborhood Watch systems.[5]

We analyzed the Single Family Data Warehouse data as of May 31, 2012, and separated the data into two categories: (1) loans that had gone into claim status and (2) loans that were still active. We selected a 100 percent review of the claim loans, 260 loans total, and elected to review a highly stratified attribute statistical sample of the 9,730 active loans. The stratified sample of the 72 loan samples was randomly selected and weighted by means of a computer program in SAS® using a seed value of 7. To meet the audit objective, we also

- Requested and received copies of the lender's FHA lender files for the loans selected for review;
- Attempted to contact some borrowers for loans on which HUD paid a claim and interviewed a borrower;

[2] 260 claim loans and 72 statistically selected active loans
[3] Audit report numbers 2009-LA-1018, 2010-LA-1009, and 2011-LA-1017
[4] HUD's Single Family Data Warehouse is a collection of database tables structured to provide HUD users easy and efficient access to single-family housing case-level data on properties and associated loans, insurance, claims, defaults, and demographics.
[5] Neighborhood Watch is a Web-based software application that displays loan performance data for lenders and appraisers by loan types and geographic areas, using FHA-insured single-family loan information.

- Conducted Internet research, identified and queried applicable county recorder offices, and searched Accurint[6] to obtain and review recorded documents related to the sampled FHA-insured mortgages; and

- Compiled and summarized the loan data with corresponding prohibited restrictive covenants.

For the audit sample, the percentage and number of loans with unallowable restrictive covenants were computed based on the weighted sampling results and extended to the population using the "surveyfreq" procedure provided by SAS®. We used a 15-strata sample design to control for potential bias that might arise from varying rates of price escalation and varying resale demand based on population density. Of the selected samples, 11 had disallowed covenants, which projects to 15.78 percent, or 1,535 loans. To account for the statistical margin of error, we subtracted the standard error (3.754) times a t-score of 1.67. As a result, we can be 95 percent confident that at least 925 of the 9,730 loans had similar problems with unallowable 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. 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 Pulte Mortgage. We did not follow standards in these areas because our objective was to identify the extent to which Pulte Mortgage allowed prohibited restrictive covenants and how that affected the FHA single-family insurance program risk. To meet our objective, it was not necessary to fully comply with the standards, nor did our approach negatively affect our review results.

BACKGROUND

Pulte Mortgage is a nonsupervised direct endorsement lender[7] headquartered in Englewood, CO. It received this FHA mortgage insurance program status in 1983. Its affiliated builders, Pulte Homes and Del Webb, were sellers of the properties discussed in this review memorandum.

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

[6] Accurint LE Plus accesses databases built from public records, commercial data sets, and data provided by various government agencies.

[7] A nonsupervised lender is a HUD-FHA-approved lending institution that has as its principal activity the lending or investment of funds in real estate mortgages and is not a supervised lender, a loan correspondent, a governmental institution, a government-sponsored enterprise, or a public or State housing agency and has not applied for approval for the limited purpose of being an investment lender.

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. However, according to HUD-FHA 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,[8] 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."[9] Therefore, the FHA fund would no longer run on only self-generated income.

We reviewed a legal opinion[10] from OIG's Office of Legal Counsel regarding the seller's restriction on conveyance of FHA properties. Counsel opined that the recorded agreements between the seller and borrowers would constitute a violation of HUD statutes, regulations, or handbook requirements. In its opinion, the Office of Legal Counsel specifically stated that 24 CFR 203.41(b), pertaining to consent by a third party, appears to violate HUD's regulations. In this case, the seller is considered a third party.

Additionally, we obtained a HUD management decision on the recommendations of a prior OIG audit[11] not related to Pulte Mortgage. In the decision, HUD agreed that the execution of prohibited restrictive covenants is a violation of Federal regulations and FHA requirements and considered the violation a serious deficiency, stating that loans with prohibited restrictive covenants are ineligible for FHA insurance.

RESULTS OF REVIEW

Pulte Mortgage did not follow HUD requirements regarding free assumability and liens when it underwrote loans that had executed and recorded agreements between Pulte Homes and the FHA borrower, containing prohibited restrictive covenants and liens in connection with FHA-insured properties. This noncompliance occurred because Pulte Mortgage did not exercise due diligence and was unaware that the restrictive covenants recorded between the sellers and the borrowers violated HUD-FHA requirements. As a result, we found 1,106 FHA-insured loans (181 claim

[8] Annual Report to Congress, Fiscal Year 2012 Financial Status, FHA Mutual Mortgage Insurance Fund
[9] U.S. Government Accountability Office testimony, GAO-12-578T, Mortgage Financing, FHA and Ginnie Mae Face Risk-Management Challenges, issued March 29, 2012
[10] The legal opinion was previously obtained during the review of a separate lender (2011-LA-1017) for a similar restriction contained in the FHA purchase agreement.
[11] Audit report 2011-LA-1017

loans and 925 active loans) with a corresponding prohibited restrictive covenant with a potential lien recorded with the applicable county recording office, and Pulte Mortgage placed the FHA fund at unnecessary risk for potential losses.

Claim Loan Review Results

We identified and reviewed all 260 claim loans underwritten by Pulte Mortgage,[12] limited to loans closed between January 1, 2008, and December 31, 2011. In our review of the applicable county recorders' documents, we identified unallowable restrictive covenants corresponding to 181 of the 260 claim loans with properties in Arizona, California, Florida, and Nevada. Of the 181 loans, 82 resulted in actual losses[13] to HUD totaling more than $9.9 million (see appendix C, table 1), and 99 resulted in claims paid totaling more than $11.8 million, but the properties had not been sold by HUD (see appendix C, table 2).

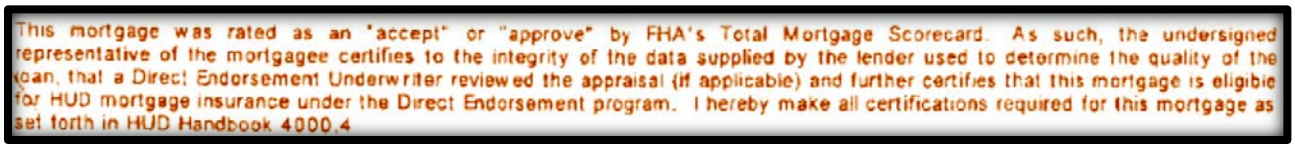
Active Loan Sample Results

Additionally, we completed a random attribute statistical sample and selected 72 of 9,730 active loans within our audit period. In our review of the applicable county recorders' documents of the sampled active FHA loans, we identified an unallowable restrictive covenant corresponding to 11 of the 72 sampled active loans with properties in Arizona, California, Florida, and Nevada. The 11 loans were active with an unpaid principal balance of more than $2.3 million (see appendix C, table 3).

Based on a highly stratified sample, designed to minimize error and accommodate varying rates of price escalation and varying demand based on population density, 15.78 percent of the 72 weighted loan samples contained restrictive covenants, which are not allowed by HUD rules. Therefore, we can be 95 percent confident that at least 925 of the 9,730 active loans in our audit period had similar problems with unallowable restrictive covenants (see Scope and Methodology).

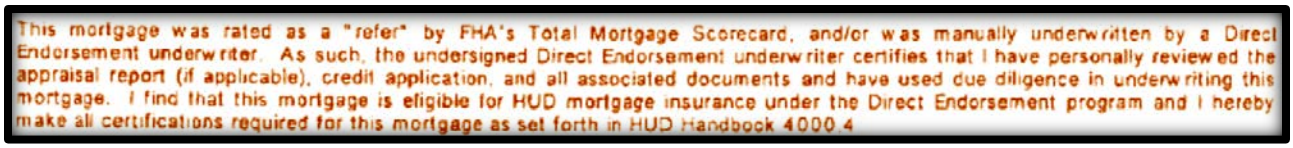
Restriction on Conveyance

For each FHA loan, the lender certifies on the Direct Endorsement Approval for HUD/FHA-Insured Mortgage (form HUD-92900-A) that the mortgage was eligible for HUD mortgage insurance under the direct endorsement program (see lender certification excerpts below).


This mortgage was rated as an "accept" or "approve" by FHA's Total Mortgage Scorecard. As such, the undersigned representative of the mortgagee certifies to the integrity of the data supplied by the lender used to determine the quality of the loan, that a Direct Endorsement Underwriter reviewed the appraisal (if applicable) and further certifies that this mortgage is eligible for HUD mortgage insurance under the Direct Endorsement program. I hereby make all certifications required for this mortgage as set forth in HUD Handbook 4000.4

[12] Based on HUD's Single Family Data Warehouse as of May 31, 2012

[13] 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)].


This mortgage was rated as a "refer" by FHA's Total Mortgage Scorecard, and/or was manually underwritten by a Direct Endorsement underwriter. As such, the undersigned Direct Endorsement underwriter certifies that I have personally reviewed the appraisal report (if applicable), credit application, and all associated documents and have used due diligence in underwriting this mortgage. I find that this mortgage is eligible for HUD mortgage insurance under the Direct Endorsement program and I hereby make all certifications required for this mortgage as set forth in HUD Handbook 4000.4

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."

Additionally, 24 CFR 203.32 states 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."[14]

Finally and of most significance, HUD Handbooks 4000.2, paragraph 5-1(B), and 4155.2, paragraph 6.A.1.h, both state 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. The restrictive covenants identified placed a prohibited restriction on the conveyance by a third party of the FHA properties, conflicting with the lender's certification that the loans met HUD-FHA insurance requirements defined in 24 CFR 203.41(a)(3).

It is also noteworthy that HUD Handbook 4155.1, paragraph 4.B.2.b, states, "FHA security instruments require a borrower to establish bona fide occupancy in a home as the borrower's principal residence within 60 days of signing the security instrument, with continued occupancy for at least one year." However, these security instruments would be between the lender and borrower, not a third party like the seller. Extra emphasis must be placed on the fact that the conveyance of the property during the occupancy period was limited by the seller, which

[14] The CFR includes exceptions; however, the exceptions do not apply in this case.

violated HUD-FHA requirements 24 CFR 203.41(b) defined at 24 CFR 203.41(a)(3)(ii) and 203.41(a)(3)(iv). The following are excerpts from multiple versions of the recorded restrictive covenants found between the seller, a third party to the FHA loans, and borrowers.

Version 1

For good and valuable consideration, pursuant to the terms of the Agreement and specifically the Buyer Declaration and Occupancy Agreement attached thereto, Buyer has granted to Seller certain rights and remedies in the event Buyer conveys or transfers, or attempts to convey or transfer, Buyer's interest in the Property for a period of one (1) year from the Closing Date. In the event of Buyer's actual or attempted conveyance or transfer within such one (1) year period, Seller may elect, in its sole discretion, to either (i) receive payment by Buyer of damages in an amount equal to the difference between (a) the fair market value of the Property at the time of Buyer's sale or other transfer of the Property, less Buyer's customary costs of resale (such as broker's commission, escrow fees and title costs) actually incurred by Buyer, and (b) the Purchase Price set forth in the Agreement, plus the actual cost of any permanent improvements made by Buyer to the Property, or (ii) repurchase the Property from Buyer as more fully set forth in the Agreement.

Version 2

For good and valuable consideration, pursuant to the terms of the Agreement and specifically the Buyer Addendum attached thereto, Buyer has granted to Seller certain rights and remedies in the event Buyer conveys or transfers, or attempts to convey or transfer, Buyer's interest in the Property for a period of one (1) year from the date of recordation of this Memorandum. In the event of Buyer's actual or attempted conveyance or transfer within such one (1) year, Seller may elect, in its sole discretion, to either (i) receive payment by buyer of damages in an amount equal to the difference between (a) the fair market value of the Property at the time of buyer's sale or other transfer of the Property, less Buyer's customary costs of resale (such as broker's commission, escrow fees and title costs) actually incurred by Buyer, and (b) the Purchase price set forth in the Agreement, plus the actual cost of any permanent improvements made by Buyer to the Property, or (ii) repurchase the Property from Buyer as more fully set forth in the Agreement.

Version 3

WHEREAS, Seller and Purchaser have entered into A Contract for Purchase and Sale ("Contract") and First Addendum thereto ("First Addendum") relating to the real property described on Exhibit A ("Unit");

WHEREAS, in the First Addendum, Purchaser represented and covenanted to Seller that Purchaser will not transfer its rights under the Contract nor enter into any agreement for the sale or other transfer of the Unit that would prevent Purchaser from holding fee simple title interest in the Unit, from and after the date of Closing for a period of at least one (1) year (the "**Holding Period**"). This Memorandum of Right to Repurchase will automatically expire one (1) year from the date of execution by all parties.

WHEREAS, pursuant to the terms of the First Amendment, Seller has the right to repurchase the Unit from Purchaser, on the terms and conditions contained within the First Addendum;

WHEREAS, Seller desires to record this Memorandum among the Public Records, to provide record notice of Seller's interest in the Unit.

Version 4

For good and valuable consideration, Buyer grants to Pulte the right to repurchase the Property, at a price and under the terms and conditions specifically set forth in the Agreement, for a period of one (1) year from the date of recordation of this Memorandum.

Version 5


For good and valuable consideration, Buyer grants to Del Webb the right to repurchase the Property, at a price and under the terms and conditions specifically set forth in the Agreement, for a period of one (1) year from the date of recordation of this Memorandum.

Version 6


Buyer grants to Pulte the right to repurchase the Property, at a price and under the terms and conditions specifically set forth in the Agreement, for a period of one (1) year from the date of recordation of this Memorandum.

The above examples illustrate the language contained in the restrictive covenants identified; specifically, that the property cannot be conveyed without limitations imposed by the seller until the occupancy period is over, which is contrary to the HUD-FHA free assumability requirements defined in 24 CFR 203.41(a)(3)(ii) and 203.41(a)(3)(iv), respectively. A distinction to be made is that the restrictive covenants, while ineligible, do not necessarily prevent FHA from obtaining clear title in the event of foreclosure and conveyance. This distinction does not, however, alter the material fact that the loans should not have reached the point of foreclosure and conveyance as they were not eligible for FHA mortgage insurance.

We also identified potential lien language, which stipulated monetary damages to the seller in the event of a breach in the agreement (see versions 1-3 above). A breach of the contract would include the borrower's conveying or transferring the property during the specified occupancy period, which is contrary to 24 CFR 203.32.

Pulte Mortgage officials stated the prohibited restrictive covenants were allowed because they believed that the documents with the restrictive covenants, which contain an owner occupancy requirement, were consistent with FHA requirements. Therefore, they allowed the use of sellers' restrictive covenants on FHA properties. Based on this information, we concluded that Pulte Mortgage did not exercise due diligence, demonstrated by its failure to ensure that language in the recorded property agreements was appropriate and followed HUD rules and regulations.

Materiality

Consistent with prior HUD findings, we determined the existence of unallowable restrictive covenants to be a significant, material deficiency. In prior reviews, 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. For the active loans reviewed, HUD determined that indemnification was appropriate if the lender could not provide adequate support indicating a termination of any restrictive language. Our recommendations are made in the same regard.

The FHA loans identified in this memorandum were determined to be ineligible for FHA insurance; therefore, any loss or claim tied to the loans identified represents an unnecessary loss to HUD's FHA insurance fund. As with any underwriting review, deficiencies identified, such as overstated income and understated liabilities, do not have to be the reason an FHA loan went into default or claim for HUD to seek indemnification. Rather, the deficiencies are used as

evidence that the loan should not have been FHA-insured. In the same regard, the audit memorandum identifies a significant material deficiency that deemed the identified loans ineligible for FHA insurance, thereby warranting recommendations for indemnification of the loans identified.

According to the FHA Emergency Fiscal Solvency Act of 2013,[15] indemnification should be an appropriate remedy when HUD has suffered a loss tied to a loan that was not originated or underwritten appropriately. It states that if the HUD Secretary determines that the mortgagee 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 mortgagee to indemnify HUD for the loss, irrespective of whether the violation caused the mortgage default. This pending legislation illustrates Congress' specific intent to protect the FHA mortgage insurance fund and ensure its solvency by providing HUD with the appropriate tools and remedies.

Impact and Risk for Losses

We identified 1,106 loans (181 claim loans and 925 active loans) within our audit period that had unallowable restrictive covenants on the FHA-insured properties. The third-party agreements, which contained the prohibited restrictive covenants preventing free assumability of the property and potential liens between the seller and borrowers, violated HUD-FHA requirements defined in 24 CFR 203.41(a)(3) and 203.32, respectively, thereby materially impacting the insurability of the questioned loans, making the loans ineligible for FHA insurance. Additionally, the borrowers in the restrictive covenant agreements were restricted in their ability to rent, lease, sell, or otherwise convey the FHA properties. By allowing the restrictive conveyance agreements on FHA properties that at minimum appeared to hinder free assumability, Pulte Mortgage may have forced borrowers with decreasing financial capability to remain in their property longer than they would have otherwise.

As a result, Pulte Mortgage's failure to exercise due diligence placed the FHA fund at unnecessary risk for potential losses by approving ineligible properties for FHA insurance and restricting borrowers' ability to rent, lease, sell, or otherwise convey the FHA properties and included language for remedies if the contract was breached. Of most significance, insuring properties that are not eligible for mortgage insurance increases the risk to an FHA fund that is already facing dangerously low levels of funding. For the 192 loans identified, HUD would not otherwise see a loss on the uninsurable FHA loans, as they would not have been approved for FHA insurance and would not be the responsibility of the FHA fund. For the 82 claim loans identified as ineligible for FHA insurance, HUD suffered a loss it should not have otherwise suffered.

[15] Pending legislation, 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.

Conclusion

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. We identified 1,106 loans (181 claim loans and 925 active loans) within our audit period 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. 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 (181 claim loans and 11 sampled active loans) loans reviewed where 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 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 (see appendix C).

RECOMMENDATIONS

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

1A. Determine legal sufficiency and if legally sufficient, pursue civil remedies (31 U.S.C. (United States Code) Sections 3801-3812, 3729, or both), civil money penalties (24 CFR 30.35), or other administrative action against Pulte Mortgage, its principals, or both for incorrectly certifying to the integrity of the data or that due diligence was exercised during the origination of FHA-insured mortgages.

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require Pulte Mortgage, after completing recommendation 1A, to

1B. Reimburse the FHA fund for the $9,909,292 in actual losses resulting from the amount of claims and associated expenses paid on 82 loans that contained prohibited restrictive covenants and liens (see appendix C, table 1).

1C. Support the eligibility of $11,865,597 in claims paid or execute an indemnification agreement requiring any unsupported amounts to be repaid for claims paid on 99 loans for which HUD has paid claims but has not sold the properties (see appendix C, table 2).

1D. Analyze all FHA loans originated, including the 11 active loans identified in this memorandum, or underwritten beginning January 1, 2008, and nullify all active restrictive covenants or execute indemnification agreements that prohibit it from submitting claims on those loans identified. The 11 active loans with prohibited

restrictive covenants had a total unpaid mortgage balance of $2,385,747, which carries a potential loss of $1,359,876[16] that could be put to better use (see appendix C, table 3).

1E. Follow 24 CFR 203.32 and 203.41 by excluding restrictive language and prohibited liens for all new FHA-insured loan originations and ensure that policies and procedures reflect FHA requirements.

[16] The potential loss was estimated based on HUD's 57 percent loss severity rate, multiplied by the unpaid mortgage balance. The 57 percent loss rate was the average loss on FHA-insured foreclosed-upon properties based on HUD's Single Family Acquired Asset Management System's "case management profit and loss by acquisition" as of December 2012.

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1B	$9,909,292		
1C		$11,865,597	
1D			$1,359,876
Total	$9,909,292	$11,865,597	$1,359,876

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. If HUD implements our recommendations to indemnify loans not originated in accordance with HUD-FHA requirements, it will reduce FHA's risk of loss to the fund. See appendix C for a breakdown, by FHA loan number, of the funds to be put to better use.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

Comment 1

PulteMortgage

March 25, 2013

Via Email (tschulze@hudoig.gov) and Overnight Delivery

Tanya E. Schulze, Regional Inspector
General for Audit
U.S. Department of Housing and Urban Development
Office of Audit (Region 9)
611 W. Sixth Street, Suite 1160
Los Angeles, CA 90017

Re: Pulte Mortgage LLC; Memorandum no. 2013-LA-180X

Dear Ms. Schulze:

Pulte Mortgage LLC ("Pulte Mortgage") acknowledges receipt of the draft audit memorandum dated March 4, 2013 (the "Audit Report") for the recent audit of Pulte Mortgage by the HUD Office of the Inspector General (the "OIG"). Pulte Mortgage appreciates this opportunity to respond in writing to the Audit Report. Pulte Mortgage has set forth its response in three sections. First, Pulte Mortgage has included an Executive Summary that briefly describes the issue under review by the OIG and Pulte Mortgage's response to the Audit Report. Second, Pulte Mortgage has included a Narrative Explanation that more fully sets forth the circumstances behind the covenant at issue in the Audit Report and Pulte Mortgage's position as to both its actions and the covenant. Finally, Pulte Mortgage has included a Summary Response that directly addresses the assertions and recommendations raised in the Audit Report on a point-by-point basis.

I. **Executive Summary**

The FHA Lender Insurance Program has the purpose of promoting responsible, owner-occupied homeownership. By the terms of its underwriting programs and its various documents, FHA makes clear that only homeowners intending to occupy their homes for at least one-year are eligible to use FHA financing for their home purchases. Nevertheless, beginning at least in the mid-2000s, owner-occupancy fraud became a major concern in the residential real estate building and financing industry, as fraudsters (known as "flippers") pretended that they were planning to occupy a new home in order to receive access to purchase newly constructed homes and favorably-priced financing terms, including FHA loans. The frauds perpetrated by these "flippers" were a significant factor in the recent real estate bubble and the financial and mortgage foreclosure crises.

It is against this background that the OIG now takes issue with a particular form of agreement that Pulte Mortgage's affiliated homebuilders used solely in order to weed out and to discourage flippers from

7390 S. Iola Street ◆ Englewood, Colorado 80112 ◆ 800-426-8898

Comment 1

purchasing their homes. This form of agreement (generally titled the occupancy addendum and declaration and referred to herein as the "Provision" or the "Provisions"), which was then sometimes recorded as part of the transaction, tracked FHA's own underwriting requirements by discouraging "flippers" from fraudulently misrepresenting their occupancy intentions and did so in a manner entirely consistent with FHA guidelines. These homebuilders elected to use the Provision, notwithstanding its potential to chill some sales. They considered it more important to be good partners with homebuyers, who sought strong owner-occupied communities, and their lenders, who were growing increasingly concerned with the risk of flippers misrepresenting their occupancy as the real estate prices bubbled upward. The homebuilders implemented the Provision with the best intentions and not for pernicious reasons, as was historically the case with restrictive covenants that prevented sale of a property to (for example) racial minorities in perpetuity. It is disappointing, now, that the usage of the Provision – with all its noble intentions of promoting strong, owner-occupied communities – would serve as the basis for the OIG to threaten tens of millions of dollars in indemnity claims, solely because Pulte Mortgage provided mortgages to these homeowners.

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Pulte Mortgage takes exception to the findings of the Audit Report, and submits that the OIG's recommendations to FHA, in particular its recommendations for reimbursement and indemnification and a referral to the HUD Office of Enforcement for review for potential treble damages under the False Claims Act, are completely without merit. As explained in more detail below, Pulte Mortgage responds to the Audit Report as follows:

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- Pulte Mortgage did not violate FHA regulations. The Provisions were consistent with FHA requirements. The Audit Report's interpretation of FHA regulations is so inappropriately aggressive that FHA's own documents would violate the OIG's reading of its terms. Indeed, the Provision developed by Pulte Mortgage's affiliated builders tracks the occupancy requirement language in FHA's own standard mortgage security documents. In fact, between January of 2008 and March of 2011, FHA performed dozens of post-endorsement reviews of loans offered for insurance by Pulte Mortgage and never identified a recorded Provision as being unacceptable.[1] Therefore, it was reasonable for Pulte Mortgage (and other lenders) to assume that the Provision was acceptable to FHA.

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- Use of the Provisions did not cause any losses to the FHA Insurance Fund. The Provisions were not a cause of any particular loan defaulting. Indeed, the Provisions helped protect the FHA against fraudulent buyers and "flippers." So, even if one assumes, for purposes of argument, that the Provisions violated FHA requirements, any violation was a highly technical one – without harm to consumers or the FHA Insurance Fund. For these reasons, the proposed remedies of a False Claims Act review and tens of millions of dollars in indemnification are unwarranted and unduly harsh.

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- HUD OIG's referral of this matter for False Claims Act review is particularly disappointing and entirely inappropriate. Pulte Mortgage at all times acted in good faith, responsibly and in a manner fully consistent with FHA requirements when it offered loans for insurance with

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[1] From 2008 through 2010, FHA performed 64 post-endorsement reviews of loans offered for FHA insurance by Pulte Mortgage.

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corresponding Provisions only in response to the industry-wide problem of investors driving up home prices. Pulte Mortgage never acted with anything even approaching knowledge of falsity or reckless indifference.

- No further actions are needed. The Provision on its own terms expires after a period of one year following the sale of the property from the original builder/seller to the original buyer, and, at the request of Pulte Mortgage, its homebuilder affiliates took steps to cease use of the Provision beginning in 2011. Therefore, any Provision corresponding to an FHA-insured loan has since expired by its own terms, and Pulte Mortgage is no longer offering loans with a Provision for FHA insurance. Consequently, no corrective measures appear to be necessary.

For these reasons, and as detailed below, Pulte Mortgage strongly disagrees with the findings and recommendations of the OIG in the Audit Report, and the final report should be amended accordingly.

II. Narrative Explanation

A. Background

Pulte Mortgage has been in the mortgage banking business and helped consumers purchase homes since 1972, with customer service being a core value of its business operation. Pulte Mortgage currently is licensed in 30 states and the District of Columbia and primarily provides purchase money home financing for purchasers of homes from affiliated builder/sellers, including the brands Pulte, Del Webb, DiVosta and Centex homes. In addition to FHA-insured loans, Pulte Mortgage loan offerings include VA, Fannie Mae, Freddie Mac and non-agency loans. Product offerings include first and second mortgages. Pulte Mortgage's loan production volume was $2.3 billion in 2010, $1.9 billion in 2011, and $2.5 billion in 2012.

Comment 8

In the Audit Report, the OIG has asserted that Pulte Mortgage violated certain regulations promulgated by the Federal Housing Administration ("FHA") by offering for FHA insurance loans for which the original buyer was subject to a one-year recorded occupancy provision under the sales contract with the builder/seller of the property (the "Provision"). Specifically, the OIG examined 332 loans underwritten by Pulte Mortgage with closing dates between January 1, 2008, and December 31, 2011 (including 260 claim loans and 72 statistically selected active loans), and determined that of that universe, 192 loans had corresponding Provisions.[2] The OIG appears to project that based on these results, it is likely that there are a total of 1,106 loans (181 claim loans and 925 active loans) offered for FHA insurance by Pulte Mortgage with corresponding Provisions.[3] The Audit Report further states that Pulte Mortgage failed to meet its responsibility at closing to ensure conditions of title to the property were acceptable to FHA, pursuant to HUD Handbooks 4000.2, paragraph 5-1(B) and 4155.2, paragraph 6.A.1.h.[4] Based on these assertions, the OIG has recommended that Pulte Mortgage make FHA whole for $9,909,292 in actual losses, agree to indemnify FHA for up to $11,865,597 in potential losses, nullify any remaining active Provisions, and agree to exclude such Provisions or similar requirements in all future loans offered for

[2] Audit Report, page 5. Pulte Mortgage has not been provided with the OIG's work product, including without limitation recorded documents or evidence of losses, and therefore reserves all rights as to the accuracy or validity of the Audit Report's assertions in this regard.
[3] Audit Report, pages 4-5.
[4] Audit Report, page 6.

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FHA insurance.[5] The OIG has further recommended that the matter of the Provision be referred to HUD's Associate General Counsel for Program Enforcement in order to determine whether to pursue civil remedies under the False Claims Act action, 31 USC §§ 3801 through 3812 and 3729, which could result in up to treble damages.

The heavy-handed recommendations are meritless. As described further below, the OIG's interpretation of the FHA regulations is unreasonable. Moreover, based on the unclear nature of the regulations in question and FHA's own documents, it is unreasonable to expect that Pulte Mortgage would treat the Provision (which tracks the language in FHA's own standard forms) as a violation of FHA regulations. Even if the Provision is ultimately determined to be in violation, the remedies recommended by the OIG (in particular full indemnification and referral for False Claims Act violations) are not warranted. The OIG has failed to demonstrate any causal relationship, or indeed any relationship whatsoever, between the Provision and any loan default and, as further discussed below, the OIG cannot demonstrate that Pulte Mortgage acted knowingly or with reckless disregard resulting in a false, fraudulent, or fictitious claim to FHA.

Though we disagree strongly with the OIG's report, Pulte Mortgage appreciates nonetheless its responsibilities as an FHA lender. Thus, in the interests of cooperating with FHA, Pulte Mortgage has already taken steps to correct any issues that could remain from the Provision. Pulte Mortgage stopped offering for insurance loans with associated Provisions. Pulte Mortgage's affiliated builders have stopped using Provisions in their sales contracts. Moreover, the standard Provision itself is only effective with regard to the first person to buy a property from the builder/seller, and only for a period of one year after the sale; and Pulte Mortgage understands that all Provisions have expired by their own terms. Furthermore, Pulte Mortgage also is unaware (and the OIG has not been able to demonstrate otherwise) of any instance where its builder affiliates actually exercised a right under the Provision against any FHA buyer closed during this time period, so no remediation is necessary.

B. Provision History

The Provision in question was designed to prevent speculative investment in housing (i.e., "flipping") and to protect against fraud – a wrong that harms not only homebuilders and their customers, but also both lenders and the FHA insurance fund (the "FHA Fund"). Throughout most of the past decade, unprecedented rises in the price of housing in the U.S. led to the phenomenon of "flipping", in which investors who had no intention of occupying a property as principal residence would purchase it, hold onto it for a brief period of time, and then resell it at a substantially higher price. In the residential homebuilding industry, the problem was acute, with putative "owner occupied" homeowners waiting in line when homebuilders released lots for sale, gaining the benefit of price appreciation while the home was constructed, then seeking to cash in shortly after they closed on their purchases. While profitable for flippers, this practice was harmful to everyone else, from consumers to builders to lenders and to FHA itself. Consumers seeking to purchase homes to live in, especially low-to-moderate-income consumers seeking to purchase their first homes, were discouraged by the astronomical housing prices or forced to turn to riskier loan types. Builders with a vested interest in assembling livable communities

[5] Audit Report, pages 10-11.

Comment 11

to attract families were forced to see communities permeated with the flippers' "for sale" and "for rent" signs, and properties in their developments constantly sold and resold, which again drove up prices further and made it harder for legitimate homebuyers to purchase housing. These spiking home prices, meanwhile, meant much larger mortgage loans, which in turn would mean much greater potential risk to the FHA Fund; the greater the amount of the loan, the greater the claim amount that FHA would have to pay if the loan went into default.

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The Provision was designed as a mechanism to prevent this. It was a contractual obligation between the builder/seller of the property and the original buyer that generally required the original buyer to occupy the property in question as his or her primary residence for one year after the sale, and provided for a breach of contract remedy for the builder/seller if the original buyer failed to do so. In the event of a breach, the builder/seller had the right to sue the original buyer for any profits realized on the buyer's sale, or (if possible) sue to require the original buyer to sell the property to the builder/seller for the original purchase price. If there was no price appreciation, however, the Provision was a nullity. Additionally, the Provision also provided substantial protection for buyers who may experience life-altering events that require them to move, such as loss of employment or a death in the family. In such circumstances, the builder/seller would agree not to enforce the Provision against the original buyer. An example of such "hardship" exemption is provided below from a Provision used in Texas:

7. **Hardship Situations**. The following events may constitute a "hardship" situation under which Seller may allow Buyer to complete a Conveyance or Transfer during the Holding Period, in Seller's discretion:

   a. A Transfer resulting from Buyer's death;
   b. A Transfer by Buyer where the spouse of Buyer becomes the only co-owner of the Property with Buyer;
   c. A Transfer resulting from a decree of dissolution of marriage or legal separation or from a property settlement agreement incident to such decree;
   d. A Transfer by Buyer into a revocable inter vivos trust in which Buyer is beneficiary;
   e. A Transfer, Conveyance, pledge, assignment or other hypothecation of the Property to secure the performance of an obligation, which Transfer, Conveyance, pledge, assignment or hypothecation will be released or reconveyed upon the completion of the performance;
   f. A Transfer by Buyer (where Buyer is not self-employed) necessary to accommodate a mandatory job transfer required by Buyer's employer;
   g. A Transfer by Buyer after the death of Buyer's spouse; or
   h. A Transfer, which, in Seller's sole independent judgment, constitutes a "hardship" situation consistent with the intentions of this [Provision].

Despite the laudable goals behind the Provision and the care with which it was designed, the OIG has stated that, in its opinion, the presence of the Provision violates FHA regulations concerning free

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assumability and liens. According to the OIG, it has access to a legal opinion (which has not been provided to Pulte Mortgage despite its request) stating that "24 CFR 203.41(b)(iv), pertaining to consent by a third party, appears to violate HUD's regulations."[6] Recognizing both that there is no section 203.41(b)(iv) of Title 24, and that a claim that an FHA regulation violates FHA regulations is an odd one for the OIG to make, Pulte Mortgage assumes that the OIG means that according to the legal opinion, the Provision and requirements like it violate the prohibition on legal restrictions on conveyance found at 24 CFR § 203.41(b). The OIG further appears to assert that the Provision is a legal restriction on conveyance because (in the OIG's opinion) it is a provision that attempts both to cause a conveyance made by the borrower to be the basis of contractual liability of the borrower for breach of an agreement not to convey, and to be subject to the consent of a third party (in this case, the builder/seller) under 24 CFR §§ 203.41(a)(3)(ii) and (iv).[7] Finally, the OIG has asserted that the Provision, apparently by virtue of being recorded, constituted a potential lien on the property at the time of offer of the loan for insurance that was not the actual mortgage, in violation of 24 CFR § 203.32(a).

The Audit Report states that this presumed noncompliance occurred "because Pulte Mortgage did not exercise due diligence and was unaware that the restrictive covenants recorded between the sellers and the borrowers violated HUD-FHA requirements."[8] This is quite a different assertion than that initially offered by the OIG in its draft audit outline (the "Audit Outline"), in which the OIG recognized that Pulte Mortgage believed that the Provision was consistent with FHA requirements and would help protect the FHA Fund from fraud (a copy of the Audit Outline is attached as Supplement A). The OIG apparently has used this presumed ignorance and lack of due diligence by Pulte Mortgage as part of its determination to recommend the penalties described above.

C. The Provision Does Not Violate FHA Regulations.

As noted above, the Provision was modeled almost entirely on the requirements of Section 5 of the FHA Mortgage Form (a copy of which is attached as Supplement B), which is itself presumably in compliance with 24 CFR § 203.41. This document states:

> Borrower shall occupy, establish, and use the Property as Borrower's principal residence within sixty days after the execution of this Security Instrument (or within sixty days of a later sale or transfer of the Property) and shall continue to occupy the Property as Borrower's principal residence for at least one year after the date of occupancy, unless Lender determines that requirement will cause undue hardship for Borrower, or unless extenuating circumstances exist which are beyond Borrower's control. Borrower shall notify Lender of any extenuating circumstances.[9]

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[6] Audit Report, page 4.
[7] Audit Report, page 7.
[8] Audit Report, page 4.
[9] FHA Mortgage Form, Section 5. The FHA Mortgage Form appears to include this provision in order to implement HUD Handbook 4155.1, Section 4.B.2.b.

Breach of this clause – such as, by flipping the property in less than a year – is a term of default and entitles the lender to require "immediate payment of all sums due ... ."[10]

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Although the FHA Mortgage Form would appear to impose a recorded "restriction" on a conveyance of the property within one year, it does so in a manner consistent with FHA's purpose of owner occupancy for one year. Thus, its restriction does not violate FHA requirements. This holds true, even though the language of 24 CFR § 203.41 prohibits legal restrictions on conveyance, which (in the sections cited in the Audit Report by the OIG) consist of legal provisions intended to cause a conveyance by the borrower to either be the basis of contractual liability of the borrower, or be subject to the consent of a third party.[11] Section 5 of the FHA Mortgage Form, as enforced by Section 9(a) of that document, certainly imposes contractual liability on the borrower for not occupying the property as principal residence (including, presumably, by conveying it) within the first year, and also subjects the borrower's ability to dispose of the property within the first year to the lender's consent. For example, if the borrower leases the property within the first year after loan consummation and does not use it as the borrower's primary residence, the lender is entitled under the FHA Mortgage Form to accelerate the entire mortgage amount.

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The Provision that the Audit Report challenges similarly imposes a one-year restriction. The Provision does so in a manner consistent with FHA's own mortgage instrument and with FHA's purpose of owner-occupancy for a period of one year. Accordingly, in the circumstance where a breach of the FHA mortgage instrument would likewise be a breach of the Provision, the Provision also complies with FHA's regulatory requirements every bit as much as FHA's own document.

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The OIG's position that the Provision is in clear violation of 24 CFR § 203.41, if followed to its logical conclusion, would mean that FHA's own document language would be in violation of FHA regulations, which is absurd. As noted, Section 5 of the FHA Mortgage Form contains a borrower occupancy requirement, and failure to so occupy without prior lender approval can lead to mortgage acceleration under Section 9. Another section of the FHA Mortgage Form, Section 9(b), permits the lender to accelerate the mortgage if the borrower attempts to convey the property to an investor. This portion of the FHA Mortgage Form implements the requirements of FHA's regulation at 24 CFR § 203.512, and this regulation expressly exempts this otherwise-impermissible restriction on conveyance from 24 CFR § 203.41. There appears to be no similar express exemption for the requirements in Section 5 of the FHA Mortgage Form or in the HUD Handbooks. Therefore, the only reasonable interpretation of FHA's own occupancy requirement is that FHA has never considered it to be in violation of 24 CFR § 203.41, and has never felt the need to exempt it from that regulation. Consequently, contract language that tracks the occupancy requirement, such as the Provision, would likewise not be in violation of 24 CFR § 203.41.

The OIG has attempted to distinguish the Provision from FHA's own occupancy requirement language by arguing that the Provision violates 24 CFR § 203.41 in part because the builder/seller in the context of the Provision is a "third party," but the lender is not.[12] This reading, of course, completely ignores the

[10] FHA Mortgage Form, Section 9.
[11] 24 CFR §§ 203.41(a)(3)(ii), (iv).
[12] Audit Report, pages 6-7.

Comment 15

fact that the homeowner and his/her subsequent buyer are the only "parties" to that transaction and that the lender is as much a third party to a subsequent sales agreement as the original builder/seller. Pulte Mortgage is not aware of any support for the OIG's assertion that FHA occupancy requirement is not in violation of 24 CFR § 203.41 solely because the lender is somehow not a third party to this sales transaction, and any assertion otherwise would have objectionable results. For example, if the FHA occupancy requirement does not violate 24 CFR § 203.41 solely because the lender is not a third party to the transaction, then the lender would be in full compliance with 24 CFR § 203.41 even if it included a separate provision in its contract with the borrower stating that the borrower would not be permitted to convey the property in question to anyone for the first ten years of the mortgage without the lender's consent, and that any attempt to do so would make the conveyance voidable by the lender (which would otherwise appear to be a legal restriction on conveyance pursuant to 24 CFR §§ 203.41(a)(3)(i) and (iv)). In other words, the OIG's attempt to distinguish the Provision from FHA's occupancy requirement would lead to lenders having the ability to clearly and openly violate 24 CFR § 203.41 in other ways, which is obviously not FHA's intent.

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The OIG's interpretation thus leads to a potentially indefensible result of invalidating FHA's own documents. For this reason, it is plainly wrong. The better, more reasonable interpretation is that FHA has never viewed its own occupancy requirement, which is limited in time and provides for hardship exceptions, to be in violation of 24 CFR § 203.41 because the requirement only burdens the homeowner for a very limited period of time and simultaneously serves the important purpose of preventing flipping and promoting true home ownership. Consequently, it was very reasonable for Pulte Mortgage to believe that the Provision, which tracks the occupancy requirement in Section 5 of the FHA Mortgage Form, was permitted by FHA.

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D. The Provision Was Not a Lien in Violation of 24 CFR § 203.32

Comment 18

The OIG has also asserted, as described above, that Pulte Mortgage was in violation of 24 CFR § 203.32(a) when it offered loans with associated Provisions for insurance, because the Provisions constituted potential liens on the property other than the lien for the actual mortgage. In this assertion, the OIG is mistaken as a matter of fact. Pulte Mortgage's Provision did not create a lien, potential or actual, on any property, and the OIG fails to quote any Provision language in the Audit Report indicating that the Provision creates such a lien.

24 CFR § 203.32(a) states:

> Except as otherwise provided in this section, 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.

A lien is a specific "legal right or interest that a creditor has in another's property, lasting usually until a debt or duty that [the lien] secures is satisfied."[13] Typically, the creditor holding a lien has the right to foreclose and take possession of the property in question if the debt secured by the lien is not satisfied.

Comment 17

The Provision gives no such rights in the property to the builder/seller. It simply creates a contractual right for the builder/seller against the original buyer (which expires after one year) in the event of a breach of the buyer's contractual obligation to occupy the property as principal residence for one-year period. The Provision only gives the builder/seller two contractual remedies: disgorgement of the buyer's profits realized on sale of the property, or resale of the property back to the builder/seller for the original sales price. In no event can the builder/seller simply take the property through foreclosure, and in the event that the buyer had already sold the property to a third party, it appears unlikely that the original builder/seller would even be able to exercise the resale remedy, since the original buyer would no longer have title to the property.

Comment 18

The OIG position appears to be that just because some Provisions were recorded makes them "potential liens." This is not true. Recordation is simply a process whereby other persons are placed on notice regarding whatever is recorded. The OIG has not demonstrated that recordation, by itself, gives the builder/seller any enforceable interest in the property itself, nor has the OIG demonstrated that the Provision in any way runs with the land, as a lien on the property would. For these reasons, the OIG's position is wrong.

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Consequently, since the Provision by its own terms does not create a lien, and the act of recordation was immaterial, any assertion by the OIG that the Provision violates 24 CFR § 203.32 must fail as a matter of course.

E. The Provision Was Reasonable Under FHA Regulations

Pre-March/April 2011

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As a threshold matter, the OIG's claims in the Audit Report depend on the presumption that the Provision clearly violated 24 CFR § 203.41 at the time the loans were offered for FHA insurance. However, this presumption ignores the specific facts and circumstances at issue here. Pulte Mortgage acted in good faith when offering loans for insurance because the Provision was based on FHA's own occupancy requirement language. The OIG's assertions are flawed, particularly because Pulte Mortgage never received any notice from FHA prior to March and April of 2011 that, in FHA's opinion, the Provision violated this regulation.

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24 CFR § 203.41(b) states that "A mortgage shall not be eligible for insurance if the mortgaged property is subject to legal restrictions on conveyance, except as permitted by this part." A "legal restriction on conveyance," in turn, is defined in relevant part at 24 CFR §§ 203.41(a)(3)(ii) and (iv) as:

> [A]ny 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,

[13] *Black's Law Dictionary* 766 (8th ed. 2005).

or trust agreement, that attempts to cause a conveyance (including a lease) made by the mortgage to:

(ii) Be the basis of contractual liability of the mortgagor for breach of an agreement not to convey, including rights of first refusal, preemptive rights or options related to mortgagor efforts to convey;

(iv) Be subject to the consent of a third party....

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As described above, the Provision was created as a means to assist in the prevention of flipping by investors. FHA itself appears to realize the dangers of flipping; in fact, FHA's response to this problem was the basis of the Provision itself. As noted above, the standard FHA Mortgage in Section 5 requires the borrower to occupy the property as the principal residence for a period of at least a year after loan consummation, unless this will cause undue hardship or there are extenuating circumstances. These terms are undefined, but Pulte Mortgage's affiliate homebuilders included these protective concepts for the consumer in the Provision.

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However, as lenders and builders discovered, more was needed to prevent flipping and to protect legitimate homebuyers. Many builders and lenders throughout the industry determined that they could adapt the solution offered in the FHA Mortgage Form to their specific circumstances. The Provision in question is one such adaptation. It closely tracks Section 5 of the FHA Mortgage Form, and provides the builder/seller with a contractual remedy against the original buyer if the buyer does not occupy the property as his or her principal residence for a period of a year after the purchase. Moreover, as with the FHA Mortgage Form, the Provision recognizes that life-altering changes can occur that require a person to move, so the Provision provides clear exemptions from liability in the event that such events occur. In fact, the hardship exception portion of the Provision quoted above provides substantially more protection to the consumer than Section 5 of the FHA Mortgage Form by setting forth specific examples of what would constitute a hardship; Section 5 does not define what constitutes a hardship, leaving it entirely at the discretion of the lender. By providing specific examples, the Provision provided comfort to consumers that they would be protected in the face of truly life-altering events.

Comment 14

The Audit Report states that Pulte Mortgage was "unaware" that the Provision violated FHA requirements and regulations.[14] This is a mischaracterization of Pulte Mortgage's position: To the contrary, our view is that it was reasonable for Pulte Mortgage, and its affiliated builders, to believe that, where a breach of the Provision would also be a default under the occupancy requirements of the FHA mortgage, the Provision was permissible under FHA regulations, and Pulte Mortgage offered the loans for insurance in good faith.

Post-March/April 2011

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Pulte Mortgage received notice from FHA in March and April of 2011, via post-endorsement reviews of various loans, that FHA viewed the Provision as being in violation of 24 CFR § 203.41. Pulte Mortgage deferred to FHA at that time and informed its underwriters not to offer for FHA insurance loans on

[14] Audit Report, page 4.

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properties for which the borrower was subject to a Provision without having the Provision removed. Pulte Mortgage began requesting that builders remove the Provision from their sales contracts, which builders themselves had already began doing for unrelated business reasons. This process has since been completed. The solution appears to have been effective; in fact, the OIG has failed to identify *any* loans with recorded Provisions in its review that were offered for FHA insurance after April of 2011. Moreover, since the Provision associated with any loan offered for insurance prior to March and April of 2011 would have since expired by its own terms after one year, Pulte Mortgage believes that all such recorded Provisions have since expired.[15]

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F. The Recommended Remedies Are Not Warranted

Even if one assumes, for argument's sake, that the Provision was in violation of 24 CFR § 203.41 at the time the loans were offered for insurance, the OIG has failed to articulate why Pulte Mortgage should indemnify FHA completely for any claims on such loans that FHA has paid or may pay in the future, as opposed to being subject to a more appropriate remedy, reasonably arrived at in partnership with FHA.

Indemnification is Unwarranted

With respect to the recommendation for indemnification, Pulte Mortgage is aware of the OIG's position that, but for the lender's allegedly erroneous certification of compliance with FHA requirements, loans subject to requirements similar to the Provision would not have been accepted for FHA insurance and FHA consequently would not have incurred any losses on such loans. The OIG appears to believe that the Provision clearly violates 24 CFR § 203.41 and 24 CFR § 203.32, that loans with an associated Provision are, as a result, ineligible for insurance by FHA, and therefore that any losses FHA incurs on claims paid for such loans must be reimbursed fully by Pulte Mortgage. In its discussion of the materiality of the alleged breaches in question, the OIG states:

> The FHA loans identified in this memorandum were determined to be ineligible for FHA insurance; therefore, any loss or claim tied to the loans identified represents an unnecessary loss to HUD's FHA insurance fund. As with any underwriting review, deficiencies identified, such as overstated income and understated liabilities, do not have to be the reason an FHA loan went into default or claim for HUD to seek indemnification.[16]

Comment 21

The OIG further states that "According to the FHA Reform Act of 2010, indemnification is an appropriate remedy when HUD has suffered a loss tied to a loan that was not originated or underwritten appropriately."[17] To our knowledge, however, the FHA Reform Act of 2010 was a bill that never actually

[15] While there may have been a some loans with associated contractual Provisions offered for insurance after April of 2011, due to human error, to Pulte Mortgage's knowledge the OIG has presented no evidence that such Provision was recorded, which appears to be the standard that the OIG is using in the Audit Report.
[16] Audit Report, page 9.
[17] *Id.*

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became law; it passed in the House of Representatives but not the Senate.[18] We are troubled that the OIG apparently would quote from a failed bill.

More importantly, the OIG's position that any technical breach – no matter how ambiguous or de minimis -- of any FHA regulation or requirement (for example, delivery of the GFE a day late) may serve as the basis for full indemnification, if adopted by FHA, would be a damaging precedent. The result of this would be a severe chilling among lenders that offer loans for FHA insurance, as the penalty would completely out of line with the technical violation. In order to prevent this and promote fairness, there should be a real and material connection between the violation in question and why the loan went into default for indemnification to be an appropriate remedy.

Had it been clear at the time to Pulte Mortgage that the Provision was not acceptable to FHA, Pulte Mortgage simply would have insisted on the removal of the Provision with respect to a given loan and resubmitted the now-compliant applicable loans for FHA insurance coverage. In other words, these loans would have been insured in any event. It is therefore fundamentally unfair for the OIG to recommend indemnification on such loans.

The Recommendation for False Claims Act Review Is Unwarranted

The OIG's recommendation of referral for a potential False Claims Act violation is similarly heavy-handed. As noted above, it was eminently reasonable for Pulte Mortgage to believe that the Provision was in compliance with FHA requirements (although it has since deferred to FHA's interpretation of these requirements), given FHA's own provisions, their unclear interaction with the regulation in question, and the pressing need for action in the face of widespread flipping. Therefore, Pulte Mortgage did not act knowingly or with reckless disregard resulting in a false, fraudulent, or fictitious claim to FHA. At all times, rather, Pulte Mortgage acted reasonably and in good faith.

The OIG's Materiality Standard is Unwarranted

Furthermore, with respect to either proposed remedy, the OIG has failed to demonstrate any connection whatsoever between the Provision and the reasons behind any loans in question going into default. Usage of the Provisions is unlike a situation where the borrower's annual income was overstated, for example, which likely would have a material effect on the loan going into foreclosure. In this circumstance, the OIG has failed to demonstrate that the presence of the Provision has in any way caused the loans in question to go into foreclosure, nor is the OIG likely to be able to do so in the future. The OIG itself has informed Pulte Mortgage in the exit conference on March 12, 2013 that it searched thoroughly for alleged consumer victims, to no avail, and that the OIG even interviewed at least one borrower who had been subject to the Provision, and the borrower did not express that he felt his ability to dispose of his home was chilled in any way.

[18] *See* http://www.govtrack.us/congress/bills/111/hr5072#overview. The bill introducing the FHA Reform Act of 2010 passed the House of Representatives on June 10, 2010. However, the Senate never passed its version of the bill. As the OIG is aware, a bill does not become law until it passes both houses of Congress in reconciled form and is signed by the President. A printout of the GovTrack website page showing the final status of the FHA Reform Act of 2010 is attached as Supplement C).

Comment 15

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Comment 20

Pulte Mortgage and other lenders and affiliated builders were very concerned about rampant speculation, as was FHA, and Pulte Mortgage continues to believe that the provisions in question were an acceptable way both to protect the buyer's right of alienability as well as to prevent speculation. While Pulte Mortgage recognizes that a key aspect of home ownership is the homeowner's right to do what he or she wants with that home, including selling it, the OIG must concede that this, like all other rights, is not necessarily absolute. As described above, the FHA Mortgage Form itself provides for at least two instances in which a homeowner's attempt to cease occupying the home would lead to mortgage acceleration, and one of these limitations is not limited to an initial 12-month period. In the face of the very real problem of "flipping", and in light of the FHA's own language in FHA Mortgage Form, Pulte Mortgage felt that the Provision was (and still is) consistent with 24 CFR § 203.41.

In summary, Pulte Mortgage did not knowingly or recklessly violate the requirements of 24 CFR § 203.41Nor was its offer of the applicable loans for FHA insurance was in no way false, fictitious, or fraudulent. Furthermore, had it been clear that the Provision was in violation of 24 CFR § 203.41, Pulte Mortgage would have taken steps to ensure that the Provision was removed and the loan would have been insured regardless, as amply demonstrated by the results of Pulte Mortgage's actions after March and April of 2011.

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III. **Summary Response**

- The OIG claims that the recorded Provision violates 24 CFR § 203.41 because it exposes the consumer to potential contract liability for attempting to move within the first year after purchasing the property and because it requires the consumer to obtain the consent of a third party (in this case, the builder/seller) in order to move.
    - Prior to March of 2011, Pulte Mortgage had no reason to believe that the Provision was in violation of this regulation.
        - The OIG's assertion to the contrary would lead to the unsupportable conclusion that FHA's own occupancy requirement in its standard documentation violates its own regulations. The Provision, which was intended only to prevent "flipping", tracked language in FHA's own Standard Mortgage Form that was put into place for exactly the same reason, which likewise would impose contractual liability on a consumer under similar circumstances, and which FHA therefore presumably has found to be implicitly permissible under its own regulations.
        - The OIG's attempt to distinguish the Provision from FHA's own occupancy requirement language fails to demonstrate why the lender is not a third party to a sales transaction between the buyer and the seller, while the original builder/seller is a third party.
        - Additionally, prior to March 2011, FHA never identified a recorded Provision as being unacceptable in any post-endorsement review it performed of a loan offered for insurance by Pulte Mortgage.
- The OIG claims that the recorded Provision also violates 24 CFR § 203.32 because it placed a potential lien on the property at the time that Pulte Mortgage offered the loan for FHA insurance.
    - The OIG has failed to demonstrate that the Provision in any way imposes a lien or even a potential lien on the property in question. The Provision does not state that it creates a lien or a potential lien, and it does not give the builder/seller a right to foreclose on the property in question. It only creates a contractual obligation between the builder/seller and the original buyer.
    - Similarly, the OIG has failed to offer any evidence or argument that the fact of recordation, by itself, creates a lien or potential lien. Recordation is simply a notice process, and does not create a lien or potential lien absent specific terms that are not present in the Provision.
- The OIG claims, because the Provision violates these regulations in the OIG's estimation, Pulte Mortgage falsely certified that the loans with recorded Provisions that it offered for insurance were in compliance with FHA regulations, exposing Pulte Mortgage to liability.
    - At the time Pulte Mortgage offered loans with recorded Provisions for FHA insurance, it was reasonable to interpret the Provisions as being in compliance with 24 CFR § 203.41, and it would therefore be highly unjust to punish Pulte Mortgage for such loans that Pulte Mortgage offered in good faith.

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- The OIG has failed to identify any loans with recorded Provisions that Pulte Mortgage offered for insurance after March and April of 2011, when it received notice from FHA that in FHA's opinion, the Provision violated FHA regulations, which demonstrates that Pulte Mortgage would not have offered such loans for insurance previously if it was clear that the Provision was in violation of 24 CFR § 203.41.
- The Provision never has been in violation of 24 CFR § 203.32, since it neither creates a lien nor a potential lien.

- The OIG claims that the fact that the loans were ineligible for FHA insurance provides a material basis for a duty of Pulte Mortgage to fully reimburse FHA for any losses it may have incurred on such loans and fully indemnify FHA for any losses it will suffer in the future on such loans, regardless of whether the reason for such ineligibility has any causal connection whatsoever with the reasons why the loans went into default.
  - This is a highly unjust position. It is not clear that the loans were ineligible, at least prior to March of 2011, and consequently any liability for loans prior to March 2011 is totally unwarranted.
  - Even if it is determined that the loans were ineligible, full reimbursement and indemnification are completely unwarranted remedies, in light of the fact that Pulte Mortgage never violated FHA regulations knowingly or with reckless disregard, but instead acted at all times reasonably and in good faith, relying on FHA's own standard document language and post-endorsement reviews.
  - Regardless of whether the loans are ultimately deemed to have been ineligible, the OIG has failed to demonstrate any connection whatsoever between the Provision and the reason why the loans went into default; in fact, the OIG interviewed at least one borrower with a Pulte Mortgage loan with an associated Provision, and the borrower did not indicate that the Provision affected the borrower in any way, including by causing the borrower to default on the loan.
- The OIG appears to use the same faulty materiality standard to recommend referral under the False Claims Act.
  - As described above, such a referral is completely unwarranted given that Pulte Mortgage acted at all times reasonably and in good faith. The OIG has failed completely to demonstrate that Pulte Mortgage ever knowingly violated FHA regulations, or even recklessly disregarded FHA regulations, and has further failed to demonstrate any connection whatsoever between the presence of a Provision and the reason why a loan went into default. Therefore, the OIG has failed to demonstrate that Pulte Mortgage ever offered false, fictitious, or fraudulent loans for FHA insurance.
- The OIG demands that any remaining Provision be removed.
  - The Provision is limited by its own terms to the first twelve months after the initial sale of the property. The OIG has not identified any loans with recorded Provisions offered for insurance after April of 2011. Therefore, every recorded Provision has expired already, and no further action is necessary.
- The OIG demands that the Provision not be used in the future.

Comment 11

- Pulte Mortgage has stopped offering loans for insurance with a Provision, and its affiliated builders have stopped including the Provision in their sales contracts. However, Pulte Mortgage urges FHA to consider that as the housing market heats up again in certain areas, investors are already expressing interest in properties, and the very real problem of "flipping" will return. Therefore, Pulte Mortgage urges FHA to set aside the harsh conclusions and recommendations in the Audit Report, so that Pulte Mortgage and other lenders can cooperate with FHA to find a reasonable, fair solution to the issue at hand.

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IV. Conclusion

Pulte Mortgage values its participation in the FHA insurance program, and is committed to complying with FHA requirements to the fullest extent required. However, Pulte Mortgage urges the OIG and FHA to reconsider the conclusions reached in the Audit Report. In our view, the Audit report demonstrates a failure to understand the purpose behind implementation of the Provision and the reasonableness of the position that the Provision did not violate FHA regulations (particularly in light of FHA's own requirements). Had it been clear that the Provision was in violation of FHA regulations, Pulte Mortgage would have caused the Provision to be canceled and the loans would still have been insured, and there is no evidence whatsoever that the Provision resulted in any loan defaults (and consequently in any loss to the FHA Fund). Pulte Mortgage further submits that the recommendations suggested by the OIG in the Audit Report are unduly severe and not warranted in light of these considerations.

Finally, Pulte Mortgage urges the OIG and FHA to consider that the problem of investors driving up home prices will return; in fact, this is an event that may happen soon, if it is not already upon us. The housing market already appears to be "heating up" again, at least in certain markets, and as it does so, investors seeking to flip properties will certainly emerge. Enactment of the recommendations contained in the Audit Report will only serve to deter mortgage lenders and builders from assisting FHA in the important goal of helping people looking for a home to live in, rather than as an investment vehicle. Consequently, Pulte Mortgage respectfully requests that the OIG withdraw its findings and recommendations in the Audit Report, so that Pulte Mortgage and others in the industry will feel free to work with FHA in advancing people's dreams of buying a home to raise a family and build a life, and supporting FHA's laudable goal of providing such people with affordable home financing. Pulte Mortgage acted at all times reasonably and in good faith, and hopes that FHA shares its view that the conclusions and remedies set forth by the OIG in the Audit Report are not warranted and, if allowed to stand, will only serve to intimidate lenders and make it harder for lenders and FHA to work together. Pulte Mortgage looks forward to cooperating with FHA in a partnership to determine an appropriate, balanced, and reasonable solution to this issue.

Very truly yours,

Michael K. Sullivan
SVP, General Counsel
Pulte Mortgage LLC

Enclosures

cc: Debra W. Still, President and Chief Executive Officer, Pulte Mortgage LLC
Martin Herrera, HUD OIG
Holly Swoboda, HUD OIG

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OIG Evaluation of Auditee Comments

Comment 1 We disagree with Pulte Mortgage's assessment of the OIG review. Specifically, we disagree with Pulte Mortgage's interpretation of FHA requirements. These assessments include:

- The prohibited restrictive covenants tracked FHA's own underwriting requirements by discouraging "flippers" from fraudulently misrepresenting their occupancy intentions and did so in a manner entirely consistent with FHA guidelines;

- The prohibited restrictive covenants were consistent with and did not violate FHA regulations; and

- The restrictive covenant language contained in the agreements signed by the seller and borrower "tracks" the language in the "FHA Mortgage Form"[17] that would make it viewed as permissible or compliant with FHA regulations.

To clarify, the audit memorandum findings do not take exception with the owner occupancy language. Pulte Mortgage, throughout its response, attempted to equate the prohibited owner occupancy language between the borrower and seller with FHA regulations. A violation would not have occurred had the cited agreements merely required a one year occupancy requirement. What Pulte Mortgage did not address is that the prohibited restrictive covenants identified go beyond merely requiring owner occupancy, and actually placed restrictions on the mortgage deed that violate FHA regulations. The audit memorandum discussed the agreement being between a third party to the mortgage, the seller, and the borrower as well as the agreement containing provisions for damages to the seller in the event of a breach, which violated 24 Code of Federal Regulation 204.41 and 203.32 respectively. By Pulte Mortgage's own admission, the seller "would agree not to enforce the Provision…" The fact that the buyer must get the seller's permission is a violation of 24 CFR 203.41(a)(3)(iv), the seller being considered a third party.

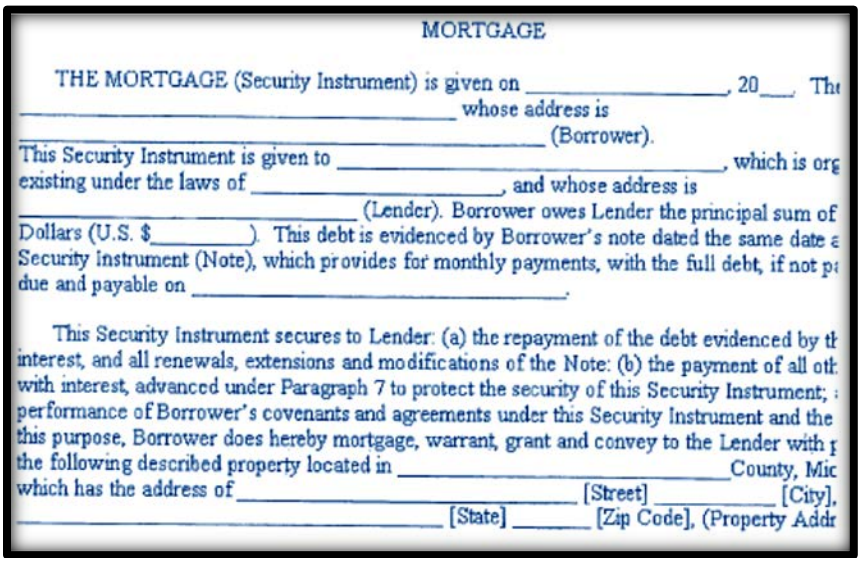
Any reference in Pulte Mortgage's response to tracking or adhering to FHA guidelines is incorrect. The regulations under 24 CFR 203.41(a)(3), for free assumability of the property, emphasize the prohibition of a restriction where the conveyance of a property be subject to the consent of a third party, in this case the seller, and that such a document cannot be the basis of contractual liability of the borrower for breach of an agreement not to convey. The findings and related examples illustrate the agreements in question are between the seller and borrower and include provisions for damages to the seller if the borrower conveys

[17] The "Supplement B" contained in Pulte Mortgage's response contained a poor copy of the "FHA Mortgage Form" and therefore was omitted from inclusion in appendix B of this audit memorandum. However, relevant excerpts were included below.

the property during the occupancy period, which clearly violate HUD FHA requirements. The violations make each identified loan ineligible for FHA mortgage insurance.

A significant, material distinction exists; the "FHA Mortgage Form" cited by Pulte Mortgage is the mortgage note between the lender and borrower, whereas the prohibited restrictive covenant discussed in the audit memorandum is between the seller, a third party to the mortgage, and the borrower. Additionally, the "FHA Mortgage Form" cited does not contain language that creates a basis of additional contractual liability of the borrower for breach of the agreement not to convey, see excerpt of Section 5 below.

Start of "FHA Mortgage Form" – Between Borrower and Lender

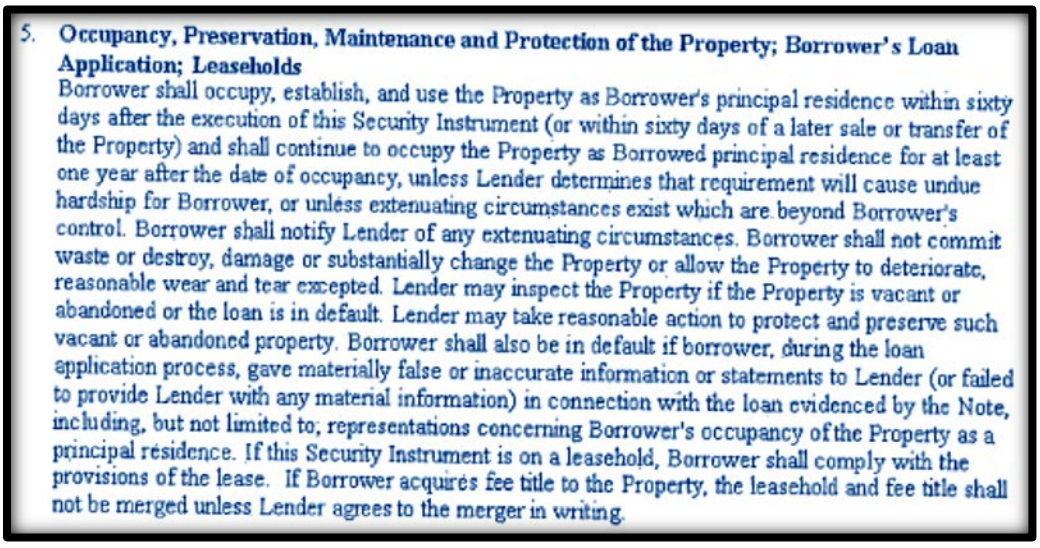


MORTGAGE

THE MORTGAGE (Security Instrument) is given on _____, 20___. The _____ whose address is _____ (Borrower). This Security Instrument is given to _____, which is org existing under the laws of _____, and whose address is _____ (Lender). Borrower owes Lender the principal sum of Dollars (U.S. $_____). This debt is evidenced by Borrower's note dated the same date a Security Instrument (Note), which provides for monthly payments, with the full debt, if not pa due and payable on _____.

This Security Instrument secures to Lender: (a) the repayment of the debt evidenced by th interest, and all renewals, extensions and modifications of the Note; (b) the payment of all oth with interest, advanced under Paragraph 7 to protect the security of this Security Instrument; a performance of Borrower's covenants and agreements under this Security Instrument and the this purpose, Borrower does hereby mortgage, warrant, grant and convey to the Lender with p the following described property located in _____County, Mic which has the address of _____ [Street] _____ [City], _____ [State] _____ [Zip Code], (Property Addr

Section 5 of "FHA Mortgage Form"

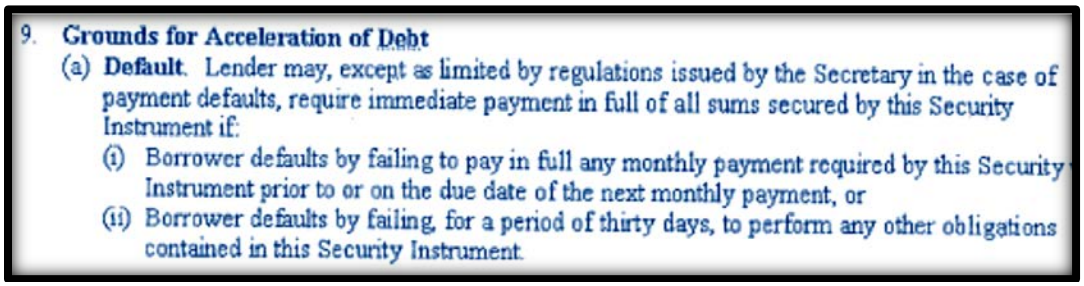


5. **Occupancy, Preservation, Maintenance and Protection of the Property; Borrower's Loan Application; Leaseholds**

Borrower shall occupy, establish, and use the Property as Borrower's principal residence within sixty days after the execution of this Security Instrument (or within sixty days of a later sale or transfer of the Property) and shall continue to occupy the Property as Borrowed principal residence for at least one year after the date of occupancy, unless Lender determines that requirement will cause undue hardship for Borrower, or unless extenuating circumstances exist which are beyond Borrower's control. Borrower shall notify Lender of any extenuating circumstances. Borrower shall not commit waste or destroy, damage or substantially change the Property or allow the Property to deteriorate, reasonable wear and tear excepted. Lender may inspect the Property if the Property is vacant or abandoned or the loan is in default. Lender may take reasonable action to protect and preserve such vacant or abandoned property. Borrower shall also be in default if borrower, during the loan application process, gave materially false or inaccurate information or statements to Lender (or failed to provide Lender with any material information) in connection with the loan evidenced by the Note, including, but not limited to, representations concerning Borrower's occupancy of the Property as a principal residence. If this Security Instrument is on a leasehold, Borrower shall comply with the provisions of the lease. If Borrower acquires fee title to the Property, the leasehold and fee title shall not be merged unless Lender agrees to the merger in writing.

We would like to clarify that the "FHA Mortgage Form" section 9, "Grounds for Acceleration of Debt" paragraph (a) are limited by regulations issued by the Secretary and paragraph (b) is subject to applicable law and with prior approval of the Secretary. In both these instances the "FHA Mortgage Form" discusses acceleration of debt at the approval of the Secretary rather than the creation of an additional liability to the seller that is found in the restrictive covenants recorded with applicable counties.

Section 9(a) of "FHA Mortgage Form"



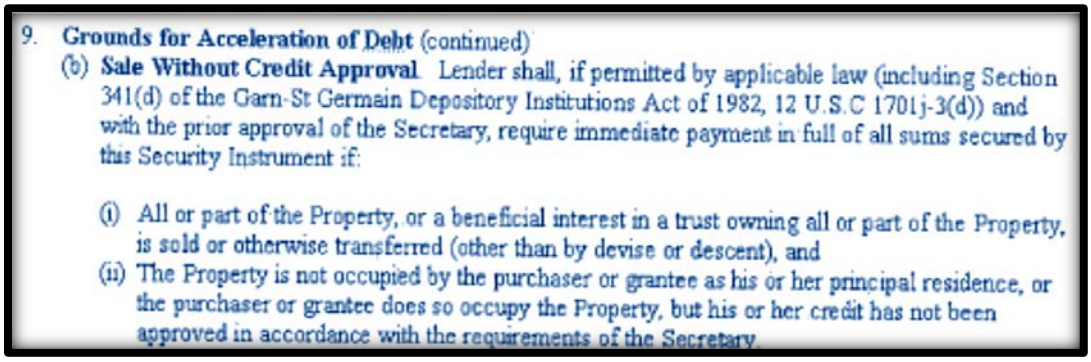
9. **Grounds for Acceleration of Debt**

(a) **Default.** Lender may, except as limited by regulations issued by the Secretary in the case of payment defaults, require immediate payment in full of all sums secured by this Security Instrument if:

(i) Borrower defaults by failing to pay in full any monthly payment required by this Security Instrument prior to or on the due date of the next monthly payment, or

(ii) Borrower defaults by failing, for a period of thirty days, to perform any other obligations contained in this Security Instrument.

Section 9(b) of "FHA Mortgage Form"



9. **Grounds for Acceleration of Debt** (continued)

(b) **Sale Without Credit Approval.** Lender shall, if permitted by applicable law (including Section 341(d) of the Garn-St Germain Depository Institutions Act of 1982, 12 U.S.C 1701j-3(d)) and with the prior approval of the Secretary, require immediate payment in full of all sums secured by this Security Instrument if:

(i) All or part of the Property, or a beneficial interest in a trust owning all or part of the Property, is sold or otherwise transferred (other than by devise or descent), and

(ii) The Property is not occupied by the purchaser or grantee as his or her principal residence, or the purchaser or grantee does so occupy the Property, but his or her credit has not been approved in accordance with the requirements of the Secretary.

Comment 2 To clarify, the audit memorandum does not, at any point, state that prohibited restrictive covenants were put in place for "pernicious reasons." Rather, the memorandum reports on OIG's findings, based on specific audit objectives, that violations did in fact occur.

Comment 3 We strongly disagree with Pulte Mortgage's assertion that the OIG memorandum serves to threaten tens of millions of dollars in indemnity claims, solely because Pulte Mortgage provided mortgages to these homeowners. We also disagree with Pulte Mortgage that the OIG's recommendations to FHA for reimbursement and indemnification and a referral to HUD Office of Enforcement are completely without merit. The basis for indemnification is in the OIG determination, consistent with HUD's prior findings, that prohibited restrictive covenants are a material, statute violation. Losses tied to loans that should not have been FHA-insured should appropriately be reimbursed to the FHA mortgage insurance fund or indemnified. The OIG recommendations are addressed to HUD for appropriate action, fulfilling a public obligation to ensure HUD funds are safeguarded and spent appropriately. See also comment 1.

The recorded prohibited restrictive covenants impacted the insurability of the reviewed loans. Pulte Mortgage had a duty to ensure loans it approved for FHA insurance were in accordance with all FHA rules and regulations. The FHA loans identified were determined to be ineligible for FHA insurance; therefore, any loss or claim tied to the loan presents an unnecessary loss to HUD's FHA insurance fund. As with any underwriting review, deficiencies identified, such as overstated income and understated liabilities, do not have to be the reason an FHA loan went into default or claim for HUD to seek indemnification. Rather, the deficiencies are used as evidence that the FHA loan should not have been FHA-insured. In the same regard, the audit memorandum identifies a significant material deficiency that deemed the identified loans ineligible for FHA insurance; thereby warranting recommendations for indemnification of the loans identified.

As outlined in the audit memorandum, we specifically addressed the materiality of the findings. The OIG takes all potential and appropriate corrective actions into account when developing audit recommendations and those recommendations are addressed to HUD, not Pulte Mortgage, for corrective action. For clarification, recommendation 1A recommends HUD's Associate General Counsel for Program Enforcement to determine legal sufficiency for civil action. It is OIG's responsibility to refer violations that may rise to the level that may warrant civil action to the HUD's Office of Program Enforcement for its consideration. It is that office's responsibility to evaluate the violations and determine what, if any, civil action is warranted. Treble damages are not stated anywhere in the recommendation or audit memorandum.

Pulte Mortgage's assertion that neither the homebuyers nor the FHA insurance fund was harmed is incorrect. The prohibited restrictive covenants all carried the potential to harm FHA buyers. The scope of our audit was narrow and specific, to identify the presence of unallowable restrictive covenants and to determine if those restrictions violated HUD rules and regulations. To that end, we concluded that there were prohibited restrictive covenants, which violated Federal statute and were not eligible for FHA insurance; therefore, any loss or claim tied to the loans identified represents an unnecessary loss to HUD's FHA insurance fund.

Based on our conclusions, it was our duty and obligation to HUD and other stakeholders, including the American public, to recommend HUD take necessary, appropriate action. In HUD's prior actions, it also deemed the deficiency significant enough to warrant indemnification. We believe the recommendations contained in the audit memorandum are fair, consistent, and appropriate given the materiality of the OIG finding. Therefore, the recommendations remain unchanged.

Comment 4 Pulte Mortgage's statement that the audit memorandum's interpretation of FHA regulations is so inappropriately aggressive that FHA's own documents would violate the OIG's reading of its terms, is incorrect and without merit. We

identified a specific situation, compared the restrictive language found to FHA regulations, and determined the recorded agreements violated HUD FHA regulations. HUD's Office of Single Family Housing has made a similar determination in similar situations. See comments 1 and 15 for detailed explanations.

Comment 5 Pulte Mortgage is incorrect in assuming that restrictive covenant agreements were acceptable because FHA conducted post-endorsement reviews. Such assumptions are dangerous and should never be a substitute for reviewing and applying the actual FHA regulations. These reviews were not necessarily all inclusive in scope and may not have included methodology to search public records for documents recorded in conjunction with the FHA-insured loans.

Comment 6 To clarify, the audit memorandum does not state that Pulte Mortgage "acted knowingly or with reckless disregard resulting in a false, fraudulent, or fictitious claim to FHA" as implied by the Pulte Mortgage's response. See also comment 2.

Comment 7 Pulte Mortgage stated that no further actions are needed because the provision term in the prohibited agreements has expired for these loans and is no longer offering loans with the prohibited restrictive covenants. We acknowledge Pulte Mortgage's efforts to address the audit memorandum findings. HUD will review the adequacy of Pulte Mortgage's corrective actions and analysis during the audit resolution process to determine if it was sufficient to satisfy the audit recommendations. The findings cited restrictive covenants with an occupancy period of twelve months; however, there is a possibility that longer occupancy periods related to other loans exist.

Although the loans in question have an expired agreement, the presence of the restrictive covenant should have prevented them from reaching the point of receiving FHA mortgage insurance. Recommendations 1B, 1C, 1D, and 1E of the audit memorandum first seek reimbursement for the ineligible loans with an actual known loss, support or indemnification for those with claims but no known loss, to nullify active loans with such restrictions or indemnify said loans, and finally to follow 24 CFR 203.32 and 203.41 by excluding restrictive language and prohibited liens for all new FHA-insured loan originations and ensure that policies and procedures reflect FHA requirements. See also comment 3.

Comment 8 To clarify we reviewed public records for 332 loans (260 claim loans and 72 statistically sampled active loans) and found that, of these, 192 (181 claim loans and 11 statistically sampled active loans) had unallowable restrictive covenants. The 11 statistically sampled active loans were projected to the universe of active loans (see Methodology and Scope section of the audit memorandum), resulting in an estimated 925 active loans with similar issues. Therefore, we reported that there were 1,106 loans (181 claim loans and 925 active loans) with unallowable restrictive covenants.

Comment 9 We disagree with Pulte Mortgage that it is unreasonable to expect that it would treat these as a violation of FHA requirements because of the unclear nature of the regulations in question and FHA's own documents. FHA regulations at 24 CFR 203.41 and 203.32 specifically prohibit restrictive covenants as identified in the audit memorandum. Additionally, HUD has previously determined that prohibited restrictive covenants were serious, material deficiencies that deemed FHA loans ineligible for mortgage insurance. Whether intentional or not, Pulte Mortgage, as the underwriter, is responsible for ensuring the loan and its title instruments meet all HUD rules and regulations. As stated in the audit memorandum, HUD Handbooks 4000.2, paragraph 5-1(B), and 4155.2, paragraph 6.A.1.h, both state 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. We also disagree that the requirements were unclear and that the FHA documents were consistent with the agreements between the seller and borrower, see comment 1.

Comment 10 Pulte Mortgage's conclusion that, because there is no evidence that the builder/seller actually exercised its right under the agreement, therefore, no remediation is necessary is not material to the issues identified in the audit memorandum because violating 24 CFR 203.41 and 302.32 rendered the loans ineligible for FHA insurance. To that end, the recommendations specifically address the deficiencies identified, utilizing appropriate remedial options available to HUD and OIG. See also comment 3.

Comment 11 OIG acknowledges Pulte Mortgage's explanation of intent and history. However, this does not lift the burden from Pulte Mortgage to ensure all FHA loans approved for FHA mortgage insurance adhere to all FHA regulations. See also comment 1.

Comment 12 During the audit, the OIG auditors determined the restrictive covenants were in violation of HUD FHA regulations. The internal legal opinion cited by Pulte Mortgage was used only as additional support that restrictive covenants are unallowable and violate FHA rules and regulations. The legal opinion was obtained and reviewed after we conducted our own analysis and came to our own conclusion that HUD requirements were violated by the execution and recording of the restrictive covenants.

Comment 13 We agree with Pulte Mortgage; the audit memorandum has been revised to reflect the citation as 24 CFR 203.41(b).

Comment 14 We disagree with Pulte Mortgage's statement that the cause included in the audit memorandum was quite a different assertion than that initially offered by the OIG in its draft finding outline. The cause included in the finding outline provided to Pulte Mortgage stated, "This occurred because Pulte Mortgage officials believed that the documents with the restrictive covenants, which contain an owner

occupancy requirement, were consistent with FHA requirements and would in-turn help protect FHA from fraud." However, we simplified the cause in the audit memorandum to state, in part that Pulte Mortgage "was unaware that the restrictive covenants recorded between the sellers and the borrowers violated FHA requirements."

Additionally, Pulte Mortgage commented in its response that our statement that Pulte Mortgage was "unaware" that the restrictive covenants were a violation was a mischaracterization. A Pulte Mortgage official clarified that in its opinion it was reasonable to believe that the provisions were permissible under 24 CFR 203.41 and it offered the loans for insurance in good faith. As a result, we have revised the audit memorandum "Restriction on Conveyance" section to incorporate more of the original language from the finding outline and the clarification provided by a Pulte Mortgage official.

Pulte Mortgage was notified that the finding outline was a working document and the draft form was presented as a courtesy to enhance open communication and keep Pulte Mortgage informed of the OIG's progress and tentative conclusions in advance of the draft audit memorandum. The "Supplement A" contained in Pulte Mortgage's response contained a copy of a working document that was not intended for an external audience and therefore has been omitted from inclusion in appendix B of this audit memorandum.

Comment 15 Pulte Mortgage's logic is flawed and does not appear to understand or make the distinction that the prohibited agreements in question are between the borrower and seller, a third party, and not between the borrower and lender. It is incorrect and inappropriate for Pulte Mortgage to compare two clearly different agreements. See also comment 1.

Comment 16 Pulte Mortgage did not appropriately apply the FHA regulations. The exceptions at 24 CFR 203.512, as discussed in its response, do not apply.

Comment 17 Pulte Mortgage presented hypothetical scenarios that are not relevant to the facts of OIG's findings. The audit memorandum presented specific instances that violated FHA regulations, as determined separately by HUD and OIG. See also comments 1 and 15.

We disagree with the Pulte Mortgage's statement that the restrictive covenants did not create an actual or potential lien. Examples of the prohibited restrictive language included in the agreements in question were included in the body of the audit memorandum. Merriam-Webster dictionary describes a lien as follows:

> "In law, a charge or encumbrance on property for the satisfaction of a debt or other duty. Common law developed two kinds of possessory lien: the specific (a lien on the specific property involved in a transaction) and the

general (a lien for the satisfaction of a balance due, not confined to a specific property involved in a transaction)…"

Therefore, one could reasonably conclude from the prohibited restrictive covenant language of the buyer owing damages to the seller in the event of a breach or the seller's right to repurchase as a lien, which violated 24 CFR 203.32. We do not disagree with the Pulte Mortgage's assertion that typically a lien gives the right to the creditor to foreclose and take possession of the property in question if the debt is not satisfied; however, by definition that it is not required. Therefore, the discussion of potential liens will remain in the audit memorandum.

Comment 19 The intention behind 24 CFR 203.41(b) is not in question. The audit scope focused solely on Pulte Mortgage and its practices and was not an internal review of HUD and its regulations and policy decisions. The prohibited restrictive covenants identified violated FHA regulations, thereby rendering them ineligible for FHA insurance. To that end, the intention behind the regulations do not change that what occurred did not meet the stated requirements for insurance. See also comments 1 and 3.

Comment 20 We acknowledge Pulte Mortgage's efforts to take corrective actions and adhere to FHA rules and regulations. Any actions taken should be directed to HUD during the audit resolution process, including providing supporting documentation. See also comment 7.

Comment 21 We agree with Pulte Mortgage and acknowledge that the FHA Reform Act of 2010 was never finalized. However, this legislation has been updated and was reintroduced to the U.S. House of Representatives and is now known as the "FHA Emergency Fiscal Solvency Act of 2013." This legislation clearly indicates the U.S. Congress' specific intent to protect and ensure the fiscal solvency of the FHA mortgage insurance fund. The audit memorandum has been updated accordingly and reflects the new, updated pending legislation. As a result, there was no need to include Pulte Mortgage's "Supplement C" in appendix B of the audit memorandum, which contained the progress of the FHA Reform Act of 2010.

Comment 22 We disagree with Pulte Mortgage's statement that the OIG's position is that any technical breach may serve as a basis for indemnification. The OIG reviews each situation independently and makes determinations on specific facts and merits. In this specific circumstance, the conditions for free assumability of the loan, as well as no additional liens outside the mortgage (with some exceptions noted in the CFR), were required to be met for the loan to be eligible for FHA mortgage insurance. We disagree that indemnification should only be utilized for traditional underwriting deficiencies (overstated income, understated liabilities, etc.). This interpretation opens a wide door for violations other than your typical underwriting deficiencies and sets a bad precedent to violating lenders. Therefore, in OIG's assessment, indemnification is an appropriate remedy in these instances

because it provides the remedy of alleviating any loss or potential loss on the loans from impacting the FHA mortgage insurance fund, as would be the case if the loans were not insured. Ultimately, the recommendations are directed to HUD for it to assessment and enter in to a management agreement during the audit resolution process with OIG on the appropriate course of action. See also comment 3.

Comment 23 We acknowledge Pulte Mortgage's admission that had it known the loans in question were in violation of FHA regulations it would have taken corrective actions. Unfortunately, the violations have already occurred, and need to be remedied. See also comment 9.

Comment 24 We strongly disagree with Pulte Mortgage's interpretation that the audit memorandum stated, "Pulte Mortgage falsely certified that loans with recorded Provisions that it offered for insurance were in compliance with FHA regulations." Rather the audit memorandum states, "For each FHA loan, the lender certifies on the Direct Endorsement Approval for HUD/FHA-Insured Mortgage (form HUD-92900-A) that the mortgage was eligible for HUD mortgage insurance under the direct endorsement program."

Comment 25 We strongly disagree with Pulte Mortgage's assertion that the audit memorandum demonstrates a failure to understand the purpose behind implementation of the prohibited agreements and the reasonability of the position that the prohibited agreements did not violate FHA regulations. Also, Pulte Mortgage's response incorrectly attempts to explain HUD's policy on implementing regulations and incorrectly interprets FHA regulations. Additionally, Pulte Mortgage inappropriately attempted to compare different agreements between the borrower and lender and the borrower and seller. As previously stated, the purpose behind the implementation of the restrictive covenants between the seller and borrower are irrelevant in light of the fact that ultimately the agreements violated 24 CFR 203.41 and 203.32, which rendered the loans ineligible for FHA insurance. See also comments 1, 9, and 15.

Appendix C

SUMMARY OF FHA LOANS REVIEWED

Table 1 - Actual loss to HUD
Claim loan review results

FHA loan number	Recommendation 1B – actual loss to HUD[18]
022-1927689	$ 71,373
023-2603944	146,239
023-2611680	143,523
023-2619967	105,390
023-2619996	288,390
023-2655731	80,896
023-2669181	116,573
023-2673344	105,125
023-2685324	105,459
023-2707816	129,494
023-2713580	69,467
023-2716167	92,088
023-2731482	130,236
023-2754772	110,901
023-2764894	114,485
023-2772117	118,331
023-2776246	136,992
023-2779167	84,883
023-2784325	109,780
023-2786411	76,201
023-2788697	159,438
023-2793680	56,021
023-2795810	89,038
023-2799953	174,561
023-2804376	75,844
023-2818776	133,341
023-2819969	97,437

[18] The actual loss to HUD was obtained from HUD's Single Family Data Warehouse in January 2013.

FHA loan number	Recommendation 1B – actual loss to HUD[18]
023-2820025	92,392
023-2821037	92,863
023-2823878	46,585
023-2823986	97,706
023-2830153	123,671
023-2830182	104,026
023-2838213	91,107
023-2848285	123,901
023-2851827	134,619
023-2855523	95,199
023-2858904	81,223
023-2879361	128,920
023-2880461	90,803
023-2884854	85,855
023-2886080	102,730
023-2908445	80,562
023-2933479	91,916
023-2943430	67,492
023-2985345	116,858
023-2996978	89,110
023-3014540	124,576
023-3018717	97,629
023-3039168	115,536
023-3047628	104,105
023-3180064	82,738
023-3311141	65,043
023-3617752	50,135
023-3814604	103,782
042-8042434	248,649
042-8084411	238,870
042-8516684	120,177
043-7466544	119,070
043-7525324	200,059
043-7573835	131,817
043-7621188	158,705
043-8056250	135,382

FHA loan number	Recommendation 1B – actual loss to HUD[18]
044-4321995	79,870
048-4640203	201,968
048-4842458	152,501
197-3761673	154,478
197-4087743	154,321
332-4483429	137,515
332-4575855	128,866
332-4616837	172,417
332-4656194	141,132
332-4656250	132,069
332-4658869	135,518
332-4661113	150,950
332-4661868	139,676
332-4664292	126,408
332-4666337	175,968
332-4676488	176,192
332-4707171	223,858
332-4751441	114,385
332-4814978	55,883
Total	**$ 9,909,292**

Table 2 - Claims paid, loss unknown
Claim loan review results

FHA loan number	Recommendation 1C – claims paid but no actual loss known[19]
022-1916640	$ 81,755
022-1931001	75,076
022-2211768	111,328
023-2622908	74,215
023-2640369	121,060
023-2644672	133,163
023-2644689	120,447
023-2645757	104,755
023-2648333	101,088
023-2648385	110,176
023-2648697	230,330
023-2655879	90,050
023-2661687	139,912
023-2665978	123,096
023-2669826	76,752
023-2689858	116,664
023-2696193	108,419
023-2714983	114,959
023-2715908	50,784
023-2722711	113,753
023-2734131	160,272
023-2741062	105,275
023-2760699	101,583
023-2774600	103,158
023-2782528	231,783
023-2791883	98,691
023-2791940	95,971
023-2814853	163,847
023-2815474	141,753
023-2823905	62,077
023-2827580	160,797
023-2838140	132,185

[19] The claims paid values were obtained from HUD's Neighborhood Watch system in January 2013.

FHA loan number	Recommendation 1C – claims paid but no actual loss known[19]
023-2838852	53,391
023-2840150	80,894
023-2845339	144,238
023-2855779	112,981
023-2863559	87,940
023-2867176	159,626
023-2883690	114,664
023-2901742	135,712
023-2908320	78,745
023-2911870	94,981
023-2921849	104,673
023-2928252	53,339
023-2929156	70,648
023-2930472	87,070
023-2948654	144,373
023-2952108	127,160
023-2954217	106,100
023-2966402	83,424
023-2986022	136,581
023-3005512	108,400
023-3016456	76,045
023-3030123	106,730
023-3053515	91,570
023-3057631	81,538
023-3073981	64,161
023-3498004	95,981
023-3503349	70,451
023-3530032	98,071
023-3617492	117,504
023-3617979	93,973
023-3774368	74,322
042-8050561	180,298
042-8079927	170,132
042-8087657	233,413
042-8091572	129,761
042-8559877	93,586

FHA loan number	Recommendation 1C – claims paid but no actual loss known[19]
043-7447279	60,250
043-7500295	250,193
043-7523845	123,747
043-7573076	119,162
043-7577084	118,366
043-7757408	91,139
043-7805468	294,226
043-7989028	25,408
043-8084823	74,065
044-4334708	139,718
044-4346770	91,864
044-4357665	91,231
045-6707713	48,385
048-4743554	156,706
091-4315182	100,042
091-4382164	239,308
197-3785482	168,871
197-3877861	121,956
332-4529992	174,964
332-4531582	111,524
332-4550184	269,478
332-4565671	131,040
332-4586869	144,024
332-4612208	106,993
332-4641624	121,667
332-4644955	339,753
332-4666655	167,819
332-4666684	142,314
332-4708125	93,329
332-4942724	43,821
332-5008601	86,584
Total	**$ 11,865,597**

Table 3 - Potential loss to HUD
Active loan sample results

FHA loan number	Unpaid mortgage balance[20]	Recommendation 1D – potential loss on active loans[16]
023-2612062	$ 245,959	$ 140,197
023-2848335	239,153	136,317
023-2971807	221,198	126,083
023-3439835	168,663	96,138
023-4056921	122,303	69,713
023-4113303	170,901	97,414
042-8555607	335,490	191,229
043-8367965	186,923	106,546
095-0847106	229,269	130,683
197-3785674	275,024	156,764
332-4950346	190,864	108,792
Total	**$ 2,385,747**	**$ 1,359,876**

[20] The unpaid mortgage balance for each loan was obtained from HUD's Single Family Data Warehouse in January 2013.