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

April 18, 2013

MEMORANDUM NO:
2013-LA-1803

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: CTX Mortgage Company LLC, Dallas TX, 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 CTX Mortgage Company LLC.[1] We selected the lender based on the results of an auditability survey, which determined that CTX 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 CTX 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 51358

Office of Audit (Region 9)
611 West Sixth Street, Suite 1160, Los Angeles, CA 90017
Phone (213) 894-8016, Fax (213) 894-8115
Visit the Office of Inspector General Web site at www.hudoig.gov.

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 842[2] loans underwritten by CTX 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 CTX 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, 770 loans total, and elected to review a highly stratified attribute statistical sample of the 10,481 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;
- Interviewed some borrowers for loans on which HUD paid a claim;

---

[2] 770 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 16-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, eight had disallowed covenants, which projects to 11.42 percent, or 1,196 loans. To account for the statistical margin of error, we subtracted the standard error (3.65) times a t-score of 1.67. As a result, we can be 95 percent confident that at least 555 of the 10,481 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 CTX Mortgage. We did not follow standards in these areas because our objective was to identify the extent to which CTX 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

CTX Mortgage was a nonsupervised direct endorsement lender[7] headquartered in Dallas, TX. It was approved to participate in HUD's FHA mortgage insurance program in 1984 and voluntarily withdrew its FHA approval status in July 2010. CTX Mortgage, which was acquired by PulteGroup with the Centex merger, had transitioned all of CTX Mortgage's loan origination production to Pulte Mortgage as of December 31, 2009. Its affiliate builder, Centex Homes, was the seller 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

[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.

mortgage loans. It is also the only government agency that operates entirely from its self-generated income from mortgage insurance paid by homeowners and costs the taxpayers nothing. FHA mortgage insurance encourages lenders to approve mortgages for otherwise creditworthy borrowers that might not be able to meet conventional underwriting requirements by protecting the lender against default. 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 CTX 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

CTX Mortgage did not follow HUD requirements regarding free assumability and liens when it underwrote loans that had executed and recorded agreements between sellers and the FHA borrower, containing prohibited restrictive covenants and potential liens in connection with FHA-insured properties. This noncompliance occurred because CTX Mortgage did not exercise

[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

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 683 FHA-insured loans (128 claim loans and 555 active loans) with a corresponding prohibited restrictive covenant with a potential lien recorded with the applicable county recording office, and CTX Mortgage placed the FHA fund at unnecessary risk for potential losses.

Claim Loan Review Results

We identified and reviewed all 770 claim loans underwritten by CTX 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 128 of the 770 claim loans with properties in Arizona, Florida, Georgia, South Carolina, and Utah. Of the 128 loans, 51 resulted in actual losses[13] to HUD totaling more than $5.2 million (see appendix C, table 1), and 77 resulted in claims paid totaling more than $7.9 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 10,481 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 8 of the 72 sampled active loans with properties in Arizona, Florida, and South Carolina. The eight loans were active with an unpaid principal balance of more than $1.5 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, 11.42 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 555 of the 10,481 active loans in our audit period had similar problems with unallowable restrictive covenants (see Methodology and Scope).

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).

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

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

occupancy period was limited by the seller, which 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 two versions of the recorded restrictive covenants found between the seller, a third party to the FHA loans, and borrowers.

Version 1

EXHIBIT "B" TO DEED

DEED RESTRICTION
OCCUPANCY PERIOD AND USE OF THE PROPERTY

As a material consideration inducing the grantor under the attached deed ("Seller") to sell to the grantee under such deed ("Buyer") that certain real property described in this Deed (the "Property"), Buyer has represented to Seller that Buyer intends to and will occupy the Property as Buyer's principal or secondary residence [or will rent the Property in accordance with neighborhood specific rules and regulations relating to such rentals] for a period of at least twelve (12) months after Buyer's acquisition of the Property (the "Occupancy Period"). Seller and Buyer have entered into a separate unrecorded agreement (the "Agreement") pursuant to which Buyer has agreed to occupy the Property as provided herein, and Buyer has agreed not to sell the Property for the duration of the Occupancy Period. This Deed Restriction is to put third parties on notice of such commitments by Buyer, and Seller's rights upon a breach of such commitments by Buyer, as provided in the Agreement and nothing contained in this Deed Restriction shall, or shall be deemed to, modify or amend the Agreement in any respect. In the event of any conflict between the provisions of the Agreement and the provisions of this Deed Restriction, the provisions of the Agreement shall prevail. Notwithstanding the foregoing, this Deed Restriction includes certain mortgagee protections which shall be in addition to, and shall not be superseded by, the mortgagee protections in the Agreement.

4. Remedies for Breach. If Buyer or Buyer's successors and assigns, breaches, violates or fails to perform or satisfy any of the covenants set forth in the Agreement, Seller, and Seller's successors and assigns, may enforce the remedies set forth in the Agreement including, without limitation, the right and option to recover all "Appreciation" in value of the Property upon a sale of the Property in violation of the Agreement, determined as provided in the Agreement, and Buyer's obligation to pay the Appreciation shall constitute a lien on the Property which shall run with the land and shall be binding on successors and assigns.

Version 2

As a material consideration inducing the grantor under the attached deed ("Seller") to sell to the grantee under such deed ("Buyer") that certain real property described in this Deed (the "Property"), Buyer has represented to Seller that Buyer intends to and will occupy the Property as Buyer's principal or secondary residence for a period of at least twenty four (24) months after Buyer's acquisition of the Property (the "Occupancy Period"). Seller and Buyer have entered into a separate unrecorded agreement (the "Agreement") pursuant to which Buyer has agreed to occupy the Property as provided herein, and Buyer has agreed not to sell the Property for the duration of the Occupancy Period. This Deed Restriction is to put third parties on notice of such commitments by Buyer, and Seller's rights upon a breach of such commitments by Buyer, as provided in the Agreement and nothing contained in this Deed Restriction shall, or shall be deemed to, modify or amend the Agreement in any respect. In the event of any conflict between the provisions of the Agreement and the provisions of this Deed Restriction, the provisions of the Agreement shall prevail. Notwithstanding the foregoing, this Deed Restriction includes certain mortgagee protections which shall be in addition to, and shall not be superseded by, the mortgagee protections in the Agreement.

4. Remedies for Breach. If Buyer or Buyer's successors and assigns, breaches, violates or fails to perform or satisfy any of the covenants set forth in the Agreement, Seller, and Seller's successors and assigns, may enforce the remedies set forth in the Agreement including, without limitation, the right and option to recover all "Appreciation" in value of the Property upon a sale of the Property in violation of the Agreement, determined as provided in the Agreement, and Buyer's obligation to pay the Appreciation shall constitute a lien on the Property which shall run with the land and shall be binding on successors and assigns.

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). A distinction 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 and 2 above). A breach of the contract would include the borrower's conveying or transferring the property during the specified occupancy period, which could result in a lien that is prohibited by 24 CFR 203.32.

CTX Mortgage officials stated the prohibited restrictive covenants were allowed because they believed that the restrictive language, coupled with an owner occupancy requirement, were consistent with FHA requirements. Therefore, they allowed the use of sellers' restrictive covenants on FHA properties. However, based on this information, we concluded that CTX 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 683 loans (128 claim loans and 555 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, CTX Mortgage may have forced borrowers with decreasing financial capability to remain in their property longer than they would have otherwise.

As a result, CTX 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 136 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 51 claim loans identified as ineligible for FHA insurance, HUD suffered a loss it should not have otherwise suffered.

Conclusion

CTX Mortgage did not follow HUD requirements regarding free assumability and liens when it underwrote loans that had executed and recorded agreements between sellers and the FHA

[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.

borrower, containing prohibited restrictive covenants and potential liens in connection with FHA-insured properties. We identified 683 loans (128 claim loans and 555 active loans) within our audit period that did not meet the requirements for FHA insurance, thereby rendering them ineligible for FHA insurance. CTX Mortgage's failure to exercise due diligence allowed prohibited restrictive covenants with the potential for liens on the FHA-insured properties, which rendered the loans uninsurable. These uninsurable loans placed the FHA fund at unnecessary risk for potential losses because HUD would not otherwise see a loss on loans not insured by the FHA fund. Of the 136 (128 claim loans and 8 sampled active loans) loans reviewed where a prohibited restrictive covenant was found, 51 resulted in an actual loss to HUD of more than $5.2 million. Another 77 of these loans had claims paid totaling more than $7.9 million. The remaining eight loans found with prohibited restrictive covenants had a total unpaid mortgage balance of more than $1.5 million with an estimated loss to HUD of more than $892,000 (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 CTX 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 CTX Mortgage, after completion of recommendation 1A, to

1B. Reimburse the FHA fund for the $5,285,281 in actual losses resulting from the amount of claims and associated expenses paid on 51 loans that contained prohibited restrictive covenants and potential liens (see appendix C, table 1).

1C. Support the eligibility of $7,975,892 in claims paid or execute an indemnification agreement requiring any unsupported amounts to be repaid for claims paid on 77 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 eight 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 eight active loans with prohibited restrictive covenants had a total unpaid mortgage balance of $1,564,969, which carries a potential loss of $892,032[16] that could be put to better use (see appendix C, table 3).

[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	$5,285,281		
1C		$7,975,892	
1D			$892,032
Total	$5,285,281	$7,975,892	$892,032

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**

CTXMortgage

CTX Mortgage Company, LLC
7390 South Iola Street
Englewood, Colorado 80112

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: CTX Mortgage Company, LLC; Memorandum no. 2013-LA-180X

Dear Ms. Schulze:

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

Comment 1

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

Comment 2

Comment 3

Comment 3

Comment 1
Comment 4

Comment 1
Comment 5

Comment 3

Comment 3

Comment 6

Comment 7

Comment 3

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. Obviously, the Provision was not put into place 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's to threaten tens of millions of dollars in indemnity claims, solely because CTX provided mortgages to these homeowners.

CTX takes exception to the findings in the Audit Report, and submits that the OIG's recommendations to FHA 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, CTX responds to the Audit Report as follows:

- CTX 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 CTX's affiliated builders tracks the occupancy requirement language in FHA's own standard mortgage security documents. In fact, FHA, to our knowledge, never identified a recorded Provision as being unacceptable in any post-endorsement review of loans offered for FHA insurance by CTX. Therefore, it was reasonable for CTX (and other lenders) to assume that the FHA language (and anything tracking it, such as the Provision) must also be acceptable to FHA.
- Usage 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.
- HUD OIG's referral of this matter for False Claims Act review is particularly disappointing and entirely inappropriate. CTX at all times acted in good faith, responsibly and in a manner fully consistent with FHA requirements when it offered loans for insurance with corresponding Provisions only in response to the industry-wide problem of investors driving up home prices. CTX 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 CTX making loans for FHA insurance in 2009.[1] Therefore, any Provision corresponding to an FHA-insured loan has since expired by its own terms, and CTX is no longer offering loans with a Provision for FHA insurance. Consequently, no corrective measures are necessary.

For these reasons, and as detailed below, CTX strongly disagrees with the findings and recommendations of the OIG in the Audit Report, and the final report should be amended to remove such faulty findings and recommendations.

---

[1] CTX ceased all loan origination operations in December 2009.

II. Narrative Explanation

A. Background

CTX was a nationwide mortgage lender and an indirect subsidiary of Centex Corp. ("Centex"), a nationwide homebuilder. Prior to mid-2008, CTX provided mortgage financing both to Centex homebuyers and retail customers. After that time, CTX primarily served only the financing needs of Centex homebuyers. In August 2009, CTX's parent, Centex Corp., merged with PulteGroup, Inc. Then, as previously noted, CTX ceased originations in December 2009 and promptly closed down its on-going business. Today, CTX exists as a corporate entity solely for the purpose of the orderly resolution of its affairs.

Comment 8

In the Audit Report, the OIG has asserted that CTX 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 842 loans underwritten by CTX with closing dates between January 1, 2008, and December 31, 2011 (including 770 claim loans and 72 statistically selected active loans), and determined that of that universe, 136 loans had corresponding Provisions.[2] The OIG appears to project that based on these results, it is likely that there are a total of 683 loans (128 claim loans and 555 active loans) offered for FHA insurance by CTX with corresponding Provisions.[3] The Audit Report further states that CTX 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 CTX make FHA whole for $5,285,281 in actual losses, agree to indemnify FHA for up to $7,975,892 in potential losses, nullify any remaining active Provisions, and agree to exclude such Provisions or similar requirements in all future loans offered for FHA insurance.[5] The OIG has further recommended that the matter of the Provision be referred to the 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.

Comment 3
Comment 1
Comment 9
Comment 3

Comment 6

These heavy-handed recommendations are without merit. 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 CTX 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 of certain FHA regulations, 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 CTX acted knowingly or with reckless disregard resulting in a false, fraudulent, or fictitious claim to FHA.

Comment 7

Comment 10

As noted above CTX stopped making FHA loans (with associated Provisions or note) in 2009. 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. Consequently, CTX understands that all Provisions have expired by their own terms. Furthermore, CTX also is unaware (and the OIG has not been able to demonstrate otherwise) of any instance were the builder/seller has actually exercised a right under the Provision against any FHA borrower, so no remediation is necessary.

---

[2] Audit Report, page 5.
[3] *Id.*
[4] Audit Report, page 6.
[5] Audit Report, pages 10-11.

Comment 11

Comment 1

B. Provision History

The Provision was designed to prevent speculative investment in housing (i.e., "flipping") in order 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 younger, 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 to attract families were forced to see their communities permeated with 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.

The Provision was designed as a mechanism to prevent this. It created an 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 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 recover 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 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 Arizona:

2(b) **Hardship Exceptions**. Notwithstanding the restrictions on transfers referenced above, Seller recognizes that a transfer of the Property may be desirable in certain circumstances and Seller may, in its sole and absolute discretion decided on a case-by-case basis, consent to a transfer of the Property during the Occupancy Period. Furthermore, Seller shall not unreasonably withhold its consent to a transfer in the following instances:

(i) A transfer necessitated by the death of Buyer or Buyer's spouse;

(ii) A transfer, conveyance, pledge, assignment or other hypothecation to secure the performance of an obligation, which transfer, conveyance, pledge, assignment, or hypothecation will be released or reconveyed upon the completion of such performance;

(iii) A transfer in connection with a significant negative change in the financial circumstances of Buyer from Buyer's financial circumstances when Buyer acquired the Property, as evidenced by documentation reasonably acceptable to Seller;

Comment 12

Comment 13

Comment 12

Comment 14

Comment 15

Comment 1

(iv) A transfer necessitated by a medical condition of Buyer or another person living with Buyer (or dependent on Buyer) for whom Buyer is the primary caretaker, as evidenced by documentation reasonably acceptable to Seller;

(v) A transfer in connection with a temporary (more than 6 months) or permanent employment related relocation of Buyer or Buyer's spouse, as evidenced by documentation reasonably acceptable to Seller;

(vi) A transfer in connection with military activation or otherwise arising in connection with military service; or

(vii) A transfer which, in Seller's sole judgment, constitutes a "hardship" situation consistent with the intent of this Deed Restriction.

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 in relation to loans offered for FHA insurance violates FHA regulations concerning free assumability and liens. According to the OIG, it has access to a legal opinion (which has not been provided to CTX 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, CTX 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]

The Audit Report states that this presumed noncompliance occurred "because CTX 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 CTX 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). Nevertheless, the OIG apparently has used this presumed ignorance and lack of due diligence by CTX as part of its determination to recommend the penalties described above.

C. The Provision Does Not Violate 24 CFR § 203.41

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:

---

[6] Audit Report, page 4.

[7] Audit Report, page 7. CTX understands that the OIG mistakenly omitted the reference to 24 CFR § 203.41(a)(3)(ii) in the Audit Report, and that the OIG plans to amend the Audit Report to include this provision. In light of that, we have referenced it here.

[8] Audit Report, pages 4-5.

> 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.[9]

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]

Comment 1

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.

Comment 1

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 were a breach of the FHA mortgage instrument would likewise breach the Provision, the Provision also complies with FHA's regulatory requirements every bit as much as FHA's own document.

Comment 16
Comment 1

The OIG's position in the Audit Report 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 therefore 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.

Comment 17
Comment 1

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

[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.
[10] FHA Mortgage Form, Section 9.
[11] 24 CFR §§ 203.41(a)(3)(ii), (iv).

the Provision is a "third party," but the lender is not.[12] This reading, of course, completely ignores the 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 the subsequent sales agreement buyer as the original builder/seller. CTX 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.

Comment 18

The OIG's interpretation thus leads to the unsupportable 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 CTX to believe that the Provision, which tracks the occupancy requirement in Section 5 of the FHA Mortgage Form, would be viewed as implicitly permissible by FHA.

Comment 1

Comment 16

D. The Provision Does Not Substantively Violate 24 CFR § 203.32

The OIG has also asserted, as described above, that CTX 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. However, CTX again stresses that the Provision tracked the FHA mortgage document's own lien restriction and therefore was arguable compliant and, at most, a virtual nullity.

Comment 1

The presence of the Provision is not material in any way to any loss suffered by FHA on the loans in question, as described further below. Had it been apparent to CTX that the Provision was in breach of FHA regulations solely because of the lien (which was solely meant to be an enforcement mechanism for the anti-investor occupancy requirement), CTX would have demanded that the Provision be amended or removed and would have reoffered the loans for FHA insurance. Unlike an error that has a substantive impact on whether the loan will go into default, such as a serious underwriting miscalculation as to the borrower's creditworthiness, the Provision's imposition of a lien (which has since expired by its own terms on all CTX-offered loans) is simply not material to any loss suffered by FHA.

Comment 3
Comment 9

Comment 3

Moreover, since the liens created by the Provision were, by their own terms, subordinate to the mortgage, FHA would take title to the affected properties free and clear since the subordinate lien would be wiped out by the foreclosure. The OIG itself appears to recognize this in the Audit Report, in which it states, "A distinction is that the restrictive covenants, while ineligible, do not necessarily prevent FHA from obtaining clear title in the event of foreclosure and conveyance."[13] In other words, when FHA paid claims to CTX and took title to the property that CTX had foreclosed, FHA did so free and clear of any subordinate lien that may have existed on the property. The OIG, of course, reasserts at this point in the Audit Report that this does not change the "material fact" that the loans should not have

Comment 1

[12] Audit Report, page 9.
[13] Audit Report, page 8.

Comment 19

Comment 3

Comment 1

Comment 6

Comment 5

been offered for FHA insurance in the first place. In doing so, the OIG fails to recognize that the liens imposed by the Provision are not in any way material to any claims offered on the loans by CTX or anyone else. No such lien was ever exercised, no such lien would survive the foreclosure process resulting in delivery of title to FHA, and every lien has since expired by its own terms. Therefore, CTX again stresses that full indemnification and referral for a False Claims Act violation based on the presence of such expired liens are not warranted.

E. The Provision Was Reasonable Under FHA Regulations

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. CTX acted in good faith when offering loans for insurance because the Provision was based on FHA's own occupancy requirement language, and CTX did not knowingly or recklessly violate the requirements of 24 CFR § 203.41. The OIG's assertions are flawed, particularly because CTX never received any notice from FHA that in FHA's opinion, the Provision violated this regulation.

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, 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....

Comment 20

Comment 1

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 CTX's affiliate homebuilders included these protective concepts for the consumer in the Provision.

Comment 1

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.

8

Comment 15

The Audit Report states that CTX was "unaware" that the Provision violated FHA requirements and regulations.[14] This is a mischaracterization of CTX's position: To the contrary, our view is that it was reasonable for CTX, and its affiliated builders, to believe that the Provision was permissible under 24 CFR § 203.41, and CTX offered the loans for insurance in good faith.

Comment 1

With respect to 24 CFR § 203.32, as described above, although the Provision placed a lien on the property, this lien was put into place only to enforce the Provision, which CTX had every reason to believe would be acceptable under FHA regulations. Furthermore, since the Provision was designed to track the FHA mortgage document's own language, a lien was thought to be appropriate and arguably compliant with FHA regulations.

F. The Recommended Remedies Are Not Warranted

Comment 3

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 CTX should have to 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 the more appropriate remedy of a civil money penalty.

Indemnification is Unwarranted

With respect to the recommendation for indemnification, CTX 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 suffered any loss 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 CTX. 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.[15]

Comment 21

The OIG further states, "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."[16] To our knowledge, however, the FHA Reform Act of 2010 was a bill that never actually became law; it passed in the House of Representatives but not the Senate.[17] We are troubled that the OIG apparently would cite from a failed bill.

Comment 22

More importantly, the OIG's posture that any technical breach – no matter how ambiguous or de minimis – may serve as a basis for indemnification, if adopted by FHA, would be a damaging precedent. The OIG's position would result in any technical breach of any FHA regulation or requirement (for example, delivery of the GFE a day late) being the basis for full indemnification. The result of this would

---

[14] Audit Report, page 4.
[15] Audit Report, page 9.
[16] Audit Report, page 9.
[17] *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 22

be a severe chilling of lenders offering loans for FHA insurance, as the penalty is 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.

Comment 23

Comment 3

Had it been clear at the time to CTX that the Provision was not acceptable to FHA, CTX 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

Comment 9
Comment 1

Comment 6

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 CTX 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, CTX did not act knowingly or with reckless disregard resulting in a false, fraudulent, or fictitious claim to FHA. At all times, rather, CTX acted reasonably and in good faith.

OIG's Materiality Standard is Unwarranted

Comment 3

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 completely 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 CTX in the exit conference on March 12, 2013 that it searched thoroughly for alleged consumer victims, to no avail, and that that the OIG even interviewed at least two borrowers who had been subject to the Provision, and the borrowers did not express that they felt their ability to dispose of their homes was chilled in any way.

Comment 1

CTX and other lenders and affiliated builders were very concerned about rampant speculation, as was FHA, and CTX 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 CTX recognizes that a key aspect of home ownership is the homeowner's right to do what he or she wants to 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, CTX felt that the Provision was (and still is) consistent with FHA requirements.

Comment 23
Comment 3

In summary, CTX did not knowingly, or recklessly violate FHA requirements, and 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, CTX would have taken steps to ensure that the Provision was removed and the loan would have been insured regardless. Therefore, the remedies recommended by the OIG are totally unwarranted.

Comment 9

Comment 1

Comment 20

Comment 1

Comment 5

Comment 1
Comment 3
Comment 22

Comment 24

Comment 1

Comment 3
Comment 9

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.
    - CTX 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.
        - FHA never identified a recorded Provision as being unacceptable in any post-endorsement review it performed of a loan offered for insurance by CTX.
- 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 CTX offered the loan for FHA insurance.
    - The Provision language tracked the FHA mortgage instrument's own restriction. Moreover, OIG has failed to demonstrate completely why full indemnification and referral for False Claims Act violations is warranted, given that the OIG cannot demonstrate that any borrower was harmed by the Provision or that FHA was not able to take clear title, and further given that the liens have long since expired by their own terms. There is simply no material connection whatsoever between the Provision and the reasons for loan default that the OIG has demonstrated.
- The OIG claims that because the Provision violates these regulations in the OIG's estimation, CTX falsely certified that the loans with recorded Provisions that it offered for insurance were in compliance with FHA regulations, exposing CTX to liability.
    - At the time CTX 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 CTX for such loans that CTX offered in good faith.
    - The OIG has failed to identify any loans with recorded Provisions that CTX offered for insurance which demonstrate that CTX would not have offered such loans for insurance previously if it was clear that the Provision was in violation of 24 CFR § 203.41.

Comment 3

- Even if it were found that the Provision violates 24 CFR § 203.32, such a violation would be technical and in no way has caused or is even connected with the reasons for loan default.

- The OIG claims that the fact that the loans were ineligible for FHA insurance provides a material basis for a duty of CTX to fully reimburse FHA for any losses it may have suffered 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.

Comment 1

Comment 3

- This is a highly unjust position. It is not clear that the loans were ineligible under 24 CFR § 203.41 or 24 CFR § 203.32 and consequently any liability for loans is totally unwarranted.

Comment 6
Comment 1
Comment 5

- Even if it is determined that the loans were ineligible, full reimbursement and indemnification are completely unwarranted remedies, in light of the fact that CTX 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.

Comment 3

- 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 two borrowers with CTX loans with associated Provisions, and the borrowers did not indicate that the Provisions affected the borrowers in any way, including by causing the borrowers to default on the loans.

Comment 3

- 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 CTX acted at all times reasonably and in good faith. The OIG has failed completely to demonstrate that CTX 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 CTX ever offered false, fictitious, or fraudulent loans for FHA insurance.

Comment 6
Comment 3

- The OIG demands that any remaining Provision be removed.

Comment 11

  - The Provision is limited by its own terms to the first twelve months after the initial sale of the property. CTX ceased making loans in 2009. Therefore, every recorded Provision has expired already, and no further action is necessary.

Comment 3

- The OIG demands that the Provision not be used in the future.
  - CTX stopped making loans in 2009.

12

Comment 25

Comment 9

Comment 3

Conclusion

CTX, while it was an active participant in the FHA program, valued its participation in the FHA insurance program, and was committed to complying with FHA requirements to the fullest extent required. However, CTX urges the OIG and FHA to consider that the conclusions reached in the Audit Report are unwarranted. In our view, the Audit report demonstrates a failure to understand the purpose behind implementation of the Provision and the reasonability 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, CTX 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). CTX further submits that the recommendations suggested by the OIG in the Audit Report are severe and not warranted in light of these considerations.

Very truly yours,

Michael K. Sullivan
Senior Vice President, General Counsel
CTX Mortgage Company, LLC

Enclosures

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

13

OIG Evaluation of Auditee Comments

Comment 1 We disagree with CTX Mortgage's assessment of the OIG review. Specifically, we disagree with CTX 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 as stated by CTX Mortgage. What CTX Mortgage does not address is that the prohibited restrictive covenants identified go beyond merely requiring owner occupancy, actually placing restrictions on the mortgage deed that violate HUD FHA regulations. A violation would not have occurred had the cited agreements merely required a one year occupancy. However, that was not the case. 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 203.41 and 203.32 respectively. By CTX Mortgage's own admission, the seller "would agree not to enforce the Provision…" again illustrates 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 CTX 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 CTX 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 CTX 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___. Th
______________________________ 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;
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 CTX Mortgage's assertion that the OIG memorandum serves to threaten tens of millions of dollars in indemnity claims, solely because CTX provided mortgages to these homeowners. We also disagree with CTX 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 recommending indemnification was in the OIG's determination, consistent with HUD's prior findings on similar violations where prohibited restrictive covenants were cited as a material, statute violation. Losses tied to loans that should not have received FHA mortgage insurance 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. CTX Mortgage had a duty to ensure loans it approved for FHA insurance were in accordance with all HUD 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.

CTX 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.

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 CTX Mortgage, for corrective action. For clarification, recommendation 1A recommends HUD's Associate General Counsel for Program Enforcement to <u>determine legal sufficiency</u> 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.

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 CTX 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 16 for detailed explanations.

Comment 5 CTX 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 HUD 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 CTX Mortgage "acted knowingly or with reckless disregard resulting in a false, fraudulent, or fictitious claim to FHA" as implied by CTX Mortgage's response. See also comment 2.

Comment 7 CTX Mortgage stated that no further actions are needed because the provision term in the prohibited agreements has expired for these loans. We acknowledge CTX Mortgage's efforts to address the audit memorandum findings. Although, the findings cited restrictive covenants with an occupancy period of twelve or 24 months, there is a possibility that longer occupancy periods related to other loans exist. HUD will review the adequacy of CTX Mortgage's analysis during the audit resolution process to determine if it was sufficient to satisfy the audit recommendations. We also acknowledge that CTX Mortgage no longer makes FHA loans and voluntarily withdrew its FHA loan status in 2010. As a result, we have removed recommendation 1E, which recommended that HUD ensure that the lender follow 24 CFR 203.32 and 203.41.

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, and 1D 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, and finally to nullify active loans with such restrictions or indemnify said loans. See also comment 3.

Comment 8 To clarify we reviewed public records for 842 loans (770 claim loans and 72 statistically sampled active loans) and found that, of these, 136 (128 claim loans and 8 statistically sampled active loans) had unallowable restrictive covenants. The 8 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 555 active loans with similar issues. Therefore, we reported that

there were 683 loans (128 claim loans and 555 active loans) with unallowable restrictive covenants.

Comment 9 We disagree with CTX 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, CTX 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 CTX Mortgage's conclusion that, because there is no evidence that the builder/seller actually exercised its rights 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 CTX Mortgage's explanation of intent and history. However, this does not lift the burden from CTX Mortgage to ensure all FHA loans approved for FHA mortgage insurance adhere to all HUD 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 CTX 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 CTX Mortgage; the audit memorandum has been revised to reflect the correct citation as 24 CFR 203.41(b).

Comment 14 As discussed during the exit conference, the original discussion draft memorandum to CTX Mortgage excluded the citation of 24 CFR 203.41(a)(3)(ii),

agreeing that this would be incorporated into the final memorandum. As a result, the audit memorandum has been updated to include this citation.

Comment 15 We disagree with CTX 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 CTX Mortgage stated, "This occurred because CTX 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 CTX Mortgage "was unaware that the restrictive covenants recorded between the sellers and the borrowers violated HUD-FHA requirements."

Additionally, CTX Mortgage commented in its response that our statement that CTX Mortgage was "unaware" that the restrictive covenants were a violation was a mischaracterization. A CTX 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 CTX Mortgage official.

CTX 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 CTX Mortgage informed of the OIG's progress and tentative conclusions in advance of the draft audit memorandum. The "Supplement A" contained in CTX 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 16 CTX 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 CTX Mortgage to compare two clearly different agreements. See also comment 1.

Comment 17 CTX Mortgage does not appropriately apply the HUD FHA regulations. The exceptions at 24 CFR 203.512, as discussed in its response, do not apply.

Comment 18 CTX Mortgage presents hypothetical scenarios that are not relevant to the facts of OIG's findings. The audit memorandum presented specific instances that violated HUD FHA regulations, as determined separately by HUD and OIG. See also comment 1.

Comment 19 We determined that CTX Mortgage's conclusion that "the OIG fails to recognize that the liens imposed by the Provision are not in any way material to any claims offered on the loans by CTX or anyone else", was irrelevant because the liens violated 24 CFR 203.32 rendering them ineligible for insurance. Therefore, the materiality to any claim offered on the loans is not relevant to the issue.

Comment 20 The intention behind 24 CFR 203.41(b) is not in question. The audit scope focused solely on CTX Mortgage and its practices and was not an internal review of HUD and its regulations and policy decisions. The prohibited restrictive covenants identified violated HUD FHA regulations, thereby rendering them ineligible for FHA insurance. To that end, the intention behind the regulations do not change the fact that what occurred did not meet the stated requirements for insurance. See also comments 1 and 3.

Comment 21 We agree with CTX 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 CTX Mortgage's "Supplement C" in appendix B of the audit memorandum.

Comment 22 We disagree with CTX Mortgage's claim 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 assess 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 CTX Mortgage's admission that had it known the loans in question were in violation of HUD 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 CTX Mortgage's interpretation that the audit memorandum stated, "CTX 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 CTX Mortgage's assertion that the audit memorandum demonstrates a failure to understand the purpose behind implementation of the prohibited agreements and the reasonableness of the position that the prohibited agreements did not violate FHA regulations. Also, CTX Mortgage's response incorrectly attempts to explain HUD's policy on implementing regulations and incorrectly interprets HUD FHA regulations. Additionally, CTX 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, 3, 9, and 17.

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]
023-2546269	$ 121,117
023-2548890	126,026
023-2600006	88,235
023-2606940	145,987
023-2607141	126,630
023-2616505	103,522
023-2626186	98,712
023-2633187	142,431
023-2636551	87,048
023-2638359	112,013
023-2639926	129,636
023-2640282	168,994
023-2645865	107,228
023-2657871	108,495
023-2658846	107,739
023-2658983	106,524
023-2662210	74,477
023-2664018	126,980
023-2667860	117,650
023-2670246	83,796
023-2672962	85,904
023-2678393	80,538
023-2687270	83,590
023-2692894	81,660
023-2702979	83,748
023-2711748	157,221
023-2734119	125,693

[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]
023-2736575	102,241
023-2739956	132,773
023-2754188	121,564
023-2767963	134,039
023-2802986	90,700
023-2808756	136,593
023-2831845	128,621
023-2841372	115,348
023-2845923	87,206
023-2859236	94,425
023-2866742	77,698
023-2881710	123,397
023-2892517	103,099
023-2895863	27,878
023-2903499	36,378
023-2904965	79,155
023-2909848	139,167
023-2915583	111,594
023-2919011	133,594
105-4956949	65,322
461-4231022	71,920
521-6513170	50,964
521-6534720	77,055
521-6566978	62,956
Total	**$ 5,285,281**

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

FHA loan number	Recommendation 1C – claims paid but no actual loss known[19]
023-2592234	$ 245,569
023-2608407	77,597
023-2610236	127,818
023-2621330	98,149
023-2623383	106,516
023-2623955	111,873
023-2624343	112,760
023-2625313	83,370
023-2633401	116,437
023-2636522	71,247
023-2637898	79,351
023-2645842	116,396
023-2650077	181,686
023-2655567	74,667
023-2674616	172,654
023-2683472	67,499
023-2687807	93,501
023-2687894	140,582
023-2700144	69,971
023-2703242	66,924
023-2705106	76,636
023-2711958	135,517
023-2740586	95,716
023-2744037	130,280
023-2745134	86,595
023-2775375	110,111
023-2778523	107,621
023-2780369	79,236
023-2780375	133,105
023-2780431	89,948
023-2780629	102,228
023-2785097	124,095

[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]
023-2799995	140,129
023-2808359	112,315
023-2841343	88,287
023-2853551	132,926
023-2888891	88,728
023-2893783	117,219
023-2897450	103,133
023-2909218	79,742
023-2909384	93,635
023-2909594	117,716
023-2912138	98,737
023-2915061	94,562
023-2916986	118,084
023-2919335	99,976
023-2921566	93,127
023-2962679	104,922
023-2967879	82,765
023-3018979	124,872
023-3030283	265,986
023-3205064	100,457
091-4329487	79,615
091-4334701	72,087
091-4353253	74,503
091-4365195	71,098
091-4374825	55,733
091-4401914	70,797
093-6334717	69,256
093-6399855	178,543
093-6419500	84,063
093-6469471	49,946
093-6483725	85,479
094-5336489	123,610
094-5358189	118,871
094-5358195	71,622
094-5392235	57,712
094-5448596	107,234

FHA loan number	Recommendation 1C – claims paid but no actual loss known[19]
094-5472782	145,958
094-5486781	96,653
094-5770285	70,178
094-5876266	63,051
094-5936786	72,410
095-0546694	144,893
461-4248454	49,851
521-6585490	185,704
521-6619326	34,052
Total	**$ 7,975,892**

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]
023-2743561	$ 166,335	$ 94,811
023-2908757	117,703	67,091
023-3174732	235,507	134,239
091-4390312	266,653	151,992
094-5353674	225,299	128,420
094-5379222	137,122	78,160
094-5505483	169,091	96,382
461-4624996	247,259	140,938
Total	**$ 1,564,969**	**$ 892,032**[21]

[20] The unpaid mortgage balance for each loan was obtained from HUD's Single Family Data Warehouse in January 2013.
[21] This value differs from the column total by a dollar because the actual figures, which included cents, were rounded.