Issue Date October 6, 2011	
Audit Report Number 2012-FW-1001	

TO: Deborah Holston
Acting Deputy Assistant Secretary for Single Family Housing, HU

Craig T. Clemmensen
Director, Departmental Enforcement Center, CACB

Dane Narode
Associate General Counsel for Program Enforcement, CACC

//signed//

FROM: Gerald R. Kirkland
Regional Inspector General for Audit, Fort Worth Region, 6AGA

SUBJECT: TXL Mortgage Corporation, Houston, TX, Did Not Comply With HUD-FHA Loan Requirements in Underwriting 16 of 20 Home Loans

HIGHLIGHTS

What We Audited and Why

We audited TXL Mortgage Corporation, a nonsupervised direct endorsement lender located in Houston, TX. We selected TXL due to one of its loan correspondents' high default rate. Our audit objectives were to determine whether TXL acted in a prudent manner and complied with U. S. Department of Housing and Urban Development (HUD) regulations, procedures, and instructions in the origination and sponsoring of Federal Housing Administration (FHA)-insured single-family mortgages and whether TXL implemented a quality control plan that met HUD-FHA requirements.

What We Found

Sixteen of 20 loans reviewed did not comply with HUD's requirements. Of the 16 loans, 8 had significant underwriting deficiencies and did not qualify for FHA insurance, and 2 qualified but were overinsured. As a result, TXL exposed HUD to unnecessary insurance risks totaling more than $713,000 and caused HUD to pay claims and incur losses of more than $36,000. Further, borrowers were overcharged more than $135,000, may not have known with which mortgage company they were dealing, and may not have understood that their mortgage company had an identity-of-interest relationship with the seller. These conditions occurred because neither TXL's quality control plan nor its policies and procedures complied with HUD-FHA requirements. Further, TXL employees either did not understand or disregarded HUD requirements.

What We Recommend

Our recommendations include that the Acting Deputy Secretary for Single Family Housing require TXL to (1) buy down eight loans by $147,289 due to overinsurance; (2) indemnify HUD for seven loans with an estimated potential loss of $566,052[1]; (3) support or repay the FHA insurance fund $900 for claims paid as of July 28, 2011, on one loan; (4) reimburse the FHA insurance fund $35,595 for actual losses on one loan; and (5) take other actions to ensure that its quality control plan and loan origination practices are in accordance with HUD requirements. We also recommend that TXL ensure that its loan correspondents stop charging buyers unearned underwriting fees, reimburse the appropriate buyers $135,126, and stop allowing its employees to originate loans through its loan correspondents. We also recommend that HUD refer TXL to the Mortgagee Review Board for administrative actions for failure to implement a quality control program in compliance with HUD requirements.

We further recommend that the Director of the Departmental Enforcement Center take appropriate administrative sanctions, including possible debarment or other remedies, against TXL for erroneously certifying that neither it nor its affiliates had identity-of-interest relationships with the sellers.

We also recommend that the Associate General Counsel for Program Enforcement pursue affirmative civil enforcement action of approximately $943,120 against TXL and/or its principals for incorrectly certifying to the integrity of the data or that due diligence was used during the underwriting of six loans that resulted in an actual loss of $35,595 on one loan and potential losses of $413,465 on five loans.

[1] The amount is based on the estimated percentage of loss of 59 percent that HUD would incur when the FHA property is foreclosed upon and resold as supported by the HUD Single Family Acquired Asset Management System's case management profit and loss by acquisition as of September 2010.

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

Auditee's Response

We provided our discussion draft to TXL on September 19, 2011, and held the exit conference on September 27, 2011. We requested a written response by September 28, but extended the due date to September 30 at TXL's request. TXL agreed with some conclusions and disagreed with others. TXL provided explanations and some documentation in its response to support its position. We reviewed the explanation and documentation; however, we determined that it was insufficient to change the report.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report. The addendums referred to in the auditee's response are available upon request.

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BACKGROUND AND OBJECTIVES

TXL Mortgage Corporation is a nonsupervised direct endorsement lender which was approved by the U. S. Department of Housing and Urban Development (HUD) to originate Federal Housing Administration (FHA)-approved mortgage loans on May 14, 1999. TXL's corporate headquarters is located at 11931 Wickchester Lane, Suite 400, Houston, TX.

The direct endorsement program simplified the process for obtaining FHA mortgage insurance by allowing lenders to underwrite and close the mortgage loan without prior HUD review or approval. Lenders are responsible for complying with all applicable HUD regulations and are required to evaluate the borrower's ability and willingness to repay the mortgage debt. Lenders are protected against default by FHA's Mutual Mortgage Insurance Fund, which is sustained by borrower premiums. FHA's mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to approve mortgages for otherwise creditworthy borrowers and projects that might not be able to meet conventional underwriting requirements by protecting the lender against default.[2]

According to HUD's Neighborhood Watch system,[3] TXL originated 666 loans totaling $103.2 million in 2008. In 2009 and 2010, it originated 910 loans totaling $143.5 million and 862 totaling $134.8 million, respectively. TXL's overall default rate was 2.55 percent for our review period.

TXL has one FHA-approved branch office located in Austin, TX, and one terminated branch in Irving, TX. TXL sponsored 20 loan correspondents (14 terminated and 6 active) in Texas and had financial affiliations or partnerships with them. HUD defines a loan correspondent as a HUD-FHA approved mortgage broker or mortgage company which, principally, originates mortgages for sale or transfer to a sponsor. FHA eliminated the use of loan correspondents after December 31, 2010, when it issued Mortgagee Letter 2010-20 on June 11, 2010. Appendix D is a table of TXL's loan correspondents and their status.

TXL operates as a mortgage banking organization but is also a private construction-lending firm. It has partnered with more than 20 homebuilders to create mortgage companies.[4]

Our audit objectives were to determine whether TXL acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination and sponsoring of FHA-insured single-family mortgages and whether it implemented a quality control plan that met HUD-FHA requirements.

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2 HUD defines a default as the inability to make timely mortgage payments or otherwise comply with mortgage terms. A loan is considered in default when no payment has been made 30 days after the due date. Once a loan is in default, the lender can exercise legal rights defined in the contract to begin foreclosure proceedings.

3 Neighborhood Watch is Web-based software that displays loan performance data for FHA-insured single-family loans. The system is designed to highlight exceptions so that potential problems are readily identifiable.

4 http://www.txlmortgage.com/AboutUS.aspx.

RESULTS OF AUDIT

Finding: TXL Did Not Comply With HUD-FHA Requirements in Originating and Underwriting 16 of 20 Home Loans

Sixteen of 20 loans reviewed did not comply with HUD-FHA requirements. Of the 16 loans, 10 had underwriting deficiencies of which 8 had significant deficiencies and should not have been approved for FHA insurance. Two of the 10 deficient loans qualified for insurance, but were overinsured. One of the 10 loans had been foreclosed upon and resold. For the six remaining loans, TXL allowed its employees to originate FHA loans for other companies at the same time they were employed by TXL. Further, in two instances TXL did not properly handle employee loans. This condition occurred because neither TXL's quality control plan nor its policies and procedures complied with HUD-FHA requirements. Further, TXL employees either did not understand or disregarded HUD requirements. As a result, TXL caused HUD to pay claims and incur losses totaling more than $36,000 and exposed HUD to unnecessary insurance risks totaling more than $713,000. Further, borrowers were overcharged more than $135,000, may not have known with which mortgage company they were dealing, and may not have understood that their mortgage company had an identity-of-interest relationship with the seller.

TXL Did Not Follow HUD-FHA Requirements

Sixteen of twenty loans reviewed did not comply with HUD's requirements. TXL allowed loan correspondents to charge borrowers unearned underwriting fees, allowed its employees to originate FHA loans for other companies at the same time they were employed by TXL, approved loans for insurance that had underwriting deficiencies, and did not properly handle employee loans.

Table 1 shows the 16 loans that had violations and underwriting deficiencies. A HUD Quality Assurance Division (QAD) report, issued July 22, 2010, cited TXL for two of the deficiencies, charging unearned underwriting fees and allowing its employees to originate loans for its correspondents; however, TXL did not provide documentation to show that it had corrected the deficiencies.

Table 1-Summary of violations

File	Case number	Mortgage company	Unearned fees	Dual employ-ment	Related parties[5]	Under-writing deficiencies	Employee loans
1	493-8728615	Baymont Financial, LTD	x	x	x	x	
2	493-9082458	Baymont Financial, LTD	x	x	x	x	
3	493-9048842	Castlerock Mortgage, LTD	x	x	x	x	
4	512-0024458	Castlerock Mortgage, LTD	x	x	x	x	
5	493-9413444	Castlerock Mortgage, LTD		x	x	x	
6	493-9042215	Friendswood Financial, LTD	x	x			
7	493-9251259	Friendswood Financial, LTD	x	x	x	x	
8	493-9041043	Glenwood Financial, LLC		x			x
9	493-9071846	Glenwood Financial, LLC	x	x			
10	493-9058168	Glenwood Financial, LLC	x	x			
11	493-9028752	Glenwood Financial, LLC	x	x			
12	493-8954521	Glenwood Financial, LLC		x		x	x
13	493-9187150	Glenwood Financial, LLC	x	x	x	x	
14	493-9289639	Glenwood Financial, LLC		x	x	x	
15	493-9330900	Glenwood Financial, LLC		x			
16	493-9577895	TXL Mortgage Corporation			x	x	
	Totals		**10**	**15**	**9**	**10**	**2**

TXL's Loan Correspondents Charged Unearned Underwriting Fees

TXL's loan correspondents charged a $285 underwriting fee for each of 10 of the 15 correspondent loans reviewed. HUD-1 settlement statements for the loans showed that the underwriting fees were made payable to the loan correspondents.

5 See the discussion beginning on page 10 pertaining to the identity-of-interest among TXL, loan correspondents, sellers, and builders.

Review of other FHA-insured loans showed that the loan correspondents charged underwriting fees for 466 of 630 additional loans. The underwriting fees that TXL's loan correspondents charged for the 476 loans totaled $135,126.

According to HUD Handbook 4060.1, paragraph 2-29A(2), the sponsor performs the loan underwriting function on behalf of the loan correspondent. Therefore, loan correspondents should not charge for underwriting because they do not perform the service, and the $135,126 in underwriting fees paid to the loan correspondents was unearned.

The July 22, 2010 QAD report cited TXL for allowing its loan correspondents to charge unearned fees. However, TXL continued this practice, and several underwriting charges were dated well after the QAD report.

TXL Allowed Its Employees To Originate Loans for Correspondents

TXL allowed its employees to originate FHA-insured loans for its loan correspondents, a practice prohibited by HUD Mortgagee Letter 96-18. The mortgagee letter states that lender employees may not work for more than one company engaged in the real estate finance business at the same time and includes working as a real estate agent or broker as well as originating or underwriting loans for more than one lending institution. In 15 of the 20 loans reviewed, the loan officers were listed as TXL employees and were also listed as loan officers for the loan correspondents.

For example, in five of the loans, a TXL loan officer was listed on the loan applications as an employee and loan officer for two loan correspondents, Castlerock Mortgage, LTD, and Baymont Financial, LTD. Further, in eight of the loans, another TXL loan officer was listed on the loan applications as an employee and loan officer of Glenwood Financial, LLC, a loan correspondent. Finally, in two of the loans, loan applications showed a TXL loan officer as an employee and loan officer for Friendswood Financial, LTD, a loan correspondent.

Further review of 630 loan applications[6] showed that there were at least 494 additional loans in which TXL's loan officers acted for the loan correspondents. In each case, the loan officer was listed as a TXL employee and was also listed as the loan officer for the loan correspondents.

[6] We selected an additional 630 HUD-1 settlement statements, loan applications, and HUD Forms 92900-A from the loan correspondents' origination files for further testing. We requested documents for 665 such loans, but TXL was only able to provide documents for 630 of them.

As a result of this practice, borrowers may not have known with which mortgage company they were doing business, and it was unclear which mortgage company would have been responsible for supervising the loan officers.

The July 22, 2010 QAD report cited TXL for allowing its loan officers to work for loan correspondents at the same time that they worked for TXL. However, the practice continued.

TXL Did Not Properly Underwrite 10 Loans

TXL's underwriters approved 10 loans with underwriting deficiencies as shown in Table 2. Eight of the 10 loans had significant underwriting deficiencies and did not qualify for FHA insurance, and 2 qualified but were overinsured.[7] Each loan had one or more of the following underwriting deficiencies: failure to show evidence that the borrowers had sufficient funds to close (five loans), accepting income documents that the sellers had handled or faxed (four loans), overinsuring loans by disregarding the 85 percent cap on the loan-to-value ratio for identity-of-interest loans (nine loans), and allowing a loan officer to process her own loan (one loan).

Table 2-Summary of underwriting deficiencies[8]

File	Case number	Insufficient funds to close	Improperly handled documents	Overinsured loan	Employee processed own loan
1	493-8728615	x	x	x	
2	493-9082458			x	
3	493-9048842	x		x	
4	512-0024458		x	x	
5	493-9413444	x		x	
6	493-9251259			x	
7	493-8954521				x
8	493-9187150	x	x	x	
9	493-9289639		x	x	
10	493-9577895	x		x	
Totals		**5**	**4**	**9**	**1**

7 Loan numbers 493-9082458 and 493-9251259.

8 See appendix E for additional details on the underwriting deficiencies.

Loans Lacked Sufficient Evidence of Funds To Close

Five of the ten loans with underwriting deficiencies lacked evidence of sufficient funds to close. Since there was no evidence that the five FHA borrowers had sufficient funds to close, the five loans were not eligible for FHA insurance and unnecessarily increased FHA's insurance risk.

For example, in FHA loan 493-9187150, the borrower needed $4,788 to close according to the HUD-1 settlement statement. The borrower's bank statement showed that the borrower had only $433. The underwriter certified that gift funds were the source of funds to close and included a copy of a cashier's check for $4,600. However, the gift funds were not listed on the HUD-1 settlement statement and were not properly documented. HUD Handbook 4155.1, paragraph 5.B.5.b, requires the donor to provide a withdrawal document showing that the funds came from the donor's personal account. There was no such evidence in the case file. Further, the gift documents were transmitted by the seller, and the gift amount was the same as the commission paid by the seller.

TXL's Underwriters Inappropriately Accepted Documents From the Sellers

In 4 of the 10 loans with underwriting deficiencies, TXL's underwriters accepted income documents that the sellers had handled and faxed. These documents included borrowers' Internal Revenue Service Forms W-2, pay stubs, Federal income tax forms, and gift documents. TXL's use of documents provided by an interested third party to the transaction was a serious control weakness that cast doubt on the validity of the documents. Since TXL did not support the loans with valid documents, it unnecessarily increased FHA's insurance risk and should indemnify HUD for those loans.

For example, in FHA loan 493-9289639, TXL's underwriters accepted and used documents relating to income and employment of the borrower that were handled or transmitted through an interested third party. The seller, Deerwood Homes Rayford Ridge L.P., handled the borrower's Federal income tax returns, W-2s, and other income documents. HUD Handbook 4155.1, paragraph 1.B.1.f., prohibits using documents for processing or underwriting when those documents were handled by or transmitted through an interested third party to the transaction.

TXL, Loan Correspondents, Builders, and Sellers Were Affiliated or Had Partnerships

In 9 of the 10 loans with underwriting deficiencies, TXL, the loan correspondents, the builders, and the sellers were affiliated or had partnership agreements. The underwriters for these loans certified to HUD that there were no affiliations among the parties. The underwriters certified on Form HUD-92900-A the following statement: "The Mortgagee, its owners, officers, employees or directors do not have a financial interest in or a relationship, by affiliation or ownership, with the builder or seller involved in this transaction." As a result of the erroneous certifications, HUD would have been unaware of these identity-of-interest transactions and the limits that they put on the maximum loan amounts.

Because TXL had an identity-of-interest relationship with builders and sellers, HUD required it to use a lower loan-to-value ratio on any of the loans in which TXL or its loan correspondents and the builders or sellers were parties. Normally, HUD allows a 97 percent loan-to-value ratio. The loan, less any financed principal mortgage insurance, has to be equal to or less than 97 percent of the appraised value of the home. However, in the case of related parties, HUD Handbook 4155.1, paragraph 2.B.2.b., limits the ratio to 85 percent. Any part of the loan over 85 percent would be overinsurance, and the overinsured portion of the loan would be ineligible. TXL overinsured the nine loans by approving them for more than the 85 percent cap; thus, increasing risk to the FHA insurance fund by the portion of the loans in excess of the cap.

For example, in loan number 493-9082458, the loan amount, not including principal mortgage insurance, was $196,734, and the appraised value of the property was $204,000. Therefore, the loan-to-value ratio was 96.4 percent.[9] However, because the builder and seller, Bayway Homes, Inc., and the lender, Baymont Financial, LTD (loan correspondent), had an identity of interest, the loan-to-value ratio should have been capped at 85 percent, or $173,400.[10] Therefore, the underwriters approved a loan that was overinsured by $23,334.[11]

A review of 630 additional loans showed 588 additional instances in which TXL's underwriters erroneously certified that the identity of interest did not exist in the transactions.

TXL Allowed Employees To Process Their Own Loans

TXL also violated HUD regulations by allowing employees to process their own FHA loans. HUD Handbook 4155.2, paragraph 3.B.3.a, prohibits employees from processing their own FHA loans. Loan documents for one of the 20 sample loans showed the employee as both the loan officer and borrower. In addition, the employee's signature appeared on the document, approving and receiving 25 percent of the loan origination fee. Allowing the employee to process her own loan cast doubt on the validity of the loan. Since TXL unnecessarily increased the insurance risk by violating the prohibition against employees processing their own loans, it should indemnify HUD for this loan.

TXL allowed at least two additional employees to process their own loans.[12] The additional loans were not part of our sample and we did not question them;

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9 The home portion of the loan (total loan less financed principal mortgage insurance) was $196,734. The appraised value was $204,000. Therefore, the loan-to-value ratio was 96.43 percent (196,734 divided by 204,000 = 96.43 percent).

10 The appraised value of $204,000 times the 85 percent cap equals a maximum loan-to-value of $173,400.

11 The home portion of the loan ($196,734) less the 85 percent loan-to-value cap ($173,400) equals $23,334 of overinsurance.

12 FHA case numbers 493-9591766 and 493-9480958.

however, TXL should review the two loans and if they were originated in violation of HUD Handbook 4155.2, paragraph 3.B.3.a., indemnify the loans.

Further, TXL failed to properly flag these three loans, and one additional loan in which the borrowers were TXL's or its affiliates' employees. HUD Handbook 4155.2, paragraph 3.B.3.a, requires employee case files to be clearly annotated with "Employment" on both the HUD-92900-LT, FHA Loan Underwriting and Transmittal Summary, and on the front of the case binder. While failure to flag the loan files is not an underwriting deficiency, TXL should ensure that it complies with the requirement.

TXL and Its Underwriters Increased the Risk to the Insurance Fund and Caused HUD To Suffer Losses

As a result of the underwriting deficiencies, TXL unnecessarily increased the insurance risks by $713,341[13] for eight loans that were overinsured and seven loans that should not have been approved for FHA insurance and caused HUD to suffer losses and pay claims totaling $35,595[14] for another loan that was both overinsured and should not have been approved. See appendix C for a schedule of indemnification and repayment amounts.

We reviewed the certifications for six manually underwritten loans with material underwriting deficiencies[15] for accuracy. TXL's direct endorsement underwriters incorrectly certified that due diligence was used in underwriting these six loans. When underwriting a loan manually, the Code of Federal Regulations (CFR) 24, Sections 203.5 and 203.255 require a direct endorsement lender to certify that it used due diligence and reviewed all associated documents during the underwriting of the loan.

TXL Contributed to the Underwriting Deficiencies By Not Implementing an Adequate Quality Control Plan

TXL did not comply with HUD's quality control requirements because it did not perform reviews of all early payment default loans and rejected loans, conduct onsite and affiliate reviews, or promptly report a significant quality control violation to HUD.

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13 The increased insurance risks included $566,052 for seven loans that should not have been underwritten for FHA insurance and $147,289 for the overinsured portions of eight.

14 Losses and claims included $35,595 for one mortgage that was foreclosed-upon and HUD subsequently sold the property, and a $900 claim on a second loan for total losses and claims of $36,495.

15 FHA case numbers 512-0024458, 493-8728615, 493-8944521, 493-9251259, 493-9048842, and 493-9577895.

TXL Did Not Perform Early Payment Default or Rejected Loan Reviews

TXL did not review loans that defaulted within the first six payments (early payment defaults) as required by HUD regulations. HUD Handbook 4060.1, REV-2, paragraph 7-6D, requires lenders to review all early payment default loans, including the loans that become 60 days or more delinquent within the first six payments. Of the loans approved by TXL officials from November 1, 2008, through October 31, 2010, at least 21 became 90 days or more delinquent within the first 6 payments. TXL officials did not review any of these early payment default loans.

Also, TXL did not review a sample of rejected loans as required by HUD regulations. HUD Handbook 4060.1, REV-2, paragraph 7-8A(1), requires lenders to review at least 10 percent or a statistical random sample that provides a 95 percent confidence level with 2 percent precision of rejected loans. TXL did not conduct quality control reviews of any of the loans rejected between November 1, 2008, and October 31, 2010.

TXL Did Not Perform Onsite and Affiliate Reviews

TXL did not perform onsite and affiliate reviews as required. HUD Handbook 4060.1, REV-2, section 7-3, requires a lender's offices, including traditional, nontraditional branch, and direct lending offices engaged in the origination or servicing of FHA-insured loans, to be reviewed to determine that they comply with HUD's requirements. In addition, HUD requires lenders to ensure that their contractors, agents, and loan correspondents are acceptable to FHA and operate in compliance with FHA requirements.

TXL Did Not Report a Significant Quality Control Finding

TXL did not report a significant finding contained in its quality control review to HUD as required, despite being notified by its quality control contractor. HUD Handbook 4060.1, REV-2, paragraph 7-3J, requires that findings of fraud or other serious violations be immediately referred, in writing (along with any available supporting documentation), to the director of the QAD in the HUD Homeownership Center having jurisdiction (determined by the State where the property is located). In lieu of submitting a paper report, lenders must use the "lender reporting" feature in the Neighborhood Watch Early Warning System. TXL's quality control contractor assigned one loan an exception rating of "5" in its August 2009 review and recommended TXL report the loan to HUD. Loans with exception ratings of "5" are considered material and unacceptable risks. TXL failed to comply with or act upon the quality control contractor's recommendation to report the loan to HUD.

Quality control is intended to guard against errors, omissions, and fraud and is designed to protect both HUD and the lender from unacceptable risk. TXL's lack of complete quality control reviews did not ensure swift and appropriate corrective action and its failure to report material violations prevented HUD from taking action to mitigate losses.

Conclusion

TXL's loan origination and quality control practices did not comply with HUD's requirements. As a result, borrowers were overcharged more than $135,000 in unearned fees, may not have known with which mortgage company they were dealing, and may not have understood that their mortgage company had an identity-of-interest relationship with the seller. Also, TXL's faulty underwriting practices exposed HUD to unnecessary insurance risks totaling more than $713,000 and caused HUD to suffer losses and pay claims totaling more than $35,000. Further, because TXL did not properly implement a quality control plan, it did not ensure the accuracy, validity, and completeness of loan originations.

Recommendations

We recommend that the Acting Deputy Assistant Secretary for Single Family Housing require TXL to

1A. Buy down $147,289 for eight overinsured loans.[16]

1B. Indemnify HUD for seven insured loans[17] with unpaid principal balances of $959,409 net of overinsurance[18], thereby putting an estimated $566,052 to better use based on the FHA insurance fund average loss rate of 59 percent of the unpaid principal balances.

1C. Review the 588 of 630 loans in which TXL's underwriters erroneously certified that an identity-of-interest did not exist and determine the amount it needs to buy down to remove the overinsured portion of the loans from the FHA portfolio.

1D. Support or repay the FHA insurance fund $900 for claims paid as of July 28, 2011, on one loan.[19] If HUD has subsequently taken title to the property or sold it, rather than seeking repayment of the claims paid, the repayment amount should be adjusted to the amount of FHA's loss. If the property is subsequently conveyed to HUD and sold, the loss amount should be adjusted to reflect any amounts repaid pursuant to this recommendation.

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16 FHA case numbers 493-9082458, 493-9048842,512-0024458, 493-9413444, 493-9251259, 493-9187150, 493-9289639, and 493-9577895.

17 FHA case numbers 493-9048842, 512-0024458, 493-9413444, 493-8954521, 493-9187150, 493-9289639, and 493-9577895.

18 We subtracted the overinsured portion of loans to determine a mortgage balance unaffected by or net of overinsurance.

19 FHA case number 493-9413444.

1E. Reimburse the FHA insurance fund $35,595 for actual losses incurred on one loan.[20]

1F. Ensure that its loan correspondents stop charging unearned underwriting fees and reimburse the appropriate buyers for the $135,126 in unearned underwriting fees identified in this report.

1G. Stop allowing its employees to originate loans through its loan correspondents.

1H. Stop allowing its employees to originate their own loans.

1I. Review FHA case numbers 493-9591766 and 493-9480958 and if the loans were originated in violation of HUD Handbook 4155.2, paragraph 3.B.3.a., indemnify the loans.

1J. Provide documentation to show that it has corrected the deficiencies identified in the July 2010 QAD report.

1K. Take actions to ensure that its quality control procedures comply with HUD requirements and are adequate to consistently identify and correct underwriting deficiencies in a timely manner and to report significant quality control findings.

1L. Ensure that its staff and loan correspondents are thoroughly trained regarding HUD regulations and procedures.

We also recommend that the Acting Deputy Assistant Secretary

1M. Refer TXL to the Mortgagee Review Board for consideration of administrative actions for failure to implement a quality control program in compliance with HUD requirements and for other violations cited in this report.

We further recommend that the Director of the Departmental Enforcement Center

1N. Take appropriate administrative sanctions, including possible debarment or other remedies, against the underwriters that erroneously certified that TXL and its affiliates did not have an identity-of-interest relationship with the sellers.

In addition, we recommend that HUD's Associate General Counsel for Program Enforcement

[20] FHA case number 493-8728615.

1O. Determine legal sufficiency, and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act (31 U.S.C. 3801-3812) and/or civil money penalties (24 CFR 30.35) against TXL and/or its principals for incorrectly certifying to the integrity of the data or that due diligence was exercised during the underwriting of six loans that resulted in actual losses of $35,595 on one loan[21] and potential losses of $413,465 on five loans,[22] for a total loss of $449,060, which could result in affirmative civil enforcement action of approximately $943,120.[23]

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21 FHA case number 493-8728615.

22 Losses include $98,778 for overinsurance and 59 percent of unpaid principal on FHA case number 493-9048842, $94,320 for overinsurance and 59 percent of unpaid principal on FHA case number 512-0024458, $30,530 for overinsurance on FHA case number 493-9251259, $100,999 for 59 percent of unpaid principal on FHA case number 493-8954521, $88,838 for overinsurance and 59 percent of unpaid principal on FHA case number 493-9577895.

23 Double damages for actual loss amounts related to one loan and potential losses related to five loans ($35,595 + $413,465 = $449,060) plus fines of $7,500 each for the six loans with material underwriting deficiencies. ($449,060 x 2) + ($7,500 x 6) = $943,120.

SCOPE AND METHODOLOGY

We performed audit work from January through July 2011. The audit period covered November 1, 2008, through October 31, 2010. We expanded our scope as necessary to determine the extent of unearned fees and erroneous certifications. We performed our audit work at TXL's headquarters and at our office in Houston, TX.

To accomplish our objectives, we

- Reviewed 20 FHA-insured loans that were originated by TXL and its loan correspondents during the audit period;
- Interviewed TXL and loan correspondent officials, loan officers and processors, and underwriters;
- Reviewed TXL and loan correspondent financial records, independent audit reports, and policies and procedures;
- Reviewed public records and HUD's Neighborhood Watch system;
- Reviewed contracts among TXL, the loan correspondents, and builders and sellers; and
- Reviewed applicable HUD regulations, requirements, mortgagee letters, and QAD reports.

We obtained a download of the FHA loans that TXL and its four Houston loan correspondents originated from November 1, 2008, through October 31, 2010, from HUD's Neighborhood Watch system. The download showed that TXL and its Houston loan correspondents originated 1,279 FHA-insured loans valued at more than $200.1 million. We did not evaluate the reliability of HUD's Neighborhood Watch system because we used the data for background purposes only.

We selected a nonrepresentative sample of 20 loans with original mortgage amounts totaling $3.1 million. We selected 20 loans which met at least one of the following criteria: (1) the loan was delinquent; (2) the loan was a refinance; (3) the borrower received gift funds; and (4) the underwriter's name was on a ranking list of the highest default underwriters in the Houston area on or about December 13, 2010. The results of our detailed testing only apply to the 20 loans selected and cannot be projected.

We performed detailed testing and reviewed the underwriting procedures for the 20 loans. We reviewed documentation from the HUD Homeownership Center loan endorsement files and loan files provided by TXL. Our testing and review included: (1) analysis of borrowers' income, assets, and liabilities; (2) review of borrowers' savings ability and credit history; (3) verification of selected data on the underwriting worksheet and settlement statements; and (4) confirmation of employment and gifts.

We obtained TXL's quality control plan and the quality control review reports and supporting documentation of reviews that its quality control contractor conducted during November 2008 through August 2010. We reviewed the quality control plan, reports, and supporting documentation to determine the sufficiency and timeliness of the quality control reviews on closed loans.

We determined the buy down portion of overinsured loans by calculating the difference between the 85 percent loan-to-value limit and the initial loan amount for each of the affected loans in appendix E. The overinsured portion of each loan is the amount by which the initial loan exceeds 85 percent of the property value as determined by the property appraisal.

Indemnification was appropriate for some loans (see appendix C) due to faulty underwriting. Faulty underwriting included lack of proof that the borrower had funds to close, the use of income documents that were invalid because they passed through the sellers' hands, and allowing an employee to originate her own loan. The indemnification amount is 59 percent of the unpaid mortgage balance. The 59 percent loss rate is based on HUD's Single Family Acquired Asset Management System's case management profit and loss by acquisition computation for fiscal year 2010 based on actual sales.

When loans were both overinsured and had significant underwriting deficiencies that warranted indemnification, we performed additional calculations to avoid double counting any savings. We subtracted the overinsured buy down amount from the unpaid mortgage balance to get a net unpaid mortgage balance. We calculated the indemnification amount as 59 percent of the net unpaid mortgage balance.

To determine the extent of the erroneous certifications, unearned fees, and other violations, we conducted a limited additional review. We determined that there were 665 new construction FHA-insured loans originated by the four Houston loan correspondents during the audit period with loans totaling $111.5 million. We requested a Form HUD-92900-A, HUD-1 settlement statement, and loan application for each loan, but TXL only provided documents for 630 of the loans.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our finding and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objectives.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

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

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Policies and procedures intended to ensure that FHA-insured loans are properly originated, underwritten, and closed.
- Safeguarding FHA-insured mortgages from high risk exposure.
- Policies and procedures intended to ensure that the quality control program is an effective tool in reducing underwriting errors and noncompliance.

We assessed the relevant controls identified above.

A deficiency in internal controls exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- TXL did not have effective controls in place to ensure that FHA-insured loans were originated, underwritten, and closed in accordance with HUD requirements (finding).

APPENDIXES

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/
1A			$147,289
1B			566,052
1D		$ 900	
1E	35,595		
1F	135,126		
Totals	$170,721	$ 900	$713,341

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 Office of Inspector General (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. Implementation of recommendation 1A will reduce the risk to the insurance fund by the amount of overinsurance. Implementation of recommendation 1B to require TXL to indemnify HUD for seven loans[24] that were not originated in accordance with HUD-FHA requirements will reduce FHA's risk of loss to the insurance fund. The amount reflects that, upon the sale of the mortgaged property, FHA's average loss experience is about 59 percent of the unpaid principal balance. The 59 percent loss rate is based on HUD's Single Family Acquired Asset Management System's case management profit and loss by acquisition computation for fiscal year 2010 based on actual sales.

[24] An eighth loan that should not have been originated had already been foreclosed and resold. Its actual losses are recorded at recommendation 1E.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

MORTGAGE
TXL
CORPORATION

September 30, 2011

Gerald R. Kirkland
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General, Region VI
819 Taylor Street, Suite 13A09
Fort Worth, TX 76102

Re: **HUD OIG Draft Audit Report Number 2011-FW-10XX**

Dear Mr. Kirkland:

Comment 1

TXL Mortgage Corporation ("TXL") welcomes the opportunity to respond to the HUD OIG's draft audit report ("OIG Report") dated September 19, 2011. We value our relationship with HUD and seek to ensure that our operations and business practices are wholly compliant with HUD's rules and regulations. In our review of the OIG Report, we found items contained therein with which we agree and items which, after careful consideration of the regulations cited, we respectfully disagree. Additionally, we find that much of the report is duplicative in nature to that of the Quality Assurance Division's ("QAD") report that was issued on January 5, 2010, and previously responded to by TXL.

Please accept this letter and the attached addenda as TXL's formal response to the OIG Report. TXL acknowledges the importance of the auditor's findings and will address each one in a comprehensive manner. We ask that the OIG consider our response in making its final determination of recommended actions.

Item #1 - TXL's Loan Correspondents Charged Unearned Underwriting Fees

Comment 2

Response: This is an issue that was originally cited in the QAD draft report dated July 22, 2010. In response to that report, TXL acknowledged the finding, adjusted its corporate policy to correct the practice, and refunded the full underwriting fees on all of the cases cited in the QAD report. As to the OIG's finding that there were unearned underwriting fees charged *after* July 22, 2010, TXL wishes to clarify that the QAD audit was still ongoing at that time. After receiving the QAD draft report, TXL was permitted a period of time to examine the findings and determine the appropriate course of action. TXL did exactly that and acted prudently in its decision to take corrective action. Specifically, on September 14, 2010, TXL issued an updated corporate policy addressing the collection of underwriting fees and distributed this information to the entire staff both electronically and via a group training session (Addendum #1). TXL submitted its formal response to the QAD draft report on November 12, 2010, and the final QAD report was issued on January 5, 2011. Thus, TXL believes that it acted in a timely and efficient manner in

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Ref to OIG Evaluation	Auditee Comments
	response to the QAD finding and that the date of the draft report, July 22, 2010, is not the operative date for determining whether the company took timely corrective action on this issue.
	Item #2 - <u>TXL Allowed its Employees To Originate Loans for Correspondents</u>
Comment 3	**<u>Response</u>:** TXL also disagrees with the conclusions for this item. TXL operates itself as a full-service lender. TXL also owns partial interests in six other lenders (the "Non-TXL Lenders"). For non-FHA loans, each of the Non-TXL Lenders has its own operations, and originates its own loans, with its own funds, in its own name, for sale to investors with which it has its own contractual relationships. For FHA loans, each of the Non-TXL Lenders was an FHA approved loan correspondent until FHA eliminated approvals for such entities effective December 31, 2010, and substantially increased the net worth requirements. Since that date, the Non-TXL Lenders have originated FHA loans as third party originators. Each of the Non-TXL Lenders possesses unique and distinct branding including without limitation its own business cards, logos, disclosures, and application packages. ABA disclosures are properly delivered in the
Comment 4	event of a referral. There can be no confusion as to with whom a customer is doing business.
Comment 3	It is true that certain TXL senior officers also hold a senior officer position with one of the Non-TXL Lenders. However, all such persons hold the appropriate officer positions of Vice President or above, Operations Manager or Branch Manager. Each individual possesses over three years of mortgage origination experience. Each of the Non-TXL Lenders and these individuals were certified through HUD on or before March 31 of each calendar year.
	All cases identified in the OIG Report in this regard are subject to section 2-9C of the applicable HUD Handbook 4060.1. This section outlines companies with joint officers and details the two circumstances where a Corporate Officer may represent more than one entity, as set forth below:
	2-9C Companies with Joint Officers. If a mortgagee has any of the same officers, stockholders, partners, or members as another entity, the officers may represent more than one entity if:
	2-9C exhibit 1, "There is a clear and effective separation of entities, and mortgagors know at all times which entity they are conducting business with."
	2-9C exhibit 2, "There is a duly appointed senior officer, with the required minimum three years experience designated to conduct exclusively the affairs of the mortgagee during normal business hours."
	While limited, this paragraph provides an express exception to the requirement that all employees of FHA approved lender be exclusively employed by the lender.
Comment 5	Accordingly, TXL has not been in violation of the applicable HUD requirements. Nevertheless, TXL has since ended this practice.
	2

Ref to OIG Evaluation **Auditee Comments**

Item #3 - TXL Did Not Properly Underwrite 10 Loans

Response: It is TXL's position that all consideration was given in making the underwriting decisions for each of the loans reviewed and that the underwriters exercised proper discretion in approving each of the loans. The OIG Report makes three specific references for underwriting deficiencies, and we will address each in the same manner.

Loans Lacked Sufficient Evidence of Funds to Close

Comment 6

TXL believes that all of the loans were properly underwritten in accordance with HUD guidelines. As the OIG is also aware, TXL Mortgage has strengthened its corporate policy on Gift Documentation and the Company has reinforced the requirement of strict adherence to the underwriting guidelines. In addition, training was conducted for all loan officers to reemphasize what items are required in connection with the demonstration of sufficient cash to close. The updated policy was issued April 29, 2010. Please see Addendum #2 for evidence of dissemination of training materials to the staff.

TXL's Underwriters Inappropriately Accepted Documents from the Sellers

Comment 7

As an initial matter, TXL notes that while the OIG Report takes issue with the fact that some documents were provided by the sellers, there is nothing in the Report suggesting that there were any irregularities in the documentation that was provided. With respect to this finding, TXL requires strict adherence to HUD requirements regarding the handling of documents. In order to reinforce its policy, on September 21, 2011, TXL issued a companywide memorandum clearly outlining TXL's policy towards the practice. Please see Addendum #3. Additionally, the issue was addressed in a group training session on September 22, 2011.

TXL, Loan Correspondents, Builders, and Sellers Were Affiliated or Had Partnerships

The OIG Report claims that TXL had an "identify of interest" with multiple homebuilders. TXL fervently disagrees with the OIG's conclusion that there was any "identity of interest" in the transactions noted. The OIG Report has misinterpreted the requirement.

Comment 8

HUD 4155.1 2.B.2.a defines an identity of interest transaction as follows:

> An ***identity of interest transaction*** is a sale between parties with family or business relationships.

However, the glossary of terms more clearly defines an identity of interest transaction as:

> An ***identity-of-interest transaction*** is a transaction for the purchase of a principal residence between
>
> - parties with a familial or business relationship, or
> - business affiliates.

3

Ref to OIG Evaluation | **Auditee Comments**

Note: An identify-of-interest transaction does *not* include an employer/employee transaction when the employee is purchasing the seller's principal residence.

Comment 8

Here, the "parties" to the sales transactions were the builders (sellers) and the individuals who purchased the properties (buyers), and there is no assertion that there was any type of "familial or business relationship" between them. Rather, the OIG Report contends that there was an "identity of interest" between the builders and the loan correspondents. The relationship between those two parties, however, is not relevant to the "identity of interest" inquiry which concerns the seller and buyer only. Stated otherwise, identity of interest is specifically focused on the "parties" to the sale, not the entity providing the financing. Thus, the conclusion that the nine loans were identity-of-interest transactions is incorrect.

Comment 8

TXL sought to further clarify this point during the OIG's exit interview. It was explained that the OIG's auditors have interpreted the Agreements of Limited Partnership as conveying ownership interests between TXL Mortgage Corporation and the home builders. This, however, is not the case. TXL does not own any interest in any builder.

Comment 8

Moreover, the claim that TXL underwriters completed erroneous certifications on HUD-92900-A is not correct. The certifications were completed by DE underwriters for TXL who verified that TXL, "its owners, officers, employees or directors do not have a financial interest in or a relationship, by affiliation or ownership, with the builder or seller involved in this transaction." This is a correct statement. TXL has neither a financial interest in, nor a relationship by affiliation or ownership with, the builders/sellers within the meaning of the rules.

<u>TXL Allowed Employees to Process Their Own Loans</u>

Comment 9

TXL takes every loan into consideration including those of the employees who represent it. TXL has adjusted corporate policy to direct all employee loans to a designated in-house loan officer who is physically separated from all other activities of the lender. While we do not believe that we have exposed HUD to unnecessary risk, we have made the appropriate adjustments in order to avoid any concern about future conflicts. Please see Addendum #4.

Item #4 - <u>TXL Contributed to the Underwriting Deficiencies by Not Implementing an Adequate Quality Control Plan</u>

Comment 10

<u>Response:</u> As a result of the QAD audit in 2010, TXL took the opportunity to re-evaluate all of its operations. From Origination through post closing Quality Control ("QC"), TXL has made, and continues to make, improvements to its business practices throughout. TXL has always had a QC process, which included management review of third-party file audits, meetings with staff, and review of Neighborhood Watch figures. However, TXL recognized the need to further improve the overall QC function. As such, we dedicated ourselves to improving our efforts in this area. Beginning in January of 2011, TXL introduced a more robust QC plan inclusive of frequent and periodic written management reports and responses, selection guidelines and review worksheets. All of this was introduced with the goal of protecting HUD, TXL, and borrowers preventing unnecessary risk and improving the overall quality of the loans originated. This information was presented to the audit team at the time of the initial interview, however has been

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Ref to OIG Evaluation **Auditee Comments**

omitted from this audit report. Copies of the plan have been provided to both the QAD and OIG and TXL has implemented it with good success.

Conclusion

It is worth noting that in January of 2010 TXL Mortgage Corporation underwent a change in management. Ownership replaced its Senior Vice President and expanded management with four newly-appointed Vice Presidents in hopes of staying abreast of what had become a rapidly changing marketplace. While TXL believes its past management regimes facilitated compliance with HUD's requirements, the changes of early 2010 allowed for specific internal oversight and more defined controls. The new management team, under direction from ownership, was tasked with adding to and improving where necessary the existing operating policies of TXL. With a renewed focus on underwriting quality, compliance, risk mitigation, and expanding existing quality control measures, the management team quickly began to identify areas needing improvement. As with any change, there has been a time delay as a result of the evaluation of policies process; however, we do believe that the changes implemented were prudent and expedient in relationship to the dynamic market.

Ownership is, as ever, committed to ensuring that the pieces are in place to deliver product consistent with the desires of the HUD. As a result of the evaluation process, the management team identified many of the changes noted. Additionally, TXL's management doubled the number of training sessions for production staff, introduced compliance checks at stops identified as critical in the loan process, sought the advice of counsel for regulatory support, and engaged in more in-depth quality control measures. Each of these steps was taken to strengthen the Company's compliance with all regulatory requirements and to ensure that the Company is originating high quality loans to worthy borrowers. The Company has also reduced its operations through winding down one of its Loan Correspondents, Glenwood Financial, in December of 2010.

TXL is engaged in the business of responsible mortgage lending. The OIG auditor's review included approximately $100,000,000 in loan originations compared to actual losses to HUD of only $36,495 during the same period. While we do cite specific objections to the draft report and recognize much of its contents as overlapping with those of the QAD, the examination has prompted further self-evaluation, implementation of increased oversight measures, and the development of policies and procedures designed to align with the demands of HUD. We believe that the risks to HUD and the FHA insurance fund have been overstated both in scope and severity. TXL is ever analyzing its business practices in hopes of delivering a sound product with reasonable risk tolerances. We want to thank the Office of Inspector General and its professional staff for their efforts here and the courteous manner with which they conducted themselves.

Sincerely,

Dale Couch

Dale Couch
President

5

OIG Evaluation of Auditee Comments

Comment 1: TXL agreed with part of the finding and disagreed with part of it. TXL explained its position for the part of the finding with which it disagreed. We reviewed TXL's explanations, but determined that no changes to the report were warranted.

Comment 2: TXL acknowledged that it had charged unearned underwriting fees in the past and had been cited by QAD for this practice on July 22, 2010. TXL stated it corrected the practice on September 14, 2010, when it issued an updated corporate policy. However, we noted four additional instances of unearned underwriting fees in late September 2010 (one on September 20, 2010, one on September 22, 2010, and two on September 24, 2010) after TXL updated its corporate policy. Therefore, we did not change the report.

Comment 3: TXL admitted that it owned partial interests in other lenders, and that its senior officers held a senior officer position with one of the non-TXL Lenders. This partial ownership and shared senior officers created business affiliations and identity-of-interest when the other lenders were themselves involved with the sellers of real estate that TXL subsequently approved for FHA underwriting.

Comment 4: TXL stated that there could be no confusion as to with whom a customer is doing business. TXL explained that each non-TXL lender had its own operations, and originated its own loans, with its own funds, in its own name, for sale to investors with which it has its own contractual relationships. TXL did not show that mortgagors would not be confused about with whom they were doing business. During the audit, TXL was the sponsor and the other lenders were loan correspondents. Therefore, TXL, and not the loan correspondents, underwrote all of the loans during that period. Purchase agreements disclosed the affiliation between the sellers and builders and the loan correspondents, but they did not disclose that the loans were underwritten by TXL and not by the loan correspondents. Further, TXL did not address the issue of whether TXL or the loan correspondent should be responsible for supervising an employee who originates loans for more than one company at a time. We did not change the report.

Comment 5: TXL stated that it had ended the practice of having employees originate loans for correspondents. TXL's statement was unclear. It is true that HUD eliminated approvals for correspondents effective December 31, 2010, and TXL would have had to cease this practice for correspondents. However, TXL did not address the issue of whether it continued to allow its employees to originate loans for non-TXL lenders who were not correspondents. We did not change the report.

Comment 6: Regarding loans that the report questioned due to a lack of sufficient evidence of funds to close, TXL stated it believed that they were properly underwritten. Further, TXL stated it strengthened its corporate policy on gift documentation, and issued an updated policy on April 29, 2010. TXL did not provide support for its position that the loans were properly underwritten. None of the loans that we questioned for lack of sufficient evidence of funds to close were originated after April 29, 2010; thus, we cannot attest to whether the policy is adequate to resolve the deficiencies identified in this report. We did not change the report.

Comment 7: TXL noted that there was nothing in the report suggesting irregularities in documentation provided by the sellers. TXL further stated that it issued a companywide memorandum outlining its policy towards the practice on September 21, 2011. Using critical documentation provided by the seller is a prohibited practice and casts doubt on the validity of the documentation. TXL did not show that it verified the data from third-party sources. Therefore, we did not change the report. We recognize that 2 days after we sent TXL the draft report, it changed its policy which should improve its process if it is implemented and complied with.

Comment 8: TXL disagreed with our conclusion that it had an identity-of-interest with multiple homebuilders and concluded that OIG had misinterpreted the requirement. TXL stated that identity-of-interest applied to buyers and sellers and not to finance companies. TXL further stated that it did not own any interest in any builder, and that the direct endorsement certifications denying financial interest, affiliation, or ownership were correct. Identity-of-interest applies not only to ownership, but to affiliation. TXL partnered with companies that were affiliated with the builders and sellers of the homes that TXL subsequently approved for FHA financing. Disclosures in the purchase agreements showed that the loan correspondents were affiliated with the sellers and builders. Since TXL was the underwriter for the loan correspondents, TXL was also affiliated with the sellers and had an identity-of-interest. Thus, the direct endorsement certifications were incorrect. We did not change the report.

Comment 9: TXL stated that it did not believe that it exposed HUD to unnecessary risk by allowing employees to process their own loans. Two days after we sent the draft report to TXL, it revised its policy to direct all employee loans to a designated in-house loan officer who is physically separated from all of its other activities. However, during the audit TXL allowed employees to process their own loans, which casts doubt on the validity of the loans. Therefore, we did not change the report.

Comment 10: TXL recognized the need to improve the overall quality control function. TXL stated that beginning in January 2011, it introduced a robust quality control plan with the goal of protecting HUD, TXL, and borrowers. TXL stated it provided the information at the time of the initial interview, and that it had been omitted from the report. We evaluated TXL’s performance during the audit period which ended October 31, 2010. Our evaluation included TXL’s October 2010 quality control report, dated February 2011. TXL’s new quality control procedures continued to be non-compliant with HUD requirements because TXL did not conduct early payment default reviews on all early payment default loans in a timely manner, and did not conduct a required on-site review of its Austin, TX branch office. Therefore, we did not change the report.

Appendix C

SCHEDULE OF INDEMNIFICATION AND REPAYMENT AMOUNTS

Loan number	Initial loan	Original mortgage amount	Unpaid mortgage balance	85 percent capped loan to value	Over-insured portion (buy down)	Claims paid as of July 28, 2011	Loss on property sale	Net unpaid mortgage balance	59% of unpaid balance	Loan status as of July 28, 2011
493-8728615	$101,315	$104,166	N/A	N/A	N/A	N/A	$35,595	N/A	N/A	Foreclosed upon and resold
493-9082458	196,734	200,176	$195,116	$173,400	$23,334	-	N/A	N/A	-	Delinquent
493-9048842	159,334	162,122	$157,112	144,500	14,834	-	N/A	$142,278	$83,944	Current
512-0024458	146,998	150,305	148,087	130,050	16,948	-	N/A	131,139	77,372	Current
493-9413444	138,725	141,153	138,093	123,250	15,475	$900	N/A	122,618	72,345	Delinquent
493-9251259	257,055	261,553	257,948	226,525	30,530	-	N/A	N/A	-	Refinanced
493-8954521	176,000	178,640	171,185	N/A	N/A	-	N/A	171,185	100,999	Current
493-9187150	152,488	155,157	150,859	136,000	16,488	-	N/A	134,371	79,279	Delinquent
493-9289639	148,365	150,961	147,186	133,450	14,915	-	N/A	132,271	78,040	Current
493-9577895	140,565	143,025	140,312	125,800	14,765	-	N/A	125,547	74,073	Delinquent
Totals	**$1,617,579**	**$1,647,258**	**$1,505,898**	**$1,192,975**	**$147,289**	**$900**	**$35,595**	**$959,409**	**$566,052**	

[a]The initial loan and original mortgage amounts are different because the initial loan is the property loan while the original mortgage amount includes both the property loan and any financed mortgage insurance premium.

[b]The 85 percent capped loan to value is 85 percent of the property value based on the property appraisal. Property appraisal amounts are in Appendix E.

[c]We classified $900 in claims paid by HUD as ineligible costs that would be required to be repaid to HUD. The loans should not have been approved for FHA insurance and, therefore, were not entitled to any claim payments. Any claims paid for these loans are required to be repaid to HUD. If HUD has taken title to the properties or sold the properties, rather than seeking repayment of the claims paid, the amount to be repaid should be adjusted to the amount of the actual losses to FHA.

[d]The net unpaid mortgage balance is the difference between the unpaid mortgage balance and the overinsured portion.

[e]The loss on property sale amount was obtained from HUD's Single Family Acquired Asset Management System. The system tracks properties from acquisition to final sales closing and maintains all accounting data associated with the case records.

[f]We classified $713,341 as funds to be put to better use. This amount includes $147,289 for the overinsured portions of eight loans and $566,052 for the estimated loss on seven loans. The estimated loss is 59 percent of the $959,409 in unpaid principal balances net of any overinsurance for the seven loans as of July 28, 2011. The 59 percent is the estimated percentage of loss HUD would incur when the FHA property is foreclosed upon and resold as supported by HUD's Single Family Acquired Asset Management System's case management profit and loss by acquisition as of September 2010.

Appendix D

LOAN CORRESPONDENTS' STATUS

Loan correspondents	City	FHA approval status
Glenwood Financial, LLC	Houston	a
Wickchester Mortgage, LLC	Houston	t
Texas Paramount Lending, LLC	Houston	t
Texas Western Mortgage, LTD	Houston	t
Texana Mortgage, LTD	Houston	t
New Home Team Financial, LTD	Irving	t
Meritage Funding, LLC	Irving	t
Texas Heritage Mortgage, LTD	San Antonio	a
Northpoint Mortgage, LTD	Houston	t
Castlerock Mortgage, LTD	Houston	a
Casa Linda Mortgage, LTD	Irving	t
Baymont Financial, LTD	Houston	a
Morton Street Mortgage, LTD	Houston	t
Crestwood Financial, LTD	Irving	t
Lakeside Lending, LTD	Waco	a
Friendswood Financial, LTD	Houston	a
Webb Family Mortgage, LTD	Irving	t
Grace America Mortgage, LTD	Houston	t
Dakota Blue Mortgage, LTD	Houston	t
Sonoma Mortgage, LTD	San Antonio	t

FHA approval status = (**t**erminated, **a**ctive)

Appendix E

OVERINSURED IDENTITY-OF-INTEREST LOANS

File number	Case number	Initial loan amount	Property value	% loan-to-value ratio calculated	85% capped loan-to-value	Difference
1	493-8728615	$101,315	$108,000	93.81%	$91,800	$9,515[25]
2	493-9082458	196,734	204,000	96.44%	173,400	23,334
3	493-9048842	159,334	170,000	93.73%	144,500	14,834
4	512-0024458	146,998	153,000	96.08%	130,050	16,948
5	493-9413444	138,725	145,000	95.67%	123,250	15,475
6	493-9251259	257,055	266,500	96.45%	226,525	30,530
7	493-9187150	152,488	160,000	95.31%	136,000	16,488
8	493-9289639	148,365	157,000	94.50%	133,450	14,915
9	493-9577895	140,565	148,000	94.98%	125,800	14,765
	Totals	**$1,441,579**	**$1,511,500**			**$156,804**

[a] The 85 percent capped loan to value amount is 85 percent of the property value.

[b] The difference is the initial loan amount less the 85 percent capped loan to value, and represents the amount of the loan that should not have been underwritten.

[25] This loan was overinsured, however, it has already been foreclosed upon and resold. The loss to HUD for this loan was $35,595. Therefore, we did not request a buy down for the overinsurance.

Appendix F

CASE NARRATIVES

Case Narrative—Loan Number 493-9187150

Mortgage amount: $155,157
Date of loan closing: July 16, 2009
Status as of July 28, 2011: 1 month delinquent
Payments before first default reported: Eleven
Payments before first 90-day delinquency reported: N/A
Underwriting deficiencies:
The underwriter did not

- Determine sufficient funds to close.
- Reject third-party handling of documents.
- Ensure that an 85 percent loan-to-value ratio was applied for an identity-of-interest transaction.

Summary
In FHA loan number 493-9187150, TXL did not properly document that the borrower had funds to close and did not reject third-party handling of borrower documents. The HUD-1 settlement statement, dated July 16, 2009, indicated that the borrower needed $4,788 in funds to close. The underwriter on July 13, 2009, certified gift funds of $4,600 as the source of funds to close. The gift was documented with a gift letter; a cashier's check, dated July 15, 2009, for $4,600; and a handwritten withdrawal slip, dated July 17, 2009. Despite HUD Handbook 4155.1, paragraph 1.B.1.f.'s prohibition against using documents for processing or underwriting when those documents were handled by or transmitted through an interested third party to the transaction, the seller provided the documents to TXL who used them for processing and underwriting the loan. Additionally, the HUD-1 settlement statement made no mention of gift funds, and the withdrawal slip had a bank-stamped date of July 15, 2009, 2 days before the handwritten date. The gift funds were also questionable because the gift fund amount of $4,600 was the same amount as the commission paid by the seller.

Further, there was insufficient evidence to support that the funds were withdrawn from the donor's personal account as required by HUD, and the borrower had only $433 in the bank according to the bank statement. HUD Handbook 4155.1, paragraph 5.B.5.b, requires the donor to provide a withdrawal document showing that the funds came from the donor's personal account. However, there were no bank statements provided to evidence the withdrawal from the donor and arrival into the borrower's account. The sole source of funds was from the gift, and no other funds were verified, thus the borrower was short $4,355 in funds to close.

TXL also exceeded the loan-to-value limit for an identity-of-interest loan transaction. When the parties to the transaction are related or have an identity of interest, HUD Handbook 4155.1, paragraph 2.B.2.b., limits the loan-to-value ratio to 85 percent. The initial loan amount was

$152,488,[26] and the appraised value of the property was $160,000. Therefore, the loan-to-value ratio was 95.3 percent. However, since the builder and seller, Deerwood Homes Rayford Ridge L.P., and the lender, Glenwood Financial, LLC (loan correspondent), had an identity of interest, the loan-to-value ratio should have been capped at 85 percent, or $136,000. As result of not applying the cap, HUD overinsured the property by $16,488.

[26] This amount represents the total loan amount minus the financed principal mortgage insurance.

Case Narrative—Loan Number 493-9413444

Mortgage amount: $141,153
Date of loan closing: December 31, 2009
Status as of July 28, 2011: 1 month delinquent
Payments before first default reported: One
Payments before first 90-day delinquency reported: Three
Underwriting deficiencies:
The underwriter did not

- Determine sufficient funds to close.
- Ensure that an 85 percent loan-to-value ratio was applied for an identity-of-interest transaction.

Summary
In FHA loan number 493-9413444, TXL did not properly document that the borrower had funds to close. According to the HUD-1 settlement statement, dated December 31, 2009, the borrower needed $3,532 to close. On December 30, 2009, the underwriter verified that $3,800 was available in the borrower's checking or savings (not gift) account for closing. However, the loan file included two gift fund letters, one from the borrower's mother for $1,500 and another from the borrower's brother for $3,800.

The $1,500 in gift funds from the mother was properly supported by a bank statement included in the file. However, the $3,800 in gift funds from the brother was not properly supported because there were no bank statements showing the funds leaving the donor's account or arriving in the borrower's account. HUD Handbook 4155.1, paragraph 5.B.5.b, requires the donor to provide a withdrawal document showing that the funds came from the donor's personal account. The cashier's check for $3,800 made payable to the title company was dated December 31, 2009.

TXL also exceeded the loan-to-value limit on an identity-of-interest loan transaction. When the parties to the transaction are related or have an identify-of-interest, HUD Handbook 4155.1, paragraph 2.B.2.b., limits the loan-to-value ratio to 85 percent. The initial loan amount was $138,725,[27] and the appraised value of the property was $145,000. Therefore, the loan-to-value ratio was 95.6 percent. However, since the builder and seller, Castlerock Communities L.P., and the lender, Castlerock Mortgage, LTD (loan correspondent), had an identity of interest, the loan-to-value ratio should have been capped at 85 percent, or $123,250. As a result of not applying the cap, HUD overinsured the property by $15,475.

[27] This amount represents the loan amount minus the financed principal mortgage insurance.

Case Narrative—Loan Number 493-8728615

Mortgage amount: $104,166
Date of loan closing: January 30, 2009
Status as of July 28, 2011: Title conveyed to insurer. Claims paid totaled $109,407. HUD sold the property on April 20, 2010, for $83,000. The total loss to HUD was $26,407.
Payments before first default reported: One
Payments before first 90-day delinquency reported: Three
Underwriting deficiencies:
The underwriter did not

- Determine sufficient funds to close.
- Reject third-party handling of documents.
- Ensure that an 85 percent loan-to-value ratio was applied for an identity-of-interest transaction.

Summary
In FHA loan number 493-8728615, TXL did not properly document that the borrower had funds to close. The HUD-1 settlement statement, dated January 30, 2009, indicated that the borrower needed $3,100 to close. The underwriter certified on January 30, 2009, that the borrower would use his own funds to close in the amount of $3,168. The file showed a $3,154 deposit made into borrower's account on the day of closing, January 30, 2009, but the source was not clear. A handwritten note on a page attached to a cashier's check said it was a "Tax Refund," and the cashier check appeared to be a refund anticipation loan, but there was no tax return in the file to support a tax refund. The copy of the check was page 2 of 6 of a fax, but the other pages to the same fax were not in the file. HUD Handbook 4155.1 requires the lender to obtain a credible explanation for large increases in an account and allows the lender to use a verification of deposit and bank statements to verify savings and checking accounts. However, the file did not contain bank statements.

A bank official documented that the bank account was opened on December 4, 2008, a month before the closing. The file included a verification of deposit, dated January 30, 2009. However, TXL's loan processor dated the verification of deposit request to the bank July 14, 2008, 5 months before the bank certified that the borrower opened an account. The verification of deposit returned from the bank showed a balance of $3,874; however, the borrower included a different bank and account in his application, with a balance of $6,000 that he claimed to be downpayment assistance. There was no information in the file to show what might have happened to the downpayment assistance. We determined that there were too many unresolved discrepancies to support funds available for closing.

In addition, the seller and builder had handled the borrower's earnings statement. TXL improperly accepted documents relating to the borrower's credit, employment, and income that were handled by the seller and transmitted from or through the seller's fax machine. Despite HUD Handbook 4155.1, paragraph 1.B.1.f.'s prohibition against using documents for processing or underwriting when those documents were handled by or transmitted through an interested third party to the transaction, the seller provided the documents to TXL who used them for processing and underwriting the loan.

TXL also exceeded the loan-to-value limit on an identity-of-interest loan transaction. When the parties to the transaction are related or have an identify-of-interest, HUD Handbook 4155.1, paragraph 2.B.2.b., limits the loan-to-value ratio to 85 percent. The initial loan amount was $101,315,[28] and the appraised value of the property was $108,000. Therefore, the loan-to-value ratio was 93.81 percent. However, since the builder and seller, Dunn & Stone Builders, LLC, and the lender, Baymont Financial, LTD (loan correspondent), had an identity of interest, the loan-to-value ratio should have been capped at 85 percent, or $91,800. As a result of not applying the cap, HUD overinsured the property by $9,515.

[28] This amount represents the loan amount minus the financed mortgage insurance amount.

Case Narrative—Loan Number 493-9048842

Mortgage amount: $162,122
Date of loan closing: June 18, 2009
Status as of July 28, 2011: Current
Payments before first default reported: N/A
Payments before first 90-day delinquency reported: N/A
Underwriting deficiencies:
The underwriter did not

- Determine sufficient funds to close.
- Ensure that an 85 percent loan-to-value ratio was applied for an identity-of-interest transaction.

Summary
In FHA loan number 493-9048842, TXL did not properly document that the borrower had funds to close. The HUD-1 settlement statement, dated June 18, 2009, indicated that the borrower needed $10,893 to close; however, the HUD-1 settlement statement did not show gift funds. The file showed a gift from the borrower's father of $11,000. The file contained a gift letter; a copy of a cashier's check, dated May 29, 2009, made payable to the borrower; a deposit slip, dated May 29, 2009; and the borrower's May-June 2009 bank statement showing the $11,000 deposited into the borrower's account. However, the file did not contain a withdrawal document showing the gift funds came from the donor's personal account as required by HUD Handbook 4155.1 paragraph 5.B.5.b.

TXL also exceeded the loan-to-value limit on an identity-of-interest loan transaction. When the parties to the transaction are related or have an identify-of-interest, HUD Handbook 4155.1, paragraph 2.B.2.b., limits the loan-to-value ratio to 85 percent. The initial loan amount was $159,334,[29] and the appraised value of the property was $170,000. Therefore, the loan-to-value ratio was 93.7 percent. However, since the builder and seller, Castlerock Communities L.P., and the lender, Castlerock Mortgage, LTD (loan correspondent), had an identity of interest, the loan-to-value ratio should have been capped at 85 percent, or $144,500. As a result of not applying the cap, HUD overinsured the property by $14,834.

[29] This amount represents the loan amount minus the financed mortgage insurance amount.

Case Narrative—Loan Number 493-9577895

Mortgage amount: $143,025
Date of loan closing: March 31, 2010
Status as of July 28, 2011: 1 month delinquent
Payments before first default reported: Six
Payments before first 90-day delinquency reported: N/A
Underwriting deficiencies:
The underwriter did not

- Determine sufficient funds to close.
- Ensure that an 85 percent loan-to-value ratio was applied for an identity-of-interest transaction.

Summary
In FHA loan number 493-9577895, TXL did not properly document that the borrower had funds to close. According to the FHA loan underwriting and transmittal summary, the borrower needed $5,899 to close. The sole source of funds was a gift, and the funds were not verified because there was no documentation showing that they were withdrawn from the donor's personal account. HUD Handbook 4155.1, paragraph 5.B.5.b, requires the donor to provide a withdrawal document showing that the funds came from the donor's personal account. According to the HUD-1 settlement statement, dated March 31, 2010, the borrower received $4835 in gift funds from a relative. According to the file, the borrower received $6,000 in gift funds, $4,835 for closing costs and $1,165 to pay off a debt. The file contained two cashier checks for $4,835 and $1,165, dated March 29, 2010, that were payable to the title company and another company, respectively.

TXL also exceeded the loan-to-value limit on an identity-of-interest loan transaction. When the parties to the transaction are related or have an identify of interest, HUD Handbook 4155.1, paragraph 2.B.2.b., limits the loan-to-value ratio to 85 percent. The initial loan amount was $140,565,[30] and the appraised value of the property was $148,000. Therefore, the loan-to-value ratio was 95 percent. However, since the builder and seller, Pine Tree Building Group, and the lender, TXL Mortgage, had an identity of interest, the loan-to-value ratio should have been capped at 85 percent, or $125,800. As a result of not applying the cap, HUD overinsured the property by $14,765.

[30] This amount represents the loan amount minus the financed mortgage insurance amount.

Case Narrative—Loan Number 493-9082458

Mortgage amount: $200,176
Date of loan closing: September 17, 2009
Status as of July 28, 2011: 3 months delinquent
Payments before first default reported: Six
Payments before first 90-day delinquency reported: Nine
Underwriting deficiencies:
The underwriter did not

- Ensure that an 85 percent loan-to-value ratio was applied for an identity-of-interest transaction.

In FHA loan number 493-9082458, TXL exceeded the loan-to-value limit on an identity-of-interest loan transaction. When the parties to the transaction are related or have an identify-of-interest, HUD Handbook 4155.1, paragraph 2.B.2.b., limits the loan-to-value ratio to 85 percent. The initial loan amount was $196,734,[31] and the appraised value of the property was $204,000. Therefore, the loan-to-value ratio was 96.4 percent. However, since the builder and seller, Bayway Homes, Inc., and the lender, Baymont Financial, LTD (loan correspondent), had an identity of interest, the loan-to-value ratio should have been capped at 85 percent, or $173,400. As a result of not applying the cap, HUD overinsured the property by $23,334.

[31] This amount represents the loan amount minus the financed mortgage insurance amount.

Case Narrative—Loan Number 512-0024458

Mortgage amount: $150,305
Date of loan closing: September 1, 2010
Status as of July 28, 2011: Current
Payments before first default reported: N/A
Payments before first 90-day delinquency reported: N/A
Underwriting deficiencies:
The underwriter did not

- Reject third-party handling of documents.
- Ensure that an 85 percent loan-to-value ratio was applied for an identity-of-interest transaction.

In FHA loan number 512-0024458, TXL improperly accepted and used documents relating to the borrower's income tax return that were transmitted from or through the seller's fax machine. Despite HUD Handbook 4155.1, paragraph 1.B.1.f.'s prohibition against using documents for processing or underwriting when those documents were handled by or transmitted through an interested third party to the transaction, the documents were transmitted through the seller to TXL who used them for processing and underwriting the loan.

TXL also exceeded the loan-to-value limit on an identity-of-interest loan transaction. When the parties to the transaction are related or have an identify-of-interest, HUD Handbook 4155.1, paragraph 2.B.2.b., limits the loan-to-value ratio to 85 percent. The initial loan amount was $146,998,[32] and the appraised value of the property was $153,000. Therefore, the loan-to-value ratio was 96.1 percent. However, since the builder and seller, Castlerock Communities L.P., and the lender, Castlerock Mortgage, LTD (loan correspondent), had an identity of interest, the loan-to-value ratio should have been capped at 85 percent, or $130,050. As a result of not applying the cap, HUD overinsured the property by $16,948.

[32] This amount represents the loan amount minus the financed mortgage insurance amount.

Case Narrative—Loan Number 493-9251259

Mortgage amount: $261,553
Date of loan closing: August 7, 2009
Status as of July 28, 2011: Refinanced, new FHA 512-0017571, current
Payments before first default reported: N/A
N/A
Underwriting deficiencies:
The underwriter did not

- Ensure that an 85 percent loan-to-value ratio was applied for an identity-of-interest transaction.

In FHA loan number 493-9251259, TXL exceeded the loan-to-value limit on an identity-of-interest loan transaction. When the parties to the transaction are related or have an identify-of-interest, HUD Handbook 4155.1, paragraph 2.B.2.b., limits the loan-to-value ratio to 85 percent. The initial loan amount was $257,055,[33] and the appraised value of the property was $266,500. Therefore, the loan-to-value ratio was 96.5 percent. However, since the builder and seller, Cervelle Custom Homes, LTD, and the lender, Friendswood Financial, LTD (loan correspondent), had an identity of interest, the loan-to-value ratio should have been capped at 85 percent, or $226,525. As a result of not applying the cap, HUD overinsured the property by $30,530.

[33] This amount represents the loan amount minus the financed mortgage insurance amount.

Case Narrative—Loan Number 493-9289639

Mortgage amount: $150,961
Date of loan closing: November 17, 2009
Status as of July 28, 2011: Current
Payments before first default reported: N/A
N/A
Underwriting deficiencies:
The underwriter did not

- Reject third-party handling of documents.
- Ensure that an 85 percent loan-to-value ratio was applied for an identity-of-interest transaction.

In FHA loan number 493-9289639, TXL improperly accepted and used documents relating to the borrower's income and employment that were handled by the seller and transmitted from or through the seller's fax machine. Despite HUD Handbook 4155.1, paragraph 1.B.1.f.'s prohibition against using documents for processing or underwriting when those documents were handled by or transmitted through an interested third party to the transaction, the seller handled and transmitted the borrower's tax returns, W-2 forms, and other income documents to TXL who used them for processing and underwriting the loan.

TXL also exceeded the loan-to-value limit on an identity-of-interest loan transaction. When the parties to the transaction are related or have an identify-of-interest, HUD Handbook 4155.1, paragraph 2.B.2.b., limits the loan-to-value ratio to 85 percent. The initial loan amount was $148,365,[34] and the appraised value of the property was $157,000. Therefore, the loan-to-value ratio was 94.5 percent. However, since the builder and seller, Deerwood Homes Stonegate L.P., and the lender, Glenwood Financial, LLC (loan correspondent), had an identity of interest, the loan-to-value ratio should have been capped at 85 percent, or $133,450. As a result of not applying the cap, HUD overinsured the property by $14,915.

[34] This amount represents the loan amount minus the financed mortgage insurance amount.

Case Narrative—Loan Number 493-8954521

Mortgage amount: $178,640
Date of loan closing: January 28, 2009
Status as of July 28, 2011: Current
Payments before first default reported: N/A
N/A
Underwriting deficiencies:
The underwriter did not

- Ensure that TXL employees did not process their own FHA loans.

In FHA loan number 493-8954521, the borrower was an employee of the lender, and the borrower was also the loan officer for this transaction. Further, the lender did not follow HUD Handbook 4155.2, paragraph 3.B.3.a, which prohibits employees from processing their own FHA loans.   In addition, the case file did not clearly annotate "Employment" on the Form HUD-92900-LT and on the front of the case binder as required. HUD Handbook 4155.2, paragraph 3.B.3.a, requires employee case files to be clearly annotated with "Employment" on both the HUD-92900-LT, FHA Loan Underwriting and Transmittal Summary, and on the front of the case binder.