



Office of Single Family Housing, Washington, DC

FHA-Insured Loans With Borrower-Financed Downpayment Assistance

**Office of Audit, Region 9
Los Angeles, CA**

**Audit Report Number: 2017-LA-0003
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//SIGNED//

From: Tanya E. Schulze, Regional Inspector General for Audit, 9DGA

Subject: HUD Failed To Adequately Oversee FHA-Insured Loans With Borrower-Financed Downpayment Assistance

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of HUD's oversight of Federal Housing Administration (FHA)-insured loans that contain borrower-financed downpayment assistance.

HUD Handbook 2000.06, REV-4, sets 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 audit.

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

If you have any questions or comments about this report, please do not hesitate to call me at 213-534-2471.



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HUD Failed To Adequately Oversee FHA-Insured Loans With Borrower-Financed Downpayment Assistance

Highlights

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) oversight of Federal Housing Administration (FHA)-insured loans originated with downpayment assistance. The audit was initiated based on the results from three HUD, Office of Inspector General (OIG) audits, which determined that lenders allowed FHA borrowers to finance their own downpayments through an increase in their mortgage interest rate as part of programs administered through housing finance agencies. Our audit objective was to determine whether HUD had adequate controls to ensure that FHA-insured loans with downpayment assistance complied with HUD requirements.

What We Found

HUD failed to adequately oversee more than \$16.1 billion in FHA loans that may have been originated with borrower-financed downpayment assistance to ensure compliance with HUD requirements, putting the FHA Mortgage Insurance Fund at unnecessary risk. Between October 1, 2015 and September 30, 2016, HUD guaranteed nearly \$12.9 billion in FHA loans that may contain questioned assistance. While governmental entities are not prohibited sources of downpayment assistance, the assistance provided through these programs did not comply with HUD requirements. FHA borrowers were required to obtain a premium interest rate and, therefore, repaid the assistance through higher mortgage payments and fees. Despite the prohibition against similar seller-funded programs, HUD's requirements appeared to have enabled the growth of these questioned programs. In addition, HUD did not adequately track these loans and review the funding structure of these programs. Despite concerns raised by OIG, HUD failed to protect FHA borrowers against the higher mortgage payments and higher fees imposed on them, which increased the risks to the FHA Insurance Fund in the event of default.

What We Recommend

We recommend that HUD (1) reconsider its position on questioned borrower-financed downpayment assistance programs, (2) develop and implement policies and procedures to review loans with downpayment assistance, (3) develop requirements for lenders to review downpayment assistance programs, (4) require lenders to obtain a borrower certification that details borrower participation, (5) ensure that lenders enter all downpayment assistance data into FHA Connection, and (6) implement data fields where lenders would be required to enter specific downpayment assistance information.

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Background and Objective

The Federal Housing Administration (FHA) was created by Congress in 1934 and as the largest insurer of mortgages in the world, provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. FHA's Mutual Mortgage Insurance Fund provides lenders with protection against losses as a result of homeowners defaulting on their mortgage loans. Lenders bear less risk because FHA will pay a claim to the lender in the event of a homeowner's default. Loans must meet certain requirements established by FHA to qualify for insurance. FHA generally operates from self-generated income and only recently began receiving part of its funding from taxpayers.

Under most FHA programs, the borrower is required to make a minimum downpayment of at least 3.5 percent of the lesser of the appraised value of the property or the sales price. Additionally, the borrower must have sufficient funds to cover borrower-paid closing costs and fees at the time of settlement. State housing finance agencies (HFA), considered to be government entities, are significant sources of home-ownership assistance, such as assistance with closing costs or rehabilitation. A majority of these programs include providing funding to borrowers for the FHA minimum cash investment. The downpayment assistance is usually provided in the form of a grant (gift) or secondary loan. Although the U.S. Department of Housing and Urban Development (HUD) does not approve downpayment assistance programs, such programs and the lenders using the programs must ensure that funds provided comply with FHA requirements and guidance. Funds used to cover the required minimum cash investment, as well as closing costs and fees, must come from acceptable sources and be verified and properly documented.

Traditionally HFAs used mortgage revenue bonds to fund and administer their downpayment assistance programs. However, late in 2011, HFAs utilized Government National Mortgage Association (Ginnie Mae) mortgage-backed securities (debt obligations) to hedge and fund their downpayment assistance programs. The vast majority of mortgage-backed securities trading occurs in the "to-be-announced" (TBA) market. The TBA market is the largest debt market in the world aside from U.S. Treasuries. HFAs prefer mortgage-backed securities over mortgage revenue bonds as these securities can fund downpayment assistance programs without using HFA funds, afford HFAs the option to pay higher lender compensation, usually require less paperwork, and are significantly more profitable.

U.S. Bank is a Ginnie Mae issuer and can pool mortgage loans into Ginnie Mae mortgage-backed securities. U.S. Bank, as the master servicer, has partnerships with HFAs throughout the country. As the master servicer, U.S. Bank is supposed to provide information on acceptable loan products, delivery, and funding; receive all first mortgage files; review first mortgage files; notify lenders of first mortgage file exceptions; approve first mortgage files; purchases pools and deliver loans; and deliver mortgage-backed securities certificates.

In April 2014, the HUD Santa Ana Quality Assurance Division referred an FHA lender to the Office of Inspector General (OIG), highlighting deficiencies related to downpayment assistance gifts, including that (1) the lender permitted downpayment assistance gift funds derived from a premium-priced mortgage and (2) the gifts were not true gifts and were repaid by the borrower through higher interest rates and fees. The Homeownership Center noted that the program violated HUD regulations and policies in effect at the time.

Our audit objective was to determine whether HUD had adequate controls to ensure that FHA-insured loans with downpayment assistance complied with HUD requirements.

Results of Audit

Finding: HUD Failed To Adequately Oversee FHA-Insured Loans With Borrower-Financed Downpayment Assistance

HUD failed to adequately oversee more than \$16.1 billion in FHA-insured loans that may have been originated with borrower-financed downpayment assistance to ensure compliance with HUD requirements and guidance, putting borrowers and the FHA Insurance Fund at unnecessary risk. Between October 1, 2015 and September 30, 2016, HUD guaranteed nearly \$12.9 billion in FHA loans that may have contained questionable borrower-financed downpayment assistance. While downpayment assistance from governmental entities, such as HFAs, is not prohibited, the structure of the assistance provided through these programs did not comply with HUD requirements. FHA borrowers were required to obtain a premium interest rate for this assistance and, therefore, repaid the assistance through higher mortgage payments and fees. This condition occurred because HUD lacked strict controls over government entity downpayment assistance. Despite the prohibition against similar seller-funded programs, HUD's requirements and guidelines appeared to have contributed to and enabled the growth of these questionable borrower-financed downpayment assistance programs. In addition, HUD did not adequately track these types of loans and did not review the actual structure of downpayment assistance programs from government entities. Despite the concerns raised by OIG, HUD's guidance, interpretations, and a recent Deputy Secretary's decision failed to protect FHA borrowers from the higher monthly mortgage payments and higher fees imposed on them, which also increased the risks to the FHA Insurance Fund in the event of default.

Questionable Borrower-Financed Downpayment Assistance Programs

OIG completed three audits of two FHA lenders, NOVA Financial & Investment Corporation¹ and loanDepot, LLC,² in which it identified the details of a funding scheme for downpayment assistance to FHA borrowers. The OIG audits were initiated based on a referral from HUD's own Quality Assurance Division. OIG determined that the lenders originated and insured FHA loans with downpayment assistance that did not always comply with HUD requirements and guidelines. In addition, the lenders improperly charged downpayment assistance-related fees that were not customary or reasonable. OIG determined that the borrower-financed downpayment assistance programs violated HUD's mission, established law, and guidance because the borrowers essentially financed their own downpayment assistance, rather than receiving downpayment assistance in the form of a true gift or secondary financing. The audits reviewed downpayment assistance in which (1) funds were

FHA borrowers financed their own downpayment assistance through higher than market interest rates.

¹ 2015-LA-1005, issued July 9, 2015

² 2015-LA-1009 and 2015-LA-1010, both issued September 30, 2015

indirectly derived from a premium-priced mortgage,³ (2) the downpayment assistance was indirectly repaid⁴ by the borrower through higher than market mortgage interest rates and fees, and (3) the funds were provided in a manner that violated section 203(b)(9)(C) of the National Housing Act.

Summary of OIG audits

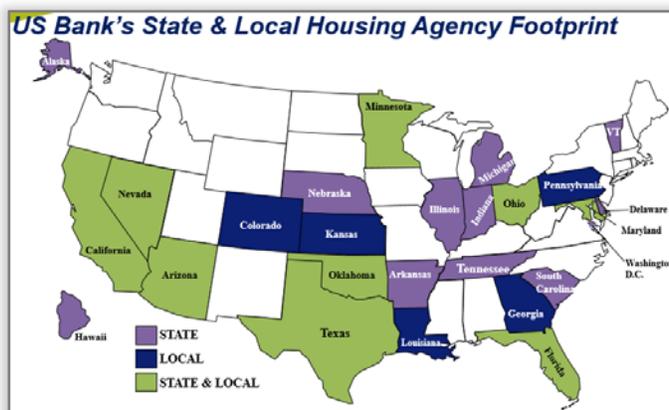
NOVA put the FHA mortgage insurance fund at unnecessary risk, including potential losses of \$48.5 million for 709 loans that contained questionable downpayment assistance. NOVA also inappropriately charged borrowers \$376,102 in misrepresented discount fees and \$7,110 in fees that were not customary or reasonable. [Audit report 2015-LA-1005, issued July 9, 2015](#)

loanDepot put the FHA insurance fund at unnecessary risk, including potential losses of \$4.7 million for 53 loans with questionable downpayment assistance and \$29.9 million for a projected 339 loans that likely contained questionable down payment assistance. Also, loanDepot inappropriately charged borrowers \$46,510 in misrepresented discount fees and \$25,700 in fees that were not customary or reasonable. [Audit report 2015-LA-1009, issued September 30, 2015](#)

loanDepot put the FHA insurance fund at unnecessary risk, including potential losses of \$5.5 million for 62 loans with questionable downpayment assistance and \$16.1 million for 178 loans that likely contained questionable down payment assistance. Also, loanDepot inappropriately charged borrowers \$13,726 in fees that were not customary or reasonable. [Audit report 2015-LA-1010, issued September 30, 2015](#)

Scope of Borrower-Financed Downpayment Assistance

U.S. Bank played a significant role in downpayment assistance programs and partnered with approximately 51 HFAs across 26 States to administer borrower-financed downpayment assistance programs, provided to borrowers in the form of gifts or secondary financing. The HFAs administered these programs with the intention of generating revenues to continually fund their programs. We obtained data from HUD’s Office of Single Family Housing and conducted analyses using the Single Family Data Warehouse.⁵ Between January 1, 2012, and September 30, 2015, we identified 114,200 FHA loans⁶ with an original mortgage balance of more than \$16.1 billion that were originated with



³ HUD Handbook 4155.1, paragraph 5.A.2.i (appendix B). Premium pricing is a lender credit to the borrower by charging a higher interest rate. The lender credit reduces the closing costs for the loan. HUD allows premium pricing when it is used by the lender in the traditional manner (that is, to cover closing costs and prepaid items) but prohibits its use to provide downpayment assistance.

⁴ HUD Handbook 4155.1, paragraph 5.B.4.b (appendix B)

⁵ The Single Family Data Warehouse is a large and extensive collection of database tables organized and dedicated to support the analysis, verification, and publication of single-family housing data.

⁶ Due to the data limitation discussed in this report, we are unable to say with 100 percent certainty that all of the loans identified contained a higher than market interest rate without reviewing every loan.

downpayment assistance from a government source. These loans may have⁷ contained questionable borrower-financed downpayment assistance similar to those identified in the audits of NOVA and loanDepot. Between October 1, 2015, and September 30, 2016, we identified 80,664 FHA loans with an original mortgage balance of nearly \$12.9 billion that were originated with downpayment assistance from a government source, illustrating the growth these programs have experienced. These loans may have contained questioned borrower-financed downpayment assistance; however, the amount could be lower given the limitations and lack of HUD’s data.

Between January 1, 2012, and September 30, 2015, FHA insured 114,200 loans with an original loan balance of \$16.1 billion that may have contained questionable downpayment assistance.

FHA loans that likely contained borrower-financed downpayment assistance

| Downpayment assistance type | HUD data code | Number of loans | Total gift or secondary loan amount | Original mortgage amount | Unpaid principal loan balance |
|--------------------------------------|----------------------------|-----------------|-------------------------------------|--------------------------|-------------------------------|
| January 1, 2012 – September 30, 2015 | | | | | |
| Gift | Government assistance | 60,842 | \$ 401,344,794 | \$ 8,581,180,616 | \$ 7,455,032,760 |
| Secondary financing | Government – State & local | 53,358 | 402,948,339 | 7,572,665,787 | 8,332,836,427 |
| Total | | 114,200 | 804,293,133 | 16,153,846,403 | 15,787,869,187 |
| October 1, 2015 – September 30, 2016 | | | | | |
| Gift | Government assistance | 32,622 | 230,412,694 | 5,545,364,991 | 5,413,647,491 |
| Secondary financing | Government – State & local | 46,948 | 409,505,226 | 7,179,890,875 | 7,006,987,351 |
| Both | Government source | 1,094 | 15,548,846 | 167,850,709 | 164,111,508 |
| Total | | 80,664 | 655,466,766 | 12,893,106,575 | 12,584,746,350 |

Inappropriate Prearranged Downpayment Assistance Scheme

Questionable borrower-financed downpayment assistance programs were utilized by HFAs around 2011 as a way for HFAs to use Ginnie Mae securities to hedge and fund their programs. The programs were the result of agreements among the FHA lender, HFA, and U.S. Bank, essentially creating a prearranged contractual relationship that took unfair advantage of FHA borrowers and the FHA Single Family Mortgage Insurance program. Collectively, U.S. Bank and the HFA developed the program and guidelines. The downpayment assistance could be in the form of a gift or secondary loan. Agreements were executed for various stages in the process

⁷ See the Scope and Methodology section for more details.

(for example, lender agreement, servicing agreement, Ginnie Mae agreement).⁸ The process began with the HFA and U.S. Bank and came full circle when the HFA sold the Ginnie Mae securities in the cash market, generating sufficient proceeds to receive reimbursement and continually fund its downpayment assistance program.

How it works:

- HFA and U.S. Bank develop downpayment assistance program guidelines
- ↓ HFA sets rate daily based on prevailing TBA pricing
- ↓ Loans are originated through participating FHA lenders
- ↓ HFA or investment bank hedges against a change in interest rates using the TBA market
- ↓ U.S. Bank purchases closed FHA-insured loans
- ↓ U.S. Bank pools loans and creates Ginnie Mae mortgage-backed securities
- ↓ HFA or investment bank purchases Ginnie Mae mortgage-backed securities at agreed-upon price
- ↓ HFA or investment bank sells Ginnie Mae mortgage-backed securities in cash market
- Must generate sufficient proceeds from the sale of the Ginnie Mae mortgage-backed securities to pay program costs and continually fund HFA downpayment assistance program

Loan and Downpayment Assistance Process

Typically, an FHA borrower learns of a downpayment assistance program through a lender or real estate agent. Additionally, HFAs market their own individual assistance programs. As a condition of these questioned borrower-financed downpayment assistance programs, the borrower is required to obtain a higher than market interest rate (premium interest rate) in exchange for the assistance. The lender qualifies a borrower for both the FHA mortgage loan and downpayment assistance at the same time. Once the borrower is approved by the lender and there is an executed sales contract, the lender registers the loan in eHousingPlus⁹ or the HFA lender portal, which informs U.S. Bank that there is a loan in the pipeline. The lender locks in the higher than market interest rate, which is not negotiable. At closing, the lender can provide the downpayment assistance funds on behalf of the HFA.¹⁰ When this happens, the HFA does not provide the downpayment assistance funds at closing; it creates a legal obligation to provide the assistance.

Once the loan is closed, a compliance package is sent to eHousingPlus, where a review is to be performed of required signatures, the uniform residential loan application, the first-time home-buyer requirement, etc. At the same time, a mortgage package is sent to U.S. Bank for review (U.S. Bank does not reunderwrite the loan.). If the loan does not comply

⁸ Due to the requirements of individual HFAs, the agreements were not consistent. HFAs could structure their programs to meet their individual needs.

⁹ eHousingPlus is a private program administrator, not affiliated with HUD, and provides software services to HFAs. It maintains the program reservation system (lender portal), Web sites, HFA guides, forms, and training materials; provides program and system training; receives reviews; posts and notifies of exceptions; and approves the compliance file.

¹⁰ Mortgagee Letter 2013-14 (appendix B)

with FHA requirements or U.S. Bank guidelines, the loan is supposed to be kicked back to the lender. If U.S. Bank determines that the loan complies, U.S. Bank purchases the loan from the lender and services the loan. U.S. Bank has the final decision to purchase the loan. As part of the loan purchase, U.S. Bank reimburses the lender for any advanced downpayment assistance, as well as any service release premium.¹¹

Premium Interest Rates Integral to HFA Downpayment Assistance Scheme

Higher than market interest rates (premium interest rates) are integral to these questionable borrower-financed downpayment assistance programs as they allow a downpayment assistance program to be self-funding (circular funding mechanism). The premium interest rate allows for better pricing on the securities market (higher value pools of mortgage-backed securities), essentially allowing HFAs to continually fund their programs at the expense of FHA borrowers.

The HFA sets the interest rate based on TBA¹² market coupons and rates. All downpayment assistance programs that use the TBA market are hedged (evaluation of the market, assistance amount, cost of funds, etc.). The intent is to be able to use the proceeds of the securities to continually fund the downpayment assistance program. The premium interest rate can fluctuate based on the assistance amount. For example, if a borrower's interest rate is 3 percent with no assistance, receiving 3 percent downpayment assistance increases the interest rate to 3.5 percent, and receiving 5 percent downpayment assistance raises the interest rate to 4 percent.

The interest rate is ultimately set by the HFA and is not negotiable. A borrower participating in a these questioned borrower-financed downpayment assistance program does not get to negotiate or explore options to reduce his or her rate. Depending on the HFA, the HFA does the calculations and hedging on its own, or it uses an investment bank. The investment bank or HFA calculates interest rates to be offered for a downpayment assistance program by taking into account prevailing market prices in the TBA mortgage-backed securities market, the amount of assistance approved by the HFA, the HFA's program fee, the lender service release premium or fee, the applicable HFA service release premium, compensation for the investment bank if applicable, and other program expenses (if any and as applicable). The premium interest rates are provided to eHousingPlus and are posted on the lender portal daily. The interest rates are also distributed by the HFA to participating lenders.

¹¹ The service release premium is a payment to a lender from the purchasing loan servicer, in this case U.S. Bank.

¹² The TBA market is the largest debt market in the world aside from U.S. Treasuries. A TBA is a contract for the purchase or sale of mortgage-backed securities to be delivered at a future agreed-upon date; however, the actual pool numbers or the number of pools that will be delivered to fulfill the trade obligation or terms of the contract are unknown at the time of the trade. Actual mortgage pools (including fixed-rate or variable-rate mortgages) guaranteed by Ginnie Mae, the Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation are then "allocated" to the TBA transactions to be delivered upon settlement. This process allows mortgage lenders to sell a product forward through primary originations by securitizing the mortgages for purchase in the secondary market.

Mortgage-Backed Securities and HFA Reimbursement

Under borrower-financed downpayment assistance programs involving an HFA and U.S. Bank, the FHA lenders originate the FHA mortgage loans and sell the mortgage loans to U.S. Bank as the master servicer and Ginnie Mae issuer. After a loan has been purchased from the lender, U.S. Bank pools the FHA loans into Ginnie Mae mortgage-backed securities. Much of the volume in the HFA mortgage-backed securities market today is in the form of TBA trading. Ginnie Mae guarantees securities backed by pools or by one or more loan packages of mortgages. U.S. Bank agrees to sell the Ginnie Mae securities, on behalf of the HFA, to an agreed-upon investment bank. Some HFA's do not use an investment bank. In these cases, U.S. Bank sells the Ginnie Mae securities directly to the HFA, and the HFA sells the Ginnie Mae securities.

Through this process, the program goal is to generate sufficient proceeds to receive reimbursement and continually fund HFA downpayment assistance programs. For example, consider a mortgage loan with an interest rate of 3.5 percent originated with 4 percent downpayment assistance in the form of secondary financing and 2 percent lender compensation.¹³ The HFA will profit .955 percent of the mortgage loan and will also have the residual income of the secondary loan for a total income of 4.955 percent without investing any HFA funds. Essentially, HFAs create revenue through borrower-financed downpayment assistance to perpetually fund their downpayment assistance program. In essence, HFAs have exploited the attraction of home ownership to create money-making programs, through premium interest rates, at the expense of borrowers that may not otherwise have been eligible.

Inadequate Oversight Controls

Although HUD's quality control process reviewed FHA loans originated with downpayment assistance, the reviews were limited and not designed to identify questionable downpayment assistance, as was found in OIG's three external audits. Specifically, HUD quality control reviews focused on ensuring compliance with required gift and secondary loan documentation requirements. HUD did not review the funding structure of HFA downpayment assistance programs to determine compliance with FHA requirements and guidelines. HUD's disregard in this area was careless, and assuming that the HFAs and their related partners (for example, U.S. Bank, lenders, etc.) would structure their programs to ensure absolute compliance with HUD requirements and guidelines presented an unnecessary risk.

Through HUD's Homeownership Centers, the Processing and Underwriting Division and Quality Assurance Division are responsible for performing FHA lender and loan reviews to ensure compliance with HUD requirements and guidelines. The Processing and Underwriting Division performs loan-level reviews known as postendorsement technical reviews. These reviews are a detailed compliance reviews of all loan documentation used by the underwriter to support the approval of the mortgage loan. They evaluate the risk that loans present to FHA's Insurance Fund and lenders' compliance with FHA's underwriting requirements, including documentation, but do not include reverification. The Quality Assurance Division's lender and

¹³ The lender compensation includes the 1 percent origination fee.

loan reviews include assessing lender performance, internal controls, and compliance with HUD origination and servicing requirements. The lender must obtain from the provider any secondary financing documentation showing the amount of funds provided to the borrower for each transaction and copies of the loan instruments.¹⁴

HUD has established criteria and internal guidance used by both divisions. Specific to downpayment assistance, the reviews consist of ensuring the compliance of the required documentation, such as the (1) gift letter that shows the donor's name, address, and telephone number; (2) the amount of the gift; (3) the nature of the donor's relationship to the borrower; and (4) a statement that no repayment is required.¹⁵ Limiting the review to the compliance of the required documentation was not adequate for HUD to determine whether the downpayment assistance complied with HUD requirements and guidelines. For example, a review of a gift letter or secondary loan note would not provide details of the interest rate, downpayment assistance requirements, or impact on the FHA borrower's loan. Without this additional information, it would be impossible for a Processing and Underwriting or Quality Assurance Division reviewer to identify whether a gift or secondary loan complied or whether the funds violated section 203(b)(9)(C) of the National Housing Act, which identifies several prohibited sources of funds for FHA borrower downpayments.

HUD's quality control process reviews also included verification of the entry and accuracy of downpayment assistance data entered by the lender into FHA Connection¹⁶ during the loan approval process. The data consisted of the (1) gift letter amount, (2) gift letter source code indicating an alternate source of funds, (3) secondary loan amount, (4) secondary loan source code, and (5) tax identification number of the entity providing the assistance. To determine whether the missing or inaccurate data were a deficiency, HUD first decided the level of risk imposed on the FHA loan. If HUD determined that there was no risk imposed due to missing or inaccurate information, the lender would not be required to enter the missing or inaccurate data. Ultimately, inaccurate or missing data impact the integrity of FHA Connection and the HUD data systems that rely on those data.

¹⁴ HUD Handbook 4000.1, paragraph II.A.5.c.iii.J.1.c, Secondary Financing Required Documentation. Previously, HUD Handbook 4155.1, paragraph 5.C.1.b, Secondary Financing Documentation Requirements. See appendix B.

¹⁵ HUD Handbook 4000.1, paragraph II.A.5.c.iii.F.3, Gift Required Documentation. Previously, HUD Handbook 4155.1, paragraph 5.B.5.a, Gift Letter Requirement. See appendix B.

¹⁶ FHA Connection is a HUD interactive system that gives approved FHA lenders real-time access to data residing in a number of HUD FHA systems. It facilitates FHA-approved lenders in originating and servicing FHA-insured single-family home mortgages and updating their lender information.

Questionable Downpayment Assistance Programs Enabled by HUD

HUD's requirements, guidelines, and interpretations on downpayment assistance from governmental entities allowed for increased risk to the FHA Single Family Mortgage Insurance program and enabled the growth of questionable borrower-financed downpayment assistance programs. Current requirements and

guidelines provide little oversight and provide HFAs broad access to the FHA program that other entities do not have. HUD interpretations also increased the risk associated with downpayment assistance programs as the main message was that HFAs could operate and access the FHA Single Family Mortgage Insurance program without

restrictions or penalty. When asked what controls were in place to prevent a government entity or HFA from creating a program that clearly violated FHA requirements and guidelines, a HUD official stated that there were no such controls. The lack of controls over government entities and how they provide downpayment assistance allowed for abuse and mismanagement of the FHA Single Family Mortgage Insurance program, as we see in this instance. Stricter controls should exist to ensure that downpayment assistance programs, regardless of the source, comply with all HUD requirements and guidelines.

HUD stated that there were no controls to prevent an HFA from creating a program that clearly violates FHA requirements and guidelines.

- HUD Handbook 4000.1, paragraph II.5.c.iii.I,¹⁷ states that FHA does not “approve” downpayment assistance programs administered by charitable organizations, such as nonprofits. Lenders must ensure that a gift provided by a charitable organization meets the appropriate FHA requirements and that the transfer of funds is properly documented. While this provision puts the burden on FHA lenders to ensure that downpayment assistance meets FHA requirements on gifts and secondary loans, it ensures only that the lenders review certain documentary requirements.
- HUD appeared to have enabled and collaborated with HFAs to create a flexible policy that would assist HFAs with their program needs and requirements. In a public message, the National Council of State Housing Agencies appeared to allude to HUD's working with HFAs to develop a flexible downpayment assistance policy.

¹⁷ Previously HUD Handbook 4155.1, paragraph 5.B.4.h (appendix B)

Excerpt from a February 12, 2014, National Council of State Housing Finance Agencies message¹⁸

During his tenure at HUD, Coulter helped develop FHA's partnership with NCSHA and state HFAs to help them fulfill their affordable homeownership mission, including working extensively last year with NCSHA and HFAs to develop a flexible policy that allows HFAs to provide downpayment assistance to borrowers in connection with FHA-guaranteed loans in a manner that best fits FHA program needs and requirements.

- HUD issued Interpretive Rule Docket No. FR-5679-N-01 (December 5, 2012) to clarify¹⁹ the scope of section 203(b)(9)(C) of the National Housing Act, which prohibits “i) the seller or any other person or entity that financially benefits from transaction ii) any third party or entity that is reimbursed, directly or indirectly, by any of the parties described in clause (i) of a homebuyer’s fund for the required minimum cash investment (downpayment) for single family mortgages to be insured by the FHA.” The ruling essentially was HUD’s interpretation that State and local governments and their agencies were permissible sources of funds for a borrower’s downpayment. However, the ruling did not suggest that HFAs could provide downpayment assistance funds in any manner or were immune from FHA regulations and guidelines. This interpretive rule also did not suggest that HFAs could inflate the cost of the FHA loan to the borrower, via higher than market interest rates, to receive reimbursement indirectly from the FHA loan. Most importantly, the interpretive rule did not supersede any HUD statute, regulations, and guidelines regarding gifts, secondary loans, and downpayment assistance.
- HUD issued Mortgagee Letter 2013-14,²⁰ detailing minimum cash investment and secondary financing requirements. The mortgagee letter allows FHA lenders to provide funds at closing on behalf of government entities, such as HFAs. Essentially, the letter allows HFAs to administer a downpayment assistance program without providing any funds at closing as long as they can demonstrate a legal obligation to provide the assistance. Given the minimal documentation requirements, there was no assurance that lenders would always be reimbursed or that the funds came from the HFA. Again, instead of tightening controls to protect borrowers and the FHA Insurance Fund, it appeared that HUD loosened controls to enable HFAs to operate more freely.
- HUD issued Mortgagee Letter 2014-08, which allows government entities to use a nonprofit organization to assist in the operation of their secondary financing assistance programs. The letter does not require HUD approval and placement on the Nonprofit Organization Roster so long as there is a documented agreement that (1) the functions performed are limited to the government entity’s secondary financing program and (2) the secondary financing legal documents (note and deed of trust) name the government

¹⁸ The message refers to Charles Coulter, former Deputy Assistance Secretary for HUD’s Office of Single Family Housing. Mr. Coulter left his position at HUD in February of 2014 to work for U.S. Bank.

¹⁹ HUD issued the interpretive rule due to uncertainty among lenders, HFAs, and associations supporting HFAs.

²⁰ The mortgagee letter was incorporated into HUD Handbook 4000.1 under paragraph II.A.5.c.ii.C (appendix B).

entity as the lender. A nonprofit participating in another HUD program that requires approval must obtain approval for the subject purpose from HUD and be placed on the Nonprofit Organization Roster.

- HUD issued the Single Family Policy Handbook 4000.1, effective September 14, 2015. This handbook consolidated FHA single-family housing policy into a single source so lenders and other stakeholders could more easily find current policy information. Handbook 4000.1 superseded Handbook 4155.1. A comparison of Handbook 4155.1 provisions in effect at the time of the OIG audits to the new provisions in Handbook 4000.1 shows significant changes in policy. Handbook 4000.1 was modified to strictly define premium pricing and eliminated the prohibition on premium pricing as a source of funds for the borrower's minimum required investment that was in Handbook 4155.1. These changes, which were included in hundreds of pages, were not flagged as a policy change and were omitted from change log documents provided to OIG and other reviewing HUD offices. Because this change impacted a key program requirement, excluding this from the log was potentially misleading to reviewers who were not aware of HUD's intention to provide a new interpretation or clarification regarding premium pricing or downpayment assistance. Although a change log is not a requirement of the clearance process,²¹ the practical and actual effect of this conscious decision by HUD was that it did not allow for a complete and thorough review. The addition of a strict definition and removal of language again lessened the controls that were in place when the prohibition was directly and plainly stated.
- On August 11, 2015, HUD also made public an Office of General Counsel legal opinion discussing borrower-financed downpayment assistance programs available to anyone, including FHA lenders. The legal opinion was made public at a time when the issue was being contested by OIG and did not go through the appropriate clearance process for directives²². The Office of General Counsel's opinion did not address the fact that HFAs were not selling their own loans in the secondary market but were impacting the terms of loans originated and held entirely by third parties and those loans were FHA insured. More generally, HUD appeared to conclude, despite the plain language of the statute (section 203(b)(9)(C) of the National Housing Act), that HUD could exempt certain entities from statutory coverage. This legal opinion, combined with a decision issued by the Deputy Secretary (discussed later in this report) on borrower-financed downpayment assistance, gave HFAs broad access to the FHA Single Family Mortgage Insurance program with few restrictions and appears to retroactively justify or validate after the fact what the OIG's audits found as violations.

²¹ Directives are communications that relay important information or guidance about HUD programs, policies, or operations. When making changes to its programs, policies, or operations using directives, HUD is required to comply with Federal statutory requirements for maintaining adequate records and ensuring information quality. HUD issued a directives handbook (Handbook 000.2, REV-3, HUD Directives System) that describes the processes in place to comply with these requirements.

²² As identified by OIG audit report 2017-LA-0002.

Impact on FHA Borrowers

The lack of oversight and restrictions on borrower-financed downpayment assistance programs negatively impacted FHA borrowers through the premium interest rate and fees. There were no requirements with regard to downpayment assistance programs and ensuring that FHA borrowers were aware of how these programs could impact their mortgage loan. Based on²³ the OIG audits of NOVA and loanDepot, it did not appear that borrowers were fully aware of the implications of a premium interest rate on their mortgage loan or that the downpayment assistance affected their mortgage interest rate. We identified some loans that contained a certification signed by the borrower, which explained that the borrower received a higher mortgage loan interest rate because of the downpayment assistance received. This practice was not consistent and was done at the discretion of the lender and HFA. During the OIG audits of NOVA and loanDepot, the lender and HFA were not always able to provide details or say with certainty whether the premium interest rate was disclosed to the borrower.

In addition to the risk to the FHA Insurance Fund, these questioned borrower-financed downpayment assistance transactions could represent significantly increased cost to borrowers. As noted in the OIG audits of NOVA and loanDepot, it appeared that in many instances, the affected borrowers were not notified of this fact. To illustrate the potential cost to the borrower, we compared a \$150,000 mortgage with and without a \$5,250 downpayment assistance gift at various interest rate levels. Comparatively, the borrowers with downpayment assistance would pay more interest and receive less principal reduction from their mortgage payments. Over the life of the mortgage loan, borrowers that participated in the questioned borrower-financed downpayment assistance programs would incur substantial added interest costs.

| Interest rate cost comparison to a mortgage loan with 3.25% interest rate and no downpayment assistance ²⁴ | 3.75% premium rate with downpayment assistance | 4.00% premium rate with downpayment assistance | 4.25% ²⁵ premium rate with downpayment assistance |
|---|--|--|--|
| Additional interest 6 years | \$ 4,223 | \$ 6,347 | \$ 8,477 |
| Reduced equity 6 years | 1,314 | 1,948 | 2,564 |
| Total 6-year cost to borrower | 5,538 | 8,294 | 11,042 |
| Total 30-year cost to borrower | 14,544 | 21,995 | 29,564 |

Although the sales price did not increase in this example, as was done as part of the now-prohibited seller-funded downpayment assistance, the borrower was required to finance the so-called downpayment assistance gift through an inflated premium interest rate for the life of the loan. Under no reasonable definition should this be a gift, given the indirect repayment of the assistance and potentially significant added cost to the borrower.

²³ Interviews were conducted as part of the audit of NOVA, 2015-LA-1005.

²⁴ If the presented scenarios took into account the \$5,250 not paid out by a borrower who received downpayment assistance, the total 6-year and total 30-year cost would still be higher across all three examples.

²⁵ Although the premium interest rate can vary, for the illustration, we used incremental interest rate increases up to a documented 1 percent premium.

In addition to the added cost, borrowers were charged fees that were not reasonable or customary as part of an FHA loan (for example, tax service fee, second mortgage fee, bond transfer fee, discount fee)(example below). Fees that were not directly charged to the borrower (for example, HFA compensation, lender fees, Ginnie Mae fees, etc.) affected the borrower as they were part of the process that determined the premium interest rate. Below is an example of a HUD-1 settlement statement with fees charged to borrowers.

| 800. Items Payable in Connection with Loan | | | |
|---|-------------|-------------------------------|----------|
| 801. Our origination charge :L1 | \$ 1,766.03 | (from GFE #1) | |
| 802. Your credit or charge (points) for the specific interest rate chosen | \$ | (from GFE #2) | |
| 803. Your adjusted origination charges to Nova Financial & Investment Corporation | | (from GFE A) | 1,766.03 |
| 804. Appraisal fee to A.A.M.S. | | (from GFE #3) (POCB \$425.00) | |
| 805. Credit report | | (from GFE #3) | |
| 806. Tax service to US Bank | | (from GFE #3) | 85.00 |
| 807. Flood certification | | (from GFE #3) | |
| 808. | | | |
| 813. Bond App Fee to E-Housing Plus | | | 225.00 |
| 814. Bond Transfer Fee to US Bank | | | 150.00 |

- As illustrated in the OIG audits of NOVA and loanDepot and in the illustration above, U.S. Bank received a tax service fee, funding fee, bond program fee, bond transfer fee, etc. These fees were charged to borrowers and appeared on the HUD-1 settlement statement and were not reasonable or necessary, as they did not relate to the primary mortgage transaction. In these cases, there were no specific documents indicating the presence of a bond.
- Participating in a questioned borrower-financed downpayment assistance program could allow for higher lender compensation. The lender could collect a 1 percent origination fee and 1 percent discount or program fee from the borrower, which would appear on the HUD-1 settlement statement. On other loans, the lender could collect a 1 percent origination or discount fee (but not both). In this instance, the lender would also receive an additional 1.75 percent upon purchase of the loan by U.S. Bank. Lenders could also pay an initial program participation fee to the HFA to participate in the program (for example, \$2,000).
- Loans could include a first mortgage compliance and administration fee (for example, \$225), which would be collected at closing, payable to eHousingPlus, and submitted with the compliance file. This fee could also appear on the HUD-1 settlement statement.
- HFAs received a percentage (for example, 1 percent) based on the loan value. HFAs also received reimbursement of the downpayment assistance through the Ginnie Mae securities process.
- Appointed investment banks, if used by the HFA, would obtain funds for the purchase of Ginnie Mae securities from and be compensated through the profit made on the later sale of the Ginnie Mae securities.

Similar Assistance Programs Previously Found To Be Inappropriate

HUD has a duty to implement stricter controls that are clearly stated and understood to ensure that risk is minimized. Risk comes in two forms: (1) to the borrower who is financing his or her own downpayment assistance through premium interest rates and fees and (2) to the FHA Insurance Fund. While it is true that a borrower becomes a homeowner in part through the downpayment assistance programs, the scheme involving HFAs, lenders, and premium interest rates placed the borrower at undue risk of loan failure. Regardless of the source of assistance and holding other variables constant, a U.S. Government Accountability Office (GAO) analysis indicated that FHA-insured loans with downpayment assistance had higher delinquency and claim rates than similar loans without such assistance.²⁶

Despite a previous prohibition against seller-funded downpayment assistance programs, HUD did not have adequate oversight of similar borrower-financed programs.

The risks associated with these questioned borrower-financed downpayment assistance programs were similar to those identified by HUD regarding seller-funded downpayment assistance. HUD failed to recognize parallels to the seller-funded downpayment assistance schemes practiced from the late 1990s until passage of the Housing and Economic Recovery Act in 2008. Then, those programs involved seller payments to a third party, which provided downpayment assistance to FHA borrowers. The seller then inflated the sales price to recover the downpayment assistance. Essentially, the FHA borrower was financing his or her own downpayment assistance via an inflated sales price. Because of this historical perspective, HUD must be proactive with similar-type downpayment assistance programs to ensure that it protects FHA borrowers and the FHA Insurance Fund by adequately reviewing downpayment assistance programs and implementing the controls, regulations, and guidelines necessary to prevent misuse of the Single Family Mortgage Insurance program.

Disagreement With HUD Deputy Secretary's Decision

Prompted by HUD's and OIG's disagreement on the conclusion of the NOVA audit,²⁷ on May 25, 2016, the HUD Deputy Secretary issued a decision on HFA borrower-financed downpayment assistance programs in which the funds are indirectly derived through higher than market mortgage interest rates. The Deputy Secretary's decision relied heavily on a HUD, Office of General Counsel, legal opinion. However, the legal opinion, according to the Office of General Counsel, was not meant to review the specific details or funding structure of borrower-financed downpayment assistance programs, as identified in OIG's audit reports. Rather, the legal opinion was meant to opine on HFAs as permissible sources of downpayment assistance. The legal opinion did not take into account the full funding structure of borrower-financed downpayment assistance programs, focusing only on the primary FHA mortgage transaction and ignoring the secondary market transaction (pooling and selling of Ginnie Mae securities). In the

²⁶ GAO 06-24, page 2

²⁷ The decision did not specifically address the two OIG audits of loanDepot. Both audits are in disagreement and have been referred to the Deputy Secretary for review and decision.

Deputy Secretary's decision, HUD stated its position that these downpayment assistance programs were permissible because HFAs, government entities, provided the downpayment assistance and they were not a source prohibited by the statute, regardless of how the HFA acquired the funds to provide the downpayment.

We strongly disagree with the decision, asserting that the downpayment assistance was provided or reimbursed indirectly by a party that benefited financially from the transaction, which is prohibited under section 203(b)(9)(C) of the National Housing Act.

Additionally, in the assistance programs identified in this report, the downpayment assistance provided in the form of a gift was not a true gift, as it was indirectly repaid by the borrower through the premium interest rate and fees. We have not taken issue with the legality of downpayment assistance programs or HFAs as a permissible source of funds.²⁸ However, section 203(b)(9)(C) of the National Housing Act identifies several prohibited sources of funds for an FHA borrower's downpayment.

We strongly disagree with HUD, maintaining that this questioned borrower-financed downpayment assistance is prohibited under the statute.

Section 203(b)(9)(C) of the of the National Housing Act states:

PROHIBITED SOURCES.— In no case shall the funds required by subparagraph (A) consist, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale:

- (i) The seller or any other person or entity that financially benefits from the transaction.
- (ii) Any third party or entity that is reimbursed, directly or indirectly, by any of the parties described in clause (i).

Our interpretation is that these questioned borrower-financed downpayment assistance programs violate the statute as their arrangements violate the plain language of the Act. The source of funds is relevant in this case as the statute prohibits direct and indirect reimbursement of the downpayment. The HFA, U.S. Bank, and the lender all communicated and executed agreements before the origination of any FHA loans with downpayment assistance. The programs funded downpayment assistance through (1) inflation of the mortgage interest rate by the lender, which netted a higher payment from investors when securitized, and (2) use of the additional amount paid by the investors to reimburse the downpayment assistance provider when U.S. Bank and the lender financially benefited from the origination transaction. HUD's insistence on allowing HFAs to continue to provide downpayment assistance tied to a premium interest rate continued to put the FHA program at unnecessary risk and allowed a significant opportunity for abuse and mismanagement of the HUD Single Family Mortgage Insurance program.

²⁸ Interpretative Rule Docket No. FR-5679-N-01 (appendix B)

Borrower-Financed Downpayment Assistance Not Adequately Tracked

Although HFAs and their respective downpayment assistance programs maintained a significant role in the FHA Single Family Mortgage Insurance program, HUD's data systems did not track FHA loans in sufficient detail to easily identify loans that contained downpayment assistance from HFAs. The data captured detailed only which loans contained downpayment assistance from a government entity. The data did not include the type of government entity, government entity name, whether the loan included a higher than market interest rate, or whether the lender provided the downpayment assistance funds at closing on behalf of the HFA. These limitations increased the overall risk as audit, management reviews, and risk assessments could not be easily or fully conducted.

Due to the limitations in HUD's data, we attempted to reconcile the data captured by HUD through third-party participants in HFA downpayment assistance programs. eHousingPlus²⁹ was not able to provide data in a timely manner, as it presented a number of objections involving coordination with a large number of HFAs. The data provided by U.S. Bank were not reliable, and we were unable to validate or reconcile the data.³⁰

As stated earlier in the report, HUD did not always require that lenders enter complete and accurate downpayment assistance data into FHA Connection. For example, we identified many instances in which the tax identification number was not entered. Tax identification number information would potentially allow for more complete tracking of HFA downpayment assistance. Allowing missing or inaccurate information decreases management's ability to adequately conduct reviews and analyses and impacts the integrity of FHA Connection and related HUD data systems.

Conclusion

While downpayment assistance from government entities, such as HFAs, is not prohibited, HUD failed to adequately oversee FHA-insured loans originated with borrower-financed downpayment assistance to ensure compliance with HUD requirements and guidance, putting the FHA Insurance Fund at unnecessary risk. Between 2012 and 2015, HUD guaranteed more than \$16.1 billion in FHA-insured loans originated with government assistance. Between October 1, 2015 through September 30, 2016, HUD guaranteed nearly \$12.9 billion in FHA loans that may have contained questionable borrower-financed downpayment assistance. The structure of the assistance provided through these programs did not comply with HUD statutes and guidance. This condition occurred because HUD lacked strict controls over government entity downpayment assistance. Despite prohibition against similar seller-funded programs, HUD's requirements and guidelines appeared to have contributed to the growth of these questionable borrower-financed downpayment assistance programs. In addition, HUD did not adequately track these types of loans and did not review the actual structure of assistance programs from government entities, specifically HFAs. Despite the concerns raised by OIG, HUD's guidance, interpretations, and a recent Deputy Secretary's decision failed to protect FHA borrowers against

²⁹ eHousingPlus serves as the downpayment assistance program manager and compliance administrator for dozens of HFAs.

³⁰ See the Scope and Methodology section for more details.

higher monthly mortgage payments and higher fees imposed on them, which also increased the risks to the FHA Insurance Fund in the event of default.

Recommendations

We recommend that HUD's Acting Deputy Secretary

- 1A. Reconsider HUD's position on questioned borrower-financed downpayment assistance programs, including an analysis of the financial impact to FHA borrowers, risk to the FHA program, and whether current statute prohibits borrower-financed downpayment assistance programs as they are currently structured.

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

- 1B. Develop and implement policies and procedures to strengthen HUD's comprehensive loan-level, postendorsement, and lender reviews by evaluating loans containing downpayment assistance (for example, interest rates, fees, borrower certifications, lender reviews, impact to borrower, related agreements, etc.). Policies and procedures should include evaluating the structure of downpayment assistance programs, including whether the programs' structure and funding mechanisms comply with all HUD requirements and guidelines.
- 1C. Develop specific requirements and guidance for lenders to review HFA downpayment assistance programs (for example, interest rates, fees, borrower certifications, lender reviews, impact to borrower, related agreements, etc.). Requirements and guidance should include evaluating the structure of downpayment assistance programs, including whether the programs' structure and funding mechanisms comply with all HUD requirements and guidelines.
- 1D. Require lenders to obtain a borrower certification that details their participation in an HFA downpayment assistance program, including relevant details of the specific program (for example, impact on interest rate, mortgage payments, fees, equity, acknowledgement of other less costly loan products, etc.).
- 1E. Ensure that lenders enter accurate and missing downpayment assistance gift data into FHA Connection when identified by HUD.
- 1F. Implement new data fields where lenders would be required to enter specific downpayment assistance information (for example, name of the source, name of assistance program, name of government entity or HFA, etc.) to allow for auditability and for HUD to generate reports and perform risk assessments.
- 1G. Review fees identified in this report that were charged as part of borrower-financed downpayment assistance programs and determine whether they are reasonable or necessary. HUD should immediately notify lenders to discontinue charging any fees that are determined to be unreasonable and unnecessary.

- 1H. Require any participating lender to reimburse borrowers that received an FHA loan with borrower-financed downpayment assistance for any fees that were determined to be unreasonable and unnecessary.

Scope and Methodology

We performed our audit fieldwork from November 2015 through June 2016, mostly from the OIG Office of Audit in Phoenix, AZ. Our audit period covered loans endorsed from January 1, 2012, through September 30, 2015.

To accomplish the objective, we

- Reviewed HUD regulations, guidance, internal procedures, and reference materials;
- Reviewed three prior OIG audits;
- Interviewed HUD, Office of Housing, management;
- Interviewed Quality Assurance Division and Processing and Underwriting Division program staff at the four Homeownership Centers: (1) Santa Ana, (2) Denver, (3) Philadelphia, and (4) Atlanta;
- Interviewed relevant parties, such as U.S. Bank, eHousingPlus, and National Homebuyer's Fund officials;
- Obtained and reviewed FHA loan data through HUD data systems;
- Obtained and reviewed FHA loan data from third parties (U.S. Bank, eHousingPlus); and
- Interviewed HFAs that administered downpayment assistance programs.

We reviewed data received from HUD that pertained to FHA loans and contained gifts and secondary loans. HUD provided a listing of loans that were endorsed between January 1, 2012, and September 30, 2015. Using these data, we conducted analyses to identify loans that likely contained downpayment assistance from a government entity. We isolated two codes³¹ that likely represented FHA loans with downpayment assistance from a government source. Between January 1, 2012, and September 30, 2015, we identified 114,200 FHA loans with an unpaid principal balance of \$16.1 billion that were originated with downpayment assistance from a government source. These loans likely contained questionable borrower-financed downpayment assistance similar to that identified in the audits of NOVA and loanDepot. In the past year between October 1, 2015, and September 30, 2016, we identified 80,664 FHA loans with an original mortgage balance of nearly \$12.9 billion that were originated with downpayment assistance from a government source. These loans likely contained questionable borrower-

³¹ 1) Gift letter source code 3 – government assistance and 2) secondary financing source code 7 – government State & Local

financed downpayment assistance similar to that identified in the audits of NOVA and loanDepot. Due to limitations in HUD's data (for example, lack of HFA and interest rate data), we cannot say with 100 percent certainty that the loans contained questionable borrower-financed downpayment assistance. Therefore, the number of loans and associated dollar amounts may be higher or lower.

To assess the reliability of the data, we reconciled the data with data from the Single Family Data Warehouse and loan data from previous OIG audits of NOVA and loanDepot. We determined that the data were sufficiently reliable. However, due to data capture limitations discussed in the audit report, the data were not sufficiently complete to determine the total universe of FHA loans with borrower-financed downpayment assistance. Therefore, the universe of loans discussed in the audit report was an estimate and could be lower or higher.

We also received data from U.S. Bank detailing FHA loans with downpayment assistance it purchased as part of HFA downpayment assistance programs. We tested the data and determined that the data were not reliable. For example, the data contained 33,185 of 115,528 records with unreliable, nonmatching FHA case numbers and 20,563 records that did not include an amount for downpayment assistance (gift or secondary financing). Further, the data contained information on loans that contained a gift or secondary loan that traced back to a HUD source code that was other than a government source.

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 findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

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 objective:

- Controls intended to ensure that FHA-insured loans with downpayment assistance from government entities (HFA) comply with FHA requirements and guidelines.

We assessed the relevant controls identified above.

A deficiency in internal control 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:

- HUD did not have adequate controls to ensure that FHA-insured loans with downpayment assistance from government entities (HFA) complied with FHA requirements and guidelines (finding).

Appendixes

Appendix A

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000



OFFICE OF HOUSING

December 9, 2016

MEMORANDUM FOR: Tanya E. Schulz
Regional Inspector General for Audit, 9DGA

FROM: Robert E. Mulderig *R. E. Mulderig*
Acting Deputy Assistant Secretary for Single Family Housing, HU

SUBJECT: Auditee Response:
HUD Failed to Adequately Oversee FHA-Insured Loans with Borrower-Financed Downpayment Assistance
OIG Draft Audit Report Number: 2017-LA-XXXX
Issue Date: December XX, 2016

The Office of Inspector General (OIG) performed the subject audit of oversight by the US Department of Housing and Urban Development (HUD) of Federal Housing Administration (FHA)-insured loans for which downpayment assistance was provided to borrowers through program administered by Housing Finance Agencies (HFAs). OIG's stated objective was to determine whether HUD had adequate controls to ensure that FHA-insured loans with downpayment assistance complied with HUD requirements.

Deputy Secretary Coloretti has asked me to respond to the draft audit report on her behalf, as well as on behalf of the Office of Housing (Housing).

Let me suggest at the outset that we believe that the title of the audit is misleading, in suggesting that HFA-sponsored downpayment-assisted FHA mortgage loans are "borrower-financed." Such loans benefit borrowers financially through the average life of an FHA loan, with interest rates that only marginally higher than FHA loans without downpayment assistance and reflect the slightly increased risk for such borrowers. As our analysis below demonstrates, the draft audit report fails to account for the benefit of the downpayment assistance and overstates interest rate differences.

FHA Response to OIG Proposed Findings and Recommendations--Overview

Housing considers such programs to be an important tool for assisting underserved but credit-worthy families across the United States to move to homeownership—and especially, for helping to make this opportunity available to those families earlier. Of course, Housing is committed to ensuring that a potential borrower enters into an FHA-insured mortgage only if and

www.hud.gov espanoLhud.gov

Comment 1

**Ref to OIG
Evaluation**

Comment 2

when his/her financial and credit record demonstrates that homeownership can be successfully sustained—both for the stability of the homeowner and, equally important, for the stability of the Mutual Mortgage Insurance (MMI) Fund. But when our strong underwriting guidelines **demonstrate that that is the case for any borrower, FHA's mission is then to expand access to credit** for homebuying for such borrowers, not to restrict it; and downpayment assistance from qualified, public purpose-driven government entities is an important tool for enhancing that opportunity.

Comment 3

Housing appreciates the analysis that the OIG has done in preparing this draft audit report. While Housing contends that the draft audit report contains certain inaccurate facts and corollary conclusions related to government-sponsored downpayment assistance, we concur with many of the overarching principles implied by the Recommendations in the draft report.

Comment 4

Absent additional evidence, Housing believes that current government-sponsored downpayment assistance programs are compliant with statute, regulation, and program guidance, while assisting potential homebuyers to secure and sustain the objective of homeownership.

Comment 5

In particular, Housing disagrees with the draft report's assertion that the use of government-sponsored downpayment assistance to fund a FHA borrower's minimum required investment is lacking FHA internal controls. FHA has internal controls to confirm compliance with the law and FHA requirements, consistent with the Office of General Counsels' legal opinion concerning the operation of governmental downpayment assistance programs. Specifically, FHA has put in place **controls to ensure that the funds being used for the borrower's minimum cash investment are legally** those of the governmental entity at closing, and originating lenders are required to obtain confirmation of that from the governmental entity. The controls in place were not designed to prevent downpayment assistance programs such as those at issue in previous OIG audits, since it is **FHA's position**—which the Deputy Secretary has confirmed—that such governmental downpayment assistance programs are legal and compliant with FHA requirements.

Comment 4

Comment 5

Of course, Housing routinely evaluates ways in which we can strengthen internal controls, and we will consider how controls for downpayment assistance programs can be improved while still maintaining access to such programs for creditworthy borrowers. We will continue to explore avenues that provide appropriate information to FHA when HFA-sponsored downpayment assistance loans are originated, allowing our reviewers to closely monitor compliance with the National Housing Act.

Comment 3

We urge you to consider the following key points and consider making appropriate revisions to the draft report, since a report with premises that are inaccurate is unlikely to serve well either your office or FHA and the Department.

Subject Downpayment Assistance Programs are Legal

Comment 5

First, let me reiterate what Deputy Secretary Coloretti has already indicated to your Office earlier regarding compliance of HFA-sponsored downpayment assistance programs with FHA guidance: Housing has not identified anything in the draft report that demonstrates such programs are noncompliant with FHA guidance or inconsistent with the legal requirements established in the National Housing Act. We have sought advice from our program counsel on an ongoing basis throughout the review cycles for what are now four different OIG audits on this matter.

**Ref to OIG
Evaluation**

Comment 5

As a result of that counsel, our determination consistently remains that the HFA-sponsored downpayment assistance programs specifically identified in your audits comply with the applicable statutory, regulatory and administrative requirements. Our counsel has provided us clear legal advice on the requirements for downpayment assistance sufficient to allow FHA to determine when a program is operating outside the bounds of the law. If evidence is presented to us demonstrating such non-compliance, FHA stands ready to take appropriate action to curtail such activity.

Comment 5

The draft audit makes clear that OIG is operating with a different view of the legal requirements applicable to downpayment assistance programs operated by Governmental Entities. As OGC has opined, and the Deputy Secretary has confirmed in her adjudication of a previous audit disagreement on this very issue, the manner in which a Governmental Entity generates the funds necessary to operate its downpayment assistance programs is not regulated by FHA, nor do the prohibitions of the National Housing Act preclude the types of funding mechanisms that OIG asserts are improper. The Deputy Secretary stated:

Comment 6

The 2012 Interpretive Rule is the Department's legal interpretation and application of the National Housing Act's "Prohibited Sources" provisions, which restrict certain persons and entities from funding the borrower's minimum required downpayment. The Interpretive Rule specifically excludes governmental entities from the "Prohibited Sources" provisions and places no restrictions or prohibitions on how governmental entities raise funds for their downpayment assistance programs. In addition, the Department's General Counsel has opined by memorandum dated August 11, 2015 ("General Counsel's opinion") and attached hereto as Attachment A, that governmental entities generate their funds for downpayment assistance programs through a variety of mechanisms (which could include the sale of mortgages on the secondary market) and, once the funds legally belong to the governmental entity, that control is sufficient to render them eligible for use as downpayment assistance and a proper source for the borrower's minimum cash investment. Neither the Interpretive Rule nor the subsequent Mortgagee Letter 2013-14, titled "Minimum Cash Investment and Secondary Financing Requirements – Acceptable Documentation for Funds Provided by Federal, State, or Local Governments, their Agencies or Instrumentalities," placed restrictions on the manner in which governmental entities raised funds. (See the Deputy Secretary's Decision: Office of Inspector General Audit of NOVA Financial & Investment Corporation's FHA-Insured Loans with Downpayment Assistance, Report 2015-LA-0010).

Comment 6

Comment 7

Additionally, contrary to the assertions in this audit, the National Housing Act and FHA's scope of authority in this area are restricted to the sales transaction being financed with the FHA insured mortgage. As stated by the Deputy Secretary, **"the "Prohibited Sources" provisions of the National Housing Act, captured at section 203(b)(9)(C) of the Act, are directed towards parties that financially benefit from the property sales transaction and the primary mortgage transaction, not transactions that occur in the secondary mortgage market."** (emphasis added; see Deputy Secretary's Decision: Office of Inspector General Audit of NOVA Financial & Investment Corporation's FHA-Insured Loans with Downpayment Assistance, Report 2015-LA-0010). We urge the OIG to accept the determination of the Deputy Secretary and the advice of the Office of General Counsel, the office charged with providing all official legal advice to the agency, and

**Ref to OIG
Evaluation**

Comment 8

evaluate these Governmental Downpayment Assistance programs based on this official understanding of the provisions of the National Housing Act. It is beyond the scope of the National Housing Act and FHA's authority to seek to regulate secondary market transactions.

Housing disagrees with the draft audit report's characterization of FHA's willingness to work with program participants to ensure they are complying with Federal law and FHA requirements, which it describes as "enabling" such programs. FHA regularly works with a variety of stakeholders to ensure that programs are working effectively to serve creditworthy, qualified borrowers across the nation; this is simply good governance on the part of FHA. The conversations referenced were never intended to skirt requirements, as intimated in the draft audit report, but rather to ensure compliance with FHA requirements and the National Housing Act. Indeed, by working with housing finance agencies in this manner, FHA was able to prevent violations of its requirements from occurring in the first place.

Comment 8

In particular, through the meetings referenced, FHA was able to prevent the operation of programs in which the governmental entity would not provide its funds to close nor make a determination as to its willingness to purchase a loan until after the loan had closed. Those meetings were intended to ensure that the governmental entity does make the determination that the borrower is to be given downpayment assistance through the entity's program and that the governmental entity either provides the funds in advance or incurs a legally binding obligation, e.g., by entering into a debt obligation or drawing from a previously established line of credit.

Comment 6
Comment 8

FHA made clear in its policy that it would call into question any downpayment assistance for which the governmental entity does not satisfy the debt or legal obligation. Contrary to the draft report's implication, the prearrangement of funds described does comply with the law and FHA's requirements and was designed to do so. The mere fact that a governmental entity's debt obligation is transferred from an originator to a servicer and then satisfied by the governmental entity does not negate the fact that this funding mechanism is compliant with Federal law and FHA requirements. If the OIG has evidence that these legal debt obligations have not been satisfied in specific downpayment assistance programs, please do provide it to Housing, so that we can pursue with the subject entities the legality of those programs.

Comment 9

Impact of Downpayment Assistance Programs for FHA Borrowers

Second, regarding the impact of HFA-sponsored downpayment assistance to FHA borrowers, our review of the OIG's analysis suggests that that analysis is flawed. By your own acknowledgment in the audit report, some of the HFA-sponsored downpayment assistance programs you have audited have as a condition for borrowers participating that they be required to complete pre-purchase counseling with a HUD-certified housing counseling agency; and the report recommends that FHA standardize this as a requirement for such programs. We are exploring this as a potential policy enhancement, but caution that program counsel have indicated to us that such a policy change will likely require new rulemaking.

Also as you acknowledge, some HFA-sponsored programs already require the borrower to certify that he/she recognizes that receiving downpayment assistance likely results in a higher interest rate overall. Housing acknowledges that not every such program has this certification requirement, though many do.

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Comment 9

But the draft audit report fails to acknowledge that every FHA borrower already receives an “**Informed Consumer Choice Disclosure Notice**,” which advises in part: “**In addition to an FHA-insured mortgage, you may also qualify for other mortgage products offered by your lender. To ensure that you are aware of available financing options, your lender has prepared a comparison of the typical costs of alternative conventional mortgage product(s), using representative loan amounts and costs. The loan amounts and costs shown below will vary from your own mortgage loan transaction. You should study the comparison carefully, ask questions, and determine which product is best for you.**”

Comment 10

Perhaps most important, we are steadfast in our conviction that the borrower financing examples shown in your draft audit report do not accurately represent the significant positive impact to the borrower. Please consider the following:

Comment 11

- The Department has empirical data demonstrating that, given recent conditions, the interest rate charged for an FHA-insured mortgage loan with HFA-sponsored downpayment assistance would unlikely be more than 0.5% higher than that which would be available without downpayment assistance. For each of the past five fiscal years, Housing compared interest rates on all HFA mortgage loans with government-sponsored downpayment assistance with mortgage loans with no downpayment assistance. The average difference in interest rates for these two scenarios was typically less than or equal to 0.25%. Please see Attachment A for the summary data which takes into accounts all single family mortgage loans for the 2012-2016 fiscal years.
- The cost analysis provided in the draft audit report—in addition to basing cost comparisons on interest rate differences of 0.5%, 0.75%, and 1.00%, though the draft report provides no basis for the magnitude of such interest rate differences—fails to take into account the cash value benefit of the downpayment itself, which would have been provided to the borrower at closing. When the cash benefit of the downpayment is applied for a single family mortgage loan with an interest rate that is 0.5% higher, Housing calculates the “**Total 6-year cost to borrower**” to be **\$2,341 less for borrowers with downpayment assistance**. That is, the borrower with downpayment assistance receives a net cash benefit of \$2,341 over the first six years of the mortgage loan. Please see the cost comparison calculation developed by Housing staff in Attachment B.
- The example in the draft report assigns a value to “**reduced equity**” under the downpayment-assisted example, and Housing acknowledges that the amount of principal paid after 6 years is \$1,314.47 less, or .9% of the \$150,000 purchase price. But on a cash basis, that amount would only be relevant if the borrower were to sell the property at that point—and then subject to changes in property values over that time. On a cash basis, the DPA borrower clearly is advantaged by downpayment assistance.
- It is not until the last payment of the 11th year that the borrower with downpayment assistance begins to be in a cash-disadvantaged position (by \$82.80 on the

Comment 11

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Evaluation

Comment 11

132nd payment). Even at this stage, the difference in owner's equity is less by only 1.4%, relative to an unchanged property value of \$150,000.

- Moreover, Housing's best information suggests that the vast majority of borrowers choosing a government-sponsored downpayment assistance program do not have an option to purchase without downpayment assistance. Therefore, Housing contends that the true equity benefit to the borrower is a +15% equity in an owned home, rather than 0% equity in a rental accommodation.
- It is significant that the borrower with downpayment assistance remains in a cash-advantaged position through 11 years of ownership, because the average term of an FHA Single Family loan is only 6 years; it would be unusual for an FHA homebuyer not to have sold his/her home or refinanced the home mortgage prior to the 11-year break-even point.
- Even with an interest rate a full 1% higher than a supposed market rate—however unlikely that might be—a borrower with downpayment assistance remains in a cash-advantaged position until the last payment of the 6th year of the mortgage. The calculations supporting this conclusion are also shown in Attachment B.

Regarding fees supposedly assessed to borrowers to facilitate the downpayment assistance transaction:

Comment 12

- The draft audit report contends that borrowers were charged fees that were not reasonable nor customary—typically in the amount of \$460 per transaction (\$85 tax service fee¹; \$225 bond application fee; and \$150 bond transfer fee). Based on data Housing has reviewed, these fees appear to be reasonable and customary in downpayment assistance transactions, satisfying the need to compensate transactional parties whose actions are necessary to ensure that the mortgage loan comports to requirements both of the HFA and of secondary market participants whose investing effectively raises the funds for the downpayment. To Housing's best knowledge, these fees have been a standard part of downpayment assistance transactions dating back to when downpayment funds were raised through the sale of mortgage revenue bonds—hence, the naming of such fees as "bond" fees.
- In addition, Housing has no evidence of cases in which FHA borrowers actually paid the subject fees as part of closing costs. Relative to the OIG audit of NOVA Financial & Investment Corp. (NOVA) audit, for example, Housing reviewed not only the 16 loans cited by the OIG, but also additional loans originated by NOVA and by other HFAs in the same

Comment 12

¹ It should be acknowledged that, at the time of the three external audits conducted by the OIG relative to downpayment assistance, payment of a tax service fee by an FHA-insured borrower was prohibited. (That prohibition is no longer relevant, under current FHA guidance.) However, as the discussion notes, Housing does not have evidence at this time that any borrower actually paid a tax service fee, since credits typically from the lender were applied to the tax service and other fees.

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Comment 12

geographic area with downpayment assistance. Although the fees were listed as charges to the borrower, credits were provided from the lender or the seller which explicitly or implicitly covered the costs of those fees.

- Thus, not only has Housing found the subject fees to be reasonable and customary; Housing does not have evidence specific to any number of cases identified in which borrowers actually paid such fees from their own financial resources.

Impact of Downpayment Assistance to the Mutual Mortgage Insurance (MMI) Fund

Finally, regarding the draft report's **suggestion** that HFA-sponsored downpayment assistance programs pose undue risk to the MMI Fund, please consider the following:

Comment 13

- Housing maintains that HFA-sponsored downpayment assistance programs are legal and wholly separate and distinct from the seller-funded assistance programs discussed in the draft audit report. The report sustains **the OIG's assertion that the HFA-sponsored downpayment assistance programs "are similar to...seller-funded downpayment assistance [involving] seller payments to a third party, which provided downpayment assistance to FHA borrowers. The seller then inflated the sales price to recover the downpayment assistance."** **The Department does not see the similarity suggested by the OIG.** In the case of seller-funded assistance, financing of the full principal amount of the downpayment was required and then interest charged over the life of the loan for that amount. In the case of downpayment assistance funded through HFAs, the downpayment finances none of the principal amount, but the loan may have a slightly higher than average interest rate charged.

Comment 6

- Moreover, HFAs are entities established by local or state governments for an expressed public purpose, to expand opportunities for affordable housing. **Housing's best information** suggests that the marginally higher interest rate paid by a borrower is for no reason other **than compensating for the "cost of doing business" by the HFA and the associated parties** that assist in generating the downpayment funds, from origination to secondary market investment; and there is no fraudulent inflation of the home sales price or other vehicle that places the borrower at higher risk. Also, it must be noted that the GAO study cited by the OIG suggesting undue risk to the MMI Fund dealt specifically with nonprofit-based, seller-funded downpayment assistance programs, not the types of programs administered by HFAs.

Comment 14

- Housing acknowledges that the delinquency and default rates for loans with government-provided downpayment assistance are somewhat higher than comparable rates for the overall FHA portfolio. FHA controls for this increased risk in utilization of its TOTAL scorecard, which analyzes downpayment source in its acceptable risk determination.
- Housing acknowledges, for example, that the Early Payment Default (EPD) rates for FHA mortgage loans with government-sponsored downpayment assistance have been higher than for loans with no such assistance. That being said, EPD rates have been at historic lows in these years, such that the percentage of new **FHA downpayment-assisted borrowers**

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Comment 14

Comment 15

Comment 3

Comment 6

Comment 7

with no Early Payment Default has consistently been above 99% during this period, rising to nearly 99.5% in FY 2016. This is well within FHA's acceptable risk threshold. Please see Attachment C for relevant data.

- Similarly, the rate of Serious Delinquency on the roughly 450,000 loans with government-sponsored downpayment assistance in the FHA loan portfolio is roughly 6.27% as of October 2016, admittedly higher than the 4.91% Serious Delinquency rate on the total 7.8 million loans in the portfolio. Again, this is within **FHA's acceptable risk threshold**. Housing considers this in the very positive light that **94% of all borrowers provided loans with downpayment assistance are successful** in meeting their ongoing mortgage obligations on a continuing basis. Please see Attachment D for relevant data.
- HUD's credit modeling for the FY2017 budget estimate also predicts that loans with government downpayment assistance will not negatively impact the MMI Fund. Compared with the OMB discount rate of 3.29%, government downpayment assistance loans have a credit subsidy rate of 3.60%, and all other purchase originations have a rate of 4.41%. As these government downpayment assistance loans are a small portion of FHA's portfolio, the overall credit subsidy rate for FHA originations remains at 4.39%, just 0.02% lower than the rate for originations without government-sponsored downpayment assistance.

Conclusion

Housing supports the essential intent of the OIG in preparing this draft audit report, to ensure that our government-sponsored downpayment assistance programs are operating in a manner which is fully compliant with statute, regulation, and program guidance; are assisting potential homebuyers to secure and sustain the objective of homeownership; and are contributing positively to the MMI Fund. We are considering certain policy updates that will strengthen downpayment assistance programs, and our Management Decision will generally support the Recommendations outlined in your draft report. However, we believe it is critically important that the audit report correctly represent the facts about and legal requirements for HFA downpayment assistance programs as Housing knows them to be, and we offer these comments to ensure that your final report will serve both our offices as effectively as possible.

We look forward to working with the OIG in our mutual objective to ensure that government-sponsored downpayment assistance programs operate such that they serve our citizens by expanding access to homebuyer credit while ensuring a sustained MMI Fund going forward. Thank you for the opportunity to comment on your draft audit report. We hope these comments are helpful as you prepare your final report.

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Comment 10

ATTACHMENT A

| Average Interest Rate by Fiscal Year (Percent, Fixed Rate Only) | | | |
|---|--------------------------|--------|--|
| Endorsement Year | Government-sponsored DPA | No DPA | Difference between Government DPA and No DPA |
| 2012 | 4.09 | 3.94 | 0.15 |
| 2013 | 3.67 | 3.60 | 0.07 |
| 2014 | 4.41 | 4.27 | 0.14 |
| 2015 | 4.21 | 3.99 | 0.22 |
| 2016 | 4.12 | 3.86 | 0.26 |

This table provides the average interest rates on loans in the five most recent fiscal years for all single family FHA-insured mortgage loans with government-sponsored downpayment assistance vs. mortgage loans with no downpayment assistance.

ATTACHMENT B

The scenarios below recreate the draft audit report examples related to the impact of HFA-sponsored downpayment assistance, but demonstrate the significant cash basis advantage to borrowers receiving downpayment assistance.

Example 1

| | Scenario A - No DPA | Scenario B With DPA | Difference |
|---|---------------------|---------------------|----------------------|
| Home Sale Price Amount | \$ 150,000.00 | \$ 150,000.00 | |
| Interest Rate | 3.250% | 3.750% | |
| Term | 360 | 360 | |
| Monthly Payment | \$ 629.96 | \$ 670.36 | |
| Cash and Equity effect of payments over time | | | |
| Downpayment | \$ 5,250.00 | \$ - | \$ (5,250.00) |
| Total interest paid | \$ 26,470.05 | \$ 30,693.22 | \$ 4,223.18 |
| Principal paid in 6 years (equity) | \$ 18,887.16 | \$ 17,572.68 | \$ (1,314.47) |
| Total 6 Year Cost to Borrower | \$ 50,607.20 | \$ 48,265.91 | \$ (2,341.30) |
| Total 6 year equity | 16.1% | 15.2% | .9% |
| Total 11 Year Cost to Borrower | \$ 88,404.72 | \$ 88,487.52 | \$ 82.80 |
| Total 11 year equity | 28.6% | 27.2% | 1.4% |

Example 1 expands upon the data provided by the OIG in the second column of the example on page 15 of the draft audit report. Based on data in the draft audit example, Housing presumes that the data depict a mortgage loan amount of \$144,750, which, when added to a \$5,250 downpayment, covers a \$150,000 home sale price.

While the data Housing has presented in Attachment A would suggest that a 0.5% difference in interest rate would clearly be on the high end of the true rate difference between FHA loans with no downpayment as compared to those with government-sponsored downpayment, that level of interest rate difference is applied to be consistent with the OIG's example.

Example 1 shows the effect of factoring in the cost of the downpayment, either provided by the borrower when the loan interest rate is 3.25% or not provided by the borrower (provided by the HFA financing) with an interest rate of 3.75%. Example 1 shows clearly that the total cost of all cash payments made by the borrower at the end of 6 years is **\$2,341.30 less for the borrower with downpayment assistance.**

It is not until the last payment of the 11th year that the borrower with downpayment assistance begins to be in a cash-disadvantaged position (by \$82.80 on the 132nd payment). Even at this stage, the difference in owner's equity is less by only 1.4%, relative to an unchanged property value of \$150,000.

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Comment 11

It is very significant that the borrower with downpayment assistance remains in a cash-advantaged position through 11 years of ownership, because the average term of an FHA Single Family loan is only 6 years; it would be unusual for an FHA homebuyer not to have sold his/her home or refinanced the home mortgage prior to the 11-year break-even point.

Example 2

| | Scenario A - No DPA | Scenario B With DPA | Difference |
|---|---------------------|---------------------|------------------|
| Home Sale Price Amount | \$ 150,000.00 | \$ 150,000.00 | |
| Interest Rate | 3.250% | 4.250% | |
| Term | 360 | 360 | |
| Monthly Payment | \$ 629.96 | \$ 712.08 | |
| Cash and Equity effect of payments over time | | | |
| Downpayment | \$ 5,250.00 | \$ - | \$ (5,250.00) |
| Total interest paid | \$ 26,470.05 | \$ 34,947.18 | \$ 8,447.13 |
| Principal paid in 6 years (equity) | \$ 18,887.16 | \$ 16,322.80 | \$ (2,564.36) |
| Total 6 Year Cost to Borrower | \$ 50,607.20 | \$ 51,269.98 | \$ 662.77 |
| Total 6-year equity | 16.1% | 14.4% | 1.7%% |

In Example 2, Housing assessed the most significant supposed interest rate difference suggested by the draft audit report (fourth column in example on page 15)—a full 1% difference—although our empirical data on average interest rates this level of rate difference for downpayment-assisted loans would be highly unusual.

Again using the parameters in the draft report example, Example 2 shows that it would not be until the last payment in the 6th year of the mortgage that the borrower with downpayment assistance would begin to be disadvantaged on a cash basis. **The difference in owner's equity at this point under this scenario would only be 1.7%, based on an unchanged \$150,000 property value.**

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Comment 14

ATTACHMENT C

| EPD Rates -Purchase Only | | | | |
|--------------------------|----------------|---------------------------|--------|---------------------------------------|
| Endorsement Fiscal Year | Government DPA | Government DPA but no EPD | No-DPA | Difference between Gov-DPA and No-DPA |
| 2012 | 0.86% | 99.14% | 0.27% | 0.59% |
| 2013 | 0.74% | 99.26% | 0.23% | 0.51% |
| 2014 | 0.74% | 99.26% | 0.32% | 0.42% |
| 2015 | 0.74% | 99.26% | 0.31% | 0.44% |
| 2016 | 0.54% | 99.46% | 0.23% | 0.31% |

The table above provides Housing's best information on risk to the MMI Fund as evidenced for new FHA-insured homebuyers over the past five fiscal years. While it is true that the rate of Early Payment Defaults for government-sponsored downpayment assistance FHA mortgage loans has been higher than for mortgage loans without downpayment assistance, both sets of EPD rates have been at historic lows in these years, such that the percentage of new FHA downpayment-assisted borrowers with no Early Payment Default has consistently been above 99% during this period, rising to nearly 99.5% in FY 2016.

Comment 14

ATTACHMENT D

| Seriously Delinquent Rate, FHA Portfolio Status as of October, 2016 | | | | | |
|---|--|------------------|------------------|--------------------------|------------------|
| DQ Status | Seller Funded (program terminated in 2009) | No DPA | Other DPA | Government-sponsored DPA | Overall |
| Current | 42,239 | 5,390,021 | 1,148,159 | 393,080 | 6,973,499 |
| 30_day | 6,802 | 247,708 | 78,212 | 24,210 | 356,932 |
| 60_day | 2,871 | 84,261 | 28,941 | 9,047 | 125,120 |
| 90_day | 5,824 | 136,728 | 42,619 | 16,904 | 202,075 |
| Bankruptcy | 2,350 | 46,566 | 13,384 | 5,087 | 67,387 |
| In Foreclosure | 3,712 | 83,683 | 21,311 | 6,506 | 115,212 |
| Other | - | 33 | 2 | 1 | 36 |
| Total | 63,798 | 5,989,000 | 1,332,628 | 454,835 | 7,840,261 |
| 90+ | 11,886 | 266,977 | 77,314 | 28,497 | 384,674 |
| SDQ Rate | 18.63% | 4.46% | 5.80% | 6.27% | 4.91% |

Downpayment Assistance Type, SF Forward Loans Only by Endorsement Fiscal Year, data from FHA SFDW on 12/5/2016

Housing evaluated the key measure we use to assess risk on the overall FHA portfolio of 7.8 million loans, the Seriously Delinquent Rate. The table shown provides the full complement of delinquency data for all loans in the portfolio as of October 2016. The Seriously Delinquent (SDQ) rate focuses on loans across the entire single family loan portfolio that are 90+ days delinquent and/or evidencing a bankruptcy or foreclosure status.

It is true that the SDQ rate for all single family mortgage loans with government-sponsored downpayment assistance loans is higher than for mortgage loans with no downpayment assistance and for the portfolio overall. However, the data show clearly that **nearly 94% of all borrowers with government-sponsored downpayment assistance do not have any serious delinquency**. Housing is confident that this is a level of risk that can be effectively monitored and controlled with ongoing policy administration.

OIG Evaluation of Auditee Comments

- Comment 1 We disagree with HUD's statement that the title of the audit report is misleading. Through the premium interest rates (higher than market), FHA borrowers are essentially financing their downpayment assistance. The assistance is repaid through the higher mortgage interest payments. Also, the premium interest rates allow HFAs to receive reimbursement through the Ginnie Mae securities market.
- Comment 2 We agree that downpayment assistance can be an important tool in providing home-ownership opportunities to borrowers. However, the desire to provide downpayment assistance should not have to come at the expense of those same borrowers that HUD is tasked with helping.
- Comment 3 We appreciate the effort that was put into HUD's analysis of downpayment assistance and related interest rates (evaluated in subsequent comments) and recognize its agreement with many of the overarching principles implied by the recommendations in the audit report.
- Comment 4 We disagree with Housing's assertion that it has adequate internal controls. As stated in the audit report, HUD does not have adequate oversight controls in place and has agreed to the need for better oversight. The controls highlighted by Housing merely serve to ensure documentation of downpayment assistance funds at closing and does not get to the substantive downpayment assistance issues. None of the FHA regulations or guidance requires a review of the HFA downpayment assistance program structure. HUD's quality control process is not designed to identify questionable downpayment assistance. We believe reviewing downpayment assistance programs for compliance with FHA regulations and guidance is a key step toward protecting FHA borrowers and the FHA Insurance Fund. See comment 10.
- Comment 5 We strongly disagree with HUD's Office of General Counsel's legal opinion and the Deputy Secretary's decision, issued May 25, 2016, and do not think they adequately support that the downpayment assistance programs in question comply with FHA regulations and guidelines. The decision was largely based on a flawed and incomplete legal opinion. The legal opinion was flawed and not based on a thorough review of HFA downpayment assistance programs. It also contained statements indicating that HUD did not fully understand how HFAs were structuring their downpayment assistance programs. For example, the premium interest rates were not agreed upon by the borrower and lender. Rather, the premium interest rates were predetermined and imposed on borrowers in exchange for downpayment assistance. The rates were not negotiable. The legal opinion did not take into account the full funding structure of borrower-financed downpayment assistance programs, focusing only on the primary FHA mortgage

transaction and ignoring the secondary market transaction (pooling and selling of Ginnie Mae securities).

Even more significant, the legal opinion was inconsistent with the existing statutory requirements in section 203(b)(9)(c) of the National Housing Act. Existing statutory requirements in this section prohibit gifts (to meet FHA's minimum required investment) that involve direct or indirect reimbursement from an entity that financially benefits from the transaction. HUD's legal opinion, on the contrary, indicates a policy that would allow prearranged transactions, which include reimbursements to gift donors by involved financial institutions that benefit from the transaction.

Comment 6 We disagree with Housing's assertion that the downpayment assistance programs in question comply with FHA regulations and guidance. As stated in the audit report, we have not taken issue with the legality of downpayment assistance programs or HFAs as a permissible source of funds (Interpretive Rule Docket No. FR-5679-N-01). We have only taken issue with the borrower-financed downpayment assistance programs in question that rely on predetermined premium interest rates that stem from agreements among HFAs, FHA lenders, and Ginnie Mae issuers (such as U.S. Bank) to net funds to reimburse the downpayment. These agreements highlight two very connected transactions: the FHA loan transaction and the secondary market transaction (pooling and selling of Ginnie Mae securities). Contrary to HUD's position, the two transactions cannot be separated; the secondary market securities transaction relies on the FHA loan transaction. The downpayment assistance programs in question need to generate revenues through the premium interest rate to perpetually fund their programs and cover related program costs. Further, Housing's response appear to be contradictory with respect to separating the primary FHA mortgage transaction and the secondary securities market transaction. In one instance when discussing whether the downpayment assistance programs in question violate the National Housing Act, Housing states that the primary FHA mortgage transaction and secondary securities market transaction should be considered separately.

Additionally, contrary to the assertions in this audit, the National Housing Act and FHA's scope of authority in this area are restricted to the sales transaction being financed with the FHA insured mortgage. As stated by the Deputy Secretary, "the "Prohibited Sources" provisions of the National Housing Act, captured at section 203(b)(9)(C) of the Act, are directed towards parties that financially benefit from the property sales transaction and the primary mortgage transaction, not transactions that occur in the secondary mortgage market."

In another instance in Housing's response, when discussing fees, Housing states that it is okay to consider both transactions together.

Based on data Housing has reviewed, these fees appear to be reasonable and customary in downpayment assistance transactions, satisfying the need to compensate transactional parties whose actions are necessary to ensure that the mortgage loan comports to requirements both of the HFA and of secondary market participants whose investing effectively raises the funds for the downpayment.

As highlighted by the downpayment assistance process described in the audit report, these programs rely on a complex structure that shows the clear relationship between the two transactions. FHA lenders allowed third parties to influence and dictate the terms of the primary FHA loan transaction. Although not direct parties to the FHA loan, the HFAs and U.S. Bank required the FHA lenders to inflate the interest rate on the mortgage loan. The FHA borrowers were required to obtain a nonnegotiable premium interest rate that was determined by the HFA. Housing's support of these questionable downpayment assistance programs allows third parties to influence FHA loans between a borrower and lender.

HUD's contradiction and continued support of these questionable HFA downpayment assistance programs, regardless of their structure, combined with its complementary requirements, guidelines, and interpretations, provide HFAs unique, broad access to the FHA Single Family Mortgage Insurance program without restrictions or penalties, further magnifying the unnecessary risk posed by these loan products. We also note that Housing did not address the fact that its own Quality Assurance Division originally found the downpayment assistance programs in question not in compliance with FHA regulations and guidelines. See comment 5.

Comment 7 We disagree with Housing's statement that the National Housing Act and FHA's scope of authority are restricted to the sales transaction being financed. The audit report does not ask HUD to regulate secondary mortgage market transactions. Rather, it states that HUD must have controls in place to ensure that downpayment assistance programs, even if from a governmental entity, comply with FHA regulations and guidelines.

As stated in comment 6 above, the secondary mortgage market transaction was dependent on the primary FHA mortgage transaction and, therefore, related. Further, the secondary mortgage market transaction dictated the terms of the primary FHA mortgage market transactions. We determined that the downpayment assistance programs in question violated the plain language of the Act.

Section 203(b)(9)(C) of the of the National Housing Act states:

PROHIBITED SOURCES.— In no case shall the funds required by subparagraph (A) consist, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale:

(i) The seller or any other person or entity that financially benefits from the transaction.

(ii) Any third party or entity that is reimbursed, directly or indirectly, by any of the parties described in clause (i).

We disagree that the source of funds is irrelevant because the statute prohibits parties that financially benefit from the FHA mortgage transaction, directly and indirectly using third-party intermediaries, from providing the downpayment. Nowhere did the interpretive rule suggest that the HFA could inflate the cost of the FHA loan to the borrower to reimburse itself indirectly from the FHA loan. Rather, the interpretive rule referred to funding through mechanisms, such as housing bonds, low-income housing tax credits, HOME program funds, and other Federal and State resources, all of which are entirely separate from the FHA loan transaction.

In the downpayment assistance programs in question, the HFA, FHA lender, and Ginnie Mae issuer (such as U.S. Bank) are parties that benefit directly from the FHA mortgage transaction. They are the conduits for reimbursement of the downpayment assistance. The HFA that provides the downpayment indirectly benefits as it is reimbursed by the Ginnie Mae issuer as part of a preplanned securitization process. Housing's position failed to address the fact that the Ginnie Mae issuers are involved in the primary FHA mortgage transaction. The HFA and Ginnie Mae issuer must communicate with the lenders about what interest rate will be required to generate sufficient proceeds at the time of securitization to reimburse the downpayment assistance provided at closing. The borrowers also pay a fee for securitization at the time of origination. In essence, the HFAs and Ginnie Mae issuers here are a source of funds that section 203(b)(9)(C) explicitly prohibits.

Comment 8 We acknowledge and appreciate part of HUD's mission to conduct outreach and work with its various stakeholders. However, as stated in the audit report and comment 4, HUD's regulations, guidance, and opinions have provided HFAs unique, broad access to the single-family FHA program without restriction. With regard to Mortgagee Letter 2013-14, Housing's response does not provide details on how it would determine that an HFA did not satisfy its legal debt obligation. HUD does not require HFAs to provide evidence beyond the debt or legal obligation letter to ensure that they reimbursed lenders for any downpayment assistance funds that were provided at closing on their behalf. Further, we identified instances in which the lender was reimbursed the downpayment assistance directly by U.S. Bank, requiring the HFA to reimburse U.S. Bank.

These complex transactions again show the connected nature of the primary FHA mortgage and secondary securities transactions. Housing's focus on a documentation standard, again, does not address the main issue of how the downpayment assistance programs are structured, a complexity demanding a higher level of oversight.

Comment 9 We appreciate Housing's willingness to explore policy enhancements that would impose additional controls on downpayment assistance programs and look forward to being part of that rulemaking process to achieve this goal. Housing also suggested that our analysis was flawed. For clarification, the OIG audit reports on NOVA³² and loanDepot³³ identified only one HFA that used a certification disclosing to the borrower that receiving downpayment assistance likely results in a higher interest rate. Unlike the "Informed Consumer Disclosure Notice" highlighted in Housing's response, the certification identified by OIG was specific to downpayment assistance. In its exploration of policy enhancements, Housing should consider requiring downpayment assistance certifications, which ensure that the borrower is fully aware that the higher interest rate is required to receive downpayment assistance, a comparison of the higher rate downpayment assistance loan to an FHA loan without a premium interest rate, and the effect of the higher rate on the mortgage loan.

Comment 10 We acknowledge Housing's analyses on interest rates related to FHA loans. Housing reviewed interest rate data for the 5-year period between 2012 and 2016, comparing FHA loans with government-sponsored downpayment assistance to FHA loans with no downpayment assistance. We disagree with Housing's analyses conclusions that the interest rate difference would not be much higher than 0.5 percent and averages less than or equal to 0.25 percent. Using specific data on two lenders, detailed below, we show interest rate differences higher than 0.5 and 0.25 percent. We also note that Housing's analyses are flawed due to its own data limitations and do not account for the variability of interest rates.

- a. As stated in the report and confirmed by Housing during the exit conference, HUD does not maintain sufficient data to adequately review downpayment assistance programs. Housing was not able to separate loans by HFA or even distinguish which FHA loans contained the type of borrower-financed downpayment assistance questioned in the audit report. This type of significant data limitation does not allow for a complete and thorough analysis.
- b. Housing's analyses assume that all loans with government-sponsored downpayment assistance in FHA's portfolio have premium interest rates and ignore variability among States and even lenders. To address these

³² 2015-LA-1005, issued July 9, 2015

³³ 2015-LA-1009 and 2015-LA-1010, both issued September 30, 2015

shortcomings, we believe interest rate analysis should be broken down into specific loan-level detail (such as by State and lender) and include only loans with known premium interest rates. To illustrate this point, we reviewed interest rates for NOVA Financial & Investment Corporation between January 2013 and August 2014. We analyzed interest rates for FHA loans with no downpayment assistance, FHA loans with borrower-financed downpayment assistance, and FHA loans with gifts from a family member.

- The average interest rate for FHA loans with downpayment assistance was 4.6 percent, compared to the average interest rate for FHA loans without downpayment assistance of 3.9 percent, a difference of 0.7 percent.
- During the period, the average interest rate difference between FHA loans with and without downpayment assistance ranged from 0.3 percent up to 1.0 percent.
- The average interest rate for FHA loans without downpayment assistance and FHA loans with a gift from a family member were virtually identical.

We also reviewed interest rates for loanDepot between October 2013 and January 2015. Again, we analyzed interest rates for FHA loans with no downpayment assistance, FHA loans with borrower-financed downpayment assistance, and FHA loans with gifts from a family member.

- The average interest rate for FHA loans with downpayment assistance was 4.6 percent, compared to the average interest rate for FHA loans without downpayment assistance of 4.1 percent, a difference of 0.5 percent.
- During the period, the average interest rate difference between FHA loans with and without downpayment assistance ranged from 0.2 percent up to 0.6 percent.
- The average interest rate for FHA loans without downpayment assistance and FHA loans with a gift from a family member were virtually identical.

Comment 11 We acknowledge that borrowers who would not otherwise qualify are able to purchase a home and Housing's additional analyses on the loan cost analysis that appears in the audit report. To clarify Housing's question on the interest rates used, the cost analysis used interest rates of 0.5, 0.75, and 1.0 percent to illustrate the additional cost to borrowers who receive inflated interest rates in exchange for downpayment assistance. The rates used in the audit report cost analysis are fully supported, based on supporting documents obtained through the audits of

loanDepot and NOVA. In addition, our interest rate analysis in comment 12 also details rate inflation of up to 1 percent.

We disagree with Housing’s assessment that FHA borrowers are clearly advantaged by downpayment assistance. Housing’s statement that a borrower who purchases rather than rents a home may start off in a better equity position does not address the significant concerns highlighted throughout the audit report. The cost analysis example in the audit report was created purely to show the differences in principal and interest between a loan with downpayment assistance and one without downpayment assistance. Initially, a borrower receiving downpayment assistance does provide less cash up front. However, that same borrower, as Housing characterized as riskier, would also begin his or her mortgage loan with higher mortgage payments. Assuming that two borrowers provide the same amount of downpayment, the borrower receiving downpayment assistance and the borrower providing his or her own downpayment both have, initially, the same equity in the property. Further, as Housing admits, the borrower who received a higher interest rate will pay less principal per month, resulting in lower equity after 6 years. If we considered the \$5,250 in the cost analysis in the audit report, the borrower receiving questionable downpayment assistance would still have a higher cost after 6 years and 30 years.

| Interest rate cost comparison to a mortgage loan with 3.25% interest rate and no downpayment assistance | 3.75% premium rate with downpayment assistance | 4.00% premium rate with downpayment assistance | 4.25% premium rate with downpayment assistance |
|---|--|--|--|
| Additional interest 6 years | \$ 4,223 | \$ 6,347 | \$ 8,477 |
| Reduced equity 6 years | 1,314 | 1,948 | 2,564 |
| Cash benefit of not providing own downpayment | 5,250 | 5,250 | 5,250 |
| Total 6-year cost to borrower | 288 | 3,044 | 5,792 |
| Total 30-year cost to borrower | 9,294 | 16,745 | 24,314 |

In describing borrowers that are, in Housing’s assessment, clearly advantaged, it fails to point to the fact that these programs have no disclosure or certification requirements as detailed in comment 9. This is probably the most concerning aspect of these questioned downpayment assistance programs. FHA borrowers are paying higher interest rates without full knowledge of the impact such rates have on their mortgage loan. Further, because there are no specific requirements on disclosure, an FHA borrower may receive downpayment assistance and may not be aware that a premium interest rate is being imposed on him or her to receive that assistance. Finally (and Housing agrees), borrowers in these questioned programs experience higher default rates (comment 14). These higher incidents of default clearly affect borrowers by putting them at higher risk of foreclosure and have the potential to negatively impact their credit ratings.

Comment 12 We disagree with Housing's assessment that the fees were reasonable and customary. In its response, Housing did not provide details or documentation to support why the fees were reasonable and customary. The fees related to the downpayment assistance and secondary securities market transaction, which occurs after the FHA loan is closed, not the primary mortgage transaction, and, therefore, should not have been charged.

Further, as stated in comment 6, Housing's statements appear to be contradictory with respect to separating the primary FHA mortgage transaction and the secondary securities market transaction. In one instance, when discussing whether the downpayment assistance programs in question violate the National Housing Act, Housing states that the primary FHA mortgage transaction and secondary securities market transaction should be considered separately. In another instance, when discussing fees, Housing states that it is okay to consider both transactions together.

Comment 13 Housing discussed the differences between the seller-funded (prohibited) and borrower-financed downpayment assistance programs. As stated in the audit report, both programs are similar. While the funding mechanisms are different, both programs involve interested third parties and the financing of the downpayment assistance. The seller-funded assistance programs increased the sales price to reimburse (finance) the downpayment assistance, while with borrower-financed programs, the downpayment assistance was reimbursed (financed) through the required premium interest rate. We note the correlation between seller-funded programs causing borrowers to pay above market mortgage payments through an artificially increased sales price and borrower-financed downpayment assistance programs causing borrowers to pay above market mortgage payments through an inflated interest rate.

Comment 14 We appreciate Housing's acknowledgement that FHA loans with downpayment assistance are riskier and have higher delinquency and default rates. We came to the same conclusion when analyzing data obtained from U.S Bank. However, Housing states that the risk imposed by FHA loans with downpayment assistance is acceptable. We disagree with Housing's characterization of risk. While it is true that a borrower becomes a homeowner, the arrangement involving the downpayment assistance in question places the borrower and FHA at undue risk of loan failure as HUD has historically experienced in similar scenarios. There is no question that an increased risk of default creates a greater risk to the FHA Insurance Fund.

Comment 15 We acknowledge HUD's statements on the fiscal year 2017 budget estimate and credit modeling. However, Housing did not provide support for its statements, therefore, we were unable to fully evaluate.

Appendix B

Criteria

12 U.S.C. (United States Code) 1709(b)(9)(C)

In no case shall the funds required by subparagraph (A) consist, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale: (i) The seller or any other person or entity that financially benefits from the transaction. (ii) Any third party or entity that is reimbursed, directly or indirectly, by any of the parties described in clause (i).

Housing and Economic Recovery Act of 2008

The Housing and Economic Recovery Act of 2008 amended Section 203(b) to include a new subparagraph (9)(C), which specifies prohibited sources for a mortgagor's [borrower] minimum investment. Section 203(b)(9)(C) of the NHA [National Housing Act] states:

Prohibited Sources. In no case shall the funds required by subparagraph (A) consist, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale:

- (i) The seller or any other person or entity that financially benefits from the transaction.
- (ii) Any third party or entity that is reimbursed, directly or indirectly, by any of the parties described in clause (i).

24 CFR Part 203; Docket No. FR-5679-N-01

Federal Housing Administration: Prohibited Sources of Minimum Cash Investment under the National Housing Act – Interpretive Rule

HUD interprets NHA Section 203(b)(9)'s prohibited sources provision in subsection (C) as not including funds provided directly by Federal, State, or local governments or their instrumentalities in connection with their respective homeownership programs."

HUD Handbook 4000.1 – Effective September 14, 2015

I.B.4.a.iii.B, Nonprofits with a Documented Agreement to Support Secondary Financing

When a Governmental Entity uses a nonprofit to assist in the operation of the Governmental Entity's secondary financing assistance programs, FHA approval and placement on the HUD Nonprofit Roster are not required so long as there is a documented agreement indicating (1) the functions performed include the Governmental Entity's secondary financing program and (2) the secondary financing legal documents (e.g., Note and deed of trust) name the Governmental Entity as the Mortgagee.

Governmental Entities that have nonprofits close the secondary financing in the name of the nonprofit must verify that the nonprofit is both FHA approved and on the HUD Nonprofit Roster. Refer to Prohibited Sources of Minimum Cash Investment Under the National Housing Act - Interpretive Rule for additional guidance and clarification on the provision of downpayment assistance through secondary financing.

II.A.5.c.i.B.2.h, Premium Pricing on FHA-Insured Mortgages

Premium Pricing refers to a credit from a Mortgagee [lender] for the interest rate chosen. Premium Pricing may be used to pay a Borrower's actual closing costs and/or prepaid items. Closing costs paid in this manner do not need to be included as part of the Interested Party limitation.

The funds derived from a premium priced mortgage:

- must be disclosed in accordance with RESPA [Real Estate Settlement Procedures Act];
- must be used to reduce the principal balance if the credit amount exceeds the actual dollar amount for closing costs and prepaid expenses; and
- may not be used for payment of debts, collection accounts, escrow shortages or missed Mortgage Payments, or Judgments.

II.A.5.c.ii.B, Minimum Required Investment Standard

The Mortgagee may only permit the Borrower's MRI [minimum required investment] to be provided by a source permissible under Section 203(b)(9)(C) of the National Housing Act, which means the funds for the Borrower's MRI must not come from:

1. the seller of the Property;
2. any other person or Entity who financially benefits from the transaction (directly or indirectly); or
3. anyone who is or will be reimbursed, directly or indirectly, by any party included in (1) or (2) above.

While additional funds to close may be provided by one of these sources if permitted under the relevant source of funds requirements above, none of the Borrower's MRI may come from these sources. The Mortgagee must document permissible sources for the full MRI in accordance with special requirements noted above.

Additionally, in accordance with HUD's Interpretive Rule, Docket No. FR-5679-N-01, HUD does not interpret Section 203(b)(9)(C) of the National Housing Act to prohibit Governmental Entities, when acting in their governmental capacity, from providing the Borrower's MRI where the Governmental Entity is originating the insured Mortgage through one of its homeownership programs.

II.A.5.c.ii.C, Required Documentation

Where the Borrower's MRI is provided by someone other than the Borrower, the Mortgagee must also obtain documentation to support the permissible nature of the source of those funds.

To establish that the Governmental Entity provided the Borrower's MRI in a manner consistent with HUD's Interpretive Rule, the Mortgagee must document that the Governmental Entity incurred prior to or at closing an enforceable legal liability or obligation to fund the Borrower's MRI. It is not sufficient to document that the Governmental Entity has agreed to reimburse the Mortgagee for the use of funds legally belonging to the Mortgagee to fund the Borrower's MRI.

The Mortgagee must obtain:

- a canceled check, evidence of wire transfer or other draw request showing that prior to or at the time of closing the Governmental Entity had authorized a draw of the funds provided towards the Borrower's MRI from the Governmental Entity's account; or
- a letter from the Governmental Entity, signed by an authorized official, establishing that the funds provided towards the Borrower's MRI were funds legally belonging to the Governmental Entity, when acting in their governmental capacity, at or before closing.

Where a letter from the Governmental Entity is submitted, the precise language of the letter may vary, but must demonstrate that the funds provided for the Borrower's MRI legally belonged to the Governmental Entity at or before closing, by stating, for example:

- the Governmental Entity has, at or before closing, incurred a legally enforceable liability as a result of its agreement to provide the funds towards the Borrower's MRI;
- the Governmental Entity has, at or before closing, incurred a legally enforceable obligation to provide the funds towards the Borrower's MRI; or
- the Governmental Entity has, at or before closing, authorized a draw on its account to provide the funds towards the Borrower's MRI.

While the Mortgagee is not required to document the actual transfer of funds in satisfaction of the obligation or liability, the failure of the Governmental Entity to satisfy the obligation or liability may result in a determination that the funds were provided by a prohibited source.

II.A.5.c.iii.F.1, Gift Definition

Gifts refer to the contributions of cash or equity with no expectation of repayment.

II.A.5.c.iii.F.3, Gift Required Documentation

The Mortgagee must obtain a gift letter signed and dated by the donor and Borrower that includes the following:

- the donor's name, address, telephone number;
- the donor's relationship to the Borrower;
- the dollar amount of the gift; and
- a statement that no repayment is required.

Regardless of when gift funds are made available to a Borrower, the Mortgagee must be able to make a reasonable determination that the gift funds were not provided by an unacceptable source.

II.A.5.c.iii.I, Downpayment Assistance Programs

FHA does not "approve" downpayment assistance programs administered by charitable organizations, such as nonprofits. FHA also does not allow nonprofit entities to provide gifts to pay off:

- Installment Loans
- credit cards
- collections

- Judgments
- liens
- similar debts

The Mortgagee must ensure that a gift provided by a charitable organization meets the appropriate FHA requirements, and that the transfer of funds is properly documented.

II.A.5.c.iii.J.1.c, Secondary Financing

The Mortgagee must obtain from the provider of any secondary financing:

- documentation showing the amount of funds provided to the Borrower for each transaction;
- copies of the loan instruments;

HUD Handbook 4155.1 – Superseded on September 14, 2015 by HUD Handbook 4000.1

5.A.2.i, Premium Pricing on FHA-Insured Mortgages

The funds derived from a premium priced mortgage may *never* be used to pay any portion of the borrower’s downpayment and *must* be disclosed on the GFE [good faith estimate] and the HUD-1 *Settlement Statement*.

5.B.4.a, Description of Gift Funds

In order for funds to be considered a gift, there must be no expected or implied repayment of the funds to the donor by the borrower.

5.B.4.d, Lender Responsibility for Verifying the Acceptability of Gift Fund Sources

Regardless of when gift funds are made available to a borrower, the lender *must* be able to determine that the gift funds were *not* provided by an unacceptable source, and were the donor’s own funds.

When the transfer occurs at closing, the lender is responsible for verifying that the closing agent received the funds from the donor for the amount of the gift, and that the funds were from an acceptable source.

5.B.5.a, Gift Letter Requirement

The lender must document any gift funds through a gift letter, signed by the donor and borrower. The gift letter must

- show the donor’s name, address, telephone number
- specify the dollar amount of the gift, and state
- the nature of the donor’s relationship to the borrower, and
- that no repayment is required.

5.B.4.j, Lender Responsibility for Ensuring That Downpayment Assistance Provider Is a Charitable Organization

The lender is responsible for ensuring that an entity providing downpayment assistance is a charitable organization as defined by Section 501(a) of the Internal Revenue Code (IRC) of 1986 pursuant to Section 501(c) (3) of the IRC.

One resource for this information is IRS [Internal Revenue Service] Publication 78, *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986*, which contains a list of organizations eligible to receive tax-deductible charitable contributions.

5.C.1.b, Secondary Financing Documentation Requirements

The lender must obtain from the provider of any secondary financing, and include in the endorsement binder documentation showing the amount of funds provided to the borrower for each transaction, and copies of the loan instruments

HUD Handbook 4155.2

9.A.1.b, Types of Lender Monitoring Tools

HOCs [Homeownership Centers] monitor the performance of lenders by

- conducting on-site and remote lender reviews
- conducting post endorsement technical reviews (PETRs) of insured loans
- analyzing Mortgagee Performance Reports and Underwriting Report System (URS) reports available through FHA Connection (FHAC)
- analyzing default and claims data from Neighborhood Watch Early Warning System reports available through FHAC
- following up on construction complaints or consumer complaints, and
- sharing information among themselves, FHA Headquarters, and the Mortgagee Review Board (MRB).

9.B.1.a, Post Endorsement Technical Reviews (PETRs)

FHA performs a post endorsement technical review (PETR) on selected cases to evaluate the risk that loans represent to FHA's insurance funds, and lender's compliance with FHA's underwriting requirements, and documentation requirements

Mortgagee Letter 2013-14 – Superseded on September 14, 2015 by HUD Handbook 4000.1
Minimum Cash Investment and Secondary Financing Requirements – Acceptable Documentation for Funds Provided by Federal, State, or Local Governments, their Agencies or Instrumentalities.

To establish that the Government Entity provided the borrower's required Minimum Cash Investment in a manner consistent with HUD's Interpretive Rule, the mortgagee [lender] must document that the Government Entity incurred prior to or at closing an enforceable legal liability or obligation to fund the borrower's required Minimum Cash Investment.

Mortgagee Letter 2014-08 – Superseded on September 14, 2015 by HUD Handbook 4000.1
This Mortgagee Letter clarifies whether nonprofit organizations assisting with a government entity's secondary financing program require HUD approval and placement on the Nonprofit Organization Roster.

Where a government entity uses a nonprofit to assist in the operation of the government entity's secondary assistance programs, HUD approval and placement on the Nonprofit Organization

Roster are not required so long as there is a documented agreement that (1) the functions performed are limited to the government entity's secondary financing program and (2) the secondary financing legal documents (Note and Deed of Trust) name the government entity as the Mortgagee.

Quality Assurance Division Desk Guide (August 2009)

Scope of Review - While QAD's [Quality Assurance Division] methodology for selecting a lender includes two approaches, targeted and random; the type of the review is determined by the magnitude of the risk factors and the scope of the lender's operations.

- Comprehensive monitoring is a review of numerous aspects of a lender's operations, including an analysis of a lender's complete loan portfolio and dealing with all aspects of the wholesale, retail, QC [quality control] and servicing departments. This review can maximize QAD's resources and may require coordination if it will involve multiple monitors.
- Main Office and Branch Office monitoring is a review of a lender's main office or branch office and its operations. This type of review is performed when a lender's major focus is origination, sponsorship, or servicing activities, or when a particular branch office (direct lending) is targeted. Main office monitoring may require coordination between the HOCs, depending on the magnitude of the review and the number of monitors involved.