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

July 26, 2016

The Honorable Jeb Hensarling
Chairman
House Committee on Financial Services
House of Representatives
Washington, DC 20515

Dear Representative Hensarling,

I am writing in regards to an issue that I wish to inform the Congress pursuant to my duty to report as it relates to serious problems, abuses or deficiencies in the administration of agency programs and operations. Through a series of audits, the Department of Housing and Urban Development's Office of Inspector General (HUD OIG) has learned of a funding arrangement for down payment assistance to Federal Housing Administration (FHA) borrowers which we believe violates the National Housing Act regarding prohibited sources for down payment assistance. In addition, the costs to the borrower far exceeds the down payment, negatively affects the borrower, and makes these loans a risk to the FHA insurance fund[1]. By HUD's own estimate, this affects some 60,000 FHA loans each year.

After issuance of the first and then subsequent similar audits, the OIG had attempted for a period of time to resolve the findings and recommendations in this matter with the Department to no avail. HUD has failed to recognize disturbing parallels to the seller-funded down payment assistance arrangements practiced in the late 1990's to 2008 which caused wide-scale problems to the program and whose reverberations are still felt today. In the last two weeks, there have been some noted developments regarding the Department's position that will be discussed later in the letter.

The Premium Interest Rate Down Payment Assistance Trap

In April 2014, HUD's Santa Ana Homeownership Center, Quality Assurance Division (HOC) self-initiated a referral on a FHA lender to the OIG's Office of Investigations, highlighting deficiencies related to down payment assistance gifts, including 1) the lender permitted down payment 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.[2] The HOC noted in the referral that the approach utilized violated HUD regulations and

[1] The insurance fund at issue in this matter is formally known as the Mutual Mortgage Insurance Fund.

[2] Premium pricing is a strategy offered by lenders to qualified borrowers through which a lender credit may become available by charging a higher interest rate. That lender credit is then applied to reduce the closing costs for the

policies in effect at the time.[3] Based on the referral, OIG identified two FHA lenders for review: Nova Financial and Investment Corporation (NOVA) and LoanDepot LLC.

During the course of three audits, HUD OIG learned that both NOVA and LoanDepot had entered into tri-party agreements among the FHA lender, a Housing Finance Agency (HFA) and U.S. Bank, a Ginnie Mae issuer.[4] These agreements were part of a program in which the Housing Finance Agency would provide down payment assistance in a grant or loan to the borrower. The FHA mortgagee would provide the primary financing to the borrower in the form of an FHA-insured loan. Upon origination, the FHA loan would be sold to U.S. Bank, which would securitize the mortgage loan through a Ginnie Mae security and service the mortgage.

Although not parties to the FHA loan, the Housing Finance Agency and U.S. Bank required the FHA lender to inflate the interest rate on the loan.[5] The HFA providing the down payment assistance and U.S. Bank had previously determined what interest rate above the market interest rate would be necessary on the FHA loan to net a premium payment from the investor when the loan was securitized. The HFA, U.S. Bank and the FHA mortgagee agreed that the premium payment would reimburse the HFA for the down payment and pay other program related fees. The increased interest rate was up to 1.5% above the market rate for FHA loans (e.g., 4.5% for Housing Finance Agency down payment assistance versus 3% for non-assisted FHA loans). The HFA, U.S. Bank and the FHA mortgagee also agreed to charge the borrower additional securitization, administration and tax fees as part of the origination, totaling $300-$600, that would not otherwise have been paid on the lower interest rate mortgage.[6] Borrowers seeking down payment assistance from the HFA were directed to a "participating" FHA lender for their FHA loan. To our knowledge, the borrower was not informed that they could receive a lower rate and could avoid these additional fees with down payment assistance from another source.

In our review, we determined that U.S. Bank has similar agreements with FHA mortgagees and Housing Finance Agencies around the country. U.S. Bank's 2014 annual report

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loan. Thus, "premium pricing" is offered as a perk or incentive to qualified borrowers. In the context of FHA-insured mortgages, HUD allows premium pricing when it is used by the lender in the traditional manner (i.e. to cover closing costs and prepaid items) but prohibits its use to provide down payment assistance.

[3] Specifically, the HOC relied upon 24 C.F.R. Part 203, HUD Handbook 4155.1, Sections 5.B.4.a, 5.B.4.b, 5.B.4.c, 5.B.4.d and HUD Handbook 4155.1, Sections 5.A.2.i, 5.A.2.j, 5.B.4.a and Mortgagee Letter 09-53. The HOC also referenced the Interpretive Rule issued by HUD OGC in December 2012 indicating that the HOC considered the Interpretive Rule in its determination to refer the matter to the OIG for any action the OIG deemed appropriate.

[4] U.S. Bank operates these programs through its Mortgage Revenue Bond Program (MRBP). See http://www.mrbp.usbank.com.

[5] At times some Housing Finance Agencies utilized investment banks to determine the interest rates and negotiate the process.

[6] The securitization fee was passed through to U.S. Bank, and was listed on the HUD-1 under various names including "bond transfer fee," "bond program fee," and "to be announced application fee." The tax fee was also paid to U.S. Bank.

indicated that FHA loans in these programs may total over $19 billion and may amount to as much as 1/3 of its government portfolio.

The Statutory Prohibition and HUD's Interpretation

To qualify a mortgage for FHA mortgage insurance, section 203(b)(9)(A) of the National Housing Act (12 U.S.C. 1709(b)(9)) requires the homebuyer to pay "in cash or equivalent on account of the property an amount equal to not less than 3.5 percent of the appraised value of the property." However, section 203(b)(9)(C)[7] of the National Housing Act (NHA) provides that no part of this required minimum investment may comprise funds provided by the seller of the property or any other person or entity who benefits financially from the sale of the property, or any person reimbursed by any such person or entity.

Section 203(b)(9)(C) of the NHA 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).*

In 2012, HUD interpreted § 203(b)(9)(C) as not prohibiting FHA from insuring mortgages originated as part of the homeownership programs of Federal, State, or local governments or their agencies or instrumentalities when such agencies or instrumentalities also directly provide funds toward the required minimum cash investment.[8] Specifically it concluded that "...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 and instrumentalities in connection with their respective homeownership programs."[9] Nowhere, however, does this interpretive rule suggest that the Housing Finance Agency may inflate the cost of the FHA loan to the borrower to reimburse itself indirectly from the FHA loan. Rather, the interpretive rule referenced funding through mechanisms such as housing bonds, low-income housing tax credits, HOME program funds, and other Federal and State resources – which are entirely separate from the FHA loan transaction.

In 2013, HUD expounded further on Housing Finance Agency down payment assistance in Mortgagee Letter 2013-14. That guidance permitted the FHA mortgagee to advance down

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[7] §2113 of the Housing and Economic Recovery Act of 2008 (HERA) amended §203(b) of the NHQA.

[8] See, 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.

[9] See, Interpretive Rule, Docket No. FR-5679-N-01 (December 5, 2012); ML 2013-14; August 11, 2015 OGC Opinion to the Principal Deputy Assistant Secretary for Housing, Permissible Source of Funds for Government Entities Down Payment Assistance Programs.

payment assistance to the borrower in the FHA transaction, where the HFA had demonstrated a legal obligation to provide the assistance and would reimburse the FHA mortgagee.

OIG does not object to these interpretations as written; they are not inconsistent with the plain language of the statute. The statute does not prohibit down payment assistance per se, or exclude Housing Finance Agencies from providing down payment assistance. In addition, these interpretations reiterate that the statutory prohibition applies to "any other person or entity that financially benefits from the transaction, or from any person who is reimbursed by any prohibited source."[10] The Mortgagee Letter also notes that "All other requirements applicable to secondary financing transactions remain in full effect, including the requirement that such financing comply with the prohibited source provisions if such financing will be providing the borrower's required Minimum Cash Investment."[11] The DPA that the mortgagee provides "on behalf of HFA" is reimbursed by U.S. Bank when it purchases the loan. U.S. Bank is subsequently reimbursed from the sale of related mortgage backed securities and the HFA participates in the transaction in name only. Mortgagee Letter 2013-14 avoids HUD review by removing the requirement to document the actual funding trail. [12]

I also note that during the pendency of the OIG NOVA audit process, FHA initiated and significantly changed its Handbook provisions applicable to down payment assistance. This was accomplished when multiple Handbooks were combined into one comprehensive Handbook, Handbook 4000.1. During this merging effort, FHA made significant core changes to the "new" handbook provisions addressing down payment assistance. A comparison of the Handbook 4155.1 provisions in effect during the audits to the "new" provisions reveals profound changes in policy which, in essence, appeared to make what problems we found arguably appropriate. These changes, which were included in hundreds of pages, were not flagged as a policy change as is general protocol and would then have been submitted for a more agency-wide review. The practical and actual effect was to deprive the OIG of the opportunity to raise concerns regarding the significant policy changes particularly as an audit was in process. The issue of FHA's failure to properly follow departmental clearance protocols for its programs, policies and operations in this matter, as well as others, will be discussed in an upcoming audit to be released in the near future.

HUD's Management Decision

On May 25, 2016, the Department issued its decision regarding our disagreement over Housing Finance Agency down payment assistance and premium pricing audit findings which arose from OIG's audit of NOVA. HUD adopted the conclusion of an OGC opinion and asserted that - because the proceeds came out of the secondary market transaction, the borrower signed no separate security instrument for the down payment, and the borrower could have refinanced out of the FHA mortgage without a penalty - there was "no expectation of repayment of the down payment assistance." However, it is clear from the documentation that the

[10] See M.L. 2013-14, p.2.

[11] See M.L. 2013-14, p.5.

[12] See M.L. 2013-14, p.4.

origination and securitization of the loan through Ginnie Mae was preprogrammed by agreements with U.S. Bank, the FHA originating mortgagee, and the Housing Finance Agency to net funds to reimburse the down payment and that the borrower paid a higher cost to make that happen. In other words, for a borrower to get the HFA's down payment assistance as part of this specific program, the borrower had to accept the higher interest rate mortgage. The higher interest rate charged to the borrower in these programs would not have been required had the borrower received the down payment assistance from another source.

HUD's generic reference to "sale of mortgages on the secondary market" as a source of HFA funding and its refusal to look at the source of HFA funding is problematic. The statute prohibits parties that financially benefit from the loan origination transaction, whether directly or using third parties as intermediaries, from providing the minimum investment. Even under a narrow reading of the prohibition, U.S. Bank benefitted from the primary market transaction, charging fees to the borrower for its participation and later reimbursing the Housing Finance Agency that advanced the down payment assistance, through securitization proceeds. The "securitization fee" charged to the borrower and passed back to U.S. Bank is, to our knowledge, unique to this funding scheme, although nearly every FHA loan is securitized through Ginnie Mae issuers. In this case, it potentially unfairly allows U.S. Bank to gain a fee that is not universally applied in other FHA transactions. The FHA lender also benefits from the transaction through its origination fees, and its sale of the mortgage to U.S. Bank results in indirect reimbursement to the Housing Finance Agency.

But HUD's determination has larger implications. A Ginnie Mae issuer is perforce an FHA-approved mortgagee. Yet, U.S. Bank could not have originated these loans directly and reimbursed the Housing Finance Agency without running afoul of the statutory provision. HUD's decision allows a FHA lender to avoid the statutory prohibition by funneling the process through another FHA lender who is also a Ginnie Mae issuer. It opens the door to future circumvention by allowing FHA lenders who are Ginnie Mae issuers or who collaborate with Ginnie Mae issuers to bury additional costs in the FHA loan transaction which can be passed through to the securitizer and cashed out in the secondary market. It also opens the door to Ginnie Mae issuers using the origination transaction to generate fees for themselves.[13]

The Cost to the Borrowers and to FHA

In addition to the legal violation, these transactions represent significant increased cost to borrowers and related risk to the FHA insurance fund. To illustrate the real cost to the borrower, the following is a comparison of costs for a $150,000 mortgage without, and with, a $3,000 down payment assistance (DPA) grant.

[13] A review of the Ginnie Mae Mortgage Backed Securities Guide, at http://ginniemae.gov/doing_business_with_ginniemae/issuer_resources/MBSGuideLib/Chapter_06.pdf, makes clear that there is no loan level borrower or issuer fee that corresponds to the securitization fee charged to the borrower at closing.

Without a $3,000 DPA grant:

-	Baseline market rate of:	**3.25%**
•	Monthly P&I =	$ 652.81
•	Annual P&I =	$ 7,833.72
•	Total Interest for 6 years* =	$27,430.10
•	Borrower's Equity at the end of 6 years:	$19,572.18
•	Total Interest for 30 years =	**$85,011.41**

With a $3,000 DPA grant:

-	Interest Rate:	**4.5%** (+1.25% premium)
•	Monthly P&I =	$ 760.03
•	Annual P&I =	$ 9,120.36
•	Total Interest for 6 years* =	$38,429.74
•	Borrower's Equity at the end of 6 years:	$16,292.27
•	Total Interest for 30 years =	**$123,610.07**

*Six years is the weighted average expected life of the loan per U.S. Bank's 2014 annual report.

Additional Cost to Borrower with a $3,000 DPA grant in a 6-year and 30-year scenario:

Additional Interest Cost after 6 years:	$10,997.64
Reduced Equity after 6 years:	$ 3,279.91
Total 6-year cost for assistance:[14]	$14,277.55
Total 30-year cost for assistance:	$38,586.66

In many instances the affected borrowers were not provided any notice of this, and OIG did not see evidence of the same during the audits. It does not appear that borrowers were notified by any direct or indirect beneficiary to the transaction they could get a lower interest rate if the down payment assistance was from a source other than the funding scheme. The borrowers in these instances do not benefit financially from the transaction. In fact, they are burdened with a higher monthly payment for the life of the loan.[15] While it is true a borrower becomes a homeowner in part through the down payment assistance programs and is no longer a renter, the arrangement involving this iteration of the Housing Finance Agency down payment

[14] Some borrower-financed down payment assistance programs provided loans rather than grants. If the example were based on a loan requiring repayment, the total cost would increase by $3,000 plus interest.

[15] Although the sales price is not increased in this instance, the homebuyer is subjected to unreasonable additional fees and is required to finance the so-called DPA "gift" through an inflated interest rate. Under no reasonable definition should this be a gift.

assistance places the borrower and the FHA at undue risk of loan failure as HUD has historically experienced in like scenarios at earlier times.

An increased risk of default creates a greater risk to the FHA insurance fund. The risk aspect of this program is already known by FHA. In a recent posting by Principal Deputy Assistant Secretary Edward Golding commenting on the Department's decision, risk is specifically highlighted by HUD as an ongoing concern of the Housing Finance Agency down payment assistance programs. Mr. Golding admits that HFA down payment assistance loans can carry greater risk. The posting further states that HUD continuously monitors risk and is "exploring additional steps we [HUD] can take to improve performance specifically in down payment assistance programs."

HUD has been down this road before with precarious down payment assistance programs. Specifically, these admitted risks are akin to those identified by HUD regarding seller-funded down payment assistance which was prevalent in the late 1990's until Congress passed the Housing Economic and Recovery Act (HERA) in 2008 that amended the National Housing Act to address growing FHA Mutual Mortgage Insurance Fund (MMIF) liquidity issues caused in significant part to the defaults of these then seller-funded DPA loans. These programs involved seller payments to a third party who provided down payments to the borrowers. HUD determined that the seller had inflated the sales price when providing these payments, which corresponded with the down payments provided to the borrower. HUD initially permitted funding by these third party groups resting on the notion that because the seller did not directly make the down payment, its later reimbursement through a third party was irrelevant. As the damage from these loans to borrowers and HUD became clear, particularly highlighted after many years of OIG and GAO reviews, HUD tried to reverse course and repeatedly tried to close down the program.[16] A review of HUD's own statements as noted in these court decisions is instructive:

> ...HUD essentially discussed two distinct negative outcomes it associated with seller-funded DPA: one directed at the consumer and one directed at HUD (and, specifically, the MMIF). With regard to harm to consumers, HUD stated that seller-funded DPA leads to sales price inflation, causing home buyers to pay above-market mortgage payments. This consequence remains even if the loans originating from seller-funded DPA do not present any added risk to HUD. [Footnote omitted] With regard to harm to itself, HUD noted that loans relying upon seller-funded DPA do, in fact, present an added risk to HUD, as they categorically perform worse than other loans. Nehemiah Corporation of America v. Alphonso Jackson, 546 F.Supp 2d 830, 841 (2008)

It is easy to see the correlation between "causing home buyers to pay above-market mortgage payments" stated above and the effect of increased payments caused by adding an interest rate premium in the case at hand. HUD's prior action initially stalled correction of the

[16] In addition, the GAO conducted an in-depth study of down payment assistance and generally noted the same concerns HUD and the OIG were recognizing while seller-funded DPA type programs were operating. The GAO report also noted concerns with non-seller funded down payment assistance in that they too were far more likely to default than loans without down payment assistance. Even the loans with non-seller down payment assistance performed worse than loans not receiving down payment assistance. GAO-06-24

problem at a timely point and ultimately required HUD to obtain a legislative fix – the 2008 HERA – which in plain language prohibits these payments not just from the seller but from any interested party or person reimbursed by the interested party.

It is exactly these types of risks, to the borrowers and to the health of the overall FHA's Fund which taxpayers rely on, that compel me to now raise these concerns. A repeat of the history regarding borrower risk and risk to the FHA must be avoided. It appears that the specific down payment assistance funding arrangements highlighted in the audits creates even more significant economic disparity over time since the borrower is burdened with a higher interest rate for the life of the loan.

As highlighted earlier, FHA Principal Deputy Assistant Secretary Golding estimates that over 60,000 FHA loans are originated per year using down payment assistance provided by Housing Finance Agencies under these borrower-reimbursed funding arrangements, in violation of the statutory prohibition. I raise this issue in order to highlight potential threats to borrowers, to the FHA's MMIF, and to the public fisc. I wish to reiterate that it is not down payment assistance programs that move me to send this letter. It is the specific funding mechanism exploited by the parties to these funding agreements which violate the plain language of the HERA and adversely affect the FHA-insured loans of participating borrowers who may have unknowingly been steered into these arrangements. Recently, however, I have been engaged in discussions with the Department that have forwarded their previously deadlocked commitment to potentially resolving this issue.

I noted earlier that prior to sending this letter, we made audit resolution attempts over a period of time. We had countless meetings and discussions with Office of General Counsel staff and the Deputy Secretary in an attempt to draw their attention to this issue and to our concerns over the last year. An opportunity to submit the legal issue that OIG and HUD disagree on to the Department of Justice, Office of Legal Counsel for an independent review was also suggested and rejected. Moreover, during the last few weeks it has become clear to us that the legal analysis supporting the continuation of this program was based on a concept and not the actual facts brought to light in the audit. The consequences of this revelation were that the program continued unabated and the issues at hand were never truly addressed. In recent days, through the involvement of the Secretary and his staff, we have been able to take some steps forward. The Deputy Secretary made a public statement released by the FHA Principal Deputy Assistant Secretary earlier this week regarding a wish to clarify the Department's earlier legal opinion, management decision, and FHA statement and that it will look into inappropriate practices of concern to the IG. We await their expeditious review and how this clarification will be fashioned. As an independent and objective reviewer of the facts, we strive to enhance program integrity with a shared commitment to improving operations and effectiveness and to reducing fraud, waste, and abuse. It is our goal to work with the head of this Department and with the Congress to improve program management.

Please contact my congressional liaison, Kathleen Hatcher, at khatcher@hudoig.gov, should you have any questions.

Sincerely,

David A. Montoya
Inspector General

cc: The Honorable Maxine Waters
Ranking Member

Attachments
NALHFA Letter 12.06.2011
Interpretive Rule 2012
Mortgagee Letter 2013
Santa Ana Homeownership Center Referral to OIG
OGC Opinion 2015
U.S. Bank MRBP Agreement