I. HOW FHA INSURANCE WORKS

1. Federal Housing Administration
   a. **Origin**: The Federal Housing Administration (FHA) was established by the National Housing Act of 1934, in the aftermath of the Great Depression, and became part of HUD in 1965.

2. FHA Insurance generally.
   a. **Role of Mortgage Insurance**
      i. The Federal Housing Administration (FHA) insures home mortgages made by private lenders against the possibility of borrower default. If the borrower does not repay the mortgage, FHA pays the lender the remaining principal amount owed plus fees and allowed costs.
      
      ii. By insuring lenders against the possibility of borrower default, FHA is intended to expand access to mortgage credit to households, such as those with smaller down payments or below-average credit histories, who might not otherwise be able to obtain a mortgage at an affordable interest rate or at all.
   
   b. **Role of FHA Insurance on the mortgage market**
      
      i. FHA also traditionally plays a countercyclical role in the mortgage market. In other words, it generally insures more mortgages during periods when lenders and private mortgage insurers tighten their lending standards and reduce activity in response to market conditions, and it generally insures fewer mortgages at times when lenders and private mortgage insurers make mortgage credit more easily available.

   c. **Basic FHA Insurance Eligibility**
      
      i. To be eligible for FHA insurance, borrowers and mortgages must meet certain criteria, and lenders must be approved by FHA. FHA charges borrowers upfront and annual fees, known as mortgage insurance premiums, for the insurance.
ii. FHA-insured loans are generally obtained by homebuyers who might find it difficult, or more expensive, to obtain a mortgage in the absence of insurance.

d. Advantages of FHA Insurance
   
   i. Lower Down Payment
      
      1. FHA-insured mortgages have lower down payment requirements than most conventional mortgages. (Conventional mortgages are mortgages that are not insured by FHA or guaranteed by another government agency, such as VA or USDA.) FHA will insure mortgages with down payments as low as 3.5%.
      
      2. Because saving for a down payment is often the biggest barrier to homeownership for first-time homebuyers and lower or moderate-income borrowers, the smaller down payment requirement for FHA-insured loans may allow these types of households to obtain a mortgage earlier than they otherwise could.

   ii. Less Stringent Credit Requirements
      
      1. Likewise, FHA-insured mortgages also have less stringent requirements related to credit history than many conventional loans. This might make FHA-insured mortgages attractive to borrowers without credit histories or with weaker credit histories, who would either find it difficult to take out a mortgage absent FHA insurance, or may find it more expensive to do so.

   iii. Higher Risk Loans.
      
      1. Mortgages with smaller down payments or made to borrowers with weaker credit histories are generally considered riskier than mortgages made to borrowers with higher down payments and stronger credit histories. Therefore, in the absence of some kind of insurance, lenders might be unwilling to offer mortgages to
these borrowers, or would charge higher interest rates to compensate for the increased risk that might be more than many of these borrowers could afford.

2. By insuring the lender against the possibility of borrower default, mortgage insurance is intended to make lenders more willing to offer affordable mortgages to these borrowers.

3. FHA-insured mortgages and subprime mortgages may appeal to some of the same pool of borrowers. However, FHA-insured mortgages are prohibited from carrying the full range of features that many subprime mortgages could carry. For example, FHA-insured loans must be fully documented, and they cannot include features such as negative amortization. (FHA mortgages can include adjustable interest rates.)

3. **Claims on defaulted loans.**
   
   a. **Claims Process**
   
   i. When an FHA-insured mortgage goes to foreclosure, the lender files a claim with FHA for the remaining amount owed on the mortgage.
   
   ii. There are seven different types of claims in the Single Family Program:
   
   1. **Conveyance** - The mortgagee obtains the property through foreclosure or by deed-in-lieu after mortgage default and deeds the property to HUD.
   
   2. **Assignment** - The mortgagee, with HUD approval, assigns a mortgage in default to HUD, and HUD becomes the mortgagee.
   
   3. **Automatic Assignment Under Section 221 (g)(4)** - Mortgagors may elect to assign certain mortgages to HUD. These mortgages must not be in default on the 20th anniversary and the election to assign must be made before the 21st anniversary. Upon assignment, HUD becomes the mortgagee.
4. **Coinsurance** - Certain FHA approved mortgages are coinsured. The mortgagee acquires a property after default and sells it rather than conveying or assigning. Any loss on the sale is shared by HUD and the mortgagee on a 90%:10% basis, respectively.

5. **Supplemental Claims/Remittances** - A supplemental claim is the only tool for mailing adjustments after payment of the initial claim has been made. Such adjustments are subject to strict time limitations and are made only when additional amounts are owed or due.

6. **Claims Without Conveyance of Title** - The property is sold at foreclosure and is not conveyed to HUD. Currently, this claim type is limited to claims involving deficiency judgments.

7. **Pre-foreclosure Sales** - Under certain circumstances the Department may provide relief to a mortgagor where the property's fair market value is less than the outstanding indebtedness. The terms of the sale and the minimum sales price are pre-authorized by the Department. If the sale is successful, a foreclosure is avoided and the mortgagee may file a claim to recover the shortage between the sales proceeds and the total indebtedness.

   iii. HUD incurs the expense of managing and marketing the foreclosed property until it is resold.

b. **Source of Funds for Paying Claims**

   i. Claims on FHA-insured loans have traditionally been paid out of an account, known as the Mutual Mortgage Insurance Fund (MMI Fund) that is funded through fees paid by borrowers, rather than through appropriations.
ii. **Mortgage Insurance Premium (MIP)**

1. MIP calculations vary depending on the loan amount, LTV of the loan (less than and equal to 95% or greater than 95%) and the duration/maturity of the loan (less than and equal to 15 years or greater than 15 years). See MLs 11-10, 12-04, 13-04, 15-01.

2. Annual
   a. Prior to April 18, 2011, the annual MIP was 0.85% or 0.90% of the loan amount paid monthly (1/12th)
   b. On April 18, 2011 it was increased to 1.10%/1.15%
   c. On April 9, 2012, it was increased to 1.20%/1.25%
   d. On April 1, 2013, it was increased to 1.30% and 1.35%
   e. On or after January 26, 2015, it was reduced to 0.80%/0.85%
   f. SF forward mortgages of 15 years or less and an LTV ratio of 78% or less, remained exempt from annual MIP until June 3, 2013 when FHA decided that those loans would pay annual MIP for 11 years
   g. For any mortgage involving a loan with an LTV of greater than 90%, FHA will assess the annual MIP until the end of the mortgage term or the first 30 years whichever occurs first. Previously, annual MIP was cancelled when a loan reached 78% LTV.

3. Upfront
   a. Prior to April 9, 2012, the Upfront MIP was 1.0% of the loan.
   b. On or after April 9, 2012, it was increased to 1.75% of the loan.
iii. If FHA were ever unable to pay claims that it owed, it can draw on permanent and indefinite budget authority with the U.S. Treasury to pay those claims without additional congressional action.

c. Depletion of the MMIF

i. In recent years, increased default and foreclosure rates, as well as economic factors such as falling house prices, have contributed to an increase in expected losses on FHA-insured loans. This increase in expected losses has put pressure on the MMI Fund and reduced the amount of resources that FHA has on hand to pay for additional, unexpected future losses. This has led to concern that FHA may need to draw on its permanent and indefinite budget authority for funds from Treasury to hold in reserve to pay for these higher expected future losses, or, eventually, to pay insurance claims.

ii. An annual actuarial review of the MMI Fund released in November 2012 showed that, according to current estimates, FHA does not currently have enough funds on hand to cover all of its expected future losses on the loans that it currently insures.

iii. As of October 2012, FHA reported that over 734,000 out of 7.7 million insured single-family mortgages (about 9.5%) were seriously delinquent, meaning that they were 90 days or more past due, in the foreclosure process, or in bankruptcy.

4. FHA Insurance compared to Conventional Private Mortgage Insurance (PMI)

a. Conventional mortgages with down payments of less than 20% are generally required to carry PMI. FHA insurance, therefore, can act as an alternative to private mortgage insurance.

b. Differences between FHA and PMI

i. Amount of Principal Insured. FHA insures the entire principal amount of the mortgage, while private mortgage insurance generally covers the amount of the mortgage that exceeds an 80% loan-to-value ratio (LTV).
ii. **Fees Charged for Insurance.**

1. PMI companies generally use a different fee structure than FHA, and often charge borrowers fees that vary based on features of the mortgage such as the loan-to-value ratio.

2. FHA charges most borrowers the same fees regardless of credit score or loan-to-value ratio, except that there is a slight difference in the annual premium charged to loans with LTVs above or below 95%.

iii. **Availability of Mortgage Insurance in Tight Credit Market.** Private mortgage insurance companies are more likely to tighten their standards or reduce the number of loans they insure during economic downturns, but FHA insurance generally remains available to qualified borrowers regardless of market conditions.

iv. **Income Requirements.** There is no income limit to qualify for an FHA-insured mortgage. There is also not a specific minimum income requirement, although FHA borrowers must be fully underwritten in accordance with FHA criteria to ensure that they are an acceptable credit risk and have sufficient income or assets to repay a mortgage. There is also a maximum mortgage amount that FHA will insure which is set in statute and varies by area, with a national ceiling that cannot be exceeded.

5. **FHA Lenders**

a. **Number of Lenders.** As of December 1999, about 10,000 lending institutions were approved to participate in FHA’s mortgage insurance programs for single-family homes.

b. **Direct Endorsement Lender Program**

i. **Abilities of an Approved FHA Lender.** Most FHA-approved lenders are authorized to originate FHA-insured loans, meaning that they can accept mortgage applications, obtain employment verifications and credit
histories on applicants, order property appraisals, and perform other tasks that precede the loan underwriting process.

ii. **Abilities of a Direct Endorsement Lender.** Approximately 2,900 of the FHA-approved lending institutions also have direct endorsement authority, meaning that they can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD’s prior review. Direct endorsement lenders may underwrite loans that either they originated or were originated by other lenders. Lenders with direct endorsement authority underwrite virtually all FHA-insured mortgages for single-family homes.

iii. **Mortgagee (Full-Eagle) vs. Correspondent (Mini-Eagles).** Mortgagees (Direct Endorsement Lenders) are also known as Full-Eagles because they perform any lender function on FHA loans. An FHA loan “correspondent” can only originate loans that are underwritten by their sponsoring mortgagee, and also are known as Mini-Eagles. A correspondent cannot underwrite, own or service FHA insured loans. They must use a mortgagee to sponsor them in an origination. Many banks become a Mini Eagle given expertise and accompanying staffing requirements necessary to become a Full Eagle, that imply minimum volumes to cover increased overhead costs.

iv. **Direct Endorsement Lender Eligibility.** FHA does have eligibility requirements to become an originator:

1. You must be a Corporation, LLC or partnership.
2. Must be a licensed Lender in a state.
3. Maintain a permanent office with at least two staff.
4. Must have one officer with three year’s experience.
5. No debarments or suspensions.
6. Must have a quality control plan.
7. Net worth and liquid assets requirements - $63M to be a loan correspondent (plus $25M per branch).
8. Please reference HUD Handbook 4060.1 for complete details on above requirements.
v. **Steps to becoming an approved FHA Lender**

1. Review all FHA General Requirements to determine the entity can be approved and maintain approval.
2. Complete audited financial statements in accordance with FHA requirements.
3. Verify the quality control plan has been implemented.
4. Complete the application and provide the necessary fee and exhibits using the Application Checklists.
5. Submit the application fee to the lockbox and submit the application to the appropriate Homeownership Center (HOC) office (may be done by a sponsor).
6. Receive approval from HOC.
7. Set up FHA Connection by requesting a password and ID from FHA.
8. Direct Endorsement lenders will coordinate a conference call with the HOC to discuss the next steps for DE.

vi. **Minimal qualifications and uneven standards.** HUD’s process for granting FHA-approved lenders direct endorsement authority—-the ability to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD’s prior review——provides only limited assurance that lenders receiving this authority are qualified. HUD’s guidance does not adequately define the level of proficiency that lenders must achieve in order to be granted direct endorsement authority. As a result, HUD’s homeownership centers have applied the guidance differently and have approved lenders that made multiple and serious underwriting errors.

vii. **Applying for FHA Insurance Endorsement as a DE Lender.**

1. **Application.** Under FHA-Single Family’s current insurance endorsement policy, a Direct Endorsement (DE) lender may apply for FHA insurance based upon its internal underwriting of the loan. During the closing process, most lenders log on to a Web-based application, FHA Connection (FHAC), to establish and update a case, log the appraisal, and complete the Insurance Application.
2. **Case Binders Sent to FHA HOC.** After the lender underwrites and closes the loan, lenders must submit information about the loan organized in a Case Binder in an FHA required stacking order. The FHA Case Binder is a subset of the lenders “loan file” and is sent to a HUD Home Ownership Center (HOC) where Reviewers and Endorsement Clerks check the paperwork to determine if the mortgage meets the eligibility requirements for insurance and that all required documents and signatures are present.

3. **HOC validation.** Then, HOC endorsement clerks validate data in the paper-based case binder against data stored in the computer system. If there is a discrepancy, the endorsement clerk may reject the binder and issue a Notice of Return (NOR) to the lender. If no problems are detected, the case is endorsed and the binder is sent to a HUD archive facility.

c. **Lender Insurance Program**

   i. **No need for prior approval from HUD.** The FHA-Single Family Lender Insurance (LI) program streamlines the process for obtaining FHA Insurance. Lenders that are authorized for LI can perform the endorsement functions themselves. LI Lenders are required to submit case binders on only a small percentage of the loans that they process.

   ii. **Program begins in 2006.** Prior to 2006, all FHA loans were submitted to one of HUD’s four Homeownership Centers (HOC) for the endorsement of the loan for insurance. HOC or contractor staff employed by the HOC would conduct a pre-endorsement review, and determine if the loan met basic FHA requirements necessary for endorsement. Under Lender Insurance mortgagees conduct pre-endorsement reviews and insure loans. Case binders are submitted to the HOCs for endorsement processing only when a severe case warning has been issued.
iii. **LI Program is expanding.** Over 700 mortgagees are currently participating in the Lender Insurance program and in any given month about eighty percent of all forward loans (all mortgages with the exception of Home Equity Conversion Mortgage loans) are being endorsed under the Lender Insurance program.

iv. **As program expands, HUD adds protections.** The program was expanded effective 2/24/2012 with new standards for initial and continuing eligibility and statutory authority for HUD to demand mortgagee indemnification in instances of fraud, misrepresentation or serious and material violations of HUD requirements.

v. **LI Eligibility.** Any lender wishing to participate in the LI program must apply using the FHA Connection Lender Insurance Certification Screen. Lenders must meet eligibility requirements. To be eligible for Lender Insurance, a mortgagee must have:

1. Unconditional Direct Endorsement approval and
2. A two year claim and default rate that does not exceed 150% of the two year claim and default rate for the states in which the mortgagee has underwritten loans.
3. Initial and ongoing eligibility for Lender Insurance is based on a comparison of a mortgagee’s previous two year claim and default rate to the two year claim and default rate for the state(s) in which the mortgagee has underwritten FHA-insured loans. Previously, a mortgagee’s claim and default rate was compared to the national claim and default rate, or to the state rate if the mortgagee underwrote loans in only one state.

vi. **HUD Monitoring.** The revised regulations for Lender Insurance provide for an ongoing review of Lender Insurance mortgagee performance. While these regulations permit more frequent review at HUD’s option, HUD will initially review Lender Insurance mortgagee performance on a
quarterly basis consistent with Credit Watch to determine continued eligibility for Lender Insurance. Previously HUD monitored a mortgagee’s Lender Insurance performance on an annual basis.

vii. **Electronic Case Binders.** Only LI lenders will be able to participate in the Electronic Case Binder program. When a lender participating in the Electronic Case Binder program submits a case binder, they do not submit paper based case binders. Instead, these lenders submit an electronic case binder containing scanned images of the final loan documents upon request from FHA.

6. **Monitoring Lender Performance & Catching Bad Lenders**

   a. **Loan Level Quality Assurance.**
      
      i. FHA loans can be denied insurance from the FHA if they determine that there is false documentation, misleading information, or any form of fraud or misrepresentation on the part of any of the parties involved.
      
      ii. If the mortgagee fails to meet a statutory or regulatory requirements, FHA also has the ability to reject insurance.

   b. **Lender Internal QC.**
      
      i. **Basic QC Plan.** HUD requires a quality-control program for each lender to include:
         
         1. conducting an on-site audit of all branch offices within 90 days of opening and annually thereafter;
         
         2. reviewing 10% of all closed loan files to ensure they were underwritten in accordance with HUD guidelines; and
         
         3. reviewing all early payment defaults (i.e., those defaults within the first six months).
      
      ii. **Must Report Serious Problems.** If, while conducting such quality controls, a DEL participant discovers any serious deficiencies, patterns of noncompliance, or fraud, the HUD handbook requires that the lender report such incidents, along with supporting documentation, to HUD.
c. **FHA Lender Initial Probation**

i. **Initial loans reviewed.** FHA-approved lenders seeking direct endorsement authority go through a probationary period during which they are required to demonstrate acceptable performance in underwriting at least 15 mortgage loans. The mortgages are submitted to and evaluated by HUD’s homeownership centers before the mortgages are finalized.

ii. **Initial loan underwriting adherence evaluated.** These evaluations rate as “good,” “fair,” or “poor” various aspects of the lender’s work, including its analysis of the credit risk posed by the borrower and the quality of the property appraisal. A “poor” rating indicates that the lender made underwriting errors that significantly increased HUD’s insurance risk.

iii. **Variation between HOCs.** While HUD’s guidance requires that lenders seeking direct endorsement authority demonstrate overall acceptable performance on these evaluations, the guidance is unclear on what constitutes “acceptable performance.” As a result, HUD’s homeownership centers have interpreted the guidance differently.

d. **Ongoing Monitoring.**

i. HUD’s homeownership centers use two monitoring tools to ensure lenders’ compliance with FHA’s lending requirements:
   1. on-site evaluations of lenders’ operations, known as lender reviews, and
   2. desk audits of the underwriting quality of loans already insured by FHA, known as technical reviews.

ii. HUD’s guidance stresses the importance of using risk analysis to allocate a larger share of monitoring resources to program activities that pose the highest risks to the Department. However, the
homeownership centers have not adequately focused their monitoring efforts on lenders and loans that pose the highest insurance risks.

iii. **Penalties.** To hold lenders accountable for program violations or poor performance, HUD may, among other things,

1. suspend their direct endorsement authority and
2. terminate their loan origination authority through its Credit Watch program, which is designed to hold lenders accountable for excessive defaults and insurance claims on FHA-insured mortgages.

iv. **Monitoring of loan default rates.** Credit Watch Termination Initiative holds single family mortgagees accountable for poorly performing loans that they originated or underwrote. This process is administered by the Quality Assurance Division (QAD) in FHA Headquarters (see 24 CFR 202.2 and 202.3(c)(2)).

v. FHA QAD compares the proportion of a mortgagee’s loans that became 90 days delinquent early in their term to the proportion of early defaults and claims on all insured loans. A mortgagee (or branch) with default and claim rates that are two or more times the average for a HUD Field Office jurisdiction may become ineligible to originate or underwrite further single family insured mortgages in that area. Before any restriction takes effect, a mortgagee will have an opportunity to present its analysis of the early defaults and claims, and conclusions about its accountability to FHA officials in Washington, DC.

e. **Mortgagee Review Board**

i. The Mortgagee Review Board (MRB) is empowered to take administrative action against FHA approved lenders that are not in compliance with FHA lending requirements. The Board reviews cases that are referred. The cases before the Board typically include cases involving lenders who knowingly and materially violate HUD/FHA
program statutes, regulations and handbook requirements. These lenders are subject to administrative sanctions by the MRB. For serious violations, the Board can withdraw a lender's FHA approval so the lender cannot participate in FHA programs. In less serious cases, the Board enters into settlement agreements with lenders to bring them into compliance. The Board can also impose civil money penalties, probation, and suspension and issue letters of reprimand.

ii. Some of the cases that are heard before the board include, but are not limited to:

1. Failure to implement and maintain a Quality Control Plan;
2. Failure to perform loss mitigation and service loans in accordance with requirements;
3. Source of funds issues regarding the borrower's down payment (e.g., improperly documented gift letters, insufficient funds to close, use of unacceptable source of funds, and improperly documented source of funds);
4. Questionable income, assets and liabilities of the borrower (e.g., failure to document discrepancies between the credit report and credit application);
5. Problems with appraisals (e.g., poor comparables, unsubstantiated value adjustments, unsupported values based on the information available, unreported physical deficiencies, "flip transactions" involving a recent change in ownership or a different owner than on the sales contract, and the same people involved in numerous transactions);
6. False statements and certifications;
7. Excessive mortgage payment to income ratios and debt to income ratios;
8. Inaccurate HUD-1 Settlement Statements (e.g., charging unallowable fees);

9. Failure to properly submit Mortgage Insurance Premiums to HUD;

10. Failure to comply with FHA's annual renewal requirements;

11. Improper branch operations (e.g., allowing employees to work for other lenders or real estate firms).

iii. List found here:

II. FHA UNDERWRITING GUIDELINES

FHA Underwriting

Sources: HUD Handbook 4155.1 for Mortgage Credit Analysis and HUD Handbook

Note: HUD Handbook 4000.1 will incorporate all previous handbooks into one complete handbook

1. Purpose of underwriting/Mortgage Credit Analysis is to:
   a. Determine a borrower’s ability and willingness to repay a mortgage debt to limit the probability of default and collection actions, and
   b. Examine the property offered as security to determine if it is sufficient collateral
   c. Limit collection actions or foreclosure.

2. 4 C’s of Credit
   a. Credit history
   b. Capacity to repay
   c. Cash assets available to close the mortgage
   d. Collateral

3. Loan Characteristics
   a. Loan Limits vary by the specific program under which the loan is insured
      i. Under 203(b) of the National Housing Act the mortgage limits may not
         1. Exceed 150% of the Freddie Mac national loan limit, or
         2. Be less than 65% of the dollar amount limitation of Freddie Mac
      ii. In High Cost Areas the loan limits may increase to 150% of the dollar amount limitation described under Section 305(a)(2) of Freddie Mac for a residence of applicable size. In these high cost areas, the loan limit is equal to the lesser of
         1. 115% of the area median house price, or
         2. The statutory ceiling for the high cost areas.
      iii. Section 214 of NHA provides mortgage limits for Alaska, Hawaii, Guam and the Virgin Islands may be adjusted up to 150 percent of the new FHA ceilings.
      iv. New York City is a high cost area
         1. One-Family: $625,500
         2. Two Family: $800,775
         3. Three Family: $967,950
         4. Four Family: $1,202,925
b. Maximum LTV ratios depend upon the type of borrower, refinance vs. purchase and stage of construction
   i. For Single Family (1-4 Unit) Purchase loans, the maximum LTV is 96.5% (credit score above 580) or 90% (credit score between 500-579).

c. Maximum Mortgage Term may not exceed 30 years from the date that amortization begins. FHA does not require that loan terms be in five year increments

d. Interest Rate.
   i. Lenders are permitted to charge a commitment fee to guarantee in writing, the interest rate and any discount points
   ii. Both Fixed rate and Adjustable Rate Mortgage (ARM) products allowed
   iii. ARMs
      1. FHA limits the initial interest rate adjustment and interest rate cap over the life of the loan.
      2. ARMs cannot represent more than 30% of all loans insured in a year by FHA and they let lenders know when they are close to reaching that limit
      3. ARMs are underwritten using the initial interest rate on the HUD 92900-A form unless it is a 1-year ARM where the LTV is 95% or greater, then lender must use initial rate plus 1% for underwriting
      4. There are required ARM disclosures and HUD has a model ARM Note.
      5. ARM loans must be fully amortizing
      6. ARM loans must use 1 year CMT (one-year treasury) or 1 year LIBOR for the loan index.
      7. ARM Interest rate adjustments must occur on an annual basis after the first adjustment

4. Approval Ratio Requirements
   a. The maximum Total Mortgage Payment to Effective Income (PTI) and Total Payments to Effective Income (DTI) ratios vary depending on credit score. Non-occupant co-borrower income may not be included.
   b. Credit Score 500-579 have a PTI of 31% and a DTI of 43 as maximum qualifying ratios and there are no compensating factors allowed if the credit score is below 580. These ratios also apply to borrowers without credit scores
   c. Credit score of 580 and above are held to the 31/43 ratios unless a compensating factor exists such as:
      i. 37/47 ratios if one of the following:
         1. Verified and documented cash reserves
2. Minimal increase in housing payment or
3. Residual income
   ii. 40/40 if no discretionary debt is present
   iii. 40/50 if two of the following:
         1. Verified and documented cash reserves
         2. Minimal increase in housing payment
         3. Significant additional income not reflected in Effective Income; and/or
         4. Residual income
   iv. Compensating factors are defined in Handbook 4000.1 starting page 200.

5. General Info on Mortgage Credit Analysis
   a. The credit report and verification forms cannot pass through the hands of the borrower, a real estate agent or any other interested third party
   b. The lender must verify the borrower’s identity and ask sufficient questions of the borrower to get a complete picture of the borrower’s financial position, source of funds for the mortgage transaction and intended use of the property.
   c. When a borrower is approved the Direct Endorsement underwriter records the results of the credit analysis on the HUD-92900-LT, FHA Loan Underwriting and Transmittal Summary and any modification of terms or approval conditions under “Underwriter Comments.”

6. General Documentation Standards
   a. All borrowers must sign Fannie Mae Form 1003, Uniform Residential Loan Application (URLA) and all addenda. Either the initial loan application or the final, if one is used, must contain the signature of all borrowers.
   b. The lender may ask the borrower to sign a general authorization form that gives the lender authority to verify information needed to process the application.
   c. Lenders may not have borrowers sign documents in blank, incomplete documents or blank sheets of paper.
   d. The mortgage loan application package must contain all documentation that supports the lender’s decision to approve the mortgage loan. When standard documentation does not provide enough information to support the approval decision, the lender must provide additional, explanatory statements that are consistent with the information in the application and must clarify or supplement the documentation submitted by the borrower.
   e. At closing, all documents in the application may be up to 120 days old or 180 days for new construction unless the nature of the documents is such that their validity for underwriting is not affected by the prescribed time frame (i.e. divorce
If the age of documents exceeds the limits, the lender must obtain updated written verification of the documentation.

f. Faxed documents must clearly identify the name of the employer or depository/investment firm and the source of information and the name, and telephone number of the individual at the institution for verifying the accuracy of the data.

g. Internet documents must clearly identify the name of the employer or depository/investment firm as well as the source of information. Additionally, Internet bank statements must provide the same information as a standard original statement including account holder, account number, detailed transaction history and account balance. Printed web pages must show the URL as well as the date and time of the print out, be derived from a website that has been verified by the lender to have existed and must be placed in the case binder.

h. The Technology Open To Approved Lenders (TOTAL) Mortgage Scorecard has been a successful tool for lender’s to more efficiently determine creditworthiness and FHA requires that all transactions be scored through TOTAL except transaction involving borrowers without credit scores or streamline refinances.

7. Required Documents for Mortgage Credit Analysis
   a. Fannie Mae Form 1003 Uniform Residential Loan Application signed and dated by all borrowers
   b. Form HUD-92900-A HUD/VA Addendum to Uniform Residential Loan Application
   c. HUD-92900-LT, FHA Loan Underwriting and Transmittal Summary
   d. Social Security Number Evidence
   e. Credit Reports for all borrowers who will be obligated on the mortgage note
   f. Verification of Deposit (VOD)
   g. Verification of Employment (VOE)
   h. Federal Income Tax Returns
   i. Sales Contract
   j. Real Estate Certification, if not contained within the purchase agreement, signed by the buyer, seller and selling real estate agent or broker
   k. Amendatory Clause, if not contained within the purchase agreement, signed by the buyer and seller.
   l. Verification of Rent or Payment History on Past/Previous Mortgages (direct verification from landlord or mortgage servicer, information on credit report, or the most recent 12 months of cancelled checks or receipts)
   m. TOTAL Scorecard Accept/Approve recommendation
8. **Detailed Documentation Requirements**

   **a. Social Security Number Evidence**
   
i. For each borrower
   
   ii. Validate each SSN either through
       
       1. Borrower/address verification screen through FHA Connection (FHAC)
       
       2. Examination of pay stubs, W-2 forms, valid tax returns obtained directly from IRS
       
       3. Use of a service provider with direct access to the SSA
   
   iii. Resolving if necessary any inconsistencies or multiple SSNs revealed during loan processing and underwriting

   **b. Credit Reports**

   i. Although acceptable credit is required, a loan cannot be rejected due to a lack of credit. In those cases, the file must document that the lender attempted to develop a satisfactory history of non-traditional credit.

   ii. **Traditional Credit**
   
       1. Two types of traditional credit reports are used
          
          a. Tri-merged credit reports (TRMCR)
          
          b. Residential Mortgage Credit Report (RMCR)
             
             i. This type is required when a borrower disputes ownership of accounts, that collections or judgments have been paid, or the balances are different than reported on TRMCR
          
     2. Red flags on credit reports:
          
          a. Whiteouts, erasures or alterations
          
          b. Mismatched personal information (SSN, residence, employment)
          
          c. All or most debts recently paid off without documented acceptable source of funds
          
          d. Check for duplicate records
          
          e. Possible non-applicant debt
          
          f. Unexplained recent inquiries
   
   iii. **Credit Scores**
   
       1. When a credit score is available, it must be used to determine eligibility
2. Loans with a credit score below 620 and a DTI in excess of 43% must be manually underwritten
3. Not eligible if the credit score is below 500. For scores between 500 and 579, loans are limited to 90% LTV (require 10% down payment). Score 580 or higher qualify for maximum financing, 96.5% LTV (3.5% down payment)

iv. Non-traditional credit
   1. These references must be documented carefully.
   2. Cannot be used to enhance the credit of borrowers with a poor payment history or to offset derogatory credit found on a traditional credit report such as collections and judgments.
   3. It is designed to assess the credit history for borrowers without types of trade lines that normally appear on a credit report.
   4. Sources of credit references include (but not limited to):
      a. Rental housing payments (info from landlord)
      b. Utility company references
      c. Insurance premiums not payroll deducted
      d. Child care payments made to businesses
      e. School tuitions

5. Other requirements:
   a. Should include a minimum of 3 sources and all must have a 12-month history
   b. No history of delinquent housing payments
   c. No more than 1 x 30 day late on a consumer debt
   d. No collection accounts or public records reporting filed in the past 12 months

v. Liabilities
   1. Get reported on Form 1003
   2. Co-signed accounts don’t have to be included if the primary obligor is paying satisfactorily in the past 12 months.
   3. Court-ordered assignment of debts don’t have to be include if you obtain the divorce decree and evidence of transfer of ownership
   4. Authorized user accounts don’t get included
   5. If a trade line indicates no monthly payment on an open account, then use 5% of balance of $10, whichever is greater
   6. Deferred student loans are not included if the deferment if is a minimum of 12 months from closing date
7. Leased payments (auto leases) should be included in DTI calculation

vi. Other issues
1. Chapter 7 bankruptcy is not a barrier if the discharge was at least 2 years ago and the borrower reestablished satisfactory credit
2. For Chapter 13, at least 1 full year has elapsed with satisfactory payment and the borrower has gotten court approval to enter the mortgage transaction
3. Foreclosure must not have occurred within the previous three years from the auction date (can be waived if it can be documented that it was out of the control of borrower (serious illness or death of a wage earner and the borrower has reestablished good credit, not divorce or inability to sell due to job transfer).
4. Short Sale – lots of conditions if didn’t default on loan. If SS came from default, follow foreclosure rule.
5. Defaulted student loans must be brought up to date and judgments must be satisfied or have a payment arrangement with evidence of payment for at least three months

c. Assets and Verification of Deposit (VOD)
i. Minimum Required Investment (MRI).
   1. Borrowers are required to invest at least 3.5% of their own funds into the loan transaction as well as have funds sufficient to close the loan. Funds may not include closing costs paid outside of closing. This is called the Minimum Required Investment (MRI).
   2. The lender may only consider assets from acceptable sources. Acceptable sources of funds to close include cash, savings, investment and retirement accounts, collateralized loans, secondary financing and gift funds. All funds to close must be verified by VOD or recent bank statements.

ii. Lender must obtain a written VOD and the borrower’s three most recent statements for all asset accounts to be used in qualifying to ensure there are enough funds to close the loan.

iii. Borrowers must explain and document any balance discrepancies (large increases or decreases), any NSF or overdraft protection usage as well as any recently opened account and source of funds.

iv. Earnest Money Deposit. For the earnest money deposit, if it exceeds 1% of the sale price, lender must obtain a cancelled check, a certification
from the deposit holder acknowledging receipt or a bank statement showing the average balance was sufficient to cover the amount of the earnest money deposit at the time of deposit.

v. Cash to Close

1. The difference between the total cost to acquire the property minus the total mortgage amount.
2. A lender may charge a reasonable origination fee and any customary and reasonable closing costs necessary to close the mortgage but the charges may not exceed the actual costs. A lender may charge discount points.
3. Closing costs include prepaid items like flood and hazard insurance, MIPs, real estate taxes and per diem interest and must comply with CFPB rules.
4. The Upfront MIP must be either entirely financed or entirely paid in cash, but not split.
5. Closing costs include purchase of personal property items (chattel), real estate agent fees, repairs or improvements not financed, and real estate tax credits.
6. The lender can apply Interested Party credits to the closing costs and prepaid items including any items POC. The refund of the items POC may be used toward the Borrower’s MRI if items POC are documented showing they were paid from the borrower’s own funds.

vi. Reserves

1. Were required just of 3-4 unit homes but after 4/21/14, required of 1-2 unit homes as well
2. For 1-2 unit properties, it must equal or exceed 1 month PITI and for 3-4 unit properties, it must be 3 months’ PITI.
3. Must be from borrower’s own funds and may not include gifts or funds from the loan transaction. This is a change from previous rules that allowed excess gift to be counted as reserves on loan for 3-4 unit properties.

vii. Source requirements

1. Interested Party Contributions. When the borrower’s MRI is provided by someone other than the borrower, the lender must obtain documentation to support the permissible nature of the source of those funds.
a. MRI funds cannot come from the seller of the property or any other person who financially benefits from the transaction (directly or indirectly) or anyone who will be reimbursed by the seller or anyone financially benefitting from the transaction. While funds to close may come from those sources, none of the borrower’s MRI can come from those sources.

b. A seller may contribute up to six percent of the lesser of the property’s sale price or the appraised value towards the buyer’s closing costs, prepaid expenses, discount points, and other financing concessions.

2. Gift funds.
   a. Gifts for MRI may be provided by a family member, employer or labor union, a close friend with a documented interest in the borrower, a charitable organization, a governmental agency or public entity that has a program providing homeownership to low or moderate income families or first-time homebuyers.
   b. Lender must document in a letter the donor’s name, address, and phone number, the relationship between the donor and borrower, the dollar amount and when the gift was given/will be given and language that certifies there is no repayment required.

3. Secondary Financing. Any financing other than the first mortgage that creates a lien against the property is considered secondary financing.
   a. Such financing is not considered a gift, even if it is a soft or silent second or has other features forgiving the debt, including not having a monthly repayment obligation.
   b. The lender must obtain documentation showing the amount of funds provided and the copies of the loan instrument.
   c. Secondary financing may be provided by a government agency or instrumentality, non-profit, private individual or organization and family members.
   d. NOTE: Government Agencies must comply with the following conditions:
i. The FHA-insured mortgage when combined with the second and any mortgages, gifts, grants, etc. cannot result in cash back to the borrower (except for documented POCs for appraisal/credit reports).

ii. The sum of all financing, Combined Loan-to-Value (CLTV) cannot exceed 100% of the acquisition cost (defined as sales price, borrower paid allowable closing costs, discount points, and pre-paid expenses and repair or rehab expenses).

iii. The required (total fixed) monthly payment cannot exceed borrower’s ability to pay.

iv. The source amount and repayment terms must be disclosed in the mortgage application.

d. Income and Verification of Employment (VOE)

i. Lender must obtain a Verification of Employment (VOE) and the borrower’s most recent paystub

ii. As an alternative to a written VOE, the lender may obtain the borrower’s original pay stubs covering the most recent 30-day period AND original IRS w-2 forms for the previous two years.
   1. The lender must also verify by telephone all current employers
   2. Include in the loan file a certification stating that all original documents were examined and the name, title and telephone number of the person with whom employment was verified. This verification must be signed and dated.
   3. All loans processed in this manner require a signed copy of IRS 4506, IRS form 8821 or a document appropriate for obtaining tax returns directly from the IRS.

iii. Additionally, the lender must obtain the most recent pay stub showing year-to-date earnings of at least one month and one of the following to verify current employment:
   1. A written VOE verbal verification of employment or
   2. Electronic verification acceptable to FHA

iv. Lender must verify the applicant’s employment history for the previous two years. The method of verification varies depending on if the applicant has been at the same or different employers over the previous two year and if there have been any employment gaps. Borrower must provide a written explanation of:
   1. Employment gaps
2. Frequent changes (more than three changes in 12-month period) in employment (should show increases in income)
3. Temporary reductions in income

v. Other sources of income that can be considered:
   1. Overtime- if it has been received for the previous two years and is likely to continue
   2. Seasonal employment- if the borrower has worked the same line of work for the past two years and is likely to be rehired
   3. Commission income- if the borrower has earned income for at least one year in the same or similar line of work
   4. If self-employed, lender has to obtain a year-to-date Profit & Loss statement and balance sheet if more than a calendar quarter has elapsed since date of most recent year-end tax return was filed
   5. SSD, SSI, VA Disability (award letters, bank statements, tax returns)
   6. Alimony, Child Support or Maintenance Income-(decree, agreements, court orders, bank statement deposits, can include voluntary agreements if you can show 12 months of cancelled checks, deposit slips or tax returns).
7. Military income
8. Section 8 Homeownership Vouchers & public assistance
9. Retirement income & pensions
10. Rental income (if a two to four unit building) or boarders
11. Investment income, Trust accounts and annuities

vi. Red Flags:
   1. Handwritten checks
   2. Round dollar amounts
   3. Inconsistent check numbers
   4. Different font types within the document
   5. Missing borrower and/or employer name as well as missing/inaccurate addresses on pay stub
   6. Personal information not in agreement with other documentation in the file (SSN)

e. Federal Income Tax Returns
   i. The lender must obtain federal income tax returns for the most recent two years including all applicable schedules
   ii. For self-employed borrowers and lender must get both individual and business tax returns unless individual tax returns show increasing income
over the past two years, the borrower is not rely on funds from the business accounts to close the loan and it is not a cash-out refinance.

iii. The lender must obtained signed IRS 4506, IRS 8821 for obtaining tax returns directly from the IRS

iv. Red flags:
   1. Handwritten tax returns prepared by a professional tax preparer
   2. Typed w-2s with computer generated pay stubs
   3. Unsigned and undated tax returns

f. Appraisal Rules
   i. Registered Appraisers
      1. The FHA Register lists appraisers who are eligible to perform FHA single-family appraisals. To conduct an appraisal for FHA insurance endorsement, the appraiser must be on the FHA Register
      2. To be eligible for placement on the FHA Register, all appraisers must be state-licensed or state-certified and must not be listed on any of these:
         a. GSA's Suspension and Debarment List (the government-wide list of parties excluded from federal procurement or non-procurement programs)
         b. HUD's Limited Denial of Participation List
         c. HUD's Credit Alert Interactive Voice Response System (CAIVRS)
      3. To be eligible to perform appraisals for FHA, the appraiser must also pass a HUD//FHA test on appraisal methods and reporting, which focuses on applied knowledge of the new Handbook 4150.2

ii. Appraisal intended for Lender and HUD. The appraiser is hired by the lender, and therefore has a contractual responsibility to the lender. However, the appraiser provides services for HUD programs, and therefore, has an obligation to perform these services commensurate with the standards and requirements of HUD. This dual responsibility of the appraiser is recognized in the review and reporting requirements of HUD. The lender and the appraiser must meet their respective obligations as prescribed by HUD/FHA. Therefore, the intended user of the appraisal report is also HUD.
iii. **Appraisal Report Must Contain:**

1. The appraiser must make a complete visual inspection of the subject property - interior and exterior - and complete the Valuation Condition (VC) form.
2. The appraiser must take photographs that show the sides, front and rear of the subject property and all improvements on the subject property with any contributory value. A photograph of the street frontage is also required.
3. The appraiser is required to submit a single photograph of each comparable sale transaction in the addenda to the appraisal report.

iv. **When Defects are found:**

1. When examination of existing construction reveals noncompliance with the General Acceptability Criteria, an appropriate specific condition to correct the deficiency is required if correction is feasible. If correction is not feasible and compliance can be effected only by major repairs or alterations, the lender will reject the property. The appraiser is only required to note conditions that are readily observable.
2. Required repairs are limited to those repairs necessary to preserve the continued marketability of the property and to protect the health and safety of the occupants.
3. A property with defective conditions is unacceptable until the defects or conditions have been remedied and the probability of further damage eliminated.
4. Defective conditions include:
   a. defective construction
   b. poor workmanship
   c. evidence of continuing settlement
   d. excessive dampness
   e. leakage
   f. decay
   g. termites
   h. other readily observable conditions that impair the safety, sanitation or structural soundness of the dwelling

v. **Valuation.**

1. As-Repaired Appraisal. The appraiser prepares the valuation "as-repaired" subject to the conditions noted on the VC form. Those
items not listed on the VC will form the basis of comparison to comparable properties for physical conditions.

2. Accurate and thorough appraisal reporting is critical to the accuracy of underwriting for the mortgage insurance process. The need for accuracy is greater for FHA-insured mortgages because buyers tend to have more limited income and lower equity in the properties.

3. There are three valuation approaches that can be used including sales comparison, cost and income approaches with detailed guidelines for each.

4. For the comparable approach, comps sale selection must be based on properties having the same or similar locational characteristics, physical characteristics and the priority the market assigns to each factor including design, appeal, style, age, size, utility, quality and condition. There are no requirements for how many comps must be included except in slow markets, there must be three within the last 12 months. The sales analyzed must be Arm’s Length Transactions unless REO and pre-foreclosure sales are so prevalent that Arm’s Length Transactions are not present.

   g. New Appraisal Rules (Draft)
      
i. The lender must review the appraisal and ensure that it is complete, accurate and provides a credible analysis of the marketability and value of the property.

   ii. The lender must also review the appraisal to determine if the subject property was sold within the 12 months prior to the case number assignment date and if violations of the restrictions on property flipping rule.

   iii. In addition to HUD guidance, the appraiser should comply with Uniform Standards of Professional Appraisal Practice (USPAP) when completing the appraisal.

   iv. Defective conditions

      1. The appraiser must identify defective conditions and provide photographic documentation of defective conditions in the appraisal report.

      2. The appraiser must identify defective conditions that require repairs to make the property comply with HUD’s MPR together with the estimated cost to cure. If the appraiser cannot determine that a property meets HUD’s Minimum Property
Requirements (MPR) or Minimum Property Standards (MPS), an inspection by a qualified individual or entity is required.

a. Examples of conditions that require an inspection include but are not limited to:
   i. Standing water against the foundation and/or excessively damp basements
   ii. Hazardous materials on site or within the improvements
   iii. Faulty or defective mechanical systems (electrical, plumbing or heating)
   iv. Evidence of possible structural failure (settlement or bulging foundation wall, unsupported floor joists, cracked masonry walls or foundation)
   v. Leaking or worn-out roofs.

b. The reason for or indication of a particular problem must be given when requiring an inspection.

9. **Underwriting the property**

   a. Lenders, including sponsoring lenders, are equally responsible, along with appraisers, for the quality, integrity, accuracy and thoroughness of appraisals. The lender will be held accountable if it knew, or should have known, that there were problems with the integrity, accuracy and thoroughness of an appraisal submitted to FHA for mortgage insurance purposes. Lenders that submit appraisals to HUD that do not meet FHA requirements are subject to the imposition of sanctions by the HUD Mortgagee Review Board (MRB). The lender must underwrite the completed appraisal report to determine if the property provides sufficient collateral for the FHA-insured mortgage. HH 4155.2

   b. All properties must meet HUD’s Minimum Property Requirements (MPR) found in the Single Family Handbook. New construction properties must also meet HUD’s Minimum Property Standards (MPS) found at 24 CFR 200.926d.

   c. If defective conditions exist and correction is not feasible, the lender must reject the property.

   d. When the appraisal report of inspection from a qualified entity indicated that repairs are required to make the property meet HUD’s MPR or MPS, the lender must comply with the repair requirements.

   e. If repairs for Existing Construction cannot be completed prior to loan closing, the lender may establish an escrow account in accordance with Repair completion escrow requirements, provided that the housing is habitable and safe for occupancy at the time of closing.
f. Repair escrow funds must be sufficient to cover the cost of the repairs or improvements.

10. **Automated Underwriting System (AUS) and Technology Open To Approved Lenders (TOTAL)**

a. Computer-based process that evaluates the borrower’s willingness to repay the loan (credit), ability to repay the loan (capacity) from information entered by the lender. Any lender automated underwriting software must be able to communicate with TOTAL and links the decision using the FHA case number.

i. There are three results from the TOTAL (Accept/Eligible, Accept/Ineligible and Refer). The underwriter must fully underwrite those applications with a Refer result. The underwriter must still underwrite all appraisals according to HUD rules.

ii. **Accept/Eligible** - The mortgage may be eligible for FHA insurance endorsement provided the lender has verified the data entered into the AUS as accurate and complete.

iii. **Accept/Ineligible** - The borrower’s credit and capacity would meet threshold approval but the mortgage does not comply the FHA’s eligibility requirements and the certificate will state what specific requirement is not met. The lender then has to determine if the reason for ineligibility can be resolved in a manner that complies with FHA guidelines.

iv. **Refer** - The underwriter must manually underwrite any mortgage application for which

v. **Conditions requiring a downgrade and manual underwriting:**

1. The mortgage file contains information or documentation that cannot be entered into or evaluated by TOTAL Mortgage Scorecard;
2. additional information, not considered in the AUS recommendation affects the overall insurability of the mortgage;
3. the Borrower has $1,000 or more collectively in Disputed Derogatory Credit Accounts;
4. the date of the Borrower’s bankruptcy discharge as reflected on bankruptcy documents is within two years from the date of case number assignment;
5. the case number assignment date is within three years of the date of the transfer of title through a pre-foreclosure sale (short sale);
6. the case number assignment date is within three years of the date of the transfer of title through a foreclosure sale;
7. the case number assignment date is within three years of the date of the transfer of title through a Deed-in-Lieu (DIL) of foreclosure;
8. only the non-occupying co-Borrower has a credit score;
9. the Mortgage Payment history requires a downgrade as defined in Housing Obligations/Mortgage Payment History;
10. the Borrower has undisclosed mortgage debt; or
11. business income shows a greater than 20 percent decline over the analysis period.
RULES LIMITING THE USE OF FHA-INSURED LOANS TO PURCHASE A FLIPPED PROPERTY

1. Property Flipping Rules\(^1\)
   
   a. **Generally:** Only owners of record can sell properties that will be financed using FHA-insured mortgages (the transaction cannot involve any sale or assignment of the sales contract).\(^2\)
   
   b. **90 Day Rule:** An FHA-insured mortgage loan may not be used to purchase a home 90 days or fewer after the date the seller purchased the home.\(^3\) (Potential waiver under certain circumstances—see below for more details).
   
   c. **91-180 Day Rule:** For a resale occurring in this timeframe in which the NEW purchase price is at least 100% MORE than the prior sales price, additional documentation is required.\(^4\)
      
      i. **Additional Documentation Required:** “An appraisal from another appraiser”—most likely means a second appraisal from a different appraiser. Lender may include documentation in file to support that increased value is the result of work done to property.\(^5\)
   
   d. **181 Day-12 Month Rule:** For resales occurring within this timeframe, FHA *may* require additional evidence of appraised value.\(^6\)

---

\(^1\) The property flipping rules apply to transactions involving “single-family properties”, which are defined as a 1-4 family dwelling designed primarily for residential use. 24 C.F.R. § 203.38.

Failure to comply with the property flipping rules “may result in HUD requesting indemnification of the mortgage loan” or other remedies under 24 C.F.R. part 25. There is no private right of action for mortgagors. 24 C.F.R. § 203.37a(d).

\(^2\) 24 C.F.R. § 203.37a(a)(1).

\(^3\) 24 C.F.R. § 203.37a(b)(2).

\(^4\) 24 C.F.R. § 203.37a(b)(3)(ii).

\(^5\) 24 C.F.R. § 203.37a(b)(3)(ii).

\(^6\) 24 C.F.R. § 203.37a(b)(4).
2. When did 90 Day & 91-180 Days Rules Go Into Effect?
   a. May 1, 2003

3. Waiver of 90-Day Rule
   a. For contracts entered into between February 1, 2010 and December 31, 2014, there is a waiver of the 90-Day rule, if the transaction qualifies (see below).\(^7\)
   b. Waiver was extended several times, through December 31, 2014. Waiver expired Dec. 31, 2014 & has not yet been renewed.

4. How to qualify for a waiver of the 90-Day Rule?\(^8\)
   a. Transaction must be arms-length. E.g.:
      i. If the seller is a business, not an individual, it was established and operates in accordance with state & federal laws;
      ii. No pattern of previous flipping (no multiple title transfers w/in a 12-month time-frame); and
      iii. Property marketed openly & fairly.
   b. If the sales price of the property is MORE than 20% above the seller’s purchase price, mortgagee must do the following:
      i. Obtain a second appraisal: Lender obtains a second appraisal or has enough documentation in the file to show the seller did enough renovation/repair/rehab work to the property to justify increase in price.
         1. If no work was done, appraiser needs to explain increase in property value;
         2. Appraiser:

---


\(^8\) 77 Fed. Reg. 71,099 (Nov. 29, 2012). The waiver does not apply to HUD reverse mortgages.
a. Must be on “FHA-roster”;
b. Borrower may not be charged for the second appraisal.

ii. Order a Property Inspection.

1. Must provide inspection report to purchaser before closing.
2. Inspection must include: Property structure (e.g., foundation & roof); exterior; interior; and insulation & ventilation systems.
3. Lender may charge borrower for inspection & report.
   a. Inspector does not need to be approved by FHA (unlike appraiser)
   b. Property Inspection Prohibitions
      i. Inspector may not have interest in property or relationship with seller;
      ii. Inspector must be paid by lender-no other party;
      iii. Inspector may not pay anyone for referring the inspection;
      iv. Inspector may not be paid for contractor referrals;
      v. Inspector may not perform repairs she recommends.

5. Policy Reasons for Waiver of 90-Day Rule
   a. FHA “encourages investors that specialize in acquiring and renovating properties to renovate foreclosure and abandoned homes, with the objective of increasing the availability of affordable homes for first-time and other purchasers, helping to stabilize real estate prices as well as neighborhoods and communities where foreclosure activity has been high.”

6. Transactions Exempt from 90-Day Rule
   a. Sales of inherited properties;

---

10 24 C.F.R. § 23.37a(c).
b. Sales of properties purchased by an employer/relocation agency to relocate an employee;

c. HUD Sales of REO properties;

d. Sales by other federal agencies of REO properties;

e. Sales of properties by nonprofit organizations approved to purchase HUD REO properties;

f. Sales of properties by state- & federally-charted financial institutions & government-sponsored enterprises (GSEs);

g. Sales of properties by local & state government agencies; and

h. In the event of an announcement by HUD, sales of properties located in areas designated by the President as federal disaster areas.
III. IDENTIFYING/RESEARCHING BAD LENDERS

1. Determine Whether the Lender is Still Approved to Make FHA-Insured Loans
   a. Search for lender on FHA’s lender list
      i. [http://www.hud.gov/ll/code/llslcrit.cfm](http://www.hud.gov/ll/code/llslcrit.cfm) or google “FHA lender list”

2. Search the Federal Register
   a. Search the Federal Register for your lender
      i. Search “Lender Name” + “FHA” or “HUD”
      ii. The HUD Mortgagee Review Board (MRB) takes administrative actions against FHA-approved lenders that are not in compliance with FHA lending requirements. Administrative sanctions range from the withdrawal of a lender’s FHA approval to settlement agreements, letters of reprimand, civil money fines, and probation.
      iii. Examples of issues: excessive mortgage payment to income ratios & debt to income ratios; false statements & certifications; failure to implement & maintain a Quality Control Plan; problems with appraisals; and failure to perform loss mitigation & service loans in accordance with requirements, etc.
         1. More on HUD Mortgagee Review Board here:

3. Search HUD Neighborhood Watch Data
   a. Neighborhood Watch is a system that helps HUD/FHA staff monitor lenders by tracking mortgage defaults & claims.
      i. Includes data regarding number of FHA-loans originated, in serious default, and in a claim status for the timeframe specified.
      ii. Data is available on a national or local level (by state or county).
b. Limitations: data is only available for the last 8 quarters (2 years). Not going to tell us about a FHA-lender’s defaults & claims for the predatory FHA loans made from 2009-2012.

   i. You can get claims & delinquency information for FHA-insured loans that were originated in the past two years.
   ii. Detailed steps below.

d. What am I looking for?
   1. HUD focuses on a “compare ratio” of 200% +
   2. HUD defines a “compare ratio” as a value that reveals the largest discrepancies between a lender’s default & claim percentage and the comparison default & claim percentage. (Basically comparing the % of the lender’s loans to go into default/claim vs. the % of other FHA lenders overall).
Step 1: go to HUD Neighborhood Watch website (https://entp.hud.gov/sfnw/public/) (you can google “HUD” “neighborhood watch”).
Step 2: Select “Early Warnings.”
Step 3: Select “Single Lender.”
Step 4: Type in the name of the lender you want to search.
Step 5: Make your next selections—Mortgagee Selections “Originator by Institution”; Delinquent Choices “ Seriously Delinquent”; 2 Year Performance Period “Data as of 12/31/14” (which is the date of the last quarter reported—there is nothing magical about this date in particular).
**Step 6: Review the results.** The results can also be exported into an Excel spreadsheet. The 2-year data for this lender shows that First Residential's compare ratio is greater than 200%.

<table>
<thead>
<tr>
<th>Rank</th>
<th>United States</th>
<th>Compare Ratio</th>
<th>Total Orig</th>
<th>Total Seriously Delinquent</th>
<th>Total Claims</th>
<th>Total Seriously Delinquent and Claims</th>
<th>% Seriously Delinquent and Claims</th>
<th>United States Total Orig</th>
<th>United States Total Seriously Delinquent</th>
<th>United States Total Claims</th>
<th>United States Total Seriously Delinquent and Claims</th>
<th>United States % Seriously Delinquent and Claims</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>United States</td>
<td>292%</td>
<td>203</td>
<td>4</td>
<td>3</td>
<td>7</td>
<td>3.45</td>
<td>1,437,797</td>
<td>16,570</td>
<td>379</td>
<td>16,949</td>
<td>1.18</td>
</tr>
</tbody>
</table>

Displaying records 1 to 1 out of a total number of 1 records

[Download this report to an Excel file](#) [Help]
Step 7: You can also run the search by county.
Step 8: Review data. Compare ratios very high in Bronx, not as high, but still 200% or more in Queens & Brooklyn. Ratios are high, but the number of seriously delinquent/claims is pretty low.
4. Search HUD Office of Inspector General Website
   a. www.hud.gov/offices/oig
   b. Audits & investigations of FHA-insured lenders available. Can search “FHA lender,” your lender’s name, or other relevant search terms.
   c. 2011 Operation Watchdog Audit of 15 FHA lenders\(^{11}\) (no major NY players)
      i. Reviewed
         1. 15 lenders with compare ratios greater than 200% of the national average for loans endorsed b/t Nov. 1, 2007 and Oct. 31, 2009.
         2. Selected 284 loans with the following characteristics from among the lenders: gone into claim status, had defaulted w/in the first 30 months, not a streamlined refi, not electronically underwritten by Fannie/Freddie, & not associated with a suspect individual underwriter.
      ii. Findings
         1. 140/284 (49%) loans were not underwritten in accordance w FHA requirements.
         2. Material deficiencies from the 140 loans fell into 9 categories.
            a. Income/employment history: 57
            b. Assets: 20
            c. Liabilities: 24
            d. Qualifying ratios: 36
            e. Gift funds: 49
            f. Credit history: 76
            g. Rent verification: 13
            h. Borrower investment: 26
            i. Skipped mortgage payments: 3

3. Missing from analysis: whether loan amount was supported by property value?

iii. Effect

1. Focuses on the effect on the FHA insurance fund, not borrowers who end up with mortgages that have not been properly underwritten.

5. Google Search

a. A Google search of the lender can help uncover useful information, including investigations by the U.S. Attorney’s office, state agencies, and more.
IV. FHA UNDERWRITING & THE FALSE CLAIMS ACT/QUI TAM

1. The False Claim Act (FCA)\textsuperscript{12} aka qui tam.
   a. **Purpose.** The FCA is the Government’s “primary litigation tool” for recovering losses resulting from fraud
      i. The FCA imposes civil penalties and treble damages on any person who “knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim.” 31 U.S.C. § 3729(a)(1)(B) (2009)
   b. **Procedure.**
      i. **Government Intervenor.** In Qui tam actions, the government has the right to intervene and join the action. If the government declines, the private plaintiff may proceed on his or her own.
      ii. **Filed Under Seal.** A qui tam action must be confidentially filed under seal in federal district court in accordance with the Federal Rules of Civil Procedure.
      iii. **Must Serve US Attorney and US Attorney General.** A copy of the complaint, with a written disclosure statement of substantially all material evidence and information in the plaintiff’s possession, must be confidentially served on the US Attorney General and the US Attorney for the district in which the complaint is brought.
      iv. **Subject to Heightened Pleading Requirement.** Complaints filed under the False Claims Act must also meet the heightened pleading standard of Federal Rule of Civil Procedure 9(b), which provides: “In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake.”
   c. **Recovery/Damages.** A qui tam plaintiff can receive between 15 and 30 percent of the total recovery from the defendant, whether through a favorable judgment or settlement. To be eligible to recover money under the Act, you must file a qui tam lawsuit. Merely informing the government about the violation is not enough. A whistleblower only receives an award if, and after, the government recovers money from the defendant as a result of the suit.

\textsuperscript{12} 31 USC § 3729
d. **Elements of the Claim.** To establish a claim under either former § 3729(a)(2) or current § 3729(a)(1)(B) of the FCA, the Government must allege that the defendant either made, used, or caused to made or used,
   i. a false statement or fraudulent course of conduct;
   ii. made or carried out with the requisite scienter;
   iii. that was material; and
   iv. that caused the government to pay out money or forfeit moneys due (i.e., that involved a claim).”

13 United States ex rel. Longhi v. Lithium Power Techs., Inc., 575 F.3d 458, 467 (5th Cir.2009).

e. **Elements of a FCA claim in detail**

i. **Theories of Liability**

   1. **False Certification Theory**

      a. **Falsely Certify Compliance.** Under the false certification theory, a claim gives rise to FCA liability when it includes a certification of compliance with a federal statute, regulation, or contract that is a prerequisite to obtaining a government benefit.

      b. **Three Types of False Certifications.** Under the false certifications theory, there are three kinds of false certifications that can lead to liability under the Act.

         i. **Factually False.** The most straightforward is a certification that is factually false, “which involves an incorrect description of goods or services provided or a request for reimbursement for goods or services never provided.”

         ii. **Legally False.** In addition, however, the FCA also prohibits certifications that are legally false—that is, false representations of compliance with a federal statute, regulation, or contractual term.

14 United States v. Wells Fargo, 972 F. Supp.2d 593,622 (SDNY 2013); See also Mikes v. Straus, 274 F.3d 687, 696 (2d Cir.2001) and United States ex rel. Feldman v. van Gorp, 697 F.3d 78, 91 (2d Cir.2012).

15 Mikes, 274 F.3d at 697.

16 Id at 696.
or they may be implied by submission of the claim itself.17

1. **Expressly false.** An expressly false claim is, as the term suggests, a claim that falsely certifies compliance with a particular statute, regulation or contractual term.

2. **Implied false.** An implied false certification claim is based on the notion that the act of submitting a claim for reimbursement itself implies compliance with governing federal rules that are a precondition to payment.

c. **False Certification On Condition of Payment.** A legally false claim—express or implicit—is only actionable under the FCA “where a party certifies compliance with a statute or regulation as a condition to governmental payment.”18 “Conditions of payment are those which, if the government knew they were not being followed, might cause it to actually refuse payment.”19

d. **Example:**20 The Complaint alleges that, through its shadow branch and reckless underwriting schemes, Allied Corp caused HUD to insure loans that were actually ineligible for FHA insurance. The Complaint explains HUD’s requirements for providing FHA insurance, then alleges that Allied Corp flouted the requirements and submitted false certifications stating that the mortgages had been originated by HUD-approved branches and had undergone quality-control procedures. To support the Government’s allegations, the Complaint specifically identifies instances in which Allied Corp “falsely certified, on a loan-by-loan basis, that it had complied with HUD rules and requirements, and that the mortgages it endorsed were eligible for FHA insurance under HUD rules.” The

---

17 Id at 698-9
18 *Mikes*, 274 F.3d at 697.
Government further alleges the false submissions were made knowingly, in order to satisfy HUD’s prerequisites for FHA insurance.

2. Fraudulent Inducement Theory.
   a. Fraudulently Induced into Entering an Agreement to Pay. Under the “fraudulent inducement” theory, FCA liability is imposed when the Government was obligated to pay based on terms of an agreement that was “procured by fraud.” The ultimate claim for payment need not be fraudulent, so long as the defendant’s fraudulent conduct initially induced the Government to take on the obligation.
   b. History. The fraudulent inducement theory stems from United States ex rel. Marcus v. Hess,\(^\text{21}\) in which the Supreme Court considered whether otherwise valid claims submitted pursuant to contracts defendants obtained through impermissible collusive bidding were fraudulent within the meaning of the FCA. The Court held that because the contracts were “induced by the [defendants’] frauds,” claims for payment based on those contracts were also fraudulent.\(^\text{22}\) “The government’s money,” the Court explained, “would never have been” paid to the defendants “had its agents known the bids were collusive.”\(^\text{23}\) In other words, the defendants’ “fraud did not spend itself with the execution of the contract.... The initial fraudulent action and every step thereafter taken, pressed ever to the ultimate goal—payment of government money to persons who had caused it to be defrauded.”\(^\text{24}\) Based on this reasoning, courts have repeatedly held that the “use of fraudulent information to


\(^{22}\) Marcus, 17 U.S. at 542–43, 63 S.Ct. 379.

\(^{23}\) Id. at 543, 63 S.Ct. 379.

\(^{24}\) Id. at 543–44, 63 S.Ct. 379.
induce the Government to provide a loan guarantee” or other contract “constitutes a false claim under the FCA.”

c. Examples:

i. In Eghbal, the Ninth Circuit held that where HUD is fraudulently induced to insure a mortgage that does not qualify for HUD insurance, otherwise valid claims submitted on that loan when it defaults constitute false claims under the FCA.

ii. In United States v. Americus Mortgage Corp., the Government alleged and withstood a Motion to Dismiss claiming that Allied Corp fraudulently induced the Government to provide FHA insurance at the time of origination by submitting false statements to the Government that its mortgages were eligible for FHA insurance, when they were not. “These false statements caused the Government provide FHA insurance and, consequently, obligated the Government to pay insurance claims on defaulted mortgages. The Government will incur these losses, set into motion by Allied Corp’s initial fraud, even if the claims for payment are not themselves false—i.e. if the mortgages have legitimately defaulted and left the holder of the mortgage uncompensated. Accordingly, the Government’s allegations against Allied Corp are also sufficient to give rise to FCA

---

25 United States v. Wells Fargo, 972 F. Supp.2d at 623 citing United States v. Eghbal, 548 F.3d 1281, 1283 (9th Cir.2008); see, e.g., United States ex rel. Longhi v. Lithium Power Techs., 575 F.3d 458, 467–68 (5th Cir.2009); Harrison v. Westinghouse Savannah River Co., 176 F.3d 776, 787 (4th Cir.1999); United States v. Veneziale, 268 F.2d 504, 505 (3d Cir.1959); see also United States ex rel. Feldman v. van Gorp, 697 F.3d 78, 91 (2d Cir.2012) (explaining the fraudulent inducement theory of FCA liability); S.Rep. No. 99–345, at 9 (1986), reprinted in 1986 U.S.C.C.A.N. 5266, 5274 (“[E]ach and every claim submitted under a contract, loan guarantee, or other agreement which was originally obtained by means of false statements or other corrupt or fraudulent conduct, or in violation of any statute or applicable regulation, constitutes a false claim.”).

26 Eghbal, 548 F.3d at 1282–83.
liability under a “fraudulent inducement” theory.”

ii. **Scienter**

1. actual knowledge of falsity,
2. acted with deliberate ignorance of the truth or falsity of the information provided, or
3. acted with reckless disregard of the truth or falsity of the information provided when the Defendants fraudulently induced.28

iii. **Materiality**

1. To plead that the false statements or fraudulent conduct were “material,” the Government must allege facts establishing that the statements or conduct had a “natural tendency to influence, or [are] capable of influencing, the decision of the decision making body to which it was addressed.”29

iv. **Causation**

1. There is a Circuit split on the question of what causation standard applies to FCA claims.30 Specifically, the Seventh Circuit has held that the Government need only demonstrate that it “would not have guaranteed the loan ‘but for’ the false statement” at issue, while the Third and Fifth Circuits have held that “the United States must demonstrate that the events which caused the defaults were related to the false statements in the applications.”

f. **Statute of Limitation**

i. False Claims Act has a six-year statute of limitations.31

ii. **Runs upon Payment.** The statute of limitations does not begin to run until HUD pays out on the insurance plan.32

---

28 Longhi, 575 F.3d at 468.
29 Id at 468 (citing Neder v. United States, 527 U.S. 1, 16, 119 S.Ct. 1827, 144 L.Ed.2d 35 (1999)).
32 See United States v. Wells Fargo Bank, N.A., 972 F.Supp.2d 593 (S.D.N.Y.2013) at 609 n. 8; see also United States ex rel. Kreindler & Kreindler, 985 F.2d 1148, 1157 (2d Cir.1993) (noting that the statute of limitations “begins to run on the date the claim is made, or, if the claim is paid, on the date of payment.”
iii. **Extension of SOL.** In Wells Fargo, SDNY held that the Wartime Suspension of Limitations Act ("WSLA"), 18 U.S.C. § 3287, tolls the statute of limitations in cases brought under the False Claims Act “[w]hen the United States is at war or Congress has enacted a specific authorization for the use of the Armed Forces.”

2. **Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) Claims**
   a. In addition to FCA, there are other statutes that penalize lenders for false statements or certifications, like Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA).  
   b. Section 1006 makes it a crime for any person who is “connected in any capacity with [HUD]” to “mak[e] any false entry in any book, report or statement of or to [HUD]” with the “intent to ... deceive any officer, auditor, examiner or agent ... of [a] department or agency of the United States ... .”
   c. Section 1014 prohibits the submission of false records or making of false statements to the FHA. Specifically, it makes it a crime for any person to “knowingly mak[e] any false statement or report, or willfully overvalues any land, property or security, for the purpose of influencing in any way the action of the [FHA] ... .”

3. **Certification to HUD that Give Rise to Claims**
   a. **Certification for Branch Approval.**
      i. To obtain HUD approval to originate loans from a specific branch office, the loan correspondent must submit HUD Form 92001–B–a form containing basic information about the branch, a general certification that the branch “meets all HUD/FHA requirements,” and a specific certification that the lender “will pay all operating costs of the branch office....”
   b. **Annual Certifications.**
      i. HUD Lenders make four certifications as part of their annual certification:

---

33 Id. at 609–10.


35 18 U.S.C. § 1006

36 18 U.S.C. § 1014
1. I certify that none of the principals, owners, officers, directors, and/or employees of the above-named lender is currently involved in a proceeding and/or investigation that could result, or has resulted in a criminal conviction, debarment, limited denial of participation, suspension, or civil money penalty by a federal, state, or local government.

2. I certify that the above named lender has not been refused a license and has not been sanctioned by any state(s) in which it originates and/or services HUD–FHA insured loans.

3. I know, or am in the position to know, whether the operations of the above named lender conform to HUD–FHA regulations, handbooks, and policies.

4. I certify that to the best of my knowledge, the above named lender conforms to all HUD–FHA regulations necessary to maintain its HUD–FHA approval, and that the above lender is fully responsible for all actions of its employees including those of its HUD–FHA approved branch offices.

c. Individual Loan Certifications
   i. DEL participants must submit a certification along with each loan for which they seek FHA insurance coverage.
   ii. That certification can be produced along with one of two forms: an automated underwriting system approved by FHA or a traditional underwriting system.
      1. If a lender chooses to employ an automated system and that system produces a positive rating, the loan officer must nevertheless certify, among other things, the “integrity of the data supplied by the lender used to determine the quality of the loan.”
      2. By contrast, if the automated system produces a “refer” or “caution” rating, the loan officer may still certify the loan’s eligibility for FHA insurance, but only by stating that
         a. the automated system negatively rated the loan details,
         b. a loan officer has personally reviewed the relevant loan information and documentation, and
         c. the loan qualifies for FHA insurance under the terms and requirements of the DEL program.
4. **Examples of False Claim Act Claims for FHA Loans:**

      
      i. Between January 1, 2001 and December 31, 2010, Allied Capital and Allied Corp, originated 112,324 home loans. Of those loans, 35,801 (approximately 32%) defaulted, costing over $834 million in insurance claims to be paid by HUD. At the instruction of Hodge, Allied Capital’s CEO, Allied Capital employees routinely entered the HUD ID numbers of an approved branch into the loan documentation for loans originating from the shadow branches. These loans were then submitted to HUD for approval, even though they falsely stated that the loans originated from an approved branch office. HUD relied on these false statements and endorsed the loans. The Government alleges that Allied Corp continued these practices when it acquired nearly all Allied Capital’s assets in 2010.

   b. **United States v. Deutsche Bank AG and MortgageIt, Inc. 11-cv-02976-LAK.**
      
      i. **Volume of Lending.** Between 1999 and 2009, MortgageIt, Inc. was an approved Direct Endorsement Lender. During that time period, MortgageIt endorsed more than 39,000 mortgages for FHA insurance, totaling more than $5 billion in underlying principal obligations. These FHA-insured mortgages were highly marketable for resale to investors because they were insured by the full faith and credit of the United States.

      ii. **Resale of Insured Loans.** MortgageIt and Deutsche Bank, which acquired MortgageIt in 2007, made substantial profits through its resale of these endorsed FHA-insured mortgages. Deutsche Bank and MortgageIt had powerful financial incentives to invest resources into generating as many FHA-insured mortgages as quickly as possible for resale to investors. By contrast, Deutsche Bank and MortgageIt had few financial incentives to invest resources into ensuring the quality of its FHA-insured mortgages through the maintenance of the mandatory quality control program, or into ensuring that MortgageIt limited its endorsement of mortgages to those loans that were eligible for FHA insurance under HUD rules.

      iii. **Extent of the Loss to HUD.**

         1. **Paid Already.** As of February 2011, HUD has paid more than $386 million in FHA insurance claims and related costs arising out of more than 3,100 mortgages. Of these, HUD has paid more than $97 million in FHA claims and related costs arising out of more
than 600 mortgages that defaulted within six months, more than $160 million in FHA claims and related costs arising out of more than 1,100 mortgages that defaulted within a year, and more than $258 million in FHA claims and related costs arising out of more than 2,000 mortgages that defaulted within two years.

2. **Soon to Be Paid.** As of February 2011, more than 7,500 additional mortgages, totaling more than $888 million in calculated unpaid principal balances, have defaulted, without any claims yet having been paid by HUD. Of these, there are more than $260 million of calculated unpaid principal balances for more than 1,700 mortgages defaulted within six months, there are more than $348 million of calculated unpaid principal balances for more than 2,300 mortgages defaulted within a year, and there are more than $493 million of calculated unpaid principal balances for more than 3,400 mortgages defaulted within two years.

iv. **Claims.** Complaint alleged multiple repeated failures to implement quality control program and underwriting failure to follow FHA guidelines. False Claims Act claims asserted.

v. **Underwriting failures.** Failure to document gift and source of gift funds, failure to develop alternative credit histories for borrowers without traditional credit reports, failure to document borrower’s cash investment in the property, failure to verify employment, failure to verify source of funds for earnest money deposits, and failure to investigate irregularities in mortgage applications for possible fraud.

vi. **Settlement of claims.**

1. $202.3 million paid to the US Government for release of FCA and FIRREA claims but not Tax claims, non-FHA mortgage origination claims, criminal prosecution.


i. **Volume of Lending/Nature of the Problem.**

1. Starting in 2000, Wells significantly increased origination of FHA-insured mortgages. To do so, Wells relied on inadequately trained employees, impermissibly paid its underwriters a bonus based on the number of loans they approved, applied heavy pressure on loan officers and underwriters to originate, approve and close loans, on short turnaround times and with lax and inconsistent underwriting standards.
2. Between 2001 and 2003, almost a third of random sampled loans evidenced material violations of FHA underwriting guidelines. In a later period, for the combined material and moderate violations rate exceeded 80%, hit a high of 87.2% in July 2003 and for 18 consecutive months never fell below 63%.

ii. Claims.
   1. Complaint alleged failure to adhere to quality control requirements (random sampling of loans, all loans that defaulted in six months) and failure to report to FHA and senior management at Wells the “material risk” loans and any serious deficiencies, patterns of non-compliance and fraud discovered within 60 days.
   2. Claims that from May 2001 to October 2005, Wells Fargo engaged in the regular practice of reckless underwriting and falsely certified that thousands of loans were eligible for FHA insurance.

iii. Underwriting violations included:
   1. Failing to document the source of funds for the borrower’s investment in the property (actual documents in the file show thousands less than reported in the application);
   2. Approving a loan that exceeded acceptable DTI ratios without acceptable and documented compensating factors;
   3. Overstating borrower income when it was entered into the AUS contrary to documentation;
   4. Using stale credit and debt variables;
   5. Failure to obtain a verification of employment and pay stubs for income documentation;
   6. Failure to obtain a payment history of housing obligations and obtain written explanations of borrower’s past derogatory credit;
   7. Failure to reconcile conflicting information on the borrower’s rental and residence histories;
   8. Understated borrower’s monthly debt obligations and overstated borrower’s assets.

iv. Case Survived Motion to Dismiss
V. POSSIBLE FORECLOSURE DEFENSES BASED ON ORIGINATION OF FHA-INSURED LOANS

1. Extremely Limited Case Law
   a. The vast majority of state & federal case law regarding the deficiencies in the origination of FHA-insured loans is brought by the U.S. under the False Claims Act (discussed above).

2. Common Facts in Predatory FHA-Insured Mortgage Transactions
   a. Inflated appraisal.
      i. Poor new construction.
      ii. Property flip with very little and/or very poor renovation work.
      iii. Appraisal otherwise inflated.
   b. Borrower has insufficient income to support monthly payment
   c. Income calculated by lender includes imputed rental income that is not realistic based on condition of property or the market. Proposed rental unit may not be a legal unit.
   d. Insufficient documentation of borrower’s income.
   e. Borrower exceeds acceptable debt-to-income ratio.
   f. Borrower is not advised that she will need to pay FHA-insurance every month, which increases the monthly mortgage payment.
   g. Urge borrowers to set aside idea of what is affordable.
   h. Making false entries on the HUD-1.

3. Parties Other Than Lender to Consider Bringing Into Action
   a. Mortgage broker, appraiser, realtor, inspector, and seller

4. Possible Defenses, Primarily Coming From Predatory Lending Body of Law
   a. Greater Business Law (GBL) § 349
i. **Law:** GBL § 349 prohibits “[d]eceptive acts or practices in the conduct of any business, trade, or commerce or the furnishing of any service in this state . . . .” N.Y Gen. Bus. Law § 349(a).

   1. 3 year statute of limitations

ii. **Elements**

   1. Party engaged in an act or practice that is deceptive OR materially misleading;
      a. Definition deceptive acts/practices (*representations or omissions*): acts/practices likely to mislead a reasonable consumer acting reasonably under the circumstances.

   2. Deceptive acts/practices directed toward consumers; AND
      a. Must demonstrate that acts/practices have broader impact on consumers at large.

   3. Individual has been injured by the deceptive/misleading acts/practices.

iii. **NOT required**

   1. Individual does not need to establish intent to defraud or mislead (proof increases damages).\(^{38}\)

   2. Proof of justifiable reliance.\(^{39}\)

   3. Repetition or pattern of deceptive behavior.


   1. Lender did not provide borrower with all required documents, including appraisal.


\(^{38}\) *Id.* at 26.

\(^{39}\) *Id.*
2. Lender failed to advise borrower that she did not qualify for a loan. Instead, lender misrepresented that borrower qualified for an FHA-insured loan by approving borrower.

3. Lender failed to properly document or calculate borrower’s income, thereby misrepresenting that borrower qualified for an FHA-insured loan.

4. Lender misrepresented to the borrower that the property was worth the appraised value by approving an FHA-insured loan.
   a. Is there a pattern of this lender making over-appraised loans using a particular mortgage broker, seller, realtor, or appraiser?

5. Lender violated the property flipping rules; therefore the loan did not qualify for FHA-financing.

6. Lender does not have adequate documentation of property value in the file; therefore the loan did not qualify for FHA-financing.

7. Disparity of bargaining power
   a. Bank v. unsophisticated individual
   b. Lender has knowledge of requirements of FHA program

8. Failure to provide required disclosures under Real Estate Settlement Procedures Act (RESPA) prior to or at closing.

9. Lender’s omissions possibly actionable here, unlike fraud.

v. Some relevant caselaw

   a. FHA-insured loan at issue.
   b. UDAP, fraud, & conspiracy. Very thorough & interesting discussion on these claims with regard to an FHA-insured loan.
   c. Plaintiff claimed 4 misrepresentations by lenders: 1) loans complied with FHA guidelines, when they did not; 2) borrowers could afford their loans, which they could not; 3)
appraisals reflected the true value of the units, when they were inflated; and 4) the construction of the units was sound.

d. Borrower argued that lender’s statements were not true because they were incomplete, in that they “did not reveal that the loans had been approved only because [the lenders] ignored and failed to comply with the FHA conditions and safeguards that were required for that approval.”

e. Court found that “a reasonable person generally would not deem an accurate statement to be misleading” and therefore found that the lenders had not made affirmative or implied misrepresentation. But found potentially actionable omission.

f. Finding not providing borrowers with appraisal is a potentially misleading omission; found that the statement “your FHA-insured loan has been approved” is not an express misrepresentation or an affirmative representation that the property to be purchased is in good condition or complies with FHA requirements.


a. FHA-insured loan at issue.

b. Reversing trial court’s grant of lender defendant’s motion to dismiss UDAP & negligent misrepresentation claims (affirming dismissal of FHA & wrongful foreclosure counts).

c. Plaintiff alleged lender failed to provide him with complete & detailed info re FHA rehab loan, advised him to take out a loan larger than necessary to purchase & renovate property, and manipulated his income to approve him for higher loan amount.


a. FHA-insured loan at issue
b. Finding that borrower’s UDAP claim not preempted by federal law. Borrower alleged that lender falsely inflated borrower’s income on application for an FHA-insured mortgage.


5. Delta Funding Corp. v. Murdaugh, 6 A.D.3d 571, 572, 774 N.Y.S.2d 797 (2d Dept. 2004) (finding that borrower had made out prima facie case under GBL § 349 in foreclosure action).

6. Fremont Inv. & Loan v. Laroc, 21 Misc. 3d 1124(A); 873 N.Y.S.2d 511 (Sup. Ct. Queens Cty 2008) (denying foreclosure defendant’s motion to vacate default and for leave to file a late answer. Found that defendants had no meritorious defenses, including their proposed defense under GBL §349, because defendants “played a role in inducing plaintiff to make the loan because they submitted a mortgage application with an incorrect and exaggerated monthly income”).

b. Common Law Fraud
   i. Law:
      1. Elements
         a. Material misrepresentation of a fact;
         b. Knowledge of its falsity;
         c. Intent to induce reliance;
         d. Justifiable reliance; and
         e. Damages. 40

40 Eurycleia Partners, LP v. Seward & Kissel, LLP, 12 N.Y.3d 553, 559, 910 N.E.2d 976, 979 (N.Y. 2009).
2. In NY, an omission, even if material, does not give rise to a fraud claim without a fiduciary relationship between the parties.\textsuperscript{41}

3. Fraud must be pled with particularity

ii. Potential theories based on common FHA-origination facts

1. Intent & justifiable reliance likely to be the most difficult elements.
2. Lender knowingly falsified borrower’s income on application.
3. Lender knew that appraisal value of home was inflated.
4. Lender knew that it did not have the necessary protections in place to ensure that underwriting was completed in accordance with FHA guidelines

iii. Some relevant caselaw

   a. FHA-insured loan at issue
   b. On appeal, affirming trial court’s grant of summary judgment to defendant lender on plaintiff’s fraud claim, finding that, although material, a statement from lender that borrowers were approved for an FHA-insured loan was not false, because borrowers were approved.

   a. FHA-insured loan at issue
   b. Affirmed trial court’s grant of summary judgment to defendant lender. Plaintiff alleged fraud against lender on the basis that lender made fraudulent representations re condition of property despite it having a damaged foundation. Court found that lender was merely the lender and that neither the lender nor the borrower obtained an inspection of

the property. Court further found that the lender did not have any knowledge of the home’s foundation defects prior to closing. Finally, Court found that the FHA appraisal did not guarantee the condition of the home.

3. *Fagbuyi v. Accredited Home Lenders*, 102125/12, NYLJ 1202635013025, at *1 (Sup. Ct. Richmond Cty. Dec. 20, 2013) (on pro bono net) (dismissing plaintiff’s fraud claim as unsubstantiated—plaintiff alleged that defendants misrepresented value of home, knew or should have known that pl. could not afford monthly payments, and misrepresented pl.’s ability to make payments. Court specifically mentioned that pl. provided no evidence of value of home at origination).


   a. It is not reasonable for borrower to rely on oral representations regarding terms of mortgage when borrower has access to the correct information in the mortgage document.
   b. Long string cite for this proposition: “*See McMorrow v. Dime Sav. Bank of Williamsburgh*, 48 A.D.3d 646, 852 N.Y.S.2d 345, 347 (2d Dept. 2008) (finding that plaintiff’s reliance on “alleged oral misrepresentations” regarding “mortgage payoff amount and prepayment penalties” was “unreasonable in light of the clear, documented written provision in the
mortgage agreement stating the penalties for the prepayment of the mortgage and a default”); Sander v. J.P. Morgan Chase Home Mortg., 56 A.D.3d 301, 867 N.Y.S.2d 87, 88 (1st Dept. 2008) (rejecting plaintiff's fraud claims against broker of an adjustable rate mortgage “in light of the clear and unambiguous terms of the mortgage documents,” and noting that plaintiff had “an obligation to exercise ordinary diligence in ascertaining the terms of the document”); Treeline Garden City Plaza LLC v. UBS Warburg Real Estate Inv. Inc., 787 N.Y.S.2d 681, 2004 WL 1305510, at *7 (Sup.Ct. Nassau Cty. 2004) (“Reliance is not reasonable or justifiable where plaintiffs, who were involved in a major transaction, such as this, [had] access to critical information (to wit: the mortgage), but failed to take advantage of that access.”). It is well settled that reliance upon a mortgage broker’s or lender’s representations “over the clear and unambiguous provisions of the mortgage [is] unreasonable and unjustifiable.” Treeline, 2004 WL 1305510, at *7.”

c. **Aiding & Abetting Fraud**

   i. **Elements of Fraud by another +Elements of Aiding & Abetting**

      1. Existence of underlying fraud;
      2. Actual knowledge of the fraud; and
      3. Substantial assistance with the perpetration of the fraud.\(^{42}\)
      4. Needs to be plead with particularity.

   ii. **Potential theories based on common FHA-origination facts**

---

\(^{42}\) Oster v. Kirschner, 77 A.D.3d 51, 55, 905 N.Y.S.2d 69, 72 (1st Dept. 2010).
1. Other bad actors (e.g., broker, realtor) may have committed fraud by disguising true condition of home, misrepresenting that property in good condition, misrepresenting the cost of the loan, misrepresenting that the loan was affordable, misrepresenting that the appraised value was the market value of the home.

2. Aid & Abet: lender assisted with the perpetration of the fraud by:
   a. Financing loan even though it knew of the fraud
   b. Failing to produce adequate documentation of value of home
   c. Failing to provide an appraisal to borrower

3. This theory may be especially helpful if your client is the victim of a one-stop shop that had previously directed borrowers to this same lender.

   iii. Some relevant caselaw

   1. *Fremont Inv. & Loan v. Lavoc*, 873 N.Y.S.2d 511 (Sup. Ct. Queens Cty 2008) (in foreclosure case, defendant borrowers alleged that pl. lender aided & abetted broker in improperly charging them certain fees in relation to the refinancing of the mortgage. Court found that defendants failed to establish a) that broker committed fraud or b) that pl. owed a duty to maintain & control broker).

   d. Unconscionability

      i. Law: “[A]n unconscionable contract has been defined as one which is so grossly unreasonable as to be unenforceable because of an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.”

      ii. Elements: Requires procedural & substantive unconscionability

         1. Procedural Unconscionability;

---

43 *Simar Holding Corp. v. GSC*, 87 A.D.3d 688, 689, 928 N.Y.S.2d 592, 595 (2d Dept. 2011).
a. Concerns the contract formation process & alleged lack of meaningful choice
   i. E.g.: high-pressure commercial tactics, inequality of bargaining power, deceptive practices & language in the contract, imbalance in sophistication of parties.

2. Substantive Unconscionability
   a. Concerns the content of the contract
      i. E.g.: inflated prices, unfair termination clauses, unfair limitations on consequential damages & improper disclaimers of warranty.
   iii. Potential theories based on common FHA-origination facts
      1. Inflated property value so that borrower takes a larger loan
      2. Borrower does not qualify for FHA-insured loan based on income
      3. Violation of property flipping rule
   iv. Some relevant caselaw
         a. FHA-insured loan at issue.
         b. Found no substantive unconscionability because Plaintiff produced no evidence that the loan did not comply with FHA’s underwriting standards.
         c. Found no procedural unconscionability because method of calculating borrower’s income was reasonable, not false as alleged by Pl, no unfair surprise regarding terms of loan because borrower signed note stating monthly payment, no evidence lender did anything to induce borrower into loan.
   v. Issues to consider
      1. Preemption (likely to be especially relevant because qualities of FHA-insured loans that are permitted by HUD are permitted by federal law)
e.  **Conspiracy**
   i.  **Law**
   1. New York does not have an independent cause of action for civil conspiracy.44
   2. But a Plaintiff “may plead the existence of a conspiracy in order to connect the actions of the individual defendants with an actionable, underlying tort and establish that those actions were part of a common scheme.”45
   3. “In order to properly plead a cause of action to recover damages for civil conspiracy, the plaintiff must allege a cognizable tort, coupled with an agreement between the conspirators regarding the tort, and an overt action in furtherance of the agreement.”46

f.  **Breach of Fiduciary Duty**
   i.  **Law**
   1. “A fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation.”47
   2. “[T]he legal relationship between a borrower and a bank is a debtor-creditor relationship that, in and of itself, does not create a fiduciary relationship.”48

---

g. **Negligence**

   i. **Law**

      1. **Elements of prima facie case:**

         a. Existence of duty;
         b. Breach of that duty;
         c. Injury; and
         d. Breach of duty was proximate cause of injury.

   ii. **Potential theories based on common FHA-origination facts**

      1. Lender approved FHA-insured loan and should have known that it was unaffordable to borrower.
      2. Lender approved FHA-insured loan and should have known that the appraised value was inflated.
      3. Lender approved FHA-insured loan and should have known that there were violations of the property flipping rule.

   iii. **Some relevant caselaw**


         a. FHA-insured loan at issue.
         b. Granting the motion for summary judgment of lender and assignee in an action. Plaintiff borrowers brought action to void mortgage based on negligence and “predatory lending” violation of NY Banking Law § 6-l.
         c. Plaintiff argued that lenders failed to exercise due care & diligence in granting her a loan to purchase property because the property was unaffordable.

---

d. The Court found that Plaintiff did not raise a triable issue of fact:
   i. Lender examined income, resources, expenses, and debts of borrower.
   ii. Proof that loan issued in accordance with FHA guidelines (closing docs, etc).
   iii. Not a high cost loan contemplated by Banking Law § 6-1.


   a. FHA-insured loan at issue.
   b. Affirming trial court’s grant of summary judgment to lender. Homeowner brought negligence action against lender, building, inspector, and realtor alleging property flooded during heavy rains. FHA-insured loan, FHA appraiser. Slab on property did not meet code elevation requirements.
   c. Plaintiff argued that lender is liable to them because lender’s appraiser owed borrowers a duty, and breached that duty by providing negligent information in the appraisal report.
   d. The Court found that the lender owed the borrower no special duty of care:
      i. Lender dealt with borrowers at arms-length.
      ii. No allegations that lender became involved in the design or construction of home.
      iii. Lender provided notice that the appraisal did not guarantee the property was free from defects &
advising borrowers to inspect property themselves, or hire an inspector.

iv. Lender did not make any representations as to condition of property.

iv. **Issues to consider**

1. Establishing duty to your client likely to be biggest hurdle.

h. **Negligent Misrepresentation**

i. **Law:**

1. Claim requires: 1) “existence of a special or privity-like relationship imposing a duty on the defendant to impart correct information to the plaintiff; 2) that the information was incorrect; 3) reasonable reliance on the information.”

2. “A special relationship may be established by persons who possess unique or specialized expertise, or who are in a special position of confidence and trust with the injured party such that reliance on the negligent misrepresentation is justified.”

3. “[A]n arm's-length borrower-lender relationship is not of a confidential or fiduciary nature[.]”

4. An omission maybe actionable.

---


51 Mandarin Trading Ltd. v. Wildenstein, 16 N.Y.3d 173, 180, 944 N.E.2d 1104, 1009 (N.Y. 2011)(internal citations omitted)


ii. Potential theories based on common FHA-origination facts

1. Plead facts to establish relationship between the borrower and the lender.
2. Argue that nature of relationship b/t borrower & lender is an issue of fact to be determined by finder of fact—not appropriate on motion to dismiss, so long as you plead that a special relationship existed.
3. Is there a special relationship between borrower and lender’s agent?

iii. Some relevant caselaw

   a. FHA-insured loan at issue.
   b. Reversing trial court’s grant of lender defendant’s motion to dismiss UDAP & negligent misrepresentation claims (affirming dismissal of FHA & wrongful foreclosure counts)
      i. Plaintiff allege lender failed to provide him with complete & detailed info re FHA rehab loan, advised him to take out a loan larger than necessary to purchase & renovate property, and manipulated his income to approve him for higher loan amount.

   a. Plaintiff alleged fraud & negligent misrepresentation by Plaintiff based on allegation that defendant intentionally underestimated settlement costs, specifically attorney’s fees, in order to induce plaintiff to take out loan.
   b. Defendant lender’s alleged superior knowledge of legal fees not sufficient to establish “unique or special expertise” that would lead to a special relationship. Court found that Plaintiff had sufficiently stated claim for fraud, however.

4. *Kimmell v. Schaefer*, 89 N.Y.2d 257, 264, 675 N.E.2d 450 (N.Y. 1996) (“Whether the nature and caliber of the relationship between the parties is such that the injured party's reliance on a negligent misrepresentation is justified generally raises an issue of fact. In determining whether justifiable reliance exists in a particular case, a fact finder should consider whether the person making the representation held or appeared to hold unique or special expertise; whether a special relationship of trust or confidence existed between the parties; and whether the speaker was aware of the use to which the information would be put and supplied it for that purpose.”) (emphasis added).

i. **Fair Housing Defenses**
   
   i. Examples: Fair Housing Act, Equal Credit Opportunity Act (ECOA) and their state and local counterparts.
   
   ii. Are predatory FHA loans being used disproportionately in communities of color? YES.
       
       1. But how to prove?

5. **Loss Mitigation Defense**
   
   a. **3 Theories of the defense**
      
      i. Affirmative defense based on failure of servicer to comply with HUD regulations regarding pre-foreclosure and loss mitigation evaluation for FHA-insured loans.
1. Compliance with the regulations is a **condition precedent** to foreclosure;

2. Failure to comply with the regulations is a **breach of contract**, because the regulations are incorporated by reference into the Mortgage (and often the Note); or

3. General **equity** defense.

b. **Challenges**

i. HUD has stated in multiple places, and courts have found, that borrowers do not have a private right of action to enforce HUD regulations.

c. **Sample loss mitigation requirements**


ii. Before 3 full monthly payments are due, mortgagee/servicer must make reasonable efforts to arrange a face-to-face meeting with the borrower, if it has a branch within 200 miles of the borrower’s property: 24 C.F.R. § 203.604

   1. Reasonable efforts include an in-person visit to the property.

iii. Mortgagee is required to review loans in default for certain loss mitigation programs, including but not limited to FHA-HAMP: Mortgagee Letters 00-05; 02-17; 08-21; 09-23; 12-22; 13-32; and others.

iv. Before commencing foreclosure, mortgagee must make sure that all servicing requirements have been met: 24 C.F.R. § 203.606(a).

d. **New York caselaw:**

i. Some, but not all, New York Courts have held that failure to comply with FHA loss mitigation is an affirmative defense to a foreclosure action.  

54 HSBC USA, N.A. v. Teed, 2014 WL 8094527 at *2 (Sup. Ct. Steuben Cty, Nov. 14, 2014); Fed. Nat. Mortgage Ass’n v. Ricks, 83 Misc.2d 814, 826, 372 N.Y.S.2d 485, 497 (Sup. Ct. Kings Cty 1975); but see U.S. Bank Natl. Ass’n v. Waters, 43 Misc. 3d 1235(A), 998 N.Y.S.2d 102 (Sup. Ct. Queens Cty 2014) (granting plaintiff’s motion for summary judgment in foreclosure matter in which defendant asserted defense based on breach of contract, among others, for failure to comply with FHA/HUD requirements for loss mitigation. Court found that failure to comply with FHA/HUD regulations regarding loss
e. **Excellent language in Steuben County case, *HSBC v. Teed***:

i. As affirmative defense to foreclosure action brought by Plaintiff, Defendant alleged that Plaintiff violated HUD regulations, incorporated into the terms of the FHA-insured mortgage, by failing to make reasonable efforts to arrange a face-to-face meeting with Defendant before bringing the foreclosure action.

ii. **Court found**: Plaintiff’s failure to make a reasonable effort to arrange a face-to-face meeting with the borrower is a failure to satisfy a condition precedent to the commencement of a foreclosure action.

iii. Court made some specific, great findings re purpose of the National Housing Act, citing to favorable law outside of New York:

1. “The legislative purpose of the National Housing Act, 12 U.S.C. 1701t, is to assist in providing a decent home and a suitable living environment for every American family. The primary beneficiary of the act, and its implementing regulations, are those receiving assistance through its various housing programs, including HUD-insured mortgages.”

2. “HUD promulgated very specific regulations outlining the mortgage servicing responsibilities of mortgages, which include notice requirements that are integral to the program.” (internal citations omitted)

iv. **Court found that Plaintiff failed to meet the notice requirements**

   1. Plaintiff failed to make reasonable efforts to arrange for face-to-face meeting with the borrower.

v. **The Court emphasized the importance of the face-to-face meeting requirement**

---

1. “The importance of making reasonable efforts to arrange for a face-to-face meeting cannot be overstated. As noted above, it is a fundamental understanding of the government-insured mortgage program that when lower income individuals are confronted with even relatively minor financial difficulties, they will often have trouble keeping up with their mortgage payments. As such, the regulations require mortgagees, who benefit greatly from the protections afforded them through the issuance of FHA backed mortgage loans, to work with mortgagors to give them a chance to take the reasonable steps necessary to save their homes.” (emphasis added).

f. Caselaw from other jurisdictions

i. Support existence of affirmative defense based on failure to meet condition precedent.


ii. Caselaw on breach of contract in other jurisdictions is split

1. There is no private right of action & good cases don’t rely on that kind of language. Instead, they focus on the language of the contract (Mortgage or Note) itself.
a. **Sample good case:** *Matthews v. PHH Mortgage Corp.*, 724 S.E.2d 196 (Va. 2012).

b. **Sample bad case:** *Wells Fargo Home Mortgage v. Neal*, 922 A.2d 538 (Md. 2007).