

UNITED STATES OF AMERICA
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
BOARD OF CONTRACT APPEALS

.....
:
:
HORIZON SAVINGS ASSOCIATION, : HUDBCA No. 91-5946-MR12
:
Respondent : Activity Docket No.91-183-MR
:
:
.....

DETERMINATION BY ADMINISTRATIVE JUDGE JEAN S. COOPER

September 1, 1992

Statement of the Case

On June 6, 1991, the Mortgagee Review Board (MRB) of the U.S. Department of Housing and Urban Development (HUD) proposed to withdraw the HUD-FHA mortgagee approval of Horizon Savings Association (HSA) for three years pursuant to 24 C.F.R. Part 25. HSA was suspended pending resolution of the proposed withdrawal action. HSA made a timely request for a hearing. It was agreed that a hearing would be held after 30 days had expired from the date of HSA's request for a hearing. It was later agreed by the parties that a modified bench decision would be issued in this case pursuant to 24 C.F.R. Section 26.24 (d). Ultimately a bench decision could not be issued because of the volume of testimony and exhibits, and significant legal issues that require a published decision.

The MRB based the suspension and proposed withdrawal on HSA's alleged failure to comply with applicable regulations, program requirements, and generally accepted business practices of prudent lenders, citing 24 C.F.R. Sections 25.9(g), (j), (k), (p), and (w) as grounds. The MRB based its action on an audit report prepared by the HUD Office of Inspector General (OIG). The Government's complaint charges HSA with overstating mortgagors' incomes, mishandling mortgagors' employment verifications, mishandling mortgagors' income tax information, using erroneous employment and other data in verifying mortgagors' incomes, taking incomplete preliminary loan applications, improperly completing and obtaining mortgagor signatures on loan applications, improperly certifying on loan applications, performing inadequate underwriting reviews, and failing to adequately implement and maintain a Quality Control Plan (QCP). HSA is also charged with failing to conduct a face-to-face interview with a mortgagor in one of the 18 loans in question.

APPLICABLE REGULATIONS AND HANDBOOK REQUIREMENTS

The Mortgage Review Board cites 24 C.F.R. §§ 25.9(g), (j), (k), (p), and (w) as grounds for imposition of the sanction of withdrawal of HSA's mortgage approval.

24 C.F.R. §25.9(g) cites as a ground for withdrawal:

Failure to comply with any agreement, certification, undertaking, or condition of approval listed on either a mortgagee's application for approval or on an approved mortgagee's Branch Office notification.

24 C.F.R. §25.9(j) cites as a ground for withdrawal:

Violation of the requirements of any contract with the Department, or violation of the requirements set forth in any statute, regulation, handbook, mortgagee letter, or other written rule or instruction.

24 C.F.R. §25.9(k) cites as a ground for withdrawal:

Submission of false information to HUD in connection with any HUD/FHA insured mortgage

24 C.F.R. §25.9(p) cites as a ground for withdrawal:

Business practices which do not conform to generally accepted practices of prudent lenders or which demonstrate irresponsibility.

24 C.F.R. §25.9(w) cites as a ground for withdrawal:

Any other reasons the Board, Secretary or Hearing Officer, as appropriate, determine to be so serious as to justify an administrative sanction.

In addition to regulatory requirements applicable to all HUD-approved mortgagees, there are also additional conditions and requirements that may be imposed through applicable HUD handbooks, mortgagee letters, and mortgagee circulars issued by HUD, although only the regulations have the force of law. 24 C.F.R. §203.2(f); Handbook 4000.2 Rev 1-Forward (Exh. G-160.)

HUD Handbook 4000.2 REV 1 (Mortgagee's Handbook - Application Through Insurance - Single Family) describes the HUD policies and procedures required of approved mortgagees in preparing and submitting applications to HUD for mortgage

insurance. Chapter 5 of Handbook 4000.2 REV-1 describes the loan origination responsibility of the mortgagee. Paragraph 5-1 of that Handbook requires that mortgagees develop loans:

in accordance with accepted practices of prudent lending institutions and HUD requirements. They must obtain and verify information with at least the same care that would be exercised in originating a loan in which the mortgagee would be entirely dependent on the property as security to protect its investment.

Paragraph 5-2 of Handbook 4000.2 REV 1 describes the procedures for obtaining borrower approval from HUD for mortgage insurance by use of HUD Form 92900, Application for Insured Mortgage. It states that the Form 92900 provides the information necessary to determine the borrower's probable ability to make the payments on the mortgage and to maintain the property. Paragraph 5-2(a) of the Handbook provides, in pertinent part:

In accordance with prudent lending practices, a face-to-face interview with the loan applicant must be conducted by a company employee, at which time the fully completed loan application should be reviewed with the loan applicant. HUD requires that the Form HUD 92900 be completed prior to the applicant(s) signing the form. The applicant(s), in signing, and the mortgagee, in signing, are certifying that the information on the form is true and correct to the best of their knowledge and belief.

Paragraph 5-5 of the Handbook describes how information for the Form 92900 is to be collected. Paragraph 5-5 states in pertinent part:

It is the mortgagee's responsibility to carefully ascertain and report all assets and liabilities for the prospective purchaser. It is important to emphasize that the credit report, verification of employment, and verification of deposits be sent directly to the mortgagee and not pass through the hands of any third party, including the borrower or real estate agent. Allowing the form to be handcarried by an interested party greatly increase the chance that false or inaccurate information may be submitted to HUD. The mortgagee must not permit the applicant borrower, or its own employees to sign any credit document or other form in blank. The purpose of having a party to the transaction sign any form is to acknowledge and/or certify

the accuracy of its content. These objectives cannot be accomplished if a form is signed in blank. In addition, the opportunity to submit false information to HUD is greatly increased.

Paragraph 5-5(b) of the Handbook describes the verification of employment and income of applicants for an insured mortgage. It states that HUD Form 92004-G, the Verification of Employment (VOE), must be sent by the mortgagee directly to the borrower's and co-borrower's employer, and that the VOE is to be returned directly to the mortgagee. The Handbook further states that the VOE must not pass through the hands of the applicant, real estate agent, or any other third party.

Paragraph 5-5(b)(2) of the Handbook describes the duty of the mortgagee to analyze the borrower's employment and income information. It states that to make a reasonably accurate estimate of the borrower's ability to make future payments on the mortgage, reliable information with regard to the borrower's base pay, overtime earnings, and prospects for continued employment must be gathered by the mortgagee.

Paragraph 5-5(e) of the Handbook describes the information that a mortgagee needs to collect for a borrower whose income is derived from a business owned by the borrower. Although the latest balance sheet and operating statement of the business are ordinarily required to estimate the amount and stability of income, in the event that the business is small with an unsophisticated bookkeeping system, the mortgagee may use other methods of verifying income, such as income tax returns.

HUD Handbook 4060.1, entitled Mortgagee Approval Handbook, also contains instructions in Appendix 1 applicable to the gathering of information necessary to complete the Form 92900 (Exh. G-159). Appendix 1 of Handbook 4060.1 states in pertinent part:

Preparation of Form HUD-92900 Application

- (1) In accordance with prudent lending practices, at least one time prior to the submission of the final application to HUD, a face-to-face interview with the loan applicant must be conducted by a company employee. The most preferable time for such face-to-face interviews is immediately prior to the signing of the final loan application (Form HUD-92900), at which time the fully completed loan application should be reviewed with the loan applicant. The interview with the applicant should include a review of the occupancy certification to minimize the likelihood of a false certification regarding intention

to occupy.

- (2) The preliminary credit application form used by the mortgagee should require, in accordance with accepted prudent loan origination practices, that the applicant mortgagor list each outstanding liability, including mortgage liabilities, and each asset, including real property. The mortgagee should obtain complete responses to all questions. All conflicts in information should be resolved and the loan file documented.
- (3) As required by HUD regulations, 24 C.F.R. Sections 203.2(a)(2) and 203.10, all loans submitted to HUD must be fully processed by employees of the mortgagee.
- (4) In accordance with prudent lending practices, the mortgagee must not permit the applicant mortgagor, or its own employees to sign any credit document or other form in blank.
- (5) HUD Handbook 4000.2 paragraph 3-7, requires the mortgagee to obtain and verify the correctness of information with at least the same care that would have been exercised had it been entirely dependent on the property as security to protect its investment. Accordingly, the final application Form HUD-92900 must list all assets and liabilities known to the mortgagee. Consideration should be given by the mortgagee to requiring some level of review by management or supervisory officials of all cases submitted to HUD for mortgage insurance.

Verifications of Employment and Verifications of Deposit
(Forms HUD 92004-G, 92004-F)

- (1) As required by paragraphs 6-3b. and 6-3c.(1) of HUD Handbook 4000.2, these forms must not pass through the hands of the applicant or any other third party.
- (2) Prudent lending practice does not permit the signing of these forms in blank by the applicant mortgagor. Also, consideration should be given by the mortgagee to limiting the handcarrying of these forms to noncommissioned employees.

HUD Handbook 4060.1, at paragraph 1-5, addresses the requirement of a quality control (QC) plan for all HUD-approved mortgagees. It states that all mortgagees must "establish and maintain an adequate written quality control plan for loan origination and servicing on a system-wide basis, including its branch offices." The purpose of the QC plan is to "assist

corporate management in determining that policies and procedures are being followed by its personnel." The QC plan is also to "assure that prompt and effective corrective measures are taken when deficiencies in loan origination or servicing are identified." The Handbook further states at paragraph 1-5(b) that the QC plan should "require the review of a sufficient number of recently closed loans" (emphasis added), and that "[i]f a pattern of deficiencies is disclosed, the scope of review should be increased."

FINDINGS OF FACT

HSA was formed in May, 1987. By March 1988, United Austin Mortgage Company (UAMC), which had been in existence since 1984, became a wholly owned subsidiary of HSA. The officers and directors of both companies were, for the most part, the same. Today, UAMC is a corporate shell, but it has not been dissolved as a corporation (Tr. 2677-2678.) When HSA was formed, Charles F. Hicks was its President and chief executive officer. Charles S. Nichols, Jr. was its Executive Vice-President and a director. Douglas B. Kadison was Chairman of the Board, and Paul A. Antrim was a director. (Exhibits G165, R10; Tr. 2658, 2668-2679.)

HSA was approved as a HUD-FHA mortgagee in 1987. In its Application for Mortgagee Approval, HSA certified that it would comply with the provisions of the HUD regulations and other requirements of the HUD Secretary (Exh. G165). HSA was also approved as a Direct Endorsement (DE) lender by HUD-FHA. Initially, HSA conducted its business in Austin, Texas. In spring 1988, HSA formed a branch office in Houston, Texas, and placed Steven Brown, a UAMC branch manager, in charge of establishing the Houston branch office. (Tr. 2688.) Brown hired Cathy Burnhagen to be the manager of the Houston branch office. Brown was Burnhagen's superior, and she reported to him. Brown returned to Austin once Burnhagen was hired, and visited the Houston branch office once a month, or less often, after that. (Tr. 2806, 2450-2452.)

Burnhagen hired Wanda Spencer as a loan officer and Deborah Blodgett as a loan processor (Tr. 2453-2454). Both women were experienced in their respective positions. Spencer had been a loan officer at various mortgage lending institutions since 1982, with almost all of her experience in HUD-FHA loan programs. Burnhagen knew both Spencer and Blodgett because she supervised them at Harbor Financial Mortgage. (Tr. 1637.) Blodgett had not worked as a processor for Spencer at Harbor Financial, but when both came to the HSA Houston branch office, Blodgett became Spencer's processor (Tr. 1378, 1643-1645).

Burnhagen did not supervise Spencer in the normal sense because of Spencer's experience, but both Spencer and Blodgett

went to Burnhagen for advice on how to handle certain problems (Tr. 112, 1375, 1380, 1649-1650). Burnhagen believed that she was aware of how Spencer and Blodgett were handling loan applications (Tr. 1663-1664, 1680). Despite the fact that it was HSA corporate policy that a branch office manager is to review every loan application before it is submitted for underwriting, I find that Burnhagen did not formally review files prior to submitting them to HSA's Direct Endorsement (DE) underwriter in Austin, despite her testimony to the contrary (Tr. 1760, 2782). Corporate management was unaware that Burnhagen was not performing the review function (Tr. 2784).

Spencer cultivated a special Hispanic clientele that was primarily interested in purchasing HUD "REO" (repossessed real estate properties owned by HUD) real estate that required only a \$100 downpayment, with no appraisal, and that was sold at very low prices. This accounted for 70% of her business. (Tr. 74.) Those purchasers applied for mortgages insured by HUD-FHA. Spencer actively sought the business of real estate brokers, agents, and developers who primarily had a Hispanic clientele. Spencer did not speak or understand Spanish, nor did Blodgett. (Tr. 48, 1393, 1737-1739.) There was only one employee in the HSA Houston branch who could communicate in Spanish, but she was rarely, if ever, used to assist with the language barrier. Spencer relied upon financially interested real estate brokers and agents to translate the questions that she had to ask to take preliminary loan applications and to review completed loan applications with applicants. (Tr. 48.) She also routinely allowed real estate brokers and agents to deliver financial documents used to qualify applicants for mortgages, including Federal tax returns, pay stubs, and W-2 forms. The use of third parties to deliver such financial documentation was not forbidden by HSA corporate policy. (Tr. 2709-2711.)

Spencer would go to the office of the referring real estate broker or agent to take the preliminary application of purchasers. This was done to accommodate the purchasers, and to be competitive with other mortgage lending companies. (Tr. 2347-2350.) If the applicants did not speak English, which was often the case, Spencer would have the real estate agent or broker ask the questions and translate the answers necessary to complete the FNMA Form 1003, which was the form used by HSA for preliminary loan applications. Spencer would not fill in the blocks for earnings at all if she was not presented with documented proof of salary or earnings. She would sometimes record the information on scraps of paper that were later purged from the loan file, but only for those cases in which she calculated the loan ratio to "qualify" an applicant. Blodgett did not regularly see such notations by Spencer. (Tr. 1488, 1489, 2395, 2398.) There was some testimony that this method of filling out a preliminary application was not unusual in the local mortgage lending community, although the form itself and the relevant HUD Handbook

both make clear that the form is to be completely filled out prior to having the applicants sign it. (Exhs. G159, App.1, at 1; G86, Tr. 1494, 1676-1677, 2707-2709.)

The applicants would sign the FNMA Form 1003 filled out by Spencer, based on what the translating agent or broker had told her were the applicants' answers. Spencer had no way of knowing if the translations were accurate because she lacked a basic knowledge of Spanish, which was the language spoken by most of her clients. She also had no way of knowing what the translators were telling the applicants, or if the applicants understood the preliminary loan application when they signed it. Spencer trusted the real estate agents, brokers, and applicants to be honest with her, and was not suspicious that they were providing her with false information. (Tr. 62,73,2383,2391-2393.) I find that Spencer did not ask applicants the value of their personal effects, despite her rather elaborate testimony to the contrary, but rather assumed that even the poorest applicants somehow accumulated at least \$15,000 in household furnishings, and either filled in what she considered to be an appropriate figure, or suggested a figure for their assent. (Tr. 60.)

Spencer would tell the applicants, using the translator if needed, what documentation was still required to process the loan, such as pay stubs, W-2 forms, and tax returns. Signatures would be obtained on blank verifications of deposit (VOD), employment (VOE), and rent (VOR) to permit the collection of the required verification information from banks, employers, and landlords, although this was clearly described as an imprudent lending practice in the relevant HUD Handbook. (Exh. G159, App.1.) According to most of the loan applicants who testified at the hearing, this was the only time that they remembered meeting Spencer. These applicants included Ocampo, Benitez, Saucedo, Mejia, Ramirez, Villegas, Nava, Santana, Trenado, Koulianos, and Navarro. The Cantus never met Spencer at all. (Tr. 2053, 752, 526, 896, 1597, 1572, 867, 686, 624, 803.)

Spencer would bring the FNMA Form 1003, together with the VOEs, VOD, VOR and any financial documentation given to her by the applicants, to Blodgett for processing. Blodgett would then type in the names and addresses of employers, banks and landlords on the verification forms. (Tr. 102-203.) Often, more than one VOE would have to be sent out because the applicants worked at more than one job, or had worked at a series of jobs for short periods. Blodgett would mail out the verifications that were to be completed by the recipients. She would also order a credit report on each applicant. When all of the necessary documentation was received by Blodgett, she would type all of the information on a HUD-FHA Form 92900, which is the loan application. Blodgett would also calculate the debt ratio, payments that would have to be made by the borrowers on the loan at closing, and the monthly mortgage payments. She then would

give the typed Form 92900 to Spencer to review with the applicants and to obtain their signatures on it if Blodgett did not do that herself. (Tr. 1382-1393, 1395-1397.)

Spencer testified that she or another HSA employee, usually Blodgett, reviewed the Form 92900 with all applicants (Tr. 85-86, 2351, 2402). However, she had the real estate brokers and agents perform this function if the applicants spoke Spanish (Tr. 87, 303). I find from the preponderance of the evidence that this function was, in fact, performed by the real estate brokers and agents in the majority of the 18 transactions at issue in this case. In the Cantu transaction, Spencer admitted that she had never met the applicants at all, although she checked on the Form 1003 that she had interviewed the Cantus face-to-face. (Tr. 92, 93; G-87.) Spencer testified that she was unaware that it was a HUD requirement that all applicants be interviewed face-to-face, preferably when going over the Form 92900 with them (Tr. 401, 2357, 2393).

It was Spencer's policy to have the applicants sign the Form 92900 but not to date it. Blodgett signed and dated the Form 92900's when Spencer returned them to her. Blodgett assumed that Spencer had done a face-to-face interview in every transaction, particularly because each Form 1003 was marked that way by Spencer. Blodgett also dated the applicants' signatures when she dated her own. (Tr. 1448, 1451, 2380-2382.) This method of dating used by Spencer and Blodgett was not HSA policy, and was not in accordance with HUD's requirements for completing the 92900 (Tr. 2747-2748). Spencer did this to avoid having to have the form retyped if there was an error (Tr. 2405). The loan package would then be sent to Austin for underwriting.

HSA had a corporate policy that allowed the hand-carrying of verifications by HSA employees when time was of the essence (Tr. 2520). However, the branch manager was supposed to reverify the information by telephone in such cases, to assure that no undue influence was exerted by the HSA employee on the person verifying information (Tr. 2702-2703, 2526-2527). This procedure was not followed at the Houston branch, and it is unclear whether Burnhagen even knew that there was a corporate policy requiring her to reverify in such instances. Both Spencer and Blodgett would handcarry verifications of employment and rent to speed along the data collection process. Although such a process is not forbidden by HUD regulation, handbook, or circular letter, HUD does suggest that mortgagees should give consideration to only allowing employees that do not receive commissions to handcarry verifications. (G159, Appendix 1, at 2.) Spencer and Blodgett felt extremely pressured to produce a lot of work under tight deadlines, and handcarried documents because of these time pressures. They were handling such a large case load, without any help from Burnhagen, that they complained to both Burnhagen and Brown, and asked that additional personnel be hired because

the workload was overwhelming the small office. (Tr. 1408-1411, 2456-2460.) Spencer was paid by commission and Blodgett received bonuses for cases closed within certain time periods (Tr. 1407, 1703, 1705, 2518-2519).

There is also compelling evidence that some of the loan applicants, real estate brokers and agents were handcarrying VOE's, but there is no evidence that either Spencer or Blodgett were giving VOE's to them or accepting them from unauthorized sources. The verification forms were widely available to real estate brokers and agents without the need for a mortgagee to supply them (Tr. 1726). It was HSA's policy to tear up any verifications received from real estate brokers or agents, and the policy was followed in the Houston branch office (Tr. 1839-1841, 2006).

Most of the information contained on the VOE's in the 18 cases in question was grossly inaccurate or false, a fact not seriously disputed by HSA. I find that some employers were trying to help their employees qualify for a mortgage, "puffing" the duration of employment or the hours worked. I find that Fred Nava was a more credible witness than his employer, Mr. Justice, on the duration of his employment, and I further find that Justice filled out Nava's VOE incorrectly and also testified as he did to help Nava get a home loan. (Tr. 859-860.) A few individuals posed as employers for purposes of verifying employment that really amounted to an occasional weekend of work to earn a little extra money. Such "employment" does not count for purposes of qualifying for a loan to be insured by HUD-FHA. In any event, I find that the verifications appeared on their faces to be legitimate and correct. I therefore find that HSA had a right to rely on them.

A mortgagee cannot rely on a verification if the information on it appears to conflict with other documentary information supplied to the mortgagee, or if there are errors that raise questions about the reliability of the verification itself. This includes names spelled incorrectly, errors in Social Security numbers or Employer Identification numbers, addresses that do not correspond with other information provided, information that conflicts with information on credit reports, pay stubs, or W-2 forms, or a verification that has been altered by white-out or erasures. If any of these discrepancies appear, the mortgagee has an obligation to resolve the apparent conflicts in the information provided. If conflicts cannot be resolved in such a way as to assure the underwriting risk, the loan must be denied, or "busted out", in the language of the industry. (Exh.G159, App.1; Tr. 80.)

A number of the loan application files at issue in this case contained conflicting information and other errors that should have been caught at some point by HSA before those loans closed

and were insured by HUD-FHA. The Villegas loan package had very obvious problems that escaped notice at every level of processing, review and underwriting at HSA. In that file, there are verification documents from both Golden Greek Carpets and Golden Creek Carpets. There is no documentation resolving this discrepancy. Rather, there was a note to the file indicating that Bargain Carpets, the employer listed on the FNMA Form 1003 is the "same" company as Golden Creek Carpets. That information came orally from Lupe Miranda, the real estate agent, to Spencer, who told it to Blodgett. It was never substantiated. The information on the FNMA Form 1003 and the Form 92900 is unreconcilable based on the actual documentation in the file. (Exhs. G97, G115, G135, G136, G137, G170, G61; Tr. 2366-2369.)

In the Santana loan file, the information on the credit report does not confirm Santana's employment with Aviles Carpeting. Also, the name of the purported employer, Aviles, is slightly different on the W-2 forms provided to HSA for 1987 and 1988. (Exh. G53.) That discrepancy should have caused someone reviewing the Santana file at HSA to enquire further. However, the most serious problems with the Santana loan application would not have shown up through a document review. The Santana loan file was permeated by false documents from counterfeit W-2 forms to fabricated pay stubs. (Exhs. G129, G53, G54, G55.) There is no evidence that either Spencer or Blodgett knew that the financial documents provided to HSA in the Santana transaction were false.

Eleven of the loans in question had fabricated tax returns that were used to prove a certain level of income to justify approval of the loan application. These were the loans for Benitez, Ocampo, Mejia, Ramirez, Nunez, Nava, Marengo, Trenado, Grisales, Koulianos, and Navarro. As in the Santana transaction, there is no probative, reliable evidence that either Spencer or Blodgett were responsible for the creation of false tax returns, or knew that the tax returns provided to HSA were not true copies of the tax returns filed with the IRS. I find that Spencer lacked both the language and the community contacts to have masterminded or directed the creation of false tax returns and the false documents that backed them up. Furthermore, there is no evidence that anyone else at HSA was involved in perpetration of the document fraud that so permeated the applications at issue in this case. I find that the Government has not proved its contention that Spencer saw "real" tax returns at preliminary loan application interviews and later saw more favorable tax returns for the same applicants that were submitted for loan approval to be proven. The testimony of a few witnesses that they "believed" that they might have shown Spencer their true tax returns when they first met her was so vague and unreliable as to lack probative value (Tr. 753-754; 1576; 1600.) Moreover, it is not credible because the real estate agents and brokers who were present at these initial meetings would not have allowed their

clients to give Spencer tax returns that would have automatically disqualified them from being approved for a loan because their income, as it appeared on the "true" tax returns, was so low.

Nonetheless, there were indications on the face of the tax returns in certain of the files that they were not genuine, and those indications should have been caught sometime during the review process that included underwriting. In the Koulianos file, the original tax return form was submitted. That was a "red flag" that the return was not, in fact, a copy of the one actually filed by Koulianos with the IRS. The tax preparer's signature is missing from the form, and the Employer Identification number is not the same for consecutive tax years, although the employer was the same. (Exhs. G62, G63.) However, the most clearly bogus tax return is the tax return for 1987 submitted in the Daniel Ocampo file. That "return" does not even calculate the tax due (Exh. G72). Blodgett relied on the affidavit signed by each applicant that not only stated that the tax returns submitted with the loan application were true copies of ones filed with the IRS, but also gave the lender permission to contact the IRS to crosscheck the information provided. The underwriting staff in Austin also gave little attention to the returns themselves for the same reason. (Tr. 1937.)

Likewise, there were indications that false pay stubs and false W-2 forms were being submitted to substantiate income levels. Those indications included names being spelled different ways, addresses for employers that did not correlate with other information in the file, suspect Social Security numbers, and employer ID numbers that conflicted from year to year. (Exhs. G32, G33, G56, G57, G61, G67, G68, G107, G138, G139, G141, G170.) Some of these discrepancies were subtle, and only an underwriter going over each line of each form with an eye for problems would have noticed them. However, others were blatant. Both kinds escaped the review and underwriting processes at HSA.

The HUD-approved Direct Endorsement underwriter for HSA was Charles Nichols. Nichols only did a cursory review of the underwriting analysis conducted by the HSA employees actually performing the underwriting function, Sharon Johnson and Amy Beggs. (Tr. 2786, 2693-2694, 2699, 2553.) Johnson was highly respected for her underwriting abilities within HSA. She was consulted by both Spencer and Blodgett when they had a difficult question that they did not trust Burnhagen to be able to answer. (Tr. 114-116.) They apparently never even considered consulting Nichols, and were unaware that he was actually HSA's approved underwriter, not Johnson. Brown was also unaware that Nichols was the DE underwriter. (Tr. 1381, 2499.) After Johnson died, Beggs took over her position. Nichols could not explain why Johnson, Beggs, and he all missed the "red flags" in some of the files, but he did indicate that it was HSA policy to underwrite a loan unless there was a reason to deny it, rather than looking

for reasons to deny a loan application. (Tr. 2715, 2721-2723, 2726.) Nichols is the only participant or principal remaining with HSA today that was involved with the loans in question (Tr.2658.)

A HUD-approved DE lender is required to have a Quality Control (QC) plan that meets certain guidelines, and to implement it. Prior to December 1989, those requirements were found at 24 C.F.R. Section 24.203.2(j). HUD Handbook 4060 also addresses the QC requirements. Essentially, HUD requires a mortgagee to institute a program of review of loan origination documents that will test the reliability of loan application information, and if a problem is found, to take action to correct it in a timely manner. To do this effectively, a mortgagee must reverify the information on which it based its decision to underwrite the loan. Prior to December, 1989, a referral and incorporation of the QC standards of FNMA (Federal National Mortgage Association) was sufficient to meet HUD requirements for an acceptable QC plan. (Exh. G159.)

In 1989, HUD issued three circular letters to all HUD-approved mortgagees to alert them to problems in quality control. Mortgagees were notified through these circular letters of altered and false financial documents such as W-2 forms, pay stubs and tax returns, and how to spot them through quality control review before the loan was approved. (Tr. 965-970; Exh. G-168.) There is no indication that anyone at HSA paid particular attention to these circular letters that could have helped HSA detect the existence of false documentation.

In 1989, Mortgage Professional Services, Inc. (MPS) was awarded the contract to prepare a QC plan for HSA, and to carry it out in accordance with FNMA guidelines. The QC plan designed by MPS was in accordance with FNMA guidelines, and the model for it had been approved by FNMA. The problem with HSA's QC plan was in its implementation. HSA was not providing the files requested and identified for QC review by MPS in a timely manner. The result was that QC reviews were being done months too late to be of any use, and timely corrections could not possibly be made. This failure was caused by the actions of Paul Antrim, the Chief Financial Officer for HSA, who delayed sending the requested files to MPS. (Tr. 2743-2744.) At the time, Nichols was unaware that Antrim was the cause of the failure of the QC plan (Tr. 2852-2853).

HSA terminated its contractual relationship with MPS in late 1989, and hired its own QC officer to do QC reviews (Tr. 2811). Presently, Beverly Lillians performs QC reviews for HSA on a part-time basis (Tr. 2537). When Nichols hired Lillians in December, 1989, he told her to design a QC plan that would prevent loans from being underwritten based on false information, such as had happened in the Houston branch in 1989 (Tr. 2542,

2563). Lillians and Amy Beggs wrote a QC plan to comply with FNMA guidelines. Initially, Lillians did some pre-underwriting reverifications of information orally, and would then do written reverifications after underwriting. Now, all of the QC reverifications are done post-underwriting, and all are in writing. About 15 files per month are subjected to a QC review, and about five of those are studied in depth each month. Lillians prepares a monthly written QC report, and then holds a staff meeting to discuss the report. (Tr. 2543, 2546, 2550, 2813.) Since her employment by HSA, she has detected no fraudulent documents in the loan files studied. (Tr. 2560.)

In September, 1989, HSA first learned that there might be false documentation in loan files submitted to HUD for insurance (Tr. 2828). David Buff, an employee in the HUD Monitoring Division in Houston, received a telephone call from a lender who informed Buff that he had to "bust out" some loans for false documentation in which Pan American Real Estate was the broker. Pan American had been on HUD's unofficial "watch list" since 1988. Ed Woerz, then Acting Chief of Mortgage Credit in HUD's Houston Office, had his staff run a computer search of all loans insured by HUD in Houston for which Pan American was the broker, to identify the mortgagees for those loans. HSA showed in the computer search as one such mortgagee. Woerz had his staff examine those loan files and do a careful QC review of the documents. They found what looked like false W-2 forms and tax returns. Woerz then called HSA to explain what his staff had found, and asked to do a "mini-review" of HSA's copies of the files. Steven Brown was sent to Houston to meet with Woerz and to be shown the problems with the loan documents that HUD uncovered through its Pan American-related review. Woerz told Brown that HSA should immediately conduct an internal investigation to learn the scope of the problem. At the same time, Woerz's office referred the suspect cases to the HUD Inspector General (IG) for investigation. (Tr. 976, 978-988, 2463-2469, 2727-2729.)

When Brown returned to Austin, he reported to Nichols and Kadison what he had learned from Woerz. It was decided that Spencer, Burnhagen, and Blodgett would be summoned to Austin without any explanation or forewarning of the reasons, and that they would be separately questioned by Brown in the presence of a corporate employee from HSA's Credit Department who specialized in detecting fraud. Within a few days, the investigative interviews with Spencer, Burnhagen, and Blodgett were held, and the in-house fraud expert concluded that none of them knew that fraudulent documents were contained in the files for loans insured by HUD. (Tr. 2732-2735.)

Next, Nichols directed Burnhagen to conduct a detailed review of all loan applications in process. She was directed to "bust out" any application that had even the smallest problem

that could in any way indicate the presence of fraud or unreliability. All of the HUD "REO" loans that were Spencer's specialty were either intentionally busted by Burnhagen to get them out of HSA's inventory, or transferred to other mortgagees. (Tr. 1683-1684, 1783, 2379.) Effective November 17, 1989, HSA refused to accept any more business from Pan American. It considered ceasing business with other real estate agencies that were involved in the "REO" market, but became concerned that it could be accused of "redlining" if it refused to accept any HUD "REO" loan applications. HSA effectively took itself out of the "REO" market by requiring large downpayments as of December 1, 1989, that made HSA noncompetitive in that market, without refusing to participate in it. Also, in November, 1989, HUD began an on-site audit of HSA. (Tr. 1415, 2731, 2736-2739.)

Spencer was terminated by HSA because Nichols was told by HUD auditors that they believed that Spencer was definitely involved in the fraud. Nichols did not interview Spencer personally, or confront her with the real reasons for her dismissal. Blodgett was also dismissed on the pretext that fewer processors would be needed by HSA. (Tr. 2739-2741.) Brown and Burnhagen are no longer employed by HSA, but their employment ceased at a later date than Spencer's or Blodgett's (Tr. 2478).

In Spring, 1990, Nichols requested a meeting with HUD because HUD had rejected three files submitted for final endorsement by HSA (Tr. 2829). Those files were for the Mejia, Trenado, and Navarro loans initially endorsed by HSA (Tr. 2835). Nichols was told that the three files were rejected by HUD for suspicion of fraud. Nichols and Amy Beggs went over those files and were unable to find indications of fraud. Nichols offered to seek Mortgagee Review Board approval for indemnification by HSA if any of the three files were found to actually contain fraudulent documents AND if HSA was involved in the fraud. HUD refused to insure the three loans, even with Nichols' conditional indemnification offer. (Tr. 2840-2842.)

In Summer, 1990, Nichols went to Washington, D.C. to meet with William Heymann and Dane Narode, both of HUD, on the subject of UAMC. At that meeting, Nichols also raised the problem of the three HSA loans rejected by HUD in 1990, and asked Heymann for help in getting those loans approved. Nichols repeated his qualified indemnification offer to Heymann, but Heymann stated that HUD would insure no loans based on fraudulent documents. At the time of the meeting with Heymann and Narode, the HUD audit report on HSA had not yet been issued. (Tr. 2843-2846.)

Nichols states that he was unaware of the scope or magnitude of the problems with fraudulent documents in HSA files until this hearing (Tr. 2861). He apparently became aware for the first time that Spencer knew no Spanish and had turned over the communication function with loan applicants to real estate agents

and brokers who had a financial interest in the loan process (Tr. 2750). Nichols is no longer the underwriter for HSA, but it is unclear who is performing that function, if anyone. Beggs is no longer employed at HSA. Nichols stated that, based upon the evidence given in this hearing, he sees that the current QC plan needs further refinements now that he understands the implications of fraudulent documentation. (Tr. 2854-2857, 2861-2862.) However, it was unclear whether Nichols was referring to doing some QC review before underwriting, or whether he was intending that a more intensive review and testing of financial documentation, particularly tax returns, be conducted. UAMC is still in existence, although its dissolution had been discussed. Its mortgagee approval has been withdrawn for six years on other facts. (Tr. 2756, 2865, 2869.) There is no longer a Houston branch of HSA. (Tr. 2682.)

DISCUSSION

The purpose of withdrawing HUD-FHA approval from a mortgagee is to protect both the public and HUD from doing business with a mortgagee that fails to adhere to the regulations and program requirements of the mortgage insurance program, and more generally, fails to adhere to prudent lending practices. 24 C.F.R. Section 25.9. A DE lender such as HSA must originate HUD-insured loans with at least as much care and prudence as it would with conventional loans because HUD has placed its reliance on the mortgagee to only approve quality loan applications for publicly funded mortgage insurance. The DE lender is the eyes and ears of HUD when originating such loans.

Failure to adhere to HUD program requirements and prudent lending practices jeopardizes the HUD-FHA mortgage insurance program and the public fisc that funds it. It is immaterial whether a mortgagee deliberately avoids and subverts the regulations and requirements imposed on it, or if it fails to follow them through misunderstanding, carelessness, or lack of knowledge. In either case, the public interest in a sound mortgage insurance program needs protection. However, mortgagees that intentionally subvert and defraud clearly pose a greater long-term risk than those that are honest but imprudent. Thus, all mitigating factors are to be considered, including the seriousness and extent of the lending irregularities, and the degree of mortgagee responsibility for the irregularities, in deciding how long the withdrawal sanction should be, if applied at all, in a given case. 24 C.F.R. Section 25.9.

Although the regulations applicable to withdrawal of mortgagee approval do not specifically address the concept of present responsibility or the prohibition against using a sanction for punitive purposes, the withdrawal of mortgagee

approval is akin to debarment. The strictures against abusive application of sanctions developed in the law of debarment and suspension are equally valid, by analogy, to this area of the law. See generally, 24 C.F.R., Part 24. The appropriateness of application of the test of present responsibility to withdrawal of mortgagee approval was acknowledged by the Government at the hearing in this case.

The gravamen of the Government's complaint against HSA is that HSA either participated in fraud or allowed a fraud to occur in eighteen loan transactions by failing to comply with HUD rules, regulations and practices applicable to loan origination, and by failing to have a working Quality Control plan in place to identify and solve loan origination irregularities. The Government is seeking to withdraw HSA's mortgagee approval as a DE lender for a period of three years. Fourteen months have already elapsed during which time HSA has been suspended pending resolution of the withdrawal action.

All of the loans in question were originated by Wanda Spencer, a loan officer in HSA's Houston branch office. Seventeen of the eighteen transactions involved Hispanic purchasers, most of whom did not speak English. For the most part, Spencer communicated with these purchasers who did not speak English through the Spanish-speaking realtors, who had a direct financial stake in the loans being approved. She trusted both these realtors and these purchasers to be honest with her.

Honesty was in short supply in this case. Many witnesses, particularly the real estate brokers and agents, perjured themselves. Others conveniently lost their memory or had memory lapses. Perhaps the most forthcoming witness was Charles Nichols, the only individual that played a role in these transactions who is still associated with HSA, and indeed, is a senior HSA officer. The Houston branch office is closed. Spencer, Brown, Burnhagen, Johnson, Beggs, and Blodgett are no longer HSA employees. There is a working quality control program in operation at HSA today, as compared to the one that was effectively shut down in 1989. Today, HSA is a different company than it was in 1989-90. The question for me to resolve is whether HSA is so different today that a withdrawal of mortgagee approval would merely be punitive, and would not in any way protect HUD, or the public interest in proper loan origination practices. I also must resolve the extent of HSA's contribution to the fraud that tainted the loan transactions in this case.

The eighteen loan transactions at issue in this case were corrupted from the outset by a concerted plan to present false information about the employment, earnings, and liabilities of the loan applicants to induce HSA to approve the loans, and to induce HUD-FHA to insure them. The sheer volume of false documentation in these cases is staggering. False verifications

of employment, false W-2 statements, false pay stubs, false Federal tax returns, false Social Security numbers for certain applicants, all documentation on which both lenders and HUD rely to make and insure a loan, were fabricated for the express purpose of deceiving the lender and HUD. HUD has every right to be outraged that it was victimized by fraud. The question, however, is whether HSA was directly or indirectly responsible for this fraud.

I conclude that a network of deceit and false papers was required, with extended contacts in the Spanish speaking community of Houston, and an ability to communicate in Spanish. Wanda Spencer lacked both. Spencer was a forthcoming, credible witness for the most part, and I have indicated those parts of her testimony that I discounted. I found her testimony that she had no idea that false information and documents were placed in HSA files to be credible. Likewise, I have no evidence or suspicion that any other HSA employee knew or suspected that false documents and information were being given to HSA.

Nonetheless, this record is so fraught with evidence of imprudent lending practices, violations of HUD requirements, and careless underwriting that it raises difficult questions about HSA's present responsibility. Even if HSA was not an willing partner in crime, it carried out its loan origination function in such an imprudent fashion that it allowed the fraud of others to flourish undetected. HUD had a right to expect vigilance from HSA, but what it actually got was inattention to detail. The end result was that the HUD mortgage insurance program was compromised and subverted.

Had the Houston branch office of HSA followed HUD requirements and prudent lending practices, and had the Austin office been more careful in its underwriting review, at least some of the fraudulent loan applications could have been discovered before public monies were committed to insure them. Because the quality control plan was not operating in a manner that would make it useful or effective, HSA denied itself even that opportunity to discover problems, albeit after the fact. Spencer's methods of taking loan application was naive, imprudent, and all but invited those who would prey upon the Government loan insurance program to come to her for business.

The key consideration in prudent lending practice is to separate the function of the real estate brokers, sellers and purchasers from the lending function. Thus, no party with a financial stake in the approval of a loan is to handle any of the loan application or verification papers, except when their signature is required, and the document is controlled by the lender. Even the employees of the lender who are paid on commission are to be as uninvolved as possible with the verification process. A loan officer such as Wander Spencer

"takes" a loan application, but she then turns over that application to salaried employees, who perform the loan processor function of obtaining the required verifications and documentary proof needed to make a prudent lending decision. The underwriting function is separated from that of both the loan officer and loan processor, to allow for yet another level of dispassionate evaluation of the quality of the loan application before the loan is approved.

The process for the lender begins with the taking of the loan application. If a fraud is in place, it will be introduced into the lending process at this earliest stage of contact, by the provision of false information to the loan officer. First, even if a loan officer asks all of the questions on the loan application, fraud cannot be prevented by that act alone. A well-rehearsed fraud is designed to take advantage of that first gathering of oral information, duly recorded on a FNMA 1003 preliminary loan application by the loan officer, to give credibility to the fraudulent information that will later be channeled through the mortgagee to "verify" and prove the false information given to the loan officer. While it is not unheard-of for a loan officer to be an active player in fraudulent loan applications, based upon the record before me in this case, Wanda Spencer was a passive player, so passive that she unwittingly helped those frauds proceed merrily on their way. She gave up any chance for detecting fraud at this initial stage of contact by letting interested parties control the process. She was a mere bystander.

Spencer ceded all control over the loan application process at the outset by having the real estate brokers effectively conduct the loan application interview by "translating" for her. Spencer had no idea what was being asked of Spanish-speaking applicants, or what they were saying in response. She only knew what the realtor, acting as "translator," chose to tell her. Thus, even if one of the applicants temporarily forgot the fraudulent script for the interview, Spencer would not have known this. To make lender control even less clear to the applicants, these interviews were invariably conducted in the realtors' office, not at HSA. The message to applicants from the outset was that the realtor, not Spencer or HSA, controlled the lending process. Spencer courted an Hispanic clientele without being able to communicate with it. HSA knew that Spencer did not speak Spanish, but according to Charles Nichols, it was not until the hearing in this case that he understood the full extent of Spencer's limitations, or how those limitations put HSA at an impossible disadvantage as a prudent lender.

It is not a HUD requirement that a loan officer conduct a face-to-face interview with an applicant, or that it be done via the Form 1003. However, it is a requirement that a face-to-face interview be conducted by the lender, preferably after the HUD

Form 92900 application for mortgage insurance is completed, to make sure that all of the information on the Form 92900 is true and complete by going over it line-by-line and explaining it to the applicant before the applicant signs the form. It is the Form 92900, not the Form 1003, on which the lending and insuring decision is made. This function, too, was ceded to the interested realtors. Thus, another protection, that a prudent lender would be very careful to control, was effectively abandoned. Loans were approved and underwritten based on only the most perfunctory face-to-face contact with the applicants, during which no one from HSA even communicated directly with many of the applicants.

The Form 1003, although only the preliminary loan application, is used as a comparative tool by loan processors and underwriters to compare the information initially given by applicants with that information verified and placed on the Form 92900. Discrepancies are to be resolved before a loan is approved. Spencer routinely left off the Form 1003 the most important information for loan approval, the applicant's earnings. While the value of one's household goods ultimately plays no real role in the decision to approve or insure a loan, earnings are the key to approval. To save herself a little trouble, Spencer imprudently filled out the Form 1003 so that it provided no documentary point of comparison on earnings.

Spencer, although an experienced loan officer, somehow never knew that HUD required a face-to-face interview with loan applicants. This appalling lack of knowledge of a key requirement reflects not only on Spencer personally, but on HSA and how it failed to communicate prudent lending practices and required practices to its employees.

The next steps in the loan origination process were done by the loan processor, who collected the necessary documents, reviewed them for accuracy and reliability, and prepared the files for review and underwriting. The loan processor at the Houston branch office of HSA was conscientious, but overworked, and she missed a number of discrepancies that should have alerted her to at least a potential problem with some of the files. She also should not have accepted explanations that came from interested realtors without independently verifying them. HSA loan processors followed a company practice of obtaining the signatures of applicants on blank verification forms. First, the HUD Handbook is clear that such a practice is unacceptable. Second, it was yet another way in which HSA deprived itself of a check on false information. There was a lot of fabricated information about non-existent employment in this case that could possibly have been avoided if HSA truly controlled the origination process by not having applicants sign verification forms until the name and address of the supposed employer was typed on the form.

Blodgett, as the loan processor, was not even to be the last reviewer of a loan file before the Houston branch sent the file to Austin for underwriting. Burnhagen, as the office manager, was to review each file, according to HSA policy. I do not know if Burnhagen ever understood this duty, but it was not done by her in any meaningful way.

The underwriting function in Austin was, in fact, not performed by the HUD-approved DE underwriter, Charles Nichols. Rather, it was done by Sharon Johnson and Amy Beggs, on whom Nichols placed almost total faith and reliance. Despite Nichols' faith in their careful scrutiny of the loan files, they too missed both the obvious and the subtle discrepancies that should have caused them to question, if not "bust," loan application with these problems.

Too much was taken for granted by HSA at every level of review. First, everyone had a very trusting nature, and they did not view loans with a skeptical eye. It was corporate underwriting policy to review a loan with the intent to approve it, rather than to disapprove it. All of the HSA employees with a reviewing function assumed that the Federal tax returns were legitimate, and did not look at them to see if they were questionable documents on their face, because of the affidavit that the returns were true copies and could be verified. As a result of its failure to verify questionable tax returns and other suspect documents, HSA became known as a lender through which false documents could be channeled without detection. Trust may be an admirable human emotion, but it is not one that a prudent lender can afford to blindly indulge. HSA was imprudent in the manner in which it approved loans, underwrote them, and caused them to be insured by HUD-FHA.

HSA also so undermined its QC plan in 1989 that the plan could not function in any meaningful way. This was the fault of a corporate officer of HSA, not the Houston branch or the QC contractor. It further convinces me that in 1989 HSA was not a responsible DE lender. The current QC plan administered by Beverly Lillians appears to be working effectively, although there should be more pre-underwriting QC review, considering what happened to HSA. Suspicious-looking Federal tax returns should be verified before underwriting to avoid a repeat of 1989.

If Spencer had conducted flawless loan application interviews, if Blodgett and Burnhagen had gone over the files with an eye to discrepancies, if Nichols and his staff had been more careful during the underwriting review, and if the QC Plan had been operating properly in 1989, HSA would have discovered some obvious discrepancies that would have caused them to "bust" some loans either at the initial application stage or at the subsequent review stages. However, these frauds were well-rehearsed, with a final performance for some taking place under

oath during the two weeks of hearing in this case. It would have been all but impossible for HSA to have discovered that most of the documents that it relied upon were fraudulent, with the exceptions referred to in the findings of fact. HUD discovered the majority of the fraudulent documents in this case in the process of tracking loans that came from Pan American Real Estate, based upon a tip. HSA "came up on HUD's screen" through HUD's search of Pan American business, not HSA business.

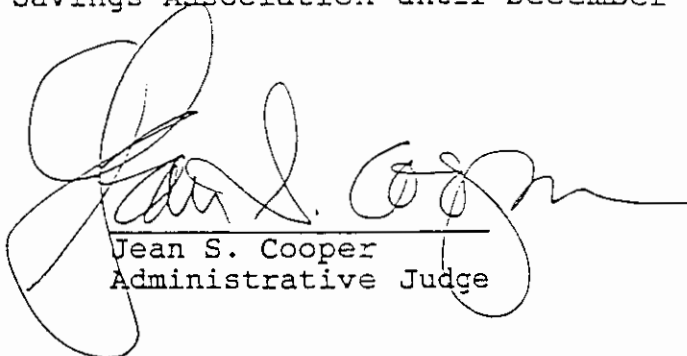
It is fortunate for the tax-paying public that so few of these loans have gone into default. However, a low default rate does not change the fact that HSA was not a prudent lender in 1989. Its loan origination practices allowed fraud to occur through laxity, overly trusting relationships with realtors and applicants, less than careful compliance with HUD requirements for useful face-to-face interviews, mishandling of verification forms, lack of resolution of discrepancies at multiple levels of review including underwriting, and negation of its QC program. The Government has cited these practices as grounds for a three-year withdrawal of mortgagee approval, and it has carried its burden of proof that grounds for withdrawal of approval exist pursuant to 24 C.F.R. Sections 25.9 (g), (j)), (k), (p), and (w).

However, these events occurred almost three years ago, and HSA has been suspended as a HUD-approved lender since June 6, 1991, based on these events. All but one of the key actors are gone, and the one who is left, Charles Nichols, is certainly taking a more responsible approach. Nonetheless, I am not convinced that HSA should be reinstated as a HUD-approved mortgagee at this time because of the pervasive carelessness that characterized its operations when it had more business. HSA can now be very careful because it has a very small loan volume, but even with that, it still is not as eagle-eyed and questioning as it should be, considering what happened to it in 1989. Also, Nichols himself was part of the problem as the underwriter who ceded his duties to others.

Although I find that a period of withdrawal of mortgagee approval is warranted, it will achieve no useful public purpose to withdraw HSA's mortgagee approval for three years. The public and HUD have been insulated from HSA since June 6, 1991, and I find that by December 6, 1992, HSA should be fully ready to resume its obligations as a HUD-approved mortgagee in a responsible and prudent manner. It is already well on its way to this goal, and it would be punitive at this time to apply a longer period of exclusion, which would not benefit either HUD or the public.

CONCLUSION

The record in this case supports a need for a withdrawal of mortgagee approval of Horizon Savings Association until December 6, 1992.



Jean S. Cooper
Administrative Judge