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JUDGE FORREST

**UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF NEW YORK**

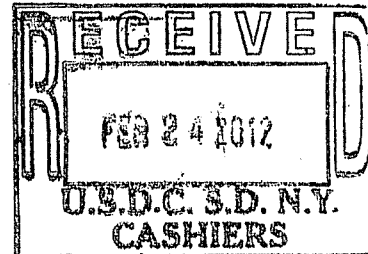
-----X  
UNITED STATES OF AMERICA,

Plaintiff,

v.

FLAGSTAR BANK, FSB,

Defendant.  
-----X



**COMPLAINT**

12 Civ 12-CV  
ECF Case

1392

**Jury Trial Demanded**

The United States of America (the "United States" or the "Government"), by its attorney, Preet Bharara, United States Attorney for the Southern District of New York, brings this action against Flagstar Bank, FSB ("Flagstar"), alleging upon information and belief as follows:

**INTRODUCTION**

1. This is a civil fraud lawsuit brought by the United States against Flagstar, one of the largest savings banks and originators of mortgage loans in the country. Over the last decade, Flagstar has improperly approved thousands of residential home mortgage loans for government insurance using unauthorized staff employees to conduct key underwriting functions in the loan approval process, setting daily quotas for these so-called "underwriting assistants" and paying

them substantial incentive awards for exceeding their quotas. Moreover, during this period, Flagstar's actual underwriters submitted false certifications to the Federal Housing Administration (the "FHA") and the United States Department of Housing and Urban Development ("HUD") stating that they had personally reviewed all of the documents associated with the loans even though they had not. These false certifications misled the FHA and HUD into believing that the loans had been fully underwritten by registered and experienced underwriters when they had not. Flagstar's use of these unauthorized staff employees to perform key underwriting functions under this quota system encouraged reckless mortgage lending, and led to thousands of loans being approved for government insurance that did not qualify for such insurance. When the loans ultimately defaulted, HUD — which had insured the loans against default — was left to cover the losses.

2. Since 1988, Flagstar has been a participant in the Direct Endorsement Lender program (the "DEL program"), a federal program administered by the FHA and HUD. The DEL program authorizes private-sector mortgage lenders ("Direct Endorsement Lenders" or "DELs") to approve mortgage loans for insurance by the FHA. If a DEL approves a loan for FHA insurance and the loan later defaults, the holder of the loan may submit an insurance claim to HUD for the costs associated with the defaulted loan, which HUD must then pay.

3. As set forth below, since at least January 1, 2002, Flagstar has been endorsing loans for FHA insurance in violation of DEL program rules, and submitting false certifications to the FHA and HUD about its underwriting practices. As a result of this misconduct, HUD has paid hundreds of millions of dollars in insurance claims on loans that Flagstar never should have endorsed for FHA insurance in the first place. HUD's net loss on these loans — taking into account property sales and other mitigation efforts — is a substantial percentage of this amount.

The United States brings this action under the False Claims Act (the “FCA”), 31 U.S.C. §§ 3729, *et seq.*, and the common law seeking damages and penalties for Flagstar’s misconduct.

4. Under the DEL program, neither the FHA nor HUD reviews a loan before it is endorsed for FHA insurance. Consequently, it is crucial that DELs follow the DEL program rules in determining which loans to approve for FHA insurance. One of these program rules is the rule requiring that DELs employ registered underwriters (“DE underwriters”) to conduct due diligence on loans before the loans are endorsed for FHA insurance. DE underwriters are experienced underwriters. To be registered as a DE underwriter, a person must have at least three years of full-time, recent experience reviewing both credit applications and property appraisals, and must have demonstrated skill in mortgage evaluation and knowledge with respect to the principles of mortgage underwriting.

5. The rule requiring that DE underwriters conduct due diligence on loans before endorsing them for FHA insurance exists to ensure that the loans that ultimately are endorsed satisfy the applicable HUD underwriting rules.

6. Notwithstanding the importance of DE underwriters to the DEL program, since at least January 1, 2002, Flagstar has been delegating key underwriting responsibilities to its so-called “underwriting assistants.” These individuals lack the qualifications necessary to be DE underwriters. At Flagstar, DE underwriters conduct an initial review of all loans and approve a subset of loans for FHA insurance with conditions. These conditions — which relate to all aspects of the loans, including the borrower’s income, assets and credit — must be satisfied before the loans can close and be endorsed for FHA insurance consistent with HUD’s underwriting rules. After a loan has been approved with conditions, however, Flagstar routinely assigns underwriting assistants to review and sign off on (*i.e.*, “clear”) many of the conditions.

Contrary to the requirements of the DEL program, these underwriting assistants make the final decision as to whether the conditions they review have been satisfied. Once all of the conditions on a loan have been cleared, a DE underwriter endorses the loan for FHA insurance, without reviewing the work performed by the underwriting assistants in clearing conditions. In fact, for years, Flagstar has expressly instructed its DE underwriters not to review the work performed by the underwriting assistants in clearing conditions or the documents on which the underwriting assistants relied in clearing the conditions. The vast majority of the loans that Flagstar has approved for FHA insurance since January 1, 2002 had conditions that were cleared by underwriting assistants.

7. In addition to allowing underwriting assistants to clear conditions on its FHA loans in violation of DEL program rules, Flagstar gives these underwriting assistants a powerful incentive to prioritize volume over quality in reviewing conditions. Flagstar pays underwriting assistants substantial incentive awards based on the volume of conditions they review per day. Flagstar assigns underwriting assistants a specific number of loans to process per day (*i.e.*, a daily quota). To satisfy this daily quota, underwriting assistants must review all of the conditions associated with these loans. If an underwriting assistant exceeds this daily quota, the underwriting assistant is paid a fixed dollar amount for each additional loan whose conditions he or she reviews above this quota. Underwriting assistants thus have a strong incentive to review as many conditions as possible as quickly as possible. And this is precisely what they have done. For example, in 2010, incentive compensation comprised more than 20% of the total annual salary of at least 10 underwriting assistants, with individual incentive compensation awards exceeding \$15,000.

8. Similarly, Flagstar pays its DE underwriters substantial incentive awards based primarily on the number of loans they underwrite per day. This compensation system gives Flagstar's DE underwriters a powerful incentive to underwrite as many loans as possible as quickly as possible, which is what they have done. For example, in 2010, incentive compensation comprised more than 40% of the total annual salary of at least 10 DE underwriters, with individual incentive compensation awards exceeding \$90,000.

9. These practices have led to reckless mortgage lending. On numerous occasions since January 1, 2002, Flagstar's underwriting assistants — who perform underwriting work that they are not authorized to perform, and who are paid substantial incentive awards if they perform this work quickly — have cleared conditions in violation of HUD's underwriting rules. Likewise, Flagstar's DE underwriters — who are paid substantial incentive awards if they underwrite loans quickly, and who do not review the work performed by underwriting assistants before endorsing loans for FHA insurance — have frequently endorsed loans for FHA insurance in violation of HUD's underwriting rules.

10. As a result of the above-described practices, Flagstar has been submitting false certifications to the FHA and HUD for years. For every loan that Flagstar endorses for FHA insurance, it is required to submit a certification to the FHA and HUD ("loan-level certification") confirming that the loan is eligible for FHA insurance. These loan-level certifications differ depending on whether the loan was underwritten manually or using an FHA-approved automated underwriting system ("AUS"). For all loans underwritten using an FHA-approved AUS, the certification provides that the loan is eligible for mortgage insurance under the DEL program (*i.e.*, that it complies with HUD's applicable underwriting rules). For all loans underwritten manually, the certification provides that a DE underwriter "personally reviewed the appraisal

report (if applicable), credit application, and all associated documents,” and further provides that the loan is eligible for mortgage insurance under the DEL program. The latter certification is broader because manually-underwritten loans frequently have one or more characteristics that suggest heightened risk.

11. Flagstar has submitted one of the above-referenced loan-level certifications to the FHA and HUD for every loan it has endorsed for FHA insurance since January 1, 2002 (the “relevant period”). Yet, notwithstanding its certifications to the contrary, a Flagstar DE underwriter did not “personally review[] the . . . credit application[] and all associated documents” for all of the loans that Flagstar manually underwrote and endorsed for FHA insurance during the relevant period. Rather, for the vast majority of these loans, underwriting assistants reviewed and signed off on many of the key documents. Furthermore, Flagstar’s DE underwriters and underwriting assistants failed to conduct the required due diligence on many of the loans that Flagstar underwrote and endorsed for FHA insurance during the relevant period. Indeed, many of these loans: (1) contain multiple obvious violations of HUD’s underwriting rules; and thus (2) were not eligible for mortgage insurance under the DEL program.

12. To date, HUD has paid hundreds of millions of dollars in FHA insurance claims and related costs arising out of defaults on loans that Flagstar endorsed for FHA insurance during the relevant period. Many of these losses were caused by Flagstar’s false loan-level certifications. Absent a truthful loan-level certification, a DEL is not entitled to endorse a given loan for FHA insurance. If the FHA and HUD had known that Flagstar’s loan-level certifications were false: (1) they would not have permitted Flagstar to endorse the corresponding loans for FHA insurance; and (2) HUD would not have had to pay hundreds of

millions of dollars in insurance claims on the loans once they defaulted. HUD's net loss — taking into account mitigation efforts — is a substantial percentage of this amount.

13. In this lawsuit, the United States is seeking treble damages and penalties under the FCA, as well as compensatory and punitive damages under the common law, for the insurance claims that HUD has paid to date for loans wrongfully endorsed by Flagstar during the relevant period.

### **JURISDICTION AND VENUE**

14. This Court has jurisdiction pursuant to 31 U.S.C. § 3730(a), 28 U.S.C. §§ 1331 and 1345, and the Court's general equitable jurisdiction.

15. Venue is appropriate in this judicial district pursuant to 31 U.S.C. § 3732(a) and 28 U.S.C. §§ 1391(b)(1) and (c), because Flagstar transacts business within this district and therefore is subject to personal jurisdiction in this district. In addition, certain loans at issue in this case were originated in this district and/or concern borrowers and properties located in this district.

### **PARTIES**

16. Plaintiff is the United States of America.

17. Defendant Flagstar is one of the largest savings banks and originators of residential mortgage loans in the United States. In 2010, Flagstar was among the top 15 largest savings banks in the country. Moreover, in 2010, Flagstar produced \$26.6 billion in mortgage loans and ended the year as a top 15 mortgage originator, a top 5 FHA lender, and a top 10 warehouse lender.

18. Flagstar, which is headquartered in Troy, Michigan, is the principal subsidiary of Flagstar Bancorp, Inc., a Michigan-based savings and loan holding company. Flagstar currently

operates banking centers in Michigan and Indiana, and home lending centers across the country. Moreover, Flagstar originates loans nationwide, with brokers and correspondents in all 50 states, including in this judicial district.

19. Flagstar originates mortgage loans primarily for the purpose of selling them to third parties. Indeed, since 2007, Flagstar has sold virtually its entire production of mortgage loans, holding very few for investment.

## **FACTS**

### **I. BACKGROUND**

#### **A. The Direct Endorsement Lender Program**

20. The FHA is the largest insurer of residential mortgage loans in the world. Pursuant to the National Housing Act of 1934, the FHA offers various mortgage insurance programs.

21. FHA mortgage insurance encourages lenders to make loans to borrowers who might not be able to meet conventional underwriting requirements by protecting lenders against defaults on the loans. In this way, FHA mortgage insurance programs help low- and moderate-income families become homeowners.

22. To qualify for FHA mortgage insurance, a loan must satisfy all of the applicable HUD underwriting requirements. These underwriting requirements relate to, among other things, the adequacy of the borrower's income and assets to meet his or her mortgage payments, the borrower's credit history, and the valuation of the property that is subject to the mortgage.

23. The DEL program is one of the mortgage insurance programs operated by the FHA. Pursuant to the DEL program, DELs may approve loans for FHA insurance without prior FHA or HUD approval. Before the implementation of the DEL program, HUD reviewed all



applications for mortgage insurance and determined, on its own, whether a particular loan qualified for insurance. Under the DEL program, by contrast, DELs determine whether or not a particular loan is eligible for FHA insurance based on the applicable HUD underwriting rules. As part of the loan endorsement process, DELs must certify that the approved loans comply with all applicable HUD underwriting rules.

24. The DEL program is supposed to work as follows: The borrower first completes a loan application. The borrower — or a loan correspondent or broker acting on the borrower's behalf — then collects all of the supporting documentation and submits the loan application and documentation to a DEL. The DEL obtains an appraisal of the subject property. A DE underwriter employed by the DEL then reviews the loan application and documentation, as well as the appraisal, and performs a mortgage credit analysis to ensure that the mortgage qualifies for FHA insurance under the applicable HUD underwriting rules. The DE underwriter makes the ultimate decision as to whether the mortgage qualifies for FHA insurance. If the DE underwriter decides that the loan may be approved for FHA insurance (*i.e.*, that it complies with the various HUD underwriting requirements), the DE underwriter closes the loan. At this time, the DEL, through its DE underwriter, certifies to the FHA and HUD that the loan complies with the applicable HUD underwriting rules. The FHA endorses the loan for FHA insurance on the basis of this certification and provides the DEL with a mortgage insurance certificate.

25. The DEL is responsible for ensuring that all aspects of the loan application, the property analysis, and the underwriting of the loan comply with all applicable HUD underwriting rules. The DEL is responsible for the actions of its DE underwriters.

26. In the event that a borrower defaults on an FHA-insured loan, the holder of the loan is able to submit a claim to HUD for the costs associated with the defaulted loan. HUD then pays off the balance of the loan and other costs.

**B. Direct Endorsement Lenders and Underwriters**

27. A mortgage lender must apply to the FHA to become a DEL.

28. To qualify for FHA approval as a DEL — and thereafter, to maintain status as a DEL — a lender must have a qualified underwriter (*i.e.*, a DE underwriter) on staff.

29. There are numerous requirements that must be met before an underwriter can serve as a DE underwriter, and thereby review and approve loans for FHA insurance. Among other things, the underwriter must have a minimum of three years full-time recent experience reviewing both credit applications and property appraisals. The underwriter also must be a reliable and responsible professional skilled in mortgage evaluation, and must be able to demonstrate his or her knowledge and experience regarding the principles of mortgage underwriting.

30. In addition, the underwriter must be registered with the FHA. The only way that an underwriter can become registered with the FHA is if a DEL registers him or her. Moreover, when a DEL registers an underwriter with the FHA, it certifies to the FHA that the underwriter has the necessary qualifications.

31. Once a DEL has registered an underwriter as a DE underwriter, the underwriter is assigned a unique identification number (a “CHUMS ID”). Whenever a DE underwriter approves a loan for FHA insurance, the DE underwriter enters his or her CHUMS ID number on the loan.

32. The FHA and HUD can use these CHUMS ID numbers to monitor the performance of particular DE underwriters.

33. To the extent that a DEL allows individuals who are not DE underwriters to underwrite FHA loans, this practice undermines the FHA and HUD's ability to monitor DE underwriter performance. The FHA and HUD have no way to monitor the performance of individuals who are not DE underwriters (*i.e.*, who have not been assigned a CHUMS ID number).

**C. The Due Diligence Required of Direct Endorsement Lenders and Underwriters**

**1. Due Diligence as Required by Regulation**

34. Because the FHA and HUD rely on DELs to determine which loans should be endorsed for FHA insurance, they require that DELs and their DE underwriters conduct adequate due diligence on loans before endorsing them for FHA insurance. This due diligence requirement is a critical part of the DEL program and is memorialized in federal regulations. *See* 48 Fed. Reg. 11928, 11929-32 (Mar. 22, 1983).

35. During the due diligence process, a DE underwriter must "evaluate [each] mortgagor's [(*i.e.*, borrower's)] credit characteristics, adequacy and stability of income to meet the periodic payments under the mortgage and all other obligations, and the adequacy of the mortgagor's available assets to close the transaction, and render an underwriting decision in accordance with applicable regulations, policies and procedures." 24 C.F.R. § 203.5(d). In addition, the DE underwriter must "have [each] property appraised in accordance with [the] standards and requirements" prescribed by HUD. 24 C.F.R. § 203.5(e).

36. The due diligence required is "the same level of care which [the lender (*i.e.*, the mortgagee)] would exercise in obtaining and verifying information for a loan in which the

mortgagee would be entirely dependent on the property as security to protect its investment.” 24 C.F.R. § 203.5(c).

37. The due diligence requirement is meant to ensure that DELs and their DE underwriters: (1) approve loans only for those borrowers who demonstrate an ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties, *see* 24 C.F.R. § 203.5(d); and (2) examine the property offered as security for the loan to confirm that it provides sufficient collateral, *see* 24 C.F.R. § 203.5(e)(3).

38. HUD has memorialized specific rules for due diligence predicated on sound underwriting principles. In particular, HUD requires DELs and their DE underwriters to be familiar with, and to comply with, the governing HUD Handbooks and Mortgage Letters, which specify the minimum underwriting requirements with which DELs must comply before endorsing a given loan for FHA insurance.

39. To ensure that borrowers have sufficient income, assets and credit, a DEL and its DE underwriters must comply with the HUD Handbooks and Mortgage Letters addressing these topics, such as HUD Handbook 4155.1, *Mortgage Credit Analysis for Mortgage Insurance on One-to-Four-Family Properties*. These HUD Handbooks and Mortgage Letters identify the minimum due diligence required in evaluating a borrower's income, assets and credit. The rules set forth in these HUD Handbooks and Mortgage Letters exist to ensure that a DEL and its DE underwriters sufficiently evaluate whether a borrower has the ability and willingness to repay the mortgage debt.

40. For example, to evaluate a borrower's income, assets and credit properly under HUD Handbook 4155.1, a DEL (through one of its DE underwriters) must, among other things, obtain and review credit histories; analyze debt obligations; reject documentation transmitted by

unknown or interested parties; inspect documents for proof of authenticity; obtain adequate explanations for collections, judgments, recent debts, and recent credit inquiries; establish income stability and make income projections; obtain explanations for gaps in employment; document any gift funds used to qualify for the loan; calculate debt-to-income ratios and compare those ratios to the fixed ratios set by HUD; and consider and document any compensating factors permitting deviations from the fixed ratios.

41. Similarly, to ensure that a mortgaged property provides sufficient collateral for an FHA loan, a DEL and its DE underwriters must comply with the HUD Handbooks and Mortgagee Letters addressing property appraisals, such as HUD Handbook 4150.1, *Valuation Analysis for Home Mortgage Insurance*. These HUD Handbooks and Mortgagee Letters identify the minimum due diligence required in evaluating property appraisals.

## **2. Due Diligence as Required by Common Law**

42. DELs owe the FHA and HUD a common law duty of due diligence.

43. The exercise of due diligence is an affirmative duty of DELs. This duty obligates DELs to comply with HUD underwriting rules, accepted practices of prudent lending institutions, and all procedures that a prudent lender would use if it were to look solely to the mortgaged property as security to protect its interests. This duty further obligates DELs to use due care in providing information to the FHA and HUD.

44. Indeed, “[t]he entire scheme of FHA mortgage guaranties presupposes an honest mortgagee performing the initial credit investigation with due diligence and making the initial judgment to lend in good faith after due consideration of the facts found.” *United States v. Bernstein*, 533 F.2d 775, 797 (2d Cir. 1976).

45. HUD has informed DELs of this common law duty. *See* 48 Fed Reg. at 11932 (“The duty of due diligence owed the Department by approved mortgagees is based not only on these regulatory requirements, but also on civil case law.”).

### **3. The Fiduciary Duty of Good Faith**

46. A fiduciary duty exists between DELs and the FHA and HUD.

47. The FHA and HUD rely on the expertise and knowledge of DELs in endorsing loans for FHA insurance. The FHA and HUD place confidence in the DELs’ decisions, and trust that they will comply with all applicable HUD underwriting rules. The confidence that the FHA and HUD place in DELs invests the DELs with a significant advantage in the parties’ relationship.

48. As a result of the fiduciary relationship between DELs and the FHA and HUD, DELs have a duty to act with good faith, candor, honesty, integrity, fairness, undivided loyalty, and fidelity (collectively, the “duty to act with good faith”) in their dealings with the FHA and HUD.

49. This duty to act with good faith also requires DELs to: (1) refrain from making misrepresentations to the FHA and HUD; (2) make full and fair disclosures to the FHA and HUD of all material facts; and (3) use reasonable care to avoid misleading the FHA and HUD in all circumstances.

50. In addition, this duty to act with good faith requires DELs to exercise sound judgment, prudence and due diligence on behalf of the FHA and HUD in endorsing loans for FHA insurance.

#### **D. Direct Endorsement Lender and Underwriter Certifications**

51. Each DEL must submit a certification to the FHA and HUD for each loan that it approves for FHA insurance. These loan-level certifications are to be signed by one of the DEL's DE underwriters.

52. The loan-level certifications are important as the FHA and HUD will rely on them for purposes of endorsing mortgage loans for FHA insurance, thereby eliminating the need for the FHA or HUD to review the loans prior to endorsement. *See* 48 Fed. Reg. at 11932.

53. A DE underwriter may underwrite an FHA loan one of two ways: (1) manually; or (2) by using an FHA-approved automated underwriting system. The language of the required loan-level certification differs depending on whether the loan is underwritten manually or using an FHA-approved AUS.

54. If a DE underwriter uses an FHA-approved AUS, the DE underwriter must enter certain information regarding the loan into the AUS. The AUS will then process the information and rate the loan as either "accept"/"approve" or "refer"/"caution."

55. If a DE underwriter uses an FHA-approved AUS and the AUS rates the loan as either "accept" or "approve," the DE underwriter must make the following certification, in sum and substance:

This mortgage was rated as an "accept" or "approve" by a FHA-approved automated underwriting system. As such, the undersigned representative of the mortgagee certifies to the integrity of the data supplied by the lender used to determine the quality of the loan, that Direct Endorsement Underwriter reviewed the appraisal (if applicable) and further certifies that this mortgage is eligible for HUD mortgage insurance under the Direct Endorsement program. I hereby make all certifications required by this mortgage as set forth in HUD Handbook 4000.4.

56. The certifications set forth in HUD Handbook 4000.4 — which are incorporated by reference in the above loan-level certification — include the certification that "the mortgage

complies with HUD underwriting requirements as contained in all outstanding HUD handbooks and Mortgagee Letters.” The above loan-level certification, therefore, represents that the loan was underwritten with the level of due diligence required by all outstanding HUD Handbooks and Mortgagee Letters, and in accordance with the applicable HUD underwriting rules.

57. If a DE underwriter uses an FHA-approved AUS and the AUS rates the loan as either “refer” or “caution,” or if a DE underwriter does not use an FHA-approved AUS, the DE underwriter must manually underwrite the loan and make the following certification, in sum and substance:

This mortgage was rated as a “refer” or “caution” by a FHA-approved automated underwriting system, and/or was manually underwritten by a Direct Endorsement underwriter. As such, the undersigned Direct Endorsement Underwriter certifies that I have personally reviewed the appraisal report (if applicable), credit application, and all associated documents and have used due diligence in underwriting this mortgage. I find that this mortgage is eligible for HUD mortgage insurance under the Direct Endorsement program and I hereby make all certifications required for this mortgage as set forth in HUD Handbook 4000.4.

58. In addition to representing that the loan was underwritten with the requisite due diligence and that the DE underwriter reviewed the property appraisal (if one was required), this loan-level certification for manually-underwritten loans also represents that the DE underwriter “personally reviewed the . . . credit application[] and all associated documents.”

59. The additional certification that the DE underwriter “personally reviewed the . . . credit application[] and all associated documents” is critical, as manually-underwritten loans frequently have one or more characteristics that suggest heightened risk.

60. The above-described loan-level certifications ensure that a certain baseline level of care is applied to all loans before they are endorsed for FHA insurance. These certifications make it possible for the FHA/HUD to delegate the authority to endorse loans for FHA insurance to DELs.



61. Absent a truthful loan-level certification, a DEL is not entitled to endorse a particular loan for FHA insurance. The FHA and HUD will not accept a loan for FHA insurance absent the required loan-level certification.

## **II. FLAGSTAR'S DIRECT ENDORSEMENT LENDER ACTIVITIES**

### **A. Flagstar's Underwriting Process**

62. At Flagstar, the underwriting process for all FHA loans — regardless of whether the loans are manually underwritten or underwritten using an FHA-approved AUS — is the same. This same underwriting process has been in place continuously at Flagstar since at least January 1, 2002.

63. The underwriting process begins when a borrower submits a loan application to Flagstar. This is done electronically. The borrower — or a loan correspondent or broker acting on behalf of the borrower — uploads the loan application to Flagstar's proprietary underwriting software system, which is called "Mortrac," together with all of the supporting documentation. A Flagstar DE underwriter then accesses the loan application and supporting documentation using Mortrac and conducts an initial underwrite of the loan. At this stage, the DE underwriter may, among other things, reject the loan application or approve it with conditions.

64. If a DE underwriter approves a loan application with conditions, he or she enters the specific language of the conditions into Mortrac. All of the conditions on a loan must be satisfied before the loan can close and be endorsed for FHA insurance consistent with HUD's underwriting rules.

65. The conditions on a loan could relate to any aspect of the loan, including the borrower's income, assets or credit. For example, the following is a condition from a loan that Flagstar approved for FHA insurance in 2006: obtain a "VOR [Verification of Rent] with 12

months history of no late payments from [the] property management [company] or 12 months cancelled [rent] checks.”

66. The vast majority of the loans that Flagstar has endorsed for FHA insurance since January 1, 2002 were approved initially with conditions.

67. After a loan application is approved with conditions, the borrower submits additional documentation to Flagstar in response to the conditions and/or Flagstar obtains additional documentation from individuals associated with the borrower (such as the borrower’s landlord or employer) in response to the conditions. For example, in response to the condition described above, Flagstar should have obtained a Verification of Rent or 12 months of canceled rent checks before the loan was closed and endorsed for FHA insurance.

68. At this point in the process, Flagstar frequently assigns underwriting assistants to review many of the conditions on a given loan. These underwriting assistants review the newly-obtained documentation regarding the conditions and decide whether the conditions have been satisfied.

69. Flagstar’s underwriting assistants are not DE underwriters, however. They do not have CHUMS ID numbers, and Flagstar has not certified to the FHA that they possess the qualifications necessary to be DE underwriters. In fact, Flagstar does not require that its underwriting assistants possess the qualifications necessary to be DE underwriters. For example, Flagstar does not require that its underwriting assistants have at least three years full-time recent experience reviewing both credit applications and property appraisals. Nor does Flagstar ensure that its underwriting assistants are reliable and responsible professionals skilled in mortgage evaluation.

70. If after reviewing a condition, an underwriting assistant determines that the condition has been satisfied (*i.e.*, that the newly-obtained documentation is sufficient to satisfy the condition), he or she will clear the condition.

71. Once all of the conditions on a loan have been cleared, a DE underwriter is notified. The DE underwriter will then sign the loan-level certification without reviewing the work performed by the underwriting assistants in clearing conditions or the newly-obtained documentation on which the underwriting assistants relied in clearing the conditions. Indeed, Flagstar expressly instructs its DE underwriters not to review the work performed by the underwriting assistants in clearing conditions.

72. In clearing the conditions on a loan, underwriting assistants review only: (1) the conditions identified by the DE underwriter; and (2) the new documentation obtained in response to those particular conditions. Underwriting assistants do not review the entire loan file. Accordingly, in clearing conditions, underwriting assistants do not have a complete picture of the loan application.

73. Since at least January 1, 2002, the vast majority of the loans that Flagstar has endorsed for FHA insurance have had conditions that were cleared by underwriting assistants. Moreover, many loans have had multiple conditions that were cleared by underwriting assistants.

74. Flagstar's underwriting assistants not only clear conditions on most of Flagstar's FHA loans, but they clear conditions relating to all aspects of the loans. Indeed, since at least January 1, 2002, underwriting assistants have cleared conditions relating to, among other things, the borrower's income, assets, and credit.

75. For example, with respect to income, an underwriting assistant may review the borrower's pay stubs and W-2s to ensure, among other things, that the documents reflect an

income level consistent with information obtained from the borrower's employer in connection with a Verification of Employment. In addition, an underwriting assistant may review documents submitted to clarify the borrower's income (*e.g.*, a statement from the borrower's employer addressing whether and the extent to which the borrower receives commissions and/or overtime pay, or a statement from the borrower's employer explaining why the borrower's year-to-date income as reflected on a pay stub is inconsistent with his or her representations regarding annual income) to ensure, among other things, that the borrower's income is sufficient to meet his or her mortgage obligations. An underwriting assistant also may review pension-related documents (*e.g.*, a letter from the borrower's pension provider regarding the borrower's monthly pension payments) to ensure, among other things, that the borrower in fact receives monthly pension payments consistent with his or her representations.

76. With respect to assets, an underwriting assistant may review documents submitted to explain large deposits (*e.g.*, gift letters) to ensure, among other things, that the borrower is not obligated to repay the amount of such deposits. In addition, an underwriting assistant may review bank statements to confirm, among other things, that the borrower has sufficient cash reserves to cover his or her mortgage obligations.

77. Finally, with respect to credit, an underwriting assistant may review documents submitted in connection with an apparent debt (*e.g.*, a credit supplement) to determine, for example, whether a third party, and not the borrower, ultimately is responsible for the debt, or whether the debt has been paid off or is lower than is reflected in a credit report. In addition, an underwriting assistant may review a statement from the borrower's landlord confirming that the borrower has consistently met his or her rental obligations (*e.g.*, a Verification of Rent) to

ensure, among other things, that the borrower is creditworthy and likely to meet his or her mortgage obligations.

**B. Flagstar's Incentive Compensation System**

78. Since at least January 1, 2002, Flagstar has maintained an incentive compensation system pursuant to which DE underwriters and underwriting assistants are paid incentive compensation based on the volume of loans they underwrite/conditions they review.

79. With respect to DE underwriters, since at least January 1, 2002, Flagstar has assigned each of its DE underwriters a daily quota of points that he or she must accumulate. A DE underwriter earns one point for each loan that he or she underwrites (*i.e.*, reviews and either rejects, suspends or approves with conditions). A DE underwriter also earns one point for reviewing the conditions on a previously-underwritten loan (*i.e.*, analyzing each condition and deciding whether to clear or not to clear each condition). On a semi-annual basis, Flagstar pays each DE underwriter a fixed dollar amount (in addition to his or her regular base pay) for each point that he or she has accumulated above his or her quota for that period. Since January 1, 2002, this fixed amount has varied between \$20.00 and \$45.00 per point.

80. Similarly, since at least January 1, 2002, Flagstar has assigned each of its underwriting assistants a daily quota of loans to process. To satisfy this daily quota, an underwriting assistant must review all of the conditions associated with these loans. On a semi-annual basis, Flagstar pays each underwriting assistant a fixed dollar amount (in addition to his or her regular base pay) for each loan that he or she has processed above his or her quota for that period. Since January 1, 2002, this fixed amount has varied between \$2.00 and \$4.00 per loan.

81. In addition to setting daily quotas that its DE underwriters and underwriting assistants are required to meet, Flagstar also sets daily targets for its DE underwriters and

underwriting assistants. These daily targets (which are higher than the daily quotas) do not represent a ceiling for purposes of earning incentive compensation. DE underwriters and underwriting assistants earn a fixed dollar amount for every point they accumulate/loan they process above their quotas, regardless of whether they also exceed their targets.

82. For example, as of November 2008, the daily quota for DE underwriters was four points, and DE underwriters earned \$25.00 for each point they accumulated above this quota. Moreover, as of November 2008, the daily target for DE underwriters was seven points. If a DE underwriter met this daily target (*i.e.*, accumulated seven points per day), the DE underwriter would earn an extra \$12,600 in incentive compensation per year. If a DE underwriter exceeded this daily target, the DE underwriter would earn even more money based on the total number of points he or she accumulated above the target.

83. As of November 2008, the daily quota for underwriting assistants was seven loans, and underwriting assistants earned \$2.50 for each loan that they processed above this quota. Moreover, as of November 2008, the daily target for underwriting assistants was 17 loans. If an underwriting assistant met this daily target (*i.e.*, reviewed the conditions on 17 loans per day), the underwriting assistant would earn an extra \$6,500 in incentive compensation per year. If an underwriting assistant exceeded this daily target, the underwriting assistant would earn even more money based on the total number of loans that he or she processed above the target.

84. In addition to the incentive compensation discussed above, from time to time, Flagstar offers its DE underwriters and underwriting assistants the opportunity to work over the weekend for additional pay. On these occasions, Flagstar pays its DE underwriters and underwriting assistants an additional fixed dollar amount for every point they accumulate/loan

they process over the weekend. To be eligible to participate in these weekend opportunities, a DE underwriter or underwriting assistant must have met his or her daily quota for the relevant period.

85. Flagstar's incentive compensation system encourages reckless mortgage lending. It encourages DE underwriters and underwriting assistants to prioritize volume over quality. If a DE underwriter or underwriting assistant works quickly and completes his or her daily quota during the regular workday, the DE underwriter or underwriting assistant will be able to: (1) avoid working after hours or over the weekend for no additional compensation simply to meet his or her quota; (2) earn substantial incentive awards for any additional work that he or she completes; and (3) participate in the weekend opportunities when they arise.

86. The chart below identifies 10 DE underwriters who were among the top incentive compensation earners at Flagstar in 2008. These 10 DE underwriters earned at least \$30,000 in incentive compensation in 2008, and the top earner received \$82,180.33 in incentive compensation. For these DE underwriters, incentive compensation comprised at least 38.1% of their total salary in 2008, and as much as 64.5%.

DE Underwriter Identifier	2008 Base Salary	2008 Incentive Compensation	Incentive Compensation as a Percentage of Total Salary
DE Underwriter 1	\$45,110.78	\$82,180.33	64.5%
DE Underwriter 2	\$39,852.28	\$50,578.10	55.9%
DE Underwriter 3	\$59,999.94	\$45,095.68	42.8%
DE Underwriter 4	\$42,923.16	\$39,140.52	47.7%
DE Underwriter 5	\$53,942.19	\$38,607.70	41.7%
DE Underwriter 6	\$58,999.98	\$36,371.03	38.1%

DE Underwriter 7	\$48,615.72	\$34,814.76	41.7%
DE Underwriter 8	\$45,098.69	\$31,956.77	41.4%
DE Underwriter 9	\$49,525.02	\$30,813.61	38.3%
DE Underwriter 10	\$45,074.12	\$30,703.21	40.5%

87. As demonstrated by the chart below, the default rates on the loans that these 10 Flagstar DE underwriters manually underwrote and approved for FHA insurance in 2008 (between 40.5% and 53.3%) were higher than the default rate for all of the manually-underwritten loans that Flagstar approved for FHA insurance in 2008 (35.9%). In other words, the FHA loans that these 10 highly-compensated DE underwriters approved for FHA insurance were more likely to default than the loans approved by their lower-compensated colleagues. For purposes of the calculations in this paragraph, a loan was counted as being in default if there was a missed payment during the course of the loan.

DE Underwriter Identifier	Total Loans	Total Defaults	Default Rate
DE Underwriter 1	478	249	52.0%
DE Underwriter 2	352	169	48.0%
DE Underwriter 3	320	150	46.8%
DE Underwriter 4	213	110	51.6%
DE Underwriter 5	180	73	40.5%
DE Underwriter 6	228	105	46.0%
DE Underwriter 7	254	124	48.8%
DE Underwriter 8	197	97	49.2%
DE Underwriter 9	171	79	46.2%
DE Underwriter 10	45	24	53.3%



88. Because HUD has no way to track the performance of Flagstar's underwriting assistants — which is one of the many reasons why Flagstar's underwriting assistants should not be clearing conditions — it is impossible to compile similar statistics for underwriting assistants. However, since January 1, 2002, a substantial portion of the total annual salary of many underwriting assistants has consisted of incentive compensation. Indeed, the chart below provides examples of ten underwriting assistants for whom at least 20% of their total salary in 2008 consisted of incentive compensation.

Underwriting Assistant Identifier	2008 Base Salary	2008 Incentive Compensation	Incentive Compensation as a Percentage of Total Salary
Underwriting Assistant 1	\$32,439.86	\$11,887.00	26.8%
Underwriting Assistant 2	\$32,031.84	\$11,641.60	26.6%
Underwriting Assistant 3	\$22,646.54	\$8,340.98	26.8%
Underwriting Assistant 4	\$37,246.50	\$12,410.00	24.9%
Underwriting Assistant 5	\$32,018.37	\$10,251.00	24.2%
Underwriting Assistant 6	\$25,017.23	\$8,001.00	24.2%
Underwriting Assistant 7	\$20,504.59	\$6,377.80	23.7%
Underwriting Assistant 8	\$27,586.14	\$7,806.40	22.0%
Underwriting Assistant 9	\$27,676.83	\$7,627.60	21.5%
Underwriting Assistant 10	\$25,552.16	\$6,992.90	21.5%

### **III. FLAGSTAR'S FALSE CERTIFICATIONS**

#### **A. Flagstar's False Loan-Level Certifications Involving the Use of Underwriting Assistants**

89. Since at least January 1, 2002, and as a result of its unauthorized use of underwriting assistants to clear conditions, Flagstar has knowingly submitted false loan-level certifications to the FHA and HUD for loans that were underwritten manually. Through these false loan-level certifications, Flagstar fraudulently induced the FHA to accept for insurance thousands of loans that were not eligible for FHA insurance and that the FHA otherwise would not have insured. Moreover, Flagstar has not only been having underwriting assistants perform underwriting tasks that they are not authorized to perform (and then been submitting false loan-level certifications to the FHA regarding the matter), but the underwriting assistants have been performing these underwriting tasks recklessly. Since at least January 1, 2002, underwriting assistants have been clearing conditions on Flagstar's FHA loans in obvious violation of HUD's underwriting rules.

##### **1. Flagstar knowingly submitted false loan-level certifications as a result of its unauthorized use of underwriting assistants**

90. Since at least January 1, 2002, for each manually-underwritten loan that Flagstar has approved for FHA-insurance, Flagstar has certified that a DE underwriter "personally reviewed the appraisal report (if applicable), credit application, and all associated documents and . . . used due diligence in underwriting this mortgage." For the vast majority of these loans, this certification was false.

91. Flagstar's DE underwriters have not reviewed all of the documents associated with its manually-underwritten loans. Rather, since at least January 1, 2002, Flagstar has had underwriting assistants clear conditions on the vast majority of these loans, and the underwriting

assistants have been the only ones to review the documents associated with the conditions they clear (including documents related to the borrower's income, assets and credit).

92. Flagstar knew that a substantial number of its certifications of compliance with HUD's DE underwriter review requirement were false. Indeed, these false certifications were the inevitable result of the very underwriting process that Flagstar has designed and implemented, and that it has required its DE underwriters to follow since at least January 1, 2002. This underwriting process — pursuant to which underwriting assistants clear conditions and DE underwriters do not review the work performed by the underwriting assistants in clearing conditions or the documents on which the underwriting assistants relied in clearing the conditions — necessarily results in false loan-level certifications. Alternatively, in falsely certifying compliance with HUD's DE underwriter review requirement, Flagstar acted with deliberate ignorance and/or reckless disregard of the truth.

93. In addition, Flagstar's false certifications of compliance with HUD's DE underwriter review requirement were grossly negligent and/or negligent, and violated Flagstar's duty of care to HUD.

**2. The FHA and HUD relied on Flagstar's false loan-level certifications involving the use of underwriting assistants**

94. The submission of a truthful loan-level certification is a prerequisite to endorsing a loan for FHA insurance.

95. The FHA and HUD relied on Flagstar's loan-level certifications in allowing Flagstar to endorse loans for FHA insurance.

96. If the FHA and HUD had known that Flagstar's loan-level certifications were false — and that Flagstar was using underwriting assistants to clear conditions — they would not have permitted Flagstar to endorse the loans for FHA insurance.

**3. Flagstar's underwriting assistants have been recklessly clearing conditions**

97. As demonstrated by the six examples below, on many occasions since January 1, 2002, Flagstar's underwriting assistants have cleared conditions on Flagstar's FHA loans in obvious violation of HUD's underwriting rules. The actions of the underwriting assistants in these six examples are not isolated events. Rather, these examples represent a small fraction, but a representative sample, of the many instances since January 1, 2002, in which underwriting assistants have erroneously and recklessly cleared conditions.

**a. The Nebraska Avenue Property**

98. FHA case number 292-4348443 relates to a property on Nebraska Avenue in St. Louis, Missouri (the "Nebraska Avenue Property"). Flagstar manually underwrote the loan for the Nebraska Avenue Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had "personally reviewed the . . . credit application[] and all associated documents." This loan closed in 2003.

99. Contrary to Flagstar's certification, a DE underwriter did not review the credit application and all associated documents. A DE underwriter initially reviewed the loan and approved it with a number of conditions, including that the borrower must "Provide W2's for Years 2002 and 2001 to Support \$2,805.83 Monthly Income." An underwriting assistant then cleared this condition, and did so in obvious violation of HUD Handbook 4.000.4, Ch. 2, § 2-4(C)(5).

100. Section 2-4(C)(5) states that "[t]he underwriter must assume [various] responsibilities," including "[a]wareness of the warning signs that may indicate irregularities, and an ability to detect fraud."

101. Here, there was an obvious irregularity with respect to the required W-2s — they reflected different employee identification numbers (“EIN”) for the borrower. Both W-2s identified the borrower as an employee of the same employer, but each contains a different EIN for the borrower. These different EINs were a clear indicator of fraud. Moreover, the 2002 W-2 was faxed to Flagstar from an unidentified third party — a further indicator of fraud. The underwriting assistant nonetheless cleared the above condition. This due diligence violation was material. The DE underwriter conditionally approved the loan based on the assumption that the borrower had made at least \$2,805.83 per month in 2002, which appears not to have been the case. Accordingly, this loan should not have been approved for FHA insurance.

102. Within three months after closing, the Nebraska Avenue loan went into default.

103. As a result, HUD has paid an FHA insurance claim of \$88,781, including costs.

**b. The Crownover Street Property**

104. FHA case number 495-7414251 relates to a property on Crownover Street in Austin, Texas (the “Crownover Street Property”). Flagstar manually underwrote the loan for the Crownover Street Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had “personally reviewed the . . . credit application[] and all associated documents.” This loan closed in 2006.

105. Contrary to Flagstar’s certification, a DE underwriter did not review the credit application and all associated documents. A DE underwriter initially reviewed the loan and approved it with a number of conditions, including that Flagstar obtain a “VOR [Verification of Rent] with 12 months history of no late payments from [the] property management [company] or 12 months cancelled checks.” An underwriting assistant then cleared this condition, and did so in obvious violation of HUD Handbook 4155.1, Ch. 2, § 2-3(A).

106. Section 2-3(A) states: “The lender must determine the borrower’s payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity-of-interest with the borrower) or verification of mortgage directly from the mortgage servicer, or through cancelled checks covering the most recent 12-month period.”

107. Here, the loan file does not contain a Verification of Rent or 12 months of cancelled rent checks. Nevertheless, the underwriting assistant cleared the above condition. This due diligence violation was material, as “the payment history of the borrower’s housing obligations” — which was not obtained — “holds significant importance in evaluating credit.” HUD Handbook 4155.1, Ch. 2, § 2-3(A). Accordingly, this loan should not have been approved for FHA insurance.

108. Within three months after closing, the Crownover Street loan went into default.

109. As a result, HUD has paid an FHA insurance claim of \$120,783, including costs.

**c. The Second North Street Property**

110. FHA case number 281-3289773 relates to a property on Second North Street in Vicksburg, Mississippi (the “Second North Street Property”). Flagstar manually underwrote the loan for the Second North Street Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had “personally reviewed the . . . credit application[] and all associated documents.” This loan closed in 2007.

111. Contrary to Flagstar’s certification, a DE underwriter did not review the credit application and all associated documents. A DE underwriter initially reviewed the loan and approved it with a number of conditions, including that Flagstar “[d]ocument receipt of social security income of no less than \$881/mth and VA Pension of \$285.70 by copy of checks or direct

deposits.” An underwriting assistant then cleared this condition, and did so in obvious violation of HUD Handbook 4155.1, Ch. 3, § 3-1.

112. Section 3-1 states: “The application package must contain all documentation supporting the lender’s decision to approve the mortgage loan. . . . All documents may be up to *120 days old* at the time the loan closes (*180 days* for new construction) unless this or other applicable HUD instructions specify a different timeframe, or the nature of the document is such that its validity for underwriting purposes is not affected by being older than the number of prescribed days (e.g., divorce decrees, tax returns).”

113. Here, there is one document in the file showing a pension payment of \$881 per month — a letter from the Department of Veterans Affairs — and it was more than one year old at the time of closing. The letter was dated November 28, 2005, and the loan closed on February 16, 2007. The underwriting assistant nonetheless cleared the above condition requiring documentation showing a pension payment of \$881 per month. This due diligence violation was material. The DE underwriter relied on the borrower’s alleged receipt of monthly pension payments of \$881 in conditionally approving this loan. Accordingly, this loan should not have been approved for FHA insurance. After this loan defaulted, the borrower identified a reduction in his monthly pension payments as a contributing factor to the default.

114. In 2007, the underwriting assistant who cleared this condition earned a substantial amount of incentive compensation. Her incentive compensation (\$14,192.40) comprised approximately 25% of her total compensation (\$56,081.31).

115. Within two months after closing, the Second North Street loan went into default.

116. As a result, HUD has paid an FHA insurance claim of \$65,386, including costs.

**d. The Swearngan Ridge Court Property**

117. FHA case number 381-8866698 relates to a property on Swearngan Ridge Court in Charlotte, North Carolina (the "Swearngan Ridge Court Property"). Flagstar manually underwrote the loan for the Swearngan Ridge Court Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had "personally reviewed the . . . credit application[] and all associated documents." This loan closed in 2008.

118. Contrary to Flagstar's certification, a DE underwriter did not review the credit application and all associated documents. A DE underwriter initially reviewed the loan and approved it with a number of conditions, including that Flagstar obtain "a verbal [Verification of Employment] for the borr[ower] with [the borrower's employer] showing employment date, employer ph number and address and person you contacted." An underwriting assistant then cleared this condition, and did so in obvious violation of HUD Handbook 4000.4, Ch. 2, § 2-4(C)(5).

119. As stated above, Section 2-4(C)(5) provides that "[t]he underwriter must assume [various] responsibilities," including "[a]wareness of the warning signs that may indicate irregularities, and an ability to detect fraud."

120. Here, there was an obvious irregularity with respect to the Verification of Employment that the underwriting assistant missed. The DE underwriter initially approved the loan conditionally based on a pay stub, dated September 15, 2008, showing semi-monthly income of \$1,786, which works out to \$3,572 per month. However, the Verification of Employment, dated October 10, 2008, revealed that the borrower made \$16 per hour and worked on average 40 hours per week, which works out to only \$2,560 per month. In addition, the year-to-date income on the Verification of Employment was \$25,680, substantially less than the year-



to-date income of \$30,362 listed on the pay stub. These discrepancies were clear indicators of fraud, which the underwriting assistant missed. This due diligence violation was material. The DE underwriter conditionally approved this loan based on the incorrect assumption that the borrower's monthly income was approximately \$1,000 higher than it actually was. Accordingly, this loan should not have been approved for FHA insurance.

121. This loan exemplifies the problems inherent in Flagstar's improper practice of using underwriting assistants to clear conditions. The underwriting assistant who cleared the above condition was not asked to clear a condition relating to the above-referenced pay stub, and thus probably never looked at it. As a result, the underwriting assistant was not aware that the information he obtained in the Verification of Employment was inconsistent with the information in the pay stub.

122. In 2008, the underwriting assistant who cleared this condition earned a substantial amount of incentive compensation. His incentive compensation (\$7,394.60) comprised almost 20% of his total compensation (\$38,656.19).

123. Within two months after closing, the Swearngan Ridge Court loan went into default.

124. As a result, HUD has paid an FHA insurance claim of \$147,030, including costs.

**e. The Tyler Bluff Lane Property**

125. FHA case number 381-8907092 relates to a property on Tyler Bluff Lane in Raleigh, North Carolina (the "Tyler Bluff Lane Property"). Flagstar manually underwrote the loan for the Tyler Bluff Lane Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had "personally reviewed the . . . credit application[] and all associated documents." This loan closed in 2008.

126. Contrary to Flagstar's certification, a DE underwriter did not review the credit application and all associated documents. A DE underwriter initially reviewed the loan and approved it with a number of conditions, including that Flagstar obtain a "[s]atisfactory VOR [Verification of Rent] (if management co) or 12 months cancelled checks (if private owner/landlord) for last 12 months . . . ." An underwriting assistant then cleared this condition, and did so in obvious violation of HUD Handbook 4155.1, Ch. 2, § 2-3(A).

127. As stated above, Section 2-3(A) requires that the DEL obtain a Verification of Rent or 12 months cancelled rent checks for the last 12 months.

128. Here, despite the clear language of the above condition, the loan file contains neither a "VOR" nor "12 months cancelled checks." Instead, it contains a lease agreement and a few alleged receipts for rent payments. These documents are plainly insufficient under Section 2-3(A). Moreover, the address listed for the borrower on the lease agreement is different than the address listed for the borrower on his credit report and pay stubs — a clear indicator of fraud. The underwriting assistant never should have cleared the above condition, and should have questioned whether the lease agreement was fraudulent. These due diligence violations were material. Accordingly, this loan should not have been approved for FHA insurance.

129. Within two months after closing, the Tyler Bluff Lane loan went into default.

130. As a result, HUD has paid an FHA insurance claim of \$161,652, including costs.

**f. The Oakland Drive Property**

131. FHA case number 261-9555150 relates to a property on Oakland Drive in Dearborn Heights, Michigan (the "Oakland Drive Property"). Flagstar manually underwrote the loan for the Oakland Drive Property, reviewed and approved it for FHA insurance, and certified

that a DE underwriter had “personally reviewed the . . . credit application[] and all associated documents.” This loan closed in 2008.

132. Contrary to Flagstar’s certification, a DE underwriter did not review the credit application and all associated documents. A DE underwriter initially reviewed the loan and approved it with a number of conditions, including that the borrower “[p]rovide 2 months bank statements supporting an EMD [earnest money deposit] of \$1,000.” An underwriting assistant then cleared this condition, and did so in obvious violation of HUD Handbook 4155.1 Ch. 2, § 2-10(B).

133. Section 2-10(B) provides: “A verification of deposit (VOD), along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account, or the account was opened recently, the lender must obtain a credible explanation of the source of those funds.” This rule is meant to ensure that the borrower has not taken on any undisclosed secondary debts to qualify for the loan.

134. Here, the borrower provided the requested bank statements, which showed a deposit of \$1,000. However, the bank statements also indicated that the borrower had obtained the \$1,000 by taking out a secondary loan for \$2,000. The underwriting assistant cleared the above condition without obtaining an explanation of the source of the \$2,000. This due diligence violation was material. It appears that the borrower took on an undisclosed secondary debt to satisfy the above condition. Accordingly, this loan should not have been approved for FHA insurance.

135. This loan highlights a common problem with Flagstar’s improper use of underwriting assistants to clear conditions. The underwriting assistants (like the underwriting assistant here) look at the newly-submitted documents solely to see if they comply with the letter

of the conditions. They fail to consider, however, whether the new documents raise any other concerns that require further follow-up, as the bank statements here did.

136. Within two months after closing, the Oakland Drive loan went into default.

137. As a result, HUD has paid an FHA insurance claim of \$84,790, including costs.

**B. Flagstar's False Loan-Level Certifications Regarding Due Diligence**

138. For each loan that Flagstar has endorsed for FHA insurance since at least January 1, 2002, Flagstar has certified that the loan was eligible for mortgage insurance under the DEL program (*i.e.*, that it complied with the applicable HUD underwriting rules). Many of these certifications were knowingly or recklessly false. Through these false certifications, Flagstar fraudulently induced the FHA to accept for insurance thousands of loans that were not eligible for FHA insurance and that the FHA otherwise would not have insured.

**1. Flagstar knowingly or recklessly submitted false loan-level due diligence certifications**

139. Since at least January 1, 2002, Flagstar has certified that each of the loans it has endorsed for FHA insurance was eligible for mortgage insurance under the DEL program (*i.e.*, that each complied with the applicable HUD underwriting rules). For many of these loans, this due diligence certification was false.

140. Contrary to its due diligence certifications, Flagstar has repeatedly failed to conduct the required due diligence on its FHA loans.

141. Many of Flagstar's FHA loans contain obvious violations of HUD's underwriting rules. Indeed, the fact that the loans do not comply with HUD's underwriting rules is apparent from the face of the documents in the loan files. Accordingly, Flagstar knew that its certifications of compliance with HUD's due diligence requirement were false. Alternatively, in

falsely certifying compliance with the due diligence requirement, Flagstar acted with deliberate ignorance and/or reckless disregard of the truth.

142. In addition, Flagstar's false due diligence certifications were grossly negligent and/or negligent, and violated Flagstar's duty of care to HUD.

143. Flagstar's false due diligence certifications were a routine occurrence, as illustrated by the six examples of due diligence violations discussed *supra* at Part III.A.3, as well as the four additional examples of due diligence violations discussed in the paragraphs below. These 10 examples represent a small fraction, but a representative sample, of the many loans for which Flagstar has submitted false due diligence certifications since January 1, 2002.

**a. The Nevada Street Property**

144. FHA case number 412-5300906 relates to a property on Nevada Street in Toledo, Ohio (the "Nevada Street Property"). Flagstar underwrote the loan for the Nevada Street Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had conducted the required due diligence on the loan application. This loan closed in 2005.

145. Contrary to Flagstar's due diligence certification, the DE underwriter who reviewed this loan and approved it for FHA insurance did not comply with HUD's underwriting rules. One of several underwriting rules that the DE underwriter violated is set forth in HUD Handbook 41551.1, Ch. 2, § 2-7(A).

146. Section 2-7 identifies the sources of income that can be used to qualify a borrower for a loan. Section 2-7(A) states: "Both overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of bonus or overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. Periods of less

than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes.”

147. Here, the DE underwriter used overtime income to qualify the borrower for the loan. However, the DE underwriter did not: (1) average the borrower’s overtime income over the past two years; (2) obtain a statement from the borrower’s employer regarding whether the overtime income was likely to continue; or (3) justify in writing the reason for not using the borrower’s average overtime income over the past two years. This due diligence violation was material, as the DE underwriter used ineligible overtime income to qualify the borrower for the loan. This due diligence violation was also obvious from the documents in the loan file. Accordingly, this loan should not have been approved for FHA insurance.

148. Within two months after closing, the Nevada Street loan went into default.

149. As a result, HUD has paid an FHA insurance claim of \$56,980, including costs.

150. This loan also contained due diligence violations of HUD Handbook 4155.1, Ch. 2, §§ 2-12 (the borrower’s debt-to-income ratios exceeded the applicable limits) and 2-13 (there were no compensating factors present to offset the borrower’s non-conforming debt-to-income ratios), as well as HUD Handbook 4150.1, Ch. 9, § 9-2(H)(2) (the comparable sales data on the appraisal was more than six months old without justification).

**b. The Midville Highway Property**

151. FHA case number 105-2827109 relates to a property on Midville Highway in Wadley, Georgia (the “Midville Highway Property”). Flagstar underwrote the loan for the Midville Highway Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had conducted the required due diligence on the loan application. This loan closed in 2006.

152. Contrary to Flagstar's due diligence certification, the DE underwriter who reviewed this loan and approved it for FHA insurance did not comply with HUD's underwriting rules. One of several underwriting rules that the DE underwriter violated is set forth in HUD Handbook 41551.1, Ch. 2, § 2-12.

153. Section 2-12 requires that DE underwriters calculate two debt-to-income ratios ("DTI ratios") on the loans they underwrite: (1) the mortgage-payment-expense-to-effective-income ratio ("MPI ratio"); and (2) the total-fixed-payment-to-effective-income ratio ("TPI ratio"). In addition, Section 2-12 sets limits for these DTI ratios that cannot be exceeded without the DE underwriter identifying compensating factors and recording the compensating factors on the Mortgage Credit Analysis Worksheet ("MCAW"). When this loan closed in 2006, the MPI ratio limit was 31% and the TPI ratio limit was 43%.

154. Here, despite the clear requirements of Section 2-12, this loan had an MPI ratio above 31%. Moreover, the DE underwriter did not identify any compensating factors to justify exceeding the 31% limit. This due diligence violation was material. Indeed, HUD has found that a DTI ratio above the applicable limit is an indicator that the borrower will not be able to meet his or her mortgage obligations. This due diligence violation was also obvious from the documents in the loan file. Accordingly, this loan should not have been approved for FHA insurance.

155. The DE underwriter who signed the due diligence certification for this loan earned a substantial amount of incentive compensation in 2006. His incentive compensation (\$42,150.58) comprised more than 50% of his total compensation (\$79,832.66).

156. Within three months after closing, the Midville Highway loan went into default.

157. As a result, HUD has paid an FHA insurance claim of \$97,855, including costs.

158. This loan also contained due diligence violations of HUD Handbook 4155.1, Ch. 2, § 3-1 (the income verification documents were faxed from an unidentified third party), as well as HUD Handbook 4000.4, Ch. 2, § 2-4(C)(5) (the DE underwriter missed warning signs of fraud).

**c. The Glascock Lane Property**

159. FHA case number 221-3959992 relates to a property on Glascock Lane in Walker, Louisiana (the “Glascock Lane Property”). Flagstar underwrote the loan for the Glascock Lane Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had conducted the required due diligence on the loan application. This loan closed in 2008.

160. Contrary to Flagstar’s due diligence certification, the DE underwriter who reviewed this loan and approved it for FHA insurance did not comply with HUD’s underwriting rules. One of several underwriting rules that the DE underwriter violated is set forth in HUD Handbook 41551.1, Ch. 2, § 2-13.

161. Section 2-13 lists the specific compensating factors that a DE underwriter can use to justify approving a loan with a DTI ratio that exceeds the applicable limit. Among these compensating factors are: “[t]here is only a minimal increase in the borrower’s housing expenses” post-mortgage; and “[t]he borrower receives documented compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and similar pension benefits.” Section 2-13 further states that “[u]nderwriters must record on the ‘remarks’ section of the [MCAW] the compensating factor(s) used to support loan approval.”



162. Here, the MCAW identifies two compensating factors: (1) “[m]inimal increase in payment”; and (2) “[t]he coborrower receives documented compensation or income not reflected in effective income. Coborr[ower] recvs. Commissions and OT pay and was recently promoted to Supervisor.” But the documents in the loan file do not support these compensating factors. The documents reveal that the borrower’s housing costs were to increase from \$600 per month pre-mortgage to \$866 per month post-mortgage — a 44% increase. The documents also reveal that the co-borrower stopped receiving commissions and overtime pay as of May 2008. This due diligence violation was material. Despite the DE underwriter’s representation to the contrary, there were no compensating factors sufficient to offset the borrower’s non-compliant DTI ratios. This due diligence violation was also obvious from the documents in the loan file. Accordingly, this loan should not have been approved for FHA insurance.

163. Within two months after closing, the Glascock Lane loan went into default.

164. As a result, HUD has paid an FHA insurance claim of \$111,003, including costs.

165. This loan also contained due diligence violations of HUD Handbook 4155.1, Ch. 2, §§ 2-12 (the DTI ratios were above the applicable limits) and 3-10(B) (the loan did not close in accordance with the loan approval).

**d. The Arcadia Drive Property**

166. FHA case number 495-8220573 relates to a property on Arcadia Drive in Alice, Texas (the “Arcadia Drive Property”). Flagstar underwrote the loan for the Arcadia Drive Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had conducted the required due diligence on the loan application. This loan closed in 2009.

167. Contrary to Flagstar’s due diligence certification, the DE underwriter who reviewed this loan and approved it for FHA insurance did not comply with HUD’s underwriting

rules. One of several underwriting rules that the DE underwriter violated is set forth in HUD Handbook 41551.1, Ch. 2, § 2-12.

168. As stated above, Section 2-12 identifies the MPI and TPI ratio limits that cannot be exceeded without the DE underwriter documenting compensating factors. When this loan closed in 2009, the MPI ratio limit was 31% and the TPI ratio limit was 43%.

169. Here, this loan was approved with a TPI ratio above 43%, and the DE underwriter failed to document any compensating factors. For the reasons set forth above, this due diligence violation was material. Moreover, this due diligence violation was obvious from the documents in the loan file. Accordingly, this loan should not have been approved for FHA insurance.

170. The DE underwriter who signed the due diligence certification for this loan earned a substantial amount of incentive compensation in 2009. His incentive compensation (\$31,841.40) comprised approximately 35% of his total compensation (\$90,822.95).

171. Within two months after closing, the Arcadia Drive loan went into default.

172. As a result, HUD has paid an FHA insurance claim of \$182,526, including costs.

173. This loan also contained due diligence violations of HUD Handbook 4155.1, Ch. 2, §§ 2-10(B) (there was no explanation for large deposits in the borrower's checking account), 2-3(C) (there was no explanation for derogatory credit) and 2-3(A) (there was no Verification of Rent).

## **2. The FHA and HUD relied on Flagstar's false loan-level due diligence certifications**

174. As discussed above, the submission of a truthful loan-level certification is a prerequisite to endorsing a loan for FHA insurance.

175. The FHA and HUD relied on Flagstar's loan-level due diligence certifications in allowing Flagstar to endorse loans for FHA insurance.

176. If the FHA and HUD had known that Flagstar's loan-level due diligence certifications were false — and that Flagstar's DE underwriters were not conducting the required due diligence on the loans they were endorsing for FHA insurance — the FHA and HUD would not have permitted Flagstar to endorse the loans for FHA insurance.

#### **IV. FLAGSTAR'S FALSE CERTIFICATIONS HAVE CAUSED SUBSTANTIAL LOSSES TO HUD**

177. To date, HUD has paid hundreds of millions of dollars in insurance claims on loans that Flagstar has endorsed for FHA insurance since January 1, 2002. This includes loans that were underwritten both manually and using an FHA-approved AUS.

178. The vast majority of the manually-underwritten loans had conditions that were cleared by underwriting assistants. Accordingly, for the vast majority of these loans, Flagstar submitted a false loan-level certification. Flagstar certified that a DE underwriter had “personally reviewed the . . . credit application[] and all associated documents” when in fact Flagstar had allowed underwriting assistants to review and sign off on many of these documents.

179. Moreover, many of these manually-underwritten loans — as well as the loans that were underwritten using an FHA-approved AUS — contain obvious and material due diligence violations. Accordingly, for many of these loans, Flagstar submitted a false loan-level due diligence certification. Flagstar certified that the required due diligence had been conducted on the loans when in fact it had not.

180. Absent the above-referenced false certifications, Flagstar would not have been able to endorse the loans for FHA insurance, and HUD would not have suffered hundreds of millions of dollars in losses on the loans. HUD's net loss — taking into account mitigation efforts — is a substantial percentage of this amount.

## **FIRST CLAIM**

### **Violations of the False Claims Act (31 U.S.C. § 3729(a)(1) (2006), and as amended, 31 U.S.C. § 3729(a)(1)(A)) Causing False Claims**

181. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

182. The Government seeks relief against Flagstar under Section 3729(a)(1) of the FCA, 31 U.S.C. § 3729(a)(1) (2006), and as amended, Section 3729(a)(1)(A) of the FCA, 31 U.S.C. § 3729(a)(1)(A).

183. As set forth above, Flagstar knowingly, or acting with deliberate ignorance and/or with reckless disregard for the truth, presented and/or caused to be presented, to an officer or employee of the Government, false and fraudulent claims for payment or approval in connection with its endorsement of FHA-insured loans, by submitting false loan-level certifications to the FHA and HUD stating that its DE underwriters had complied with HUD's DE underwriter review and due diligence requirements.

184. HUD has paid insurance claims, and incurred losses, relating to thousands of FHA-insured loans wrongfully endorsed by Flagstar because of Flagstar's false claims.

185. By reason of Flagstar's false claims, the Government has been damaged in a substantial amount to be determined at trial, and is entitled to a civil penalty as required by law for each violation.

## **SECOND CLAIM**

### **Violations of the False Claims Act (31 U.S.C. § 3729(a)(1)(B)) Use of False Statements**

186. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

187. The Government seeks relief against Flagstar under Section 3729(a)(1)(B) of the FCA, 31 U.S.C. § 3729(a)(1)(B), or in the alternative, under Section 3729(a)(2) of the FCA, 31 U.S.C. § 3729(a)(2) (2006).

188. As set forth above, Flagstar knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, made, used or caused to be made or used, false records and/or statements material to false or fraudulent claims in connection with its endorsement of FHA-insured loans. Specifically, Flagstar submitted false loan-level certifications stating that its DE underwriters had complied with HUD's DE underwriter review and due diligence requirements. These false statements were material, because, without them, Flagstar would not have been able to endorse the loans for FHA insurance.

189. HUD has paid insurance claims, and incurred losses, relating to thousands of FHA-insured loans wrongfully endorsed by Flagstar because of Flagstar's false records and/or statements.

190. By reason of Flagstar's false records and/or statements, the Government has been damaged in a substantial amount to be determined at trial, and is entitled to a civil penalty as required by law for each violation.

### **THIRD CLAIM**

#### **Breach of Fiduciary Duty**

191. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

192. Flagstar is a fiduciary of the FHA and HUD, and owes the FHA and HUD fiduciary duties.

193. As a fiduciary of the FHA and HUD, Flagstar has a duty to act for, and give advice to, the FHA and HUD for the benefit of the FHA and HUD as to whether particular loans should be endorsed for FHA insurance under the DEL program.

194. As a fiduciary of the FHA and HUD, Flagstar has a duty to act with good faith in its dealings with the FHA and HUD.

195. As a fiduciary of the FHA and HUD, Flagstar has a duty to: refrain from making misrepresentations to the FHA and HUD; make full and fair disclosures to the FHA and HUD of all material facts; and use reasonable care to avoid misleading the FHA and HUD in all circumstances.

196. As a fiduciary of the FHA and HUD, Flagstar has a duty to exercise sound judgment, prudence and due diligence on behalf of the FHA and HUD in endorsing loans for FHA insurance.

197. As set forth above, Flagstar breached its fiduciary duties to the FHA and HUD.

198. As a result of these breaches, HUD has paid insurance claims, and incurred losses, relating to thousands of FHA-insured loans wrongfully endorsed by Flagstar.

199. By reason of these breaches, the Government is entitled to compensatory and punitive damages, in an amount to be determined at trial.

#### **FOURTH CLAIM**

##### **Gross Negligence**

200. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

201. Flagstar owes the FHA and HUD a duty of reasonable care and a duty to conduct due diligence.

202. As set forth above, Flagstar breached its duties to the FHA and HUD.

203. As set forth above, Flagstar recklessly disregarded its duties to the FHA and HUD.

204. As a result of the gross negligence of Flagstar, HUD has paid insurance claims, and incurred losses, relating to thousands of FHA-insured loans wrongfully endorsed by Flagstar.

205. By reason of this gross negligence, the Government is entitled to compensatory and punitive damages, in an amount to be determined at trial.

#### **FIFTH CLAIM**

##### **Negligence**

206. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

207. Flagstar owes the FHA and HUD a duty of reasonable care and a duty to conduct due diligence.

208. As set forth above, Flagstar breached its duties to the FHA and HUD.

209. As a result of the negligence of Flagstar, HUD has paid insurance claims, and incurred losses, relating to thousands of FHA-insured loans wrongfully endorsed by Flagstar.

210. By reason of this negligence, the Government is entitled to compensatory damages, in an amount to be determined at trial.

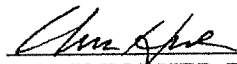
WHEREFORE, the Government respectfully requests that judgment be entered in its favor and against Flagstar as follows:

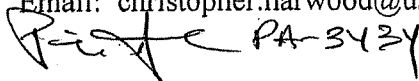
- a. For treble the Government's damages for claims paid by HUD, in an amount to be determined at trial;
- b. For compensatory damages for claims paid by HUD, in an amount to be determined at trial;
- c. For such civil penalties as are required by law;
- d. For punitive damages;
- e. For costs, pursuant to 31 U.S.C. § 3729(a); and
- f. For such further relief as the Court deems proper.

Dated: New York, New York  
February 24, 2012

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