Wielding a Heavy Enforcement Hammer Has Unintended Consequences for the FHA Mortgage Market

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Three factors are causing lenders to pull back on Federal Housing Administration (FHA) lending: the risk that they will be required to indemnify the FHA if a loan defaults, the high costs of servicing delinquent loans, and the significant but uncertain litigation risk associated with defaulting loans. My colleagues and I have addressed the indemnification factor in detail on a number of occasions (see Parrott 2014; Zandi and Parrott 2013) and the servicing factor more recently (see Goodman 2014). In this brief, I address the litigation factor.

The certifications that the lenders are required to sign in order to do business with the FHA open them up to liability under two statutes: the False Claims Act and the Financial Institutions Reform, Recovery, and Enforcement Act. The dramatic scale of the liability and little it takes to trigger it has had a chilling effect on FHA lending, as some lenders have pulled back in an effort to reduce their litigation risk. Slight modifications to the enforcement regime–some already in progress– would encourage proper lender behavior much more effectively, without unnecessarily constraining access to credit.

The False Claims Act and FIRREA

The False Claims Act allows the federal government to recoup damages from people or entities that knowingly submit false or fraudulent claims for payment or approval. Liability under this act is extensive: violators are required to pay civil penalties of $5,000 to $11,000 per claim and, much more critically, a fine equal to triple the loss amount (known as "treble damages"). The statute also contains a *qui tam* provision that allows people who are not part of the government to file suit on its behalf and collect a share of the profits (whistleblowing provisions).

The statute was passed in 1863 to address the widespread fraud against the government during the Civil War. At that time, both the Union and Confederate Armies were being sold inferior goods: horses and mules that were sick, rations that were nearly spoiled, rifles and ammunition that did not work properly, and uniforms made with an inferior material called shoddy, rather than wool. (The shoddy did not hold up well in the rain, giving rise to the expression "shoddy merchandise.") The statute was enacted to address the issue. In keeping with this original intent, in the 150 years since, the False Claims Act has largely been used to go after defense contractors who knowingly defraud the government.

How has the statute come to be used on FHA lenders?

The FHA's direct endorsement program grants qualified lenders the authority to deem mortgages eligible for FHA insurance. As part of this delegation, lenders are required to certify annually that their quality control mechanisms comply with all relevant HUD rules. Lenders must again certify that each loan deemed eligible complies with all relevant HUD rules. If it is later determined that the lender has violated HUD rules in connection with the submission of a claim for FHA insurance, the Department of Justice (DOJ) asserts that such violations rise to the level of a false claim, as defined in the False Claims Act, thus allowing the government to pursue legal action.

The act was first used publicly in the mortgage space in 2011, when the United States filed suit against Deutsche Bank (DB) for violations of the Act.[1] The government claimed that DB failed to implement adequate "quality control" plan for mortgages and therefore falsified its annual certifications of compliance with HUD regulations, and that DB made underwriting and due diligence mistakes on individual loans and therefore falsified its certifications on these loans.

This suit was soon followed by suits against several other entities. Indeed, all five of the top 2011 lenders–Wells Fargo, JPMorgan Chase, Bank of America, Quicken Loans, and Citibank–have been hit with actions involving this act.

Although public information is scant on the list of institutions the Department of Justice has targeted for violating the False Claims Act, we know that most of the nation's largest lenders have opted to settle such claims and at least two have opted to fight them. Bank of America, Citibank, Deutsche Bank, First Horizon, JPMorgan Chase, MetLife, SunTrust, and U.S. Bank have all settled, or have agreed to do so, paying the government more than $4 billion among them. The FHA's two largest lenders, Quicken Loans and Wells Fargo, have chosen instead to fight them.

In many of these suits, DOJ also filed claims under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). A byproduct of the savings and loan crisis, this statute initially allowed the government to sue people or entities that committed bank fraud. Using broad and undefined statutory language of FIRREA covering any claims that "affect" financial institutions, DOJ has begun to turn the statute against banks. FIRREA has a longer statute of limitations and lower burden of proof than the False Claims Act. In addition, federal actions under FIRREA need not prove government loss or injury, and they enjoy broad subpoena and investigative powers.

Mortgage Certifications

Lenders are required to provide both a company-level certification annually and a loan-level certification on each loan submitted to the FHA for coverage. The annual certification attestations have 10 clauses, including the following:

- The mortgagee was responsible for all actions of its employees.
- All employees were properly licensed, and none were under indictment for, or had been convicted on, an offense that reflects adversely upon the mortgagee's integrity, competence, or fitness to meet the responsibilities of an FHA-approved mortgagee.
- The operation is in compliance with all the program's regulations, requirements, and processes.
- The lender must report to HUD any instances of noncompliance and receive explicit clearance to continue with the certification process

Without the annual certification, a lender may not endorse loans for FHA insurance.[2]

In 2015, in an attempt to address concerns with the breadth of the certification language extending to all relevant HUD rules, the annual certification was revised to include a knowledge and diligence qualification to a number of the certifications ("to the best of my knowledge and after conducting a reasonable investigation").

Additionally, for each loan, lenders certify that they conducted due diligence and/or ensured data integrity such that the endorsed mortgage complies with HUD rules and is "eligible for HUD mortgage insurance under the Direct Endorsement program" (HUD 92900-A). For each loan underwritten using the automated underwriting system, the lender must certify to "the integrity of the data supplied by the lender used to determine the quality of the loan." For manual underwriting, the lender must certify that the underwriter "personally reviewed the appraisal report (if applicable), credit application and all associated documents and has used due diligence in underwriting the mortgage."[3] Both the loan-level and annual certifications require that if a mistake is later discovered, the institution self-reports the issue to the FHA.

Enforcement by the HUD Inspector General and DOJ

According to the Inspector General Act of 1978, the HUD inspector general is charged with

- conducting and supervising audits and investigations related to HUD programs,
- promoting efficiency and effectiveness in the administration of HUD programs and operation,
- preventing and detecting fraud and abuse in these programs, and

- providing a way to keep the HUD Secretary and Congress full and completely informed about problems and deficiencies related to the administration of these programs and the need for corrective action.[4]

In carrying out these duties and responsibilities the inspector general "shall report expeditiously to the Attorney General when the Inspector General has reasonable grounds to believe there has been a violation of Federal Criminal Law" (Sec. 4(d)).

In practice, the HUD inspector general performs audits. Where the inspector general finds underwriting mistakes that violate either the loan-level certification or the annual lender certification, he or she refers the case to the Department of Justice.

When DOJ receives evidence of such mistakes, it typically subpoenas the loan files on a subset of loans that go to claim and reviews a further subset of the files received. The department takes the number of mistakes within the set reviewed and extrapolates from that percentage to the number of mistakes likely made on the lender's loans during the applicable period. That number becomes the baseline for the damage demand and any settlement proposal.

Faced with the assertion of substantial liability, most financial institutions settle rather than risk litigation. Lenders take this stance in part because the statute provides DOJ with powerful tools in litigation (broad language, broad powers, and high penalties and damages for relatively small mistakes), and in part because prolonged litigation exposes lenders to high expense and further reputational risk.

The Effect of This Regime

The certifications make a good deal of sense in theory, as they align lender incentives with compliance. However, these certifications create a basis upon which a False Claims Act claim can be made. The challenge is that the lenders are being asked to certify to a level of perfection that they can rarely if ever achieve in underwriting, which by its nature requires a level of judgment. Before the 2015 changes to the annual certification, lenders were being required to certify that they were making virtually no mistakes, either in their own internal processes or on any given loan. Given that lenders could not be sure that they ever reached that level of perfection, they were basically being asked to open themselves up to suit for violations of the False Claims Act whenever a loan went into default and the government decided to pursue a claim.

The recent change to the annual certification certainly helped. But it has left several issues unresolved, especially in light of the current environment in which the government has opted to vigorously pursue claims against lenders. For example, statement 9 states (2015 addition in italics):

> I certify that, to the best of my knowledge and after conducting a reasonable investigation, the Mortgagee does now, and did at all times throughout the Certification Period, comply with all HUD-FHA regulations and requirements applicable to the Mortgagee's continued approval and operations, including those contained in HUD handbooks, Mortgagee Letters, Title 1 Letters, policies, and any agreements entered into between the Mortgagee and HUD, *except for those instances of non-compliance, if any, that the Mortgagee timely reported to HUD during the*

Certification Period and for which the Mortgagee received explicit clearance from HUD to continue with the certification process.

Mortgagees are comfortable certifying that they have processes in place to ensure compliance, but they are uncomfortable certifying that those compliance systems will produce endorsed loans that are defect-free. This discomfort is further complicated by the lack of clarity over the meaning of "reasonable investigation." The term is not defined and has little history of use, leaving lenders unsure of what processes they need to put into place to satisfy HUD. In addition, without a clear materiality threshold, HUD lacks the processes and support structures to allow lenders who timely report noncompliances to receive explicit clearance from HUD on all instances.

Exacerbating the uncertainty is the sheer magnitude of the penalties at issue. An example helps us appreciate the scale of the penalties. If a lender is found to have violated the False Claims Act on a loan for which the government suffered a loss of $200,000, the lender is subject to a penalty of $600,000. If the lender is found to have violated the act on, say, 1,000 loans of the same loss amount, the lender is subject to a penalty of $600 million.[5] Notwithstanding the extreme level of recovery available to the government on these loans, HUD also retains all loan-level insurance premiums paid monthly by borrowers for the benefit of insurance coverage the lenders are being denied. Given the high likelihood of mistakes sufficient to trigger liability under the False Claims Act on any given loan, large-scale liability is entirely plausible for even medium-sized lenders, even though it represents more than most would make in profits in an entire quarter and many would make in an entire year. In fact, current settlements have likely wiped out any profit a number of lenders may have made on FHA lending going back several years.

An additional alleged quirk in DOJ's investigative process puts still more upward pressure on the fines involved. The Department of Justice determines a lender's total liability by calculating the defect rate on a sample of loans. This process makes some sense given the number of loans involved, but it is contrary to the underlying nature of loan-level underwriting and inconsistent with prior regulatory enforcement action under HUD regulations. Lenders claim that since the sample is inevitably drawn from a random population of loans that have gone to claim (and later scrutinized for errors, which may not be material to the default), this error rate is not representative of the actual defect rate across an entire pool (and may not be representative across the claim population). As a result, simply multiplying found defects to the total number of loans in some larger comparison group is at best fraught with error and at worst invalid. Since there is no transparency as to how the sample is selected, what defects are considered material, or what universe of loans this defect rate is ultimately applied to (all loans that have been endorsed, only loans that went to claim), it is impossible to verify these concerns.

Faced, then, with the possibility of extremely high fines for mistakes over which they may have little control, lenders have begun to protect themselves the only way available to them: credit overlays, risk-based pricing, or a general pull away from FHA lending in search of other ways to serve FHA-type borrowers. In other words, because lenders have determined that they cannot eliminate their significant legal risk by improving their underwriting systems, perfection being beyond the reach of even the best systems, they are reducing the risk of having to file a claim with the FHA to begin with.[6]

Enforcement's Effects on Access to Credit

The pullback has been strongest among lenders with the deepest pockets, who also happen to be the FHA's largest lenders. For example, between 2011 and the first quarter of 2015, the Wells Fargo share of the FHA market contracted from 37 percent to 16 percent, the JPMorgan Chase share contracted from 9 percent to 2 percent, and the Bank of America share contracted from 17 percent to 2 percent (figure 1). These numbers include both retail and wholesale (correspondent and broker) origination. These institutions have also contracted their share of GSE lending (as discussed, the False Claims Act litigation risk is by no means the only source of friction in the mortgage origination process), but their contraction in FHA lending is much more dramatic.

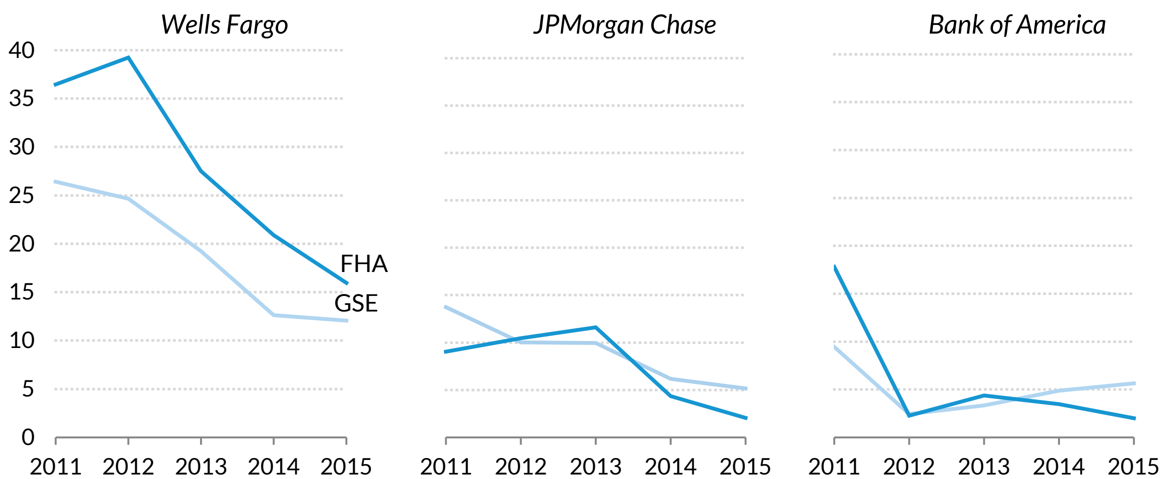
As the larger FHA lenders pulled back most aggressively, the market for FHA lenders grew less concentrated. In the first quarter of 2015, the top five lenders were responsible for roughly 38 percent of FHA originations, down from 72 percent in 2011 (table 1). The top 10 lenders were responsible for about 51 percent of FHA originations, down from 83 percent in 2011.

Less concentration is typically good for a market, leading to more competition and more options for consumers. Unfortunately, that has not been the case in the FHA market.

First, competitive pressures did not drive lenders to ease their overlays. The very concerns that led the larger lenders to pull back hard led much of the rest of the market to remain overly cautious, leaving the credit score it takes to get an FHA loan abnormally high. According to CoreLogic servicing data, the share of borrowers with credit scores below 640 has gone from 45 percent in 2001 to 55 percent in 2007, 7 percent in 2011, and 6 percent in 2014.

FIGURE 1

FHA and GSE Market Share for the Three Historically Largest Lenders (percent)



Source: Urban Institute calculations from eMBS data.

TABLE 1

Top Issuers' Market Share by Loan Amount

	FHA				GSE			
	Top 5	Top 10	Top 25	25th	Top 5	Top 10	Top 25	25th
2011	71.85	83.40	93.37	0.32	60.87	73.55	83.53	0.25
2012	63.91	73.96	87.18	0.61	46.44	58.99	70.72	0.45
2013	53.08	66.31	82.30	0.60	42.38	53.49	67.68	0.53
2014	40.08	55.78	75.13	0.90	32.55	44.71	61.59	0.68
2015 Q1	37.63	50.55	73.80	1.08	32.43	43.22	60.53	0.72

Sources: Inside Mortgage Finance and Urban Institute calculations from eMBS data.

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Second, many of the small independent nonbanks taking up the market share left behind by the larger banks are more lightly regulated and thinly capitalized, raising the concern that they are more open to taking the risk because they have less to lose, not because they can manage it better. The risk in this market shift is best demonstrated by the dramatic increase in the market share of the smallest lender in table 1. The 25th-largest lender has gone from a 0.32 percent market share in 2011 to a 1.08 percent market share in the first quarter of 2015.

It would thus appear that HUD and DOJ's enforcement effort, which presumably intends to protect consumers by penalizing bad actors and to better contain risk in the system, is instead constraining access to credit and pushing risk into quarters where it is less well managed. A lose-lose situation of the worst sort.

How to Improve the Situation

What can be done to improve the situation? In short, rationalize the enforcement regime. By punishing lenders heavily for failing to achieve perfection, authorities are incenting less lending, not improved underwriting. The government should instead punish lenders for the mistakes they can control and impose penalties reflective of damages suffered. This would incent lenders to improve their underwriting and expand their lending again—a much better outcome.

A first step is the March 2015 issuance of the FHA Handbook, to take effect September 14, 2015. The handbook, covering both originations and servicing, is intended to give lenders very detailed information on what constitutes the "quality" manufacturing of loans. It compiles the FHA's 900 mortgagee letters through time and attempts to remove inconsistencies.

But the handbook is not enough. To continue to move forward, it is crucial to right-size the punishment to the crime if mistakes are made (and they inevitably will be). One possible way is to delineate the universe of possible mistakes according to severity, then attach penalties appropriate to the level of severity and culpability. HUD could frame this universe by releasing its defect taxonomy, which requires more severe penalties for intentional fraud, and by limiting its certification standards to reasonable processes and procedures rather than perfection. That way, lenders could focus on addressing mistakes over which they have reasonable control.

Implementing the Defect Taxonomy

In September 2014, the FHA proposed a methodology for assessing loan quality, also known as a defect taxonomy.[7] The taxonomy is meant to address lenders' fears that even a minor, immaterial, unintentional error in a loan that has no bearing on actual risk would be sufficient for the FHA to request indemnification and would be grounds for the loan to be considered defective under the False Claims Act. This taxonomy describes nine defects and four tiers of defect severity.

- Tier 1 violations are those in which the loan contains a material violation of a statutory requirement.
- Tier 2 violations are those in which the errors, when identified and cured, lead the loan to be unapprovable, by causing the loan to either exceed approval limits by a large margin or breach loan guidelines by a large degree, where the tolerance thresholds are spelled out. (This tier is meant to capture "large errors.")
- Tier 3 violations are those in which the errors, when identified and cured, lead the loan to be unapprovable, by causing the loan to either exceed approval limits by a small margin or breach loan guidelines by a small degree, where the tolerance thresholds are spelled out. (This is meant to capture "small errors".)
- Tier 4 violations are those in which, with the correct inputs, the loan would still be approved.

All levels of fraud will be assigned a tier 1 severity rating. But, if the FHA determines that the lender adhered to requirements and did not know or could not have known about the fraud through exercise of standard industry underwriting practices, the defect will be assigned a cause code that clears the lender of responsibility.

The defect taxonomy is precisely the kind of first step needed, yet the FHA has not taken any further steps since it was released for comment in 2014. After some additional clarification, moving ahead with the taxonomy would finally begin to better align lenders' incentives to address their enforcement risk by improving their underwriting rather than constraining access to credit.

Narrowing Certifications

The second crucial step is to better focus the powerful hammer of the False Claims Act on actions over which lenders have more control and thus should be held accountable. Annual certifications are unnecessarily broad. Lenders should certify to material compliance based on what they knew or should have known after reasonable diligence. The FHA needs to recognize that underwriting certifications require an exercise of judgment on the underwriter's part. It is also important that certifications are made against a backdrop that includes a reasonable defect taxonomy, which provides comfort and clarity on the materiality of defects and reserves significant liability for the fraudulent acts that the act was intended to address.

Conclusion

The goals of the enforcement arms of government should recognize the need to maintain the stability of the US housing market and access to credit. Overly aggressive, unnecessary enforcement of the False Claims Act and FIRREA is constraining access to credit. The Department of Justice and HUD's inspector general could protect consumers and taxpayers by motivating lenders to improve their underwriting, not simply shut it down. We would all be much better served by their enforcement efforts if they did.

Notes

1. Citibank, Bank of America, and Flagstar Bank all settled before DB, but DB/Mortgage IT was the first filing.
2. U.S. v Wells Fargo Bank, No 12 Civ 7527 (S.D.N.Y. Oct 9, 2012), at *15.
3. U.S. v Wells Fargo Bank, No 12 Civ 7527 (S.D.N.Y. Oct 9, 2012), at *16.
4. See "The IG Act," Office of Inspector General, Department of Housing and Urban Development, https://www.hudoig.gov/about/ig-act.
5. Controversy surrounds how the government calculates the loss amount on which tremble damages are based. Normally, if a loan is for $250,000, and the government recovers $60,000 on the property and reimburses $10,000 in expenses, then losses would be $200,000. Treble damages would thus be $600,000. In some cases, however, the government has taken the $250,000 loan amount, tripled it, then subtracted the recoveries. Under that calculation, treble damages are $700,000 (($250,000 x3)-$50,000), considerably higher than the typical calculation illustrated in the text. The greater the recoveries, the more the "gross trebling" distorts the economics. For a fuller discussion, see Andrew W. Schilling, Ross E. Morrison and Michelle L. Rogers, "FCA Allows Treble Damages–'But Treble What?'," Law360, March 26, 2013, http://www.buckleysandler.com/uploads/36/doc/FCA%20Allows%20Treble%20Damages.pdf.
6. Though I have discussed only the False Claims Act, and the Department of Justice's enforcement role, it is important to realize that if DOJ is not interested in a case, the HUD inspector general can opt to pursue the lender under the Program Fraud Civil Remedies Act of 1986. This law was enacted to ensure federal agencies have redress for false statement and smaller claims that DOJ does not wish to pursue. The act provides for $5,000 for each claims, plus double damages, which a cap of $150,000. A number of smaller lenders have been sued and settled under these provisions.
7. See "FHA's Single Family Housing Loan Quality Assessment Methodology (Defect Taxonomy)," proposed draft posted for feedback, US Department of Housing and Urban Development, September 16, 2014, http://portal.hud.gov/hudportal/documents/huddoc?id=SFH_POLI_LQA.pdf.

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About the Author

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