

## Fixing FHA's Certification: Time to Turn a Sword into a Plowshare

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Many lenders continue to choose not to lend to a considerable number of borrowers who would qualify for a loan insured by the Federal Housing Administration (FHA), partly because of uncertainty over how the FHA enforces its underwriting rules. To address this uncertainty, FHA committed back in 2014 to take two key steps: clarify its underwriting rules and align the severity of its penalties with the seriousness of the mistakes. For more on the problem and FHA's approach to addressing it, see [here](#).

The FHA has made great strides on the first of these commitments, reconciling and combining decades' worth of rules spread across hundreds of mortgagee letters into a single guidebook. The new guidebook will take effect next week, bringing considerable clarity to what is required in the underwriting and servicing of an FHA loan.

However, it's made less progress on its second commitment, aligning the severity of penalties with the seriousness of the mistakes.

In June, it rolled out a [defect taxonomy](#), which breaks out mistakes by category of severity. A much underappreciated step towards rationalizing how it penalizes lenders for mistakes, over time this should become the centerpiece for a more sensible alignment of penalties and mistakes. However, without penalties assigned to the various tiers, the taxonomy today functions a bit like the pilings of an unfinished bridge, critical to the long term structure but of little near term use.

Around the same time, FHA also took a step to rationalize the most severe, and currently least rational, of all civil penalties, those available under the False Claims Act. On every loan submitted to the FHA for insurance, lenders must certify that the loan file is accurate and compliant with the FHA's rules. If they later submit an insurance claim to the FHA and it is determined that the loan file has inaccuracies or that the loan is otherwise noncompliant, the lender can be held liable under the False Claims Act, giving rise to treble damages. There is no minimum threshold for a mistake, so even the smallest of errors, indeed errors that are almost impossible to control for, put the lender on the hook for substantial liability. The False Claims Act presents the most dramatic misalignment of the severity of penalties and the significance of the mistakes, making it one of the biggest drivers of lenders' credit overlays.

Recognizing the significance of the problem, a rare coalition of [housing policy experts, economists, civil rights leaders, consumer advocate groups](#) and [industry leaders](#) came together to advocate for focusing this powerful enforcement tool on mistakes that are within a lender's control and worthy of the heavy penalty, thus incentivizing lenders to manage their False Claims Act risk by improving their underwriting rather than simply pulling back on their lending. On Tuesday, FHA [proposed changes](#) to the certification intended to do precisely this.

Before turning to the changes, though, it is important to understand what FHA is *not* attempting to do here. It is *not* attempting a comprehensive overhaul of the way in which lenders are penalized for underwriting mistakes, nor even of the way in which lenders are held accountable under the False Claims Act. While the former is the best long-term solution and the latter would be a meaningful intermediate step (for why see [here](#)), the FHA has said that it doesn't have the resources to do either any time soon.

So instead, FHA is proposing a considerably more targeted effort: narrowing False Claims Act liability by tightening the language in the lenders' loan-level certifications. It attempts to do so with two changes.

- ✓ First, FHA attempts to change the requirement that lenders certify the veracity of the information submitted by the borrower to a requirement that lenders validate that information according to FHA protocol. Thus, lenders would not be held liable for mistakes in the information submitted that would have been impossible to validate.
- ✓ Second, FHA changes a requirement that lenders review each loan after it closes and before it's submitted to FHA for insurance coverage (Pre-Endorsement Review) and certify that it contains *no* defects, to one in which lenders must perform such a review and certify that it contains no defects *that would have affected the insurability of the loan*.<sup>1</sup> This addition is intended to narrow the catch-all for liability to more significant mistakes.

Both of these moves attempt to tighten the certification in precisely the way that it should be tightened: limiting liability to mistakes that lenders can and should avoid. As drafted, however, it is not entirely clear that either achieves this objective.

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<sup>1</sup> The proposal would also move the Pre-Endorsement Review requirement from the HUD Handbook to the loan-level certification. The practical impact of the move is limited, though, as lenders today must certify to compliance with the requirement in any case.

In the first move, the relevant requirement is on page three of the proposed loan-level certification and reads as follows:

The undersigned representative of the mortgagee also certifies that all information entered into TOTAL Mortgage Scorecard is true, complete, and accurate based upon information obtained by the mortgagee and validated pursuant to FHA requirements.

Unfortunately, this could easily be read to require that lenders certify that the information that the *borrower* provides is “true, complete, and accurate.” So the FHA needs to clarify that what they *mean* to require is that lenders certify that the information entered into TOTAL accurately represents, or is based upon, what the borrower has provided. So something like the following:

The undersigned representative of the mortgagee also certifies that all information entered into TOTAL Mortgage Scorecard accurately represents, or is accurately based upon, information obtained by the mortgagee and validated pursuant to FHA requirements.

In FHA’s second move, the relevant requirement is on page four of the proposed lender level certification and reads as follows:

A Pre-Endorsement Review has been completed and revealed no deficiencies or defects in the documents listed at HUD Handbook 4000.1, II.A.7.b. that would render the loan ineligible for FHA insurance endorsement.

As mentioned, this is intended to limit the catch-all liability to more significant mistakes, so that lenders don’t face treble damages for foot faults that are all but impossible to avoid consistently. Unfortunately, there are two reasons that it does not have this affect.

First, the range of mistakes that would render a loan ineligible for insurance is potentially remarkably broad. This is because throughout FHA’s voluminous eligibility requirements there is no limitation offered on which kinds of mistakes in meeting the requirements *don’t* affect eligibility. Absent some limitation like this, limiting liability to mistakes that affect insurability doesn’t limit liability much, if at all.

Second, on page three of the proposed loan level certification, lenders must certify that “this mortgage meets the Final Underwriting Decision (TOTAL) requirements for approval.” Lenders are thus liable here for *any* mistakes in meeting the requirements for approval under TOTAL, significant or insignificant and irrespective of the Pre-Endorsement Review. As the [TOTAL User's Guide](#) incorporates virtually all other

FHA rules into its requirements (see, for example, Sections 1.5.5, 1.5.8 and 2.2.1), the requirement that a lender certify to all TOTAL requirements appears once again to re-introduce treble damages liability for any and all mistakes, precisely the result FHA is trying to avoid.

To truly limit treble damages liability in the way that it intends, FHA needs to address both of these issues. The most straight-forward way to do this would be to limit treble damages liability in both places to *material* mistakes. Thus, the relevant language on page four would read:

A Pre-Endorsement Review has been completed and revealed no *material* deficiencies or defects in the documents listed at HUD Handbook 4000.1, II.A.7.b.

And on page three:

...this mortgage *materially* meets the Final Underwriting Decision (TOTAL) requirements for approval.

If FHA makes these modest adjustments (I include a red-line with the recommendations at the end of this note), or others that would accomplish the same kind of clarification, then it would achieve its objective: narrowing lenders' False Claims Act liability to a range of mistakes over which they actually have some control. This would in turn begin to convert the powerful tool of False Claims Act liability from a blunt instrument used to make it easier to extract large sums from large banks, into a more precise one used to improve the process by which loans are made. And this is *precisely* the policy shift that is needed. While this certainly won't open the credit box in and of itself- there are a number of issues contributing to the problem that remain to be addressed (similar [challenges in servicing](#), for instance)- *failing* to do this will make it much more likely that it remains closed, undermining a key administration priority and slowing the recovery of the housing market.

FHA should be commended for continuing to tackle the substantively and politically challenging issue of uncertainty, and urged to make the small changes needed to finally begin to address the challenge adequately here.

The changes suggested are tracked below.

On page 3:

This mortgage was rated as an “accept” or “approve” by FHA's TOTAL Mortgage Scorecard. As such, the undersigned representative of the mortgagee certifies that the mortgagee reviewed the TOTAL Mortgage Scorecard findings and that this mortgage materially meets the Final Underwriting Decision (TOTAL) requirements for approval. The undersigned representative of the mortgagee also certifies that all information entered into TOTAL Mortgage Scorecard ~~is true, complete and accurate~~ accurately represents, or is accurately based upon, information obtained by the mortgagee and validated pursuant to FHA requirements.

On page 4:

(h) A Pre-Endorsement Review has been completed and revealed no material deficiencies or defects in the documents listed at HUD Handbook 4000.1, II.A.7.b. ~~that would render the loan ineligible for FHA insurance endorsement.~~

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