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Why Getting FHA's Loan Servicing Rules 'Right' Matters

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In recent years, servicing U.S. Federal Housing Administration-insured loans has become risky business. The U.S. Department of Housing and Urban Development has heightened its monitoring and enforcement, with servicers experiencing increased Quality Assurance Division (QAD) reviews, HUD Office of Inspector General inquiries, Mortgagee Review Board (MRB) actions and indemnification demands. Additionally, False Claims Act[1] and Financial Institutions Reform, Recovery and Enforcement Act of 1989[2]-based claims have amplified the potential consequences of noncompliance. Indeed, during fiscal year 2014 alone, the U.S. Department of Justice boasted a record $5.69 billion in settlements and judgments from civil cases involving the FCA.[3] These developments have made it particularly important to get the rules "right," but as nearly all FHA servicers know, that is not an easy feat.

Keeping Up with Evolving Requirements

The FHA is in the process of developing a comprehensive Single Family Handbook that, when complete, is intended to "[b]e a single, authoritative source of policy," "[u]se clear, consistent, more direct language," "[a]lign the flow of the SF Handbook to the mortgage process," and "[m]ake it easier to understand and implement policy changes."[4] On June 24, 2015, HUD published the final servicing section of the SF Handbook, which organizes and consolidates existing servicing rules, but also materially changes some rules without identifying which rules were changed. However, until the final version of the SF Handbook becomes effective on March 14, 2016, servicers must continue to rely upon the existing piecemeal guidance including HUD regulations, handbooks, mortgagee letters, frequently asked questions and other sources, to determine the rules applicable to their FHA servicing operations.

Identifying particular, currently operative rules can turn into an absurdly complicated undertaking. This may include reviewing a currently applicable regulation, locating the rule under review in a HUD Handbook published more than 20 years ago (which likely will be more detailed than the regulation) and then reading numerous mortgagee letters (that often supersede or substantively change a handbook provision), frequently asked questions and other published guidance in order to attempt to determine the ultimate scope and contours of the rule. In some cases, a new mortgagee letter will expressly state that it replaces and supersedes specifically enumerated past guidance. In other cases, however, a new

mortgagee letter may not explicitly describe the prior guidance that it is amending or be clear regarding the extent to which prior guidance is amended, such that a servicer must independently arrive at those conclusions. To make matters more complicated, there is no straightforward or foolproof method for determining if a mortgagee letter has been overridden by a subsequent mortgagee letter.

The following example demonstrates the complexity of navigating the mortgagee letters:

- Mortgagee Letter 2008-43 (ML 2008),[5] on pre-foreclosure sales (PFS), explicitly supersedes one mortgagee letter in its entirety and supersedes specific pages of another mortgagee letter, which makes the process of identifying the controlling requirement somewhat straightforward.

- However, Mortgagee Letter 2013-23 (ML 2013),[6] which covers certain PFS and deed in lieu (DIL) requirements, supersedes only certain portions of three other mortgagee letters (including the aforementioned ML 2008), but only to the extent there are conflicting provisions. This requires servicers to undertake the imprecise task of determining what provisions are conflicting.

- However, a person reviewing ML 2013 may not know that Mortgagee Letter 2014-15 (ML 2014),[7] which was published a year later, supersedes ML 2013 in its entirety. And, don't forget that ML 2013 had superseded certain conflicting provisions of other mortgagee letters including ML 2008, so by superseding ML 2013 in its entirety, ML 2014 potentially reinstates the provisions that had otherwise been superseded by ML 2013.

If you find that you are still confused regarding how these mortgagee letters interact, that's not surprising.

The difficulty associated with knowing the rules is exacerbated by the extraordinary volume of rule changes over the years. With respect to loss mitigation alone, HUD's website identifies 66 mortgagee letters published since 1996, with nearly one-third of these clarifications, augmentations and/or amendments to the loss mitigation process being published since 2013.[8]

The FHA Rules Don't Necessarily Align With Other Requirements

Even with a system in place to identify and keep track of the FHA's evolving rules, the process of conforming servicing practices to such rules may prove difficult. This is in part because the FHA's servicing rules do not always align with requirements imposed under otherwise applicable federal and state laws or investor requirements. Indeed, servicers cannot follow such other regimes and be confident that they also are in compliance with the FHA's servicing requirements. For example, the FHA rules set forth a very specific loss mitigation waterfall, which outlines a priority order of loss mitigation options for borrowers in default or imminent default. However, the FHA's loss mitigation waterfall does not coincide with Fannie Mae's loss mitigation options, either in sequence or in substance. As a result, a servicer following Fannie Mae loss mitigation parameters for FHA loans will almost certainly be in violation of the FHA's loss mitigation requirements. This issue has become more pervasive in recent years due to dramatic servicing overhauls at the federal level, through Congress and the U.S. Consumer

Financial Protection Bureau and at the state level, through state legislatures and agencies.

Common Deficiencies

The compliance risks that servicers face are further amplified by the fact that FHA servicing practices are under heightened scrutiny with increasing collaboration among regulatory reviewers. If a servicer is out of compliance with the FHA's servicing requirements, HUD's MRB may initiate administrative proceedings, generally following referrals from QAD audits and/or HUD's OIG.[9]

In May 2015, HUD's OIG released an audit report on an FHA servicer which found that the servicer failed to properly implement HUD's loss mitigation requirements and that the servicer's quality control program was deficient, among other things.[10] The resulting recommendations included that the servicer indemnify HUD for claims filed on certain loans and establish and implement a fortified QC plan.[11] Unfortunately, findings such as these are not unique. The QAD, through the regional homeownership centers (HOCs), seems to be auditing more servicers, more often, particularly with respect to delinquent loan servicing practices. Generally, to the extent that the findings are accurate, they appear to reflect lack of clarity in HUD's published guidelines, servicers servicing in accordance with generally-applicable procedures (as opposed to FHA-specific procedures) or servicers failing to have end-to-end procedures in place to ensure compliance with the broad range of FHA requirements. The following are among some of the most common, recent QAD, HOC and MRB findings:

- QC plan did not conform to FHA requirements;[12]

- Failed to ensure delinquent servicing staff were qualified to evaluate FHA delinquent mortgages and were knowledgeable with the FHA regulations regarding loss mitigation options, servicing and collections activities;

- No evidence of compliance with face-to-face interview requirement;

- Failed to timely review the loan for all loss mitigation options, document the borrower's qualification for loss mitigation or follow the appropriate loss mitigation waterfall without reasonable explanation;

- Failed to evidence that required property inspection and preservation activities were performed;

- Failed to document that a foreclosure referral was appropriate and that management reviewed the loan prior to referring it to a foreclosure attorney;

- Failed to correctly and/or timely report loan status in the Single Family Default Monitoring System;
- Modified loan term or interest rate did not comply with applicable FHA requirements; and
- Failed to timely notify HUD of mortgage insurance termination.[13]

What Can Happen If You Get The Rules Wrong

There are abundant, wide-ranging opportunities for a servicer to find itself out of compliance with the FHA's servicing requirements and HUD has numerous weapons in its arsenal to address noncompliance. These include, among other things, indemnification demands, [14] civil money penalties (CMP) [15] and administrative actions affecting FHA approval.[16] For instance, in 2014, a mortgagee was required to pay a CMP of $475,000, indemnify HUD for losses, refund loss mitigation incentive fees to HUD and refund late fees and inspection fees improperly charged to borrowers due to an alleged failure to comply with HUD requirements regarding QC plans, servicing and loss mitigation, among other things.[17] Similarly, in 2013, in addition to indemnifying 122 loans, another lender was required to pay a CMP of $523,000 as well as make administrative payments, as a result of an alleged failure to properly implement and document compliance with HUD's loss mitigation requirements.[18]

The greatest risk of failing to meet the FHA's servicing requirements, however, may be the potential of needing to defend against cases brought under the FCA or FIRREA. Indeed, in 2014 alone, we are aware of FCA and FIRREA-based claims arising from FHA origination and servicing deficiencies resulting in settlements ranging from $10 million[19] to over $400 million[20] for a single lender.

The FCA, which authorizes the DOJ and private persons (through qui tam actions as relators) to bring civil actions against alleged violators, [21] establishes civil liability — with penalties up to $11,000 per violation and treble damages — for any person who, among other acts knowingly presents or causes to be presented, a false or fraudulent claim for payment or approval.[22] FIRREA authorizes civil enforcement for violations of (or conspiracies to violate) several enumerated criminal predicate offenses, including laws prohibiting the making of false or fraudulent statements, claims, reports or transactions.[23] Essentially, facts giving rise to an FCA violation also give rise to a FIRREA claim.

The FCA and FIRREA have been invoked based on the certifications that mortgagees are required to make in connection with (i) the HUD application addendum, (ii) insurance claims and (iii) annual recertification. These certifications are serving as the bases for enforcement actions by relators and the DOJ under increasingly aggressive theories of recovery. With abundant opportunities for false statements to give rise to a FCA or FIRREA claim and the high stakes (as demonstrated by the penalties and resulting settlements), the risks associated with these types of cases should not be underestimated.

Risk Mitigation

FHA servicers may reduce their risks by ensuring that their policies, procedures and practices are up-to-date. FHA rules and guidance are constantly changing. And, although it may be difficult to keep up with all the changes — with new federal and state rules to implement, corporate reorganizations changing the personnel responsible for following FHA changes and rule updates that don't necessarily clearly identify what exactly is changing — it is still integral to do so. While the new SF Handbook section on servicing, once effective on March 14, 2016, should consolidate all guidance into one place, even the initial undertaking of identifying material changes that the SF Handbook makes to a servicer's existing policies and procedures will take time and precision.

Additionally, even when the updates are incorporated into a servicer's written policies and procedures, they will need to be adopted into actual practices. This likely will mean that employee training will be necessary. Servicers likely should monitor employee practices and/or conduct employee interviews from time to time to test for gaps between stated policies and procedures and actual practices. To the extent gaps exist, re-training may be necessary.

Servicers should also make it a priority to adopt a robust and compliant QC plan for servicing FHA loans. A servicer's QC plan must meet quantitative and qualitative sampling requirements, such that it tests the requisite number of FHA loans, as well as evaluates whether additional sampling may be warranted based on portfolio characteristics and/or actual QC findings. And don't forget that a QC plan must address and attempt to resolve the root causes of identified deficiencies in order to prevent repeat findings.

Of course, having a written QC plan that accurately reflects FHA requirements is not enough. A servicer's actual practice must conform to the plan. A robust QC plan will provide little refuge if it is not actually executed by the servicer or if it fails to prevent similar findings from occurring in the future.

Not surprisingly, the rules continue to change. Come Sept. 14, the QC section of the SF Handbook will become effective with updated rules. Now is the time to ensure there are no QC compliance issues in September.

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[1] 31 U.S.C. §§ 3729-3733.

[2] 12 U.S.C. § 1833a.

[3] Justice Department Recovers Nearly $6 Billion from False Claims Act Cases in Fiscal Year 2014, (last visited June 9, 2015)

[4] HUD, Single Family Housing Policy Drafting Table, (last visited June 9, 2015).

[5]http://portal.hud.gov/hudportal/documents/huddoc?id=08-43ml.doc (last visited June 9, 2015).

[6] http://portal.hud.gov/hudportal/documents/huddoc?id=13-23ml.pdf (last visited June 9, 2015).

[7] http://portal.hud.gov/hudportal/documents/huddoc?id=14-15ml.pdf (last visited June 9, 2015).

[8] See HUD, Loss Mitigation & Policy Guidance, (last visited June 9, 2015).

[9] HUD's OIG is independent of HUD. It audits and investigates HUD's programs and operations. For example, it has audited specific mortgagees' servicing compliance to determine whether HUD has engaged in adequate supervision and enforcement with respect to such mortgagees.

[10] HUD-OIG Audit Report, First Niagara Bank, Lockport, NY, ARN: 2015-NY-1006 (May 22, 2015).

[11] Id.

[12] It should be noted that HUD's QC Plan requirements will be changing, effective September 14, 2015. See HUD Handbook 4000.1, Ch. V, (last visited June 9, 2015).

[13] For example MRB notices of administrative action, see 78 Fed. Reg. 21618-01 (Apr. 11, 2013); Notice, 79 Fed. Reg. 41586-01 (July 16, 2014); Notice, 80 Fed. Reg. 18433-01 (Apr. 6, 2015). QAD/HOC audit findings are not publicly available.

[14] See e.g., 12 U.S.C. § 1708(c)(3)(E)(v); HUD Handbook 4155.2, 9.D.4.b.

[15] 24 C.F.R. § 30.35(c).

[16] 12 U.S.C. § 1708(c)(3).

[17] 80 Fed. Reg. 18434 (Apr. 6, 2015).

[18] 79 Fed. Reg. 41588 (July 16, 2014)

[19] U.S. v. HSBC Bank USA NA, Stipulation and Order of Settlement and Dismissal (June 19, 2014).

[20] U.S. et al v. SunTrust Mortgage Inc., Consent Judgment (June 17, 2014). $968 million settlement that includes $418 million to settle FHA origination and servicing violations.

[21] See 31 U.S.C. § 3730.

[22] 31 U.S.C. §§ 3729(a)(1)(A).

[23] 12 U.S.C. § 1833a.

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