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HUD's Proposal to Terminate FHA Insurance Policies Could Terminate the FHA Program

U.S. Consumer Financial Services Alert

By Krista Cooley, Kathryn Baugher

If there is anything that galls servicers of government-insured loans, it is the forfeiture or curtailment of all accrued interest from mortgage insurance claims resulting from the failure to foreclose fast enough within artificially created state time lines. At first glance, the U.S. Department of Housing and Urban Development ("HUD" or the "Department") listened to the complaints of servicers who argued that they should not be penalized for pursuing foreclosure avoidance options or experiencing delays in the legal system beyond their control. HUD's proposed regulation regarding changes to the Federal Housing Administration's ("FHA") single-family mortgage insurance claim filing process includes proposals that pro rate the curtailment of interest based on actual delays caused by the servicer, proposing to eliminate the complete forfeiture of accrued interest for only one day of delay. So far, so good, but HUD did not stop there. HUD also proposed the complete extinguishment of an FHA insurance policy if the servicer does not complete foreclosure within a new set of artificial time lines. Read together, HUD's reform is to provide servicers with more accrued interest if they do not foreclose fast enough, unless, of course, HUD invalidates the whole insurance policy—the loss of both principal and interest—by virtue of HUD's subjective definition of unreasonable delays. Few servicers think that is progress.

This proposal raises significant questions and concerns for FHA mortgagees that hold and service FHA-insured loans, many of which could have a chilling effect on FHA lending and servicing activities if HUD were to implement the proposed claim filing deadline as proposed and without significant changes to HUD's claim filing guidelines and procedures.

Below, we briefly summarize the proposed regulatory changes and discuss some of the key concerns and questions raised by the Department's proposed regulation, with a focus on the issues raised by the proposed claim filing deadline. We note that HUD proposed a very similar regulatory change almost 25 years ago that would have terminated the FHA insurance contract based on conveyance delays related to property damage and/or title issues. Based on strong objections from mortgagees, HUD reconsidered its proposal and determined that insurance termination on such grounds would be "unnecessarily harsh."¹ Instead, the Department determined that it could protect the Mutual Mortgage Insurance Fund ("Insurance Fund") through less drastic measures, such as curtailment of interest and costs. Hopefully, upon consideration of the concerns raised by this proposal, HUD will again conclude that unilateral termination of an FHA insurance policy based on delays that often are outside of a mortgagee's control continues to be a draconian penalty that could negatively impact mortgagees' participation in the FHA program and, ultimately, the access to housing opportunities for those borrowers served by the FHA program.

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I. Claim Filing Deadline and Termination of FHA Mortgage Insurance

A. Summary of the Proposed Regulation

Currently, HUD's regulations do not provide a filing deadline for mortgagees to submit claims for FHA insurance benefits.² Accordingly, a mortgagee may file its claim for insurance benefits with the FHA at any time, as long as the mortgagee fulfills all other applicable requirements pertaining to a claim for FHA insurance. As noted above, the proposed regulation would establish a deadline to file a claim for FHA insurance benefits. After the deadline has passed, the mortgagee would be prohibited from filing a claim for insurance benefits, and the insurance policy would be terminated.³

To accomplish these changes, HUD has proposed to add new sections to its regulations governing FHA servicing. Specifically, a new Section 203.317a would provide that "the contract of insurance shall be terminated if the mortgagee fails to file a claim within the maximum time periods for filing a claim of insurance benefits in § 203.372."⁴ The proposed new Section 203.372 would provide that:

*No claim for insurance benefits may be filed, regardless of claim processing type, more than 12 months after expiration of a period of time from the date of default that is equal to the amount of time provided in the reasonable diligence timeframe established under § 203.356(b) for the jurisdiction unless the Secretary has approved an extension.*⁵

FHA insurance claims for all FHA-insured loans endorsed after the effective date of HUD's final regulation would be subject to this deadline.⁶

In addition, claims would be subject to the following deadlines based on claim type:

- **Foreclosure Claims**: Mortgagees would be required to "file a claim for insurance benefits no later than 3 months from the date of the occurrence of one the following events, whichever event is the last to occur: (i) The date of the foreclosure sale; (ii) The date of expiration of the redemption period (the period allowed the mortgagor to redeem and regain ownership of the property); (iii) The date that the mortgagee acquires possession of the property (i.e., the property is vacant); or (iv) Such further time as the Secretary or the Secretary's designee may approve in writing."⁷
- **Pre-Foreclosure Sale Claims**: Mortgagees would be required to "file a claim for insurance benefits no later than 3 months following the date of closing[.]"⁸
- **Deed-in-Lieu of Foreclosure Claims**: Mortgagees would be required to "file a claim for insurance benefits no later than 3 months from the date of conveyance of the property to the mortgagee or the date of conveyance of the property to the Secretary, whichever occurs first."⁹

In summary, according to HUD's press release on the proposed regulation, the proposal would require mortgagees to submit claims within three months from the point at which they obtain marketable title to the property or successfully sell the property to a third party,¹⁰ with a maximum claim filing deadline based on the servicing time line from the date of default for all FHA-insured mortgages. Importantly, such time lines must include any reconveyance and re-filing activities. Specifically, the proposed regulation would expressly state that "[t]he filing of a claim does not toll the time periods set forth in this section or guarantee an extension of

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time in which to file or refile a claim that has been withdrawn or denied for any reason, including claims resubmitted after the initial claim resulted in a repurchase of a loan or re-conveyance of property.”¹¹

According to the preamble, HUD is proposing these deadlines in order to bring greater certainty to the mortgagee insurance claims process, which the Department feels necessary based on its perception that some mortgagees do not file claims promptly on a rolling basis, choosing instead to wait and file multiple claims at once at a later point in time.¹² The Department stated that the uncertainty regarding when claims will be filed, combined with the large number of claims being filed at once, strains FHA's resources and may negatively affect FHA's ability to project the future state of, and therefore its obligation to protect, the Insurance Fund.¹³ To the extent FHA-approved servicers disagree with these conclusions, comments to the proposed regulation should address this point.

B. HUD's Authority to Impose a Claim Filing Deadline Is Unclear

As a threshold matter, questions exist as to whether the Department has the authority to implement the proposed regulation regarding termination of the FHA insurance contract upon failure to file a claim. HUD derives its authority to administer the FHA program from the National Housing Act (“NHA”).¹⁴ The NHA does not expressly provide HUD with the authority to unilaterally terminate FHA insurance contracts on the basis of delayed claims. Where termination of the FHA insurance contract is authorized, such as when the mortgagee and borrower agree to voluntarily terminate the insurance policy, the NHA provides express authority to do so.¹⁵ No similar provision provides HUD with the express authority to terminate unilaterally the FHA insurance contract on the basis of claim filing delays.

Moreover, the section of the NHA governing the payment of insurance expressly states that “insurance benefits shall be paid...and shall be equal to the original principal obligation of the mortgage (with such additions and deductions as the Secretary determines are appropriate).”¹⁶ The NHA also requires that “[a]t least one of the procedures for payment of insurance benefits specified in [sections of the statute governing claim payment upon assignment of the mortgage or conveyance of title to property] shall be available to a mortgagee with respect to a mortgage.”¹⁷ This language is not permissive, but rather requires that claims shall be paid and evidences Congress' intent to provide for the payment of FHA insurance benefits in at least the amount of the unpaid principal balance of the loan. While the provisions provide the Department with discretion as to additional amounts that may be included in the claim, the NHA requires payment of a claim.

Finally, the NHA also includes an incontestability clause, which states that any insurance contract executed by the Secretary “shall be conclusive evidence of the eligibility of the loan or mortgage for insurance, and the validity of any contract of insurance so executed shall be incontestable...except for fraud or misrepresentation.”¹⁸ The legislative intent behind this provision was to provide lending institutions adequate protection by applying the law of estoppel against the government if it challenged the validity of an already approved insurance contract.¹⁹ Based on the plain language of the incontestability clause, once the insurance contract is issued, the FHA insurance contract cannot be invalidated, except for fraud or misrepresentation as provided in the NHA. Notwithstanding this statutory provision, the proposed regulation would terminate, and thus invalidate, an FHA insurance contract if the mortgagee did not file an insurance claim within the suggested maximum time lines. The proposed regulation does not address how the Department could invalidate FHA insurance

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contracts on that basis without amendment to the incontestability clause to include such delays as grounds for invalidation of the FHA insurance contract.

C. How to Calculate the Claim Filing Deadline Is Unclear

To the extent that the Department could overcome the issues raised above, additional questions and concerns remain regarding the proposed insurance termination regulation. As a preliminary matter, while HUD's proposal clearly intends to impose a claim filing deadline, how to calculate that deadline is not as clear.

The text of the proposed regulation states that, unless HUD provides an extension, FHA insurance claims cannot be filed more than 12 months after expiration of a period of time from the date of default that is equal to the amount of time provided in the reasonable diligence time frame established under Section 203.356(b) of HUD regulations.²⁰ Section 203.356(b) requires mortgagees to exercise reasonable diligence in prosecuting the foreclosure and authorizes HUD's Secretary to provide mortgagees with reasonable diligence time frames for each state.²¹ The presently applicable reasonable diligence time frames are set forth in Mortgagee Letter 13-38, which provides that "[t]he reasonable diligence time frame begins with the first legal action required by the jurisdiction to commence foreclosure and ends with the later date of acquiring good marketable title to and possession of the property."²² For example, in Florida, the reasonable diligence time frame is 15 months, meaning that a mortgagee has 15 months from the first legal action to initiate foreclosure in which to acquire title to and possession of the property.

Read literally, the proposed regulation would appear to set the claim filing deadline at the date of default, plus the reasonable diligence allowance, plus 12 months. To again take Florida as an example, the claim filing deadline would be 27 months from the date of default. This standard does not expressly account for either the six months that HUD generally permits between the date of default and the initiation of foreclosure, during which time mortgagees are required to attempt to evaluate the borrower for, and, if eligible, provide, loss mitigation alternatives and take all necessary steps to begin the foreclosure process,²³ or the 30 days permitted by the current regulation to transfer the property to HUD through a conveyance claim.²⁴ Notably, subtracting these seven months from the 12 months noted in the deadline calculation above would leave only five months remaining to cover actual delays, unless the Secretary were to grant an extension.

While this standard seems clear, we question whether the language of the proposed regulation captured HUD's true intention, as an example in the preamble seems to support a different proposition. Specifically, HUD provides two "examples of claim curtailment proration."²⁵ In the second example, the Department's "final outcome" calculates curtailment of expenses based on delays in initiating the first legal deadline to foreclose, as well as the reasonable diligence time frame.²⁶ While the example suggests that the mortgagee could under those circumstances file a claim, the proposed claim filing deadline in Section 203.372 would appear to bar such a claim, as the delays in HUD's example would exceed the date of default, plus reasonable diligence, plus the 12-month requirement articulated in the proposed regulation.²⁷

Given the extreme consequences of missing the claim filing deadline, HUD cannot afford to be ambiguous regarding how to calculate the deadline. First and foremost, the claim filing deadline should be revised to expressly include both the six-month period between default and the initiation of foreclosure and the 30-day period between acquiring possession of the

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property and filing a claim, as well as any period HUD intends to build into the time line to account for potential delays. Moreover, any subsequent guidance provided by the Department must accurately reflect the claim filing deadline to prevent confusion among mortgagees regarding how to calculate a claim filing deadline.

D. The Maximum Claim Filing Deadline Is Insufficient to Account for Delays Outside of the Mortgagee's Control

As noted above, the claim filing deadline does not expressly account for either the six months the current regulation affords mortgagees to evaluate a delinquent loan for loss mitigation alternatives before initiating foreclosure or the 30 days provided in the current regulation for filing a conveyance claim and encompasses any time necessary for reconveyance. Thus, if a mortgagee experiences more than five months of delays, cumulative from default through claim filing, for any reason, the mortgagee will be unable to obtain FHA insurance benefits absent an extension from the Department. Delays, however, can occur at every stage of the process due to reasons outside the mortgagee's control. These delays can add up quickly, resulting in the mortgagee missing the claim filing deadline, despite the mortgagee's efforts.

With regard to loss mitigation, the proposed claim filing deadline would place mortgagees in the middle of a tug of war between competing policy objectives. On one hand, HUD requires lenders to engage in loss mitigation outreach with the goal of keeping borrowers in their homes when possible.²⁸ This policy, and the threat of treble damages for failure to engage in loss mitigation,²⁹ gives lenders the incentive to be generous with borrowers and lenient if, for example, a borrower takes additional time to return documents necessary to evaluate and approve a loss mitigation option. A lender might reasonably decide to delay the initiation of foreclosure and risk interest curtailment if there is a possibility that the borrower will qualify for loss mitigation after the first legal deadline has passed. The proposed regulation, however, would create a strong incentive for lenders to initiate foreclosure sooner rather than later to try to avoid termination of the insurance policy based on delay. Additionally, other applicable laws, such as the Consumer Financial Protection Bureau's servicing rules in Regulation X,³⁰ may prevent the initiation of foreclosure within the first legal deadline time frame. The Department's proposed changes to debenture interest curtailment, which we discuss below, acknowledge that mortgagees should not be unfairly punished for such delays; however, if such delays ultimately cause the mortgagee to exceed the proposed claim filing deadline, the resulting loss of any ability to file an insurance claim will be much more severe than interest curtailment.

With regard to reasonable diligence time frames, whether the proposed claim filing deadline is reasonable will depend in large part on whether the reasonable diligence time frames themselves are reasonable. The reasonable diligence time lines are a key element of the proposed claim filing deadline and, thus, must accurately reflect the time it takes to foreclose in each jurisdiction. HUD must also ensure that it updates these time frames promptly in response to changing market and legal conditions such that the time frames remain reasonable and do not become outdated. We also note that, presently, FHA guidelines permit the extension of reasonable diligence time lines based on delays typical in foreclosure proceedings, but outside of the servicer's control, such as court delays or foreclosure-related litigation, without requiring the servicer to obtain an extension of the time line from HUD. Under the proposed regulation, any extension must first be approved by the Department.

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Given the severe consequences of missing the claim filing deadline, these issues must be addressed by HUD if it moves forward with the proposed claim filing deadline.

With regard to the claim filing process, in addition to the overall deadline discussed above, the proposed regulation would require mortgagees to submit claims within three months from the point at which they obtain marketable title to the property or successfully sell the property to a third party.³¹ Given the requirements HUD has imposed on mortgagees related to marketable title and conveyance condition, such time frames are not reasonable.

Specifically, with the publication of Mortgagee Letter 13-18, mortgagees are responsible for paying all property taxes, outstanding homeowner association/condominium fees, and utility bills prior to conveyance. Identifying and paying these items has proved to be a time-consuming challenge for the industry. Delays in accomplishing these tasks, which are often beyond a mortgagee's control, should not result in the mortgagee being unable to file a claim for insurance benefits. In addition, HUD must provide greater clarity regarding what constitutes "conveyance condition" for properties to be conveyed to HUD and establish a clear and reasonable process for determining that a property has met the condition requirements prior to conveyance, particularly in high-risk areas. The short overall deadline, and the three-month allowance in the foreclosure-specific deadline, would not accommodate prolonged dialogue between a mortgagee and HUD regarding whether any particular property is in conveyance condition. Mortgagees would need detailed, unambiguous, written standards of what constitutes acceptable property condition if they will be required to meet a tight deadline or face the draconian penalty of FHA insurance termination.

Finally, with regard to reconveyance, the proposed regulation states that the filing of a claim does not toll the proposed filing deadlines or guarantee an extension of time in which to file or refile a claim that has been withdrawn or denied for any reason, including claims resubmitted after the initial claim resulted in a repurchase of a loan or reconveyance of property.³² Given the aggressive proposed claim filing deadlines, the claim filing deadline may expire before HUD even notifies the mortgagee of a reconveyance. Even if any time remained between reconveyance and the claim filing deadline, it likely would not be sufficient time for the mortgagee to remedy the issues that led to the reconveyance and resubmit the claim. It seems likely that, for many reconveyed properties, the claim filing deadline would expire before the mortgagee could resubmit the claim, and the FHA insurance would therefore be terminated. This would constitute an unusually harsh penalty, particularly given that reconveyances are often the result of property condition issues, some of which arise because of circumstances outside of the servicer's control, such as vandalism. An alternative, were HUD to implement the proposed claim filing deadline, would be to implement a reasonable period of time for addressing the issues that lead to reconveyance and refiling of the claim.³³

E. A Better Extension Request and Approval Process Would Be Necessary

Historically, the Department's response to delays outside of the mortgagee's control, such as those described above, has been to provide an extension process, which it implements through the Extensions and Variances Automated Requests System ("EVARS"). The proposed regulation would continue to provide for extensions to the proposed claim filing deadlines; however, as currently drafted, an extension would be required for any extension of HUD's required time frames,³⁴ including time frames, like the reasonable diligence time frame, that currently do not require affirmative Departmental approval. Under the proposed

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regulation as currently drafted, it appears that a written extension from HUD is the only option to avoid termination of the FHA insurance policy if the lender anticipates exceeding the claim filing deadline. Thus, if HUD were to implement the proposal as currently contemplated, the Department could expect to be flooded with requests for extensions related to all servicing time lines, including the first legal deadline, the reasonable diligence time frame, and the claim filing deadline. HUD must ensure that it has adequate procedures and staff to handle the increased volume of extension requests, as it would be essential that HUD implement a truly functional process for mortgagees to request and HUD to approve extensions to avoid missing the claim filing deadline and face FHA insurance termination.

To that end, HUD would need to ensure that it applied clear, consistent standards to extension requests, such that mortgagees would be able to predict with reasonable certainty whether a request would be approved or denied. Given that HUD's refusal to provide an extension could result in termination of the FHA insurance contract and a bar to claim filing, the process could be viewed as providing the Department with an incentive to deny such extension requests merely to avoid paying FHA insurance claims. Thus, clear, reasonable, written guidelines, provided in advance, would be imperative to ensure that HUD's decisions regarding extension requests do not appear to be arbitrary. Timely responses from HUD would also take on extra importance, given the consequences of missing the claim filing deadline. As a related matter, mortgagees should be permitted to submit extension requests in advance of missing a deadline, as soon as it becomes apparent that the deadline may be missed, rather than being required to wait until the deadline is imminent, as is the current EVARS process.

To the extent HUD moves forward with the proposed regulation, the Department should clarify whether an approved extension to the first legal deadline or the reasonable diligence time frame would extend the overall claim filing deadline by an equivalent period of time, including with respect to extensions that do not require prior HUD approval. Pursuant to HUD guidelines, including Mortgagee Letter 13-38, certain extensions to the first legal deadline and reasonable diligence time frame are automatically granted (for example, in connection with foreclosure mediation or bankruptcy), provided the mortgagee documents the allowable delay in the loan/claim file. Under the proposed regulation, if the mortgagee were to exceed the standard reasonable diligence time frame by two months for an allowable reason, and documented the claim file accordingly, would the claim filing deadline also automatically be extended by two months? The proposed regulation does not address this question. If a mortgagee were to be required to request an extension every time it anticipates exceeding the claim filing deadline, regardless of whether an extension to the first legal deadline or reasonable diligence time frame was already expressly or automatically approved, HUD should make that requirement clear.

Unless HUD implements a predictable and efficient process for obtaining extensions governed by written guidelines—and reliably grants extensions for mortgagees to complete these tasks—the proposal to penalize mortgagees by terminating the FHA insurance policy would be patently unfair.

F. Additional Questions and Considerations Regarding the Proposal to Terminate FHA Insurance Based on Claim Filing Delays

In addition to the above concerns, the proposed regulation leaves many significant questions unanswered about how HUD would implement FHA insurance termination based on claim

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filing delays. Perhaps most importantly, the proposed regulation does not provide the FHA mortgagee with an opportunity to appeal the determination that the FHA insurance contract has been terminated. The proposed regulation also does not address how, if at all, mortgagees would be reimbursed for mortgage insurance premiums upon termination of the insurance contract.

The proposal also does not address how HUD's systems would or could reflect that FHA insurance has terminated as a result of claim filing delays. The proposed regulatory changes would amend Section 203.318 of the regulations to clarify that written notice to the HUD Secretary upon termination of the insurance contract under Section 203.317a is not required;³⁵ however, the proposed regulation and its preamble are silent as to how HUD will track and maintain records of loans with terminated insurance contracts under the proposed Section 203.317a. How will FHA Connection and other HUD systems reflect these terminated and, thus, uninsured loans? Does the Department plan to track the servicing time lines of FHA-insured loans independently or rely solely on FHA-approved servicers to determine when a loan's FHA insurance contract will be terminated?

Also unclear is how HUD will monitor and enforce ongoing servicing requirements in connection with loans for which the insurance contract has been terminated, or whether the Department would continue to have jurisdiction over the loan to do so. For example, would HUD continue to require delinquency reporting on the Single Family Default Monitoring System ("SFDMS") in connection with loans for which the insurance contract has terminated? Would HUD attempt to require servicers to provide FHA's loss mitigation assistance options to borrowers who paid upfront and annual FHA insurance premiums once the FHA insurance contract is terminated? How will HUD enforce its servicing or other requirements in connection with an uninsured loan? For example, if a loan with a terminated insurance policy is still reflected in HUD's systems as an insured loan and is selected for review by HUD or Office of Inspector General auditors, how would HUD determine that the insurance had been terminated? Would the mortgagee still be held responsible for administrative or other sanctions for servicing delays or other allegations of improper origination or servicing?

Finally, though no less important, the proposed regulation does not address essential questions regarding the treatment of loans in Ginnie Mae pools once the FHA insurance is terminated as a result of claim filing delays. Determining whether a loan is no longer an FHA-insured loan and, thus, no longer eligible for inclusion in a Ginnie Mae pool,³⁶ could create significant disruptions to the way in which Ginnie Mae securities are administered. Moreover, mortgagees could face significant financial consequences in buying such uninsured loans out of the Ginnie Mae pools after losing the ability to ultimately recoup the funds used for such buyouts through the FHA insurance policy. The proposed regulation is silent as to these collateral consequences of the proposed regulation as currently drafted.

II. Disallowance of Expenses Due to Mortgagee Failure to Meet Time Lines

As noted above, the Department is also considering changes to the regulations that provide for payment of expenses in connection with FHA insurance. Specifically, the proposed regulation would require mortgagees to curtail, on a prorated basis, additional expenses incurred as a result of the mortgagee's failure to comply with certain time lines, including, among others, the deadline for taking the first legal action to commence foreclosure, the reasonable diligence time frame, and the time frame to convey a property to HUD after

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obtaining title and possession or during such periods of delay.³⁷ If a mortgagee misses any of these deadlines, the mortgagee must curtail on a prorated basis enumerated expenses that were (a) incurred during or as a result of any failure by the mortgagee to act within the applicable time period, or (b) reasonably estimated to have been incurred during or as a result of any failure by the mortgagee to act within the applicable time period if the amount of expenses specifically incurred beyond the applicable deadline is unavailable or not itemized; and (c) any additional expenses incurred as a result of the mortgagee's failure to comply with the time frame.³⁸ The additional expenses that mortgagees would be required to curtail would include, but not necessarily be limited to, "taxes, special assessments, hazard insurance, forced placed insurance, flood insurance, homeowner association (HOA)/condominium association (COA) fees or dues, utilities, inspections, debris removal, and any property preservation and protection expenses[.]"³⁹

We question the appropriateness of this proposed requirement. Interest curtailment is conceptually appropriate as a penalty, because interest represents money that a mortgagee expects to earn as a consequence of making a loan. The expenses that the proposed regulation would curtail, such as taxes and insurance, are not amounts that accrue to the benefit of the lender; rather, they are amounts that mortgagees expend for the preservation and protection of the property and the lien status of the mortgage. Moreover, based on the proration formula set forth in the preamble to the proposed regulation, the expenses incurred "during any period of delay" may be expenses that the mortgagee would have incurred even if a deadline had not been missed. Thus, this proposed requirement seems likely to force lenders to absorb the cost of reasonable expenses that ultimately benefit the Department upon conveyance of the property, even in circumstances where the delay did not cause or increase such expenses.

III. Prorated Debenture Interest Curtailment

Notwithstanding the above concerns regarding the Department's proposed regulation, we can end on a high note regarding one of the proposals. In response to industry requests that HUD amend its debenture interest curtailment process to avoid the harsh penalty of curtailment once a deadline is missed, even if only by one day, the Department's proposed regulations would amend the regulatory provisions regarding curtailment of debenture interest to more closely align the curtailment to the actual delay in servicing the loan. Specifically, the proposed regulation would provide for pro rata curtailment of debenture interest, as follows:

*When the mortgagee fails to meet any one of the applicable requirements of §§ 203.355, 203.356(b), 203.359, 203.360, 203.365, 203.606(b)(1), 203.366, or 203.402(u), within the specified time and in a manner satisfactory to the Secretary (or within such further time as the Secretary may approve in writing), the interest allowance in such cash payment shall be reduced by the amount determined, based on a pro rata calculation of interest by day, to have been incurred as a result of the failure of the mortgagee to comply with the specified time period[.]*⁴⁰

This proposal, if adopted by the Department, would constitute a positive change.

Based on an example in the preamble, however, we note one potential issue with regard to the current proposal. The preamble states that the pro rata reduction is designed to curtail

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debenture interest by the amount “incurred as a result of” the delay.⁴¹ But, based on example 1 in the preamble’s “examples of claim curtailment proration,” if HUD finalized the proposed regulation as currently drafted, the Department would review each step of the default servicing process in isolation, rather than evaluate whether the overall process caused debenture interest to be earned during an overall delay. In the Department’s example, the mortgagee exceeds the first legal deadline by 50 days. The reasonable diligence time frame is 15 months, but the mortgagee completes that process in 13 months—in other words, with 60 days to spare in the allotted time frame. The preamble states that, under these facts, the mortgagee is required to curtail interest, and other expenses, as a result of the 50-day delay in initiating foreclosure. This 50-day delay is not offset by the fact that the mortgagee completed foreclosure 60 days before the reasonable diligence deadline. A different approach the Department could consider would be to curtail interest based on any overall net delay, rather than as a step-by-step process.

* * * * *

The Department’s proposal to implement a claim filing deadline that, if missed, will result in termination of the FHA insurance policy raises significant concerns and many questions about how HUD would implement or enforce the claim termination deadline it proposed. Termination of the FHA loan insurance is a drastic penalty—one that should be reserved for only the most extreme circumstances. Unfortunately, under the proposed regulation, due to factors that are often outside lenders’ control, a mortgagee could forfeit their FHA insurance benefits by exceeding the proposed claim filing deadline. If the Department were to implement the proposed regulation as currently drafted, such action could fundamentally change the business considerations of FHA lenders and servicers. The uncertainties raised by the proposed regulation, coupled with the uncertainty that a mortgagee will have regarding the ultimate enforceability of the FHA insurance contract, may cause mortgagees to reconsider participation in the FHA program if HUD adopts this proposal.

If HUD is determined to proceed down this path, it should consider extending the claim filing deadline, as well as improving the process for requesting and obtaining extensions to servicing deadlines. Moreover, the proposed regulation is ambiguous or silent with respect to a number of key issues and should be revised to ensure that HUD’s expectations are crystal clear. Even with these suggested changes, HUD may be headed toward a Pyrrhic victory, gaining certainty with respect to claim filing at the expense of the sustainability of the overall FHA program.

The proposed regulation can be found [here](#). Comments are due by September 4, 2015.⁴² If you have any questions regarding the proposed regulation, or HUD servicing and claim filing requirements, please contact Krista Cooley, at krista.cooley@klgates.com or (202) 778-9257, or Kathryn Baugher at kathryn.baugher@klgates.com or (202) 778-9435.

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¹ 57 Fed. Reg. 47,966, 47,967 (Oct. 20, 1992).

² One exception to that statement involved rehabilitation loans that are not first liens on the property. For such loans, HUD's regulations currently provide that "[a] claim for insurance benefits on a loan secured by other than a first mortgage shall be filed within one year from the date of default, or within such additional period of time as may be approved by the Commissioner." See 24 C.F.R. § 203.474.

³ 80 Fed. Reg. 38,410, 38,411 (July 6, 2015).

⁴ Id. at 38,415 (citing proposed section 203.317a).

⁵ Id. (citing proposed section 203.372(b)).

⁶ See id. at 38,412.

⁷ Id. at 38,412 (citing proposed section 203.372(c)(1)).

⁸ Id. at 38,412 (citing proposed section 203.372(c)(2)).

⁹ Id. at 38,412 (citing proposed section 203.372(c)(3)).

¹⁰ See "FHA Proposes Deadline for Lenders to File Claims," U.S. Dep't of Hous. & Urban Dev., Press Release, HUD No. 15-082 at http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2015/HUDNo15-082.

¹¹ 80 Fed. Reg. 38,410, 38,412 (July 6, 2015) (citing proposed section 203.372(c)(1)).

¹² See id. at 38,410.

¹³ See id. at 38,410–11.

¹⁴ 12 U.S.C. § 1701 et seq.

¹⁵ See id. § 1715t.

¹⁶ Id. § 1710(a)(5) (emphasis added).

¹⁷ Id. § 1710(a)(3) (emphasis added).

¹⁸ Id. § 1709(e).

¹⁹ See Jay F. Zook, Inc. v. Brownstein, 237 F. Supp. 800, 807 (N.D. Ohio 1965) (citing H.R. Rep. No. 76-313 (1939)).

²⁰ 80 Fed. Reg. 38,410, 38,415 (July 6, 2015) (citing proposed Section 203.372(b)).

²¹ 24 C.F.R. § 203.356(b).

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²² Mortgagee Letter 13-38 (emphasis added).

²³ See 24 C.F.R. §§ 203.355(a), 203.501, 203.605.

²⁴ See id. § 203.359.

²⁵ See 80 Fed. Reg. 38,410, 38,412 (July 6, 2015).

²⁶ See id. at 38,413. In this example, the mortgagee takes 252 days (i.e., 8.4 months) to initiate the first legal to foreclose. The mortgagee also takes an additional 540 days to complete foreclosure and file a claim. In this hypothetical example, the reasonable diligence time frame is 300 days. (Although the example states that the reasonable diligence time frame “includes 30 days to file a claim,” we note that reasonable diligence time frames as defined in Mortgagee Letter 13-38 do not include any time in which to file a claim.) Thus, the mortgagee has exceeded the reasonable diligence time frame by 240 days (i.e., eight months). Under these circumstances, the preamble states that the “final outcome” is that “[t]he mortgagee is required to curtail total claim expenses of \$15,099.05.” Id. at 38,413.

²⁷ Based on the claim filing deadline set forth in proposed Section 203.372, the delays in the preamble’s second example should bar a claim filing. To make HUD’s example more concrete, assume that the date of default was January 1, 2014. The hypothetical mortgagee files a claim 792 days later (252 days to initiate foreclosure, plus 540 days to prosecute the foreclosure and file the claim), on March 12, 2016. However, if the text of the proposed regulation is taken literally, the claim filing deadline would be November 1, 2015: the date of default (January 1, 2014), plus the reasonable diligence allowance (300 days), plus 12 months. The example notes that the mortgagee received a 30-day extension to the first legal deadline. While it is not clear that this extension would also extend the claim filing deadline, even if it did, the claim filing deadline still would have passed.

²⁸ 24 C.F.R. §§ 501, 605.

²⁹ 24 C.F.R. § 30.35(c)(2) (“The penalty for [failure to engage in loss mitigation] shall be three times the amount of the total mortgage insurance benefits claimed by the mortgagee with respect to any mortgage for which the mortgagee failed to engage in such loss mitigation actions.”).

³⁰ Under Regulation X, “[i]f a borrower submits a complete loss mitigation application before the 120th day of delinquency or before the servicer makes the first foreclosure notice or filing, then the servicer cannot make the first foreclosure notice or filing unless one of the following occurs: (i) the servicer sends a notice to the borrower stating that the borrower is ineligible for any loss mitigation option and the appeal process is inapplicable, the borrower did not timely appeal, or the appeal has been denied; (ii) the borrower rejects all the offered loss mitigation options; or (iii) the borrower fails to perform under a loss mitigation agreement.” Consumer Financial Protection Bureau, RESPA Exam Procedures (August 2013) at 45; see also 12 C.F.R. § 1024.41(g). Regulation X gives servicers 30 days from the receipt of a complete loss mitigation application to evaluate the borrower for loss mitigation and provide the borrower with written notice stating which loss mitigation option, if any, the servicer will offer to the borrower. See 12 C.F.R. § 1024.41(c)(1). After the servicer provides the notice stating which loss mitigation option, if any, it will offer to the borrower, the borrower has 14 days to appeal the servicer’s denial of any trial or permanent loan modification available to the borrower. See 12 C.F.R. § 1024.41(h). Regulation

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X then gives servicers 30 days to determine whether to offer the borrower a loss mitigation option based on the appeal. See 12 C.F.R. § 1024.41(h).

Thus, if a borrower submits a complete loss mitigation application within 74 days of the first legal deadline, completing the loss mitigation review and appeal process mandated by Regulation X will likely cause the lender to miss the first legal deadline. Moreover, because a lender needs additional time after the denial of the appeal in which to complete the HUD-mandated foreclosure review process and take the steps necessary to initiate foreclosure, lenders acting reasonably may miss the first legal deadline even if a borrower submits a loss mitigation application as early as 75 days after the date of default. If a borrower waited until the day before the first legal deadline to submit a complete loss mitigation application, the lender might miss the first legal deadline by three months or more as a result of complying with Regulation X.

³¹ 80 Fed. Reg. 38,410, 38,415 (July 6, 2015). As a related matter, HUD must provide greater clarity regarding when it permits conveyance of a property during the redemption period. The proposed regulation provides the following caveat with respect to the deadline noted above: "In the event any applicable redemption period exceeds the claim filing timeframe as stated in the previous sentence, the timeframe will be extended by a period of time equal to the applicable redemption period, unless the conveyance is permitted by FHA during the redemption period." Id. at 38,415 (citing proposed Section 203.372(b)). Given the serious consequences of missing the claim filing deadline, there can be no ambiguity regarding when the deadline will and will not be extended. To the extent HUD decides to finalize this proposed regulation, the Department will need to provide mortgagees with clear, specific, written guidance as to when FHA will or will not permit conveyance during redemption periods.

³² See id. at 38,415 (citing proposed Section 203.372(d)).

³³ We note that, in the loan origination context, if a mortgagee submits an unacceptable case binder to HUD for insurance endorsement, HUD issues a Notice of Return ("NOR") to the lender and returns the case binder to the lender for the lender to take corrective action. HUD allows lenders to resubmit the case binder for reconsideration within 30 days of the date on which the NOR was issued (or within the original 60-day period for submitting the case binder, whichever is later.) See HUD Handbook 4155.2, ¶ 8.C.7.e. The loan is not deemed uninsurable simply because the lender failed to get it right the first time. HUD could apply the same principle in connection with properties that are reconveyed after the lender files a timely claim for insurance benefits.

³⁴ See 80 Fed. Reg. 38,410, 38,415 (July 6, 2015).

³⁵ Id. at 38,415.

³⁶ Ginnie Mae Mortgage-Backed Securities Guide 5500. REV-1, ¶ 9-2, (A) ("Each mortgage must be, and must remain, insured or guaranteed under the National Housing Act ... and must at all times comply with the requirements for obtaining and maintaining such insurance or guaranty.").

³⁷ See 80 Fed. Reg. 38,410, 38,415 (July 6, 2015) (referencing proposed Section 203.402(u)).

³⁸ Id. at 38,415.

³⁹ Id.

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⁴⁰ Id. (citing proposed Section 203.402(k)).

⁴¹ Id. at 38,412.

⁴² Id. at 38,411.

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K&L Gates' Consumer Financial Services practice provides a comprehensive range of transactional, regulatory compliance, enforcement, and litigation services to the lending and settlement service industry. Our focus includes first- and subordinate-lien, open- and closed-end residential mortgage loans, as well as multi-family and commercial mortgage loans. We also advise clients on direct and indirect automobile and manufactured housing finance relationships. In addition, we handle unsecured consumer and commercial lending. In all areas, our practice includes traditional and e-commerce applications of current law governing the fields of mortgage banking and consumer finance.

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