

# **FHA Loan Underwriting and Origination Abuses**

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## **Outline**

- How FHA Insurance Works
- FHA Underwriting Guidelines
- FHA Anti-Property Flipping Rules
- Identifying/Researching Bad Lenders
- The Most Common Violations of FHA Underwriting Standards
- FHA Underwriting and the False Claims Act/Qui Tam
- Possible Defenses for Faulty Underwriting

## How FHA Insurance Works

- Dating back to 1934, FHA insures home mortgages by private lenders against the possibility of borrower default.
- When a borrower defaults, FHA pays the lender the remaining principal amount plus fees and allowable costs.
- Since lenders will be made whole if a borrower defaults and thus bear little to no risk, FHA insurance encourages lenders to expand access to mortgage credit to riskier borrowers.
- FHA Loan regulations and guidelines are found in the CFR, HUD Handbooks, and Mortgage Letters.

## FHA Loan Basics

- 1-4 Unit properties that are used at least 50% for residential
- Statutory loan limits (check online for your county).
- Loan-to-Value(LTV) Limits 96.5% (3.5% borrower contribution) for credit scores 580 and above, for credit scores of 500-579, 90% LTV.
- Maximum 30 year loans but no prescribed number of years or increments
- Both fixed and ARM loans. ARMs cannot represent more than 30% of all loans insured in a year by FHA and ARMs can't have abusive features.
- Borrower's front and back end DTI for no credit scores and scores between 500-579 is 31%/43% and for 580 and above can be 40%/50% if multiple compensating factors are present

## Mutual Mortgage Insurance Fund (MMIF)

- The FHA Insurance is paid for exclusively by borrower payments into the MMIF. This payment is called Mortgage Insurance Premium (MIP).
- Borrowers pay into the fund at closing with an upfront payment as well as an annual premium paid monthly.
- Both MIP payments represent a percentage of the total loan amount. The upfront MIP went from 1% to 1.75% of the loan in April 2012.
- Annual MIP went from 0.9% to its height at 1.35% on April 1, 2013 but was reduced again as of January 26, 2015 to 0.85%
- For a \$300,000 purchase (\$289,500 loan) the upfront MIP would be \$5,066.25 at closing and the annual MIP was \$325.69 monthly at its height but now would be \$205.06 monthly.

## Direct Endorsement and Lender Insurance Programs

- Direct endorsement (DE) lenders may underwrite loans that either they originate or are originated by other lenders (correspondents). FHA allows this because the lender certifies it is following FHA underwriting guidelines.
- A DE applies for a FHA case number from FHA Connection web portal. After the lender underwrites and closes the loan, the lender submits a paper Case Binder (a subset of closing docs) to a FHA Homeownership Center where they review the loan for compliance with FHA rules and then issue the FHA insurance.
- Under the Lender Insurance program started in 2006, mortgagees additionally can conduct their own pre-endorsement review and insure the loan with FHA insurance themselves.
- Case binders (electronic) are submitted to the HOCs for endorsement processing only when a severe case warning has been issued.
- Lenders are eligible for Lender Insurance Status if:
  - They have an unconditional Direct Endorsement approval
  - They have a two year claim rate and default rate that does not exceed 150% of the claim and default rates for the states in which they have underwritten loans previously.
- HUD monitoring increased from annually to quarterly for these lenders

## Monitoring Bad Lending

- FHA Lending is based on lenders annually certifying that they adhere to FHA rules and regulations.
- Lenders must have quality control plans involving a review of loans that defaulted in six months or less and also pull randomly a percentage of the loans in order to catch when they are not following the rules. The lender must report serious violations of underwriting guidelines or fraud to HUD promptly.
- For DE lenders, loan level quality assurance is done at HUD HOCs.
- DE lender's initial probation requires acceptable performance on 15 loans.
- Ongoing monitoring through onsite evaluations, desk audits of insured loans and Credit Watch (default rate reporting).
- Mortgagee Review Board can take administrative actions such as suspend or terminate lending authority

## FHA Underwriting Guidelines

- Purpose of FHA Mortgage Credit Analysis is to:
  - Determine a borrower's ability and willingness to repay a mortgage debt to limit the probability of default and collection actions, and
  - Examine the property offered as security to determine if it is sufficient collateral
  - Limit collection actions or foreclosure.
- 4 C's of Credit
  - Credit history
  - Capacity to repay
  - Cash assets available to close the mortgage
  - Collateral

## FHA Underwriting General Requirements

- Lenders may not have borrowers sign documents in blank, incomplete documents or blank sheets of paper.
- **The mortgage loan application package must contain all documentation that supports the lender's decision to approve the mortgage loan.** When standard documentation does not provide enough information to support the approval decision, the lender must provide additional, explanatory statements that are consistent with the information in the application and must clarify or supplement the documentation submitted by the borrower.
- At closing, all documents in the application must be **less than 120 days old**
- The Technology Open To Approved Lenders (TOTAL) Mortgage Scorecard has been a successful tool for lenders to more efficiently determine creditworthiness and FHA requires that **all transactions must be scored through TOTAL except transaction involving borrowers without credit scores** or streamline refinances.

## Required Documents for Mortgage Credit Analysis

- Fannie Mae Form 1003 Uniform Residential Loan Application signed and dated by all borrowers
- Form HUD-92900-A HUD/VA Addendum to Uniform Residential Loan Application
- HUD-92900-LT, FHA Loan Underwriting and Transmittal Summary
- Social Security Number Evidence
- Credit Reports for all borrowers who will be obligated on the mortgage note
- Verification of Deposit (VOD)
- Verification of Employment (VOE)
- Federal Income Tax Returns
- Sales Contract
- Real Estate Certification, if not contained within the purchase agreement, signed by the buyer, seller and selling real estate agent or broker
- Amendatory Clause, if not contained within the purchase agreement, signed by the buyer and seller.
- Verification of Rent or Payment History on Past/Previous Mortgages (direct verification from landlord or mortgage servicer, information on credit report, or the most recent 12 months of cancelled checks or receipts)
- TOTAL Scorecard Accept/Approve recommendation
- Uniform Residential Appraisal Report (URAR)
- Explanatory Statements

## Income

- Employment Income
  - A Lender must obtain a **Verification of Employment (VOE)**. The borrower's most recent pay stub must show year to date earnings of at least one month and the lender must obtain a verbal verification of employment.
  - Must examine the last **two years of employment and explain any gaps that last one or more months**.
  - Must determine whether the income level will continue through at least the **first three years of the loan**.
- Income stability takes precedence over job stability.
- A borrower with a 25% or greater ownership interest in a business is considered self-employed for underwriting purposes.
- Other forms of income are also accepted and each type has its own guidelines: Overtime, Seasonal, Commission, Social Security, Pensions, VA Disability, Alimony, Child Support, Military Income, Section 8 Homeownership Vouchers, Rental Income and Investment Income.

## Credit

- Although acceptable credit is required, a loan cannot be rejected due to a lack of credit. In those cases, the file must document that the lender attempted to develop a satisfactory history of non-traditional credit.
- Loans with a credit score below 620 and a DTI in excess of 43% must be manually underwritten (can't just rely on TOTAL Scorecard)
- Borrower is not eligible if his/her credit score is below 500. For scores between 500 and 579, loans are limited to 90% LTV (require 10% down payment). Score 580 or higher qualify for maximum financing, 96.5% LTV (3.5% down payment)
  - If TOTAL Scorecard is Accept/Approve, borrower need not provide an explanation of adverse credit or derogatory info but there needs to be proof judgments are satisfied.
  - If TOTAL Scorecard is Refer, the borrower must provide an explanation for major indicators of derogatory credit and any minor indications within the past two years
- Lender must document the credit analysis and for any derogatory items it must determine if late payments were based on a disregard for financial obligations, inability to manage debt or factors beyond the borrower's control (delayed mail, dispute with creditors)

## Non- Traditional Credit

- These references must be documented carefully.
- **Cannot be used to enhance the credit of borrowers with a poor payment history or to offset derogatory credit found on a traditional credit report such as collections and judgments.**
- It is designed to assess the credit history for borrowers without types of trade lines that normally appear on a credit report.
- Sources of credit references include (but not limited to):
  - Rental housing payments (info from landlord)
  - Utility company references
  - Insurance premiums not payroll deducted
  - Child care payments made to businesses
  - School tuitions
- Other requirements:
  - Should include a minimum of 3 sources and all must have a 12-month history
  - No history of delinquent housing payments
  - No more than 1 x30 day late on a consumer debt
  - No collection accounts or public records reporting filed in the past 12 months

## Liabilities

- A borrower generally cannot have back end liabilities that exceed 43% unless the credit score is above 580 and there is a compensating factor which raises the limit to (47%) or 50% with two factors
- Prior foreclosure, bankruptcy and short sales are not a problem if enough time has passed (2-3 years).

## Assets

- Important for four requirements:
  - Minimum Required Investment (at least 3.5%)
  - Earnest Money Deposit
  - Cash to Close
  - Reserve requirements (1-3 months of mortgage)
- HUD has very specific source of funds rules for FHA loans, especially for gift funds and secondary financing (loans or grants for down payment assistance to first-time homebuyers) and requires letters documenting how the borrower acquired funds
- Acceptable asset sources: cash, savings, investment and retirement accounts, collateralized loans, secondary financing and gift funds.
- Lender must document in a letter the following: the donor's name, address, and phone number, the relationship between the donor and borrower, the dollar amount, when the gift was given/will be given, and language that certifies there is no repayment required.
- Minimum Required Investment funds cannot come from the seller of the property or any other person who financially benefits (directly or indirectly) or will be reimbursed from the transaction.

## Appraisal Rules

- Lenders must use appraisers from a FHA approved list
- To be on the list, appraisers have to be licensed by the state, not on any watch lists and to have passed a test on FHA appraisal rules
- The appraiser is hired by the lender but for the benefit of both the lender and HUD (not the purchaser)
- Although an FHA appraisal is both interior and exterior and must identify any conditions structural or mechanical that endangers the health and safety of occupants, it is not a detailed inspection and it is recommended that a purchaser still get their own inspection.



## Appraisal Rules

- Appraiser can identify required repairs that must be completed in order to close the loan
- A property with defective conditions is unacceptable until the defects or conditions have been remedied and the probability of further damage eliminated.
- Defective conditions include:
  - defective construction
  - poor workmanship
  - evidence of continuing settlement
  - excessive dampness
  - leakage
  - decay
  - termites
  - other readily observable conditions that impair the safety, sanitation or structural soundness of the dwelling

## FHA Anti-Property Flipping Rules

- **Property Flipping Rules (24 C.F.R. § 203.37a) (in effect May 1, 2003)**
  1. 90 Day Rule: An FHA-insured mortgage loan *may not* be used to purchase a home 90 days or fewer after seller's purchase.
  2. 91-180 Day Rule: For a resale in this timeframe, if the NEW purchase price is at least 100% MORE than the prior price, a 2<sup>nd</sup> appraisal is required.

### Anti-Property Flipping Rules, cont'd

- **Waiver of 90-Day Rule**
  - Waiver potentially available to loans made between 2/1/10-12/31/14 (waiver not extended for 2015).
- **To qualify for waiver of 90-Day Rule**
  - Transaction must be arms-length.
  - If sales price is more than 20% above seller's purchase price, mortgagee must 1) obtain second appraisal & 2) order a property inspection.
- **Some transactions are exempt from 90-Day Rule**
  - E.g.: sale of inherited property.

### Identifying Bad Lenders

- **Is lender still approved to make FHA-loans?**
  - FHA lender list: (<http://www.hud.gov/l/code/lscrit.cfm>)
- **Search the Federal Register for your lender**
  - Publishes administrative actions by HUD Mortgagee Review Board (MRB) against lenders who violate lending requirements.
- **Google search**
  - Press releases, investigations by state agencies.

## Identifying Bad Lenders, cont'd

### • Search HUD Neighborhood Watch Data

- HUD Neighborhood Watch:  
<https://entp.hud.gov/sfnw/public/>
  - Helps HUD/FHA staff monitor lenders & track mortgage defaults/claims.
  - You can get claims & delinquency information for FHA-insured loans that were originated in the past two years.
  - Data is available on a national, state, or county level.
- What am I looking for?
  - HUD looks at “compare ratio”, which essentially compares the % of the lender’s loans to go into default/claim status vs. the % of FHA lenders as a whole.
  - HUD uses compare ratio higher than 200% as red flag.

## Neighborhood Watch Search

*Please follow along in your supplement in order to see the search images.*

Step 1: go to HUD Neighborhood Watch website-  
<https://entp.hud.gov/sfnw/public/>

Step 2: Select “Early Warnings.”

Step 3: Select “Single Lender.”

Step 4: Type in the name of the lender you want to search.

## Neighborhood Watch Search, cont'd

Step 5: Make your next selections--Mortgagee Selections "Originator by Institution"; Delinquent Choices "Seriously Delinquent"; 2 Year Performance Period "Data as of 12/31/14"(which is the date of the last quarter reported-there is nothing magical about this date).

Step 6: Review the results. The results can also be exported into an Excel spreadsheet. The 2-year data for this lender shows that First Residential's compare ratio is greater than 200%.

Step 7: You can also run the search by county.

Step 8: Review data. Compare ratios very high in Bronx, not as high, but still 200% or more in Queens & Brooklyn. Ratios are high, but the number of seriously delinquent/claims is pretty low.

*We should think about how to get from HUD data going further back than two years.*

## Most Common Violation of FHA Underwriting Standards

- HUD OIG 2011 "Operation Watchdog" audit
  - 15 lenders with compare ratios 200%+, 284 loans
  - 140 loans with materials deficiencies in 9 categories:
    - Credit History (76)
    - Income/Employment History (57)
    - Gift Funds (49)
    - Qualifying Ratios (36)
    - Borrower Investment (26)
    - Liabilities (24)
    - Assets (20)

## HUD Underwriter Training Red Flags:

- Red flags on credit reports
  - Whiteouts, erasures, or alterations
  - Mismatched personal information (SSN, employment)
  - All/most debts recently paid off without proper documentation of source
- Documentation red flags
  - Handwritten checks
  - Round dollar amounts
  - Missing borrower/employer name & missing/inaccurate address on pay stub.

## Violations Identified in Case Law

- Failure to document gift and source of gift funds
- Approving loan that exceeded acceptable DTI ratios
- Overstating borrower's income
- Using stale credit & debt information
- Understating debts & overstating assets
- Failure to obtain payment history of housing obligations
- Failure to develop alternative credit histories for borrowers without traditional credit reports
- Failure to document borrower's cash investment in the property
- Failure to verify employment
- Failure to verify source of funds for earnest money deposits
- Failure to investigate irregularities in mortgage applications for possible fraud.

Sources: *United States v. Deutsche Bank & MortgageIT*, 11-cv-02976-LAK (SDNY) & *United States v. Wells Fargo Bank*, 972 F.Supp.2d 593 (SDNY 2013)

## FHA Underwriting and the False Claims Act (FCA)

- The FCA is the Government's "primary litigation tool" for recovering losses resulting from fraud
  - The FCA imposes civil penalties and treble damages on any person who "knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim." 31 U.S.C. § 3729(a)(1)(B) (2009)
- A FCA action must be confidentially filed under seal in federal district court under the Fed. Rules Civ. Pro. A copy of the complaint, with a written disclosure statement of substantially all material evidence and information in the plaintiff's possession, must be confidentially served on the US Attorney General and the US Attorney for the district in which the complaint is brought.
- In FCA actions, the government has the right to intervene and join the action. If the government declines, the private plaintiff may proceed on his or her own.
- A FCA plaintiff can receive between 15 and 30 percent of the total recovery from the defendant, whether through a favorable judgment or settlement.
- Many False Claims Act cases are brought against lenders for not following FHA underwriting guidelines and other FHA rules despite the lender certifying that they have followed guidelines. Claims become actionable when they receive the FHA insurance claims for a defaulted loan. Example: *US v. Wells Fargo*, 972 F.Supp.2d 593 (S.D.N.Y. 2013) .

## Possible Defenses for Faulty Underwriting

- **Extremely Limited Case Law:** vast majority of case law concerning deficiencies in the origination of FHA-insured loans is brought by U.S. under False Claims Act.
- **Common facts in predatory FHA mortgages**
  - Inflated appraisal
  - Insufficient income to support monthly payment
  - Insufficient documentation of income or credit
  - Borrower's income miscalculated (inflated rental income)
  - Borrower exceeds acceptable DTI

## Potential Defenses

### N.Y Gen. Bus. Law §349

- Elements
  - Party engaged in an act or practice that is deceptive OR materially misleading +
  - Deceptive acts/practices directed toward consumers +
  - Individual has been injured by the deceptive/misleading acts/practices.
    - Deceptive acts/practices (**representations or omissions**): acts/practices likely to mislead a reasonable consumer acting reasonably under the circumstances.
- NOT required: Intent to defraud or mislead, justifiable reliance, or pattern of behavior.
- Case examples: *Saucier v. Countrywide Home Loans*, 64 A.3d 428 (D.C. 2013) (FHA insured loan); *Fremont Inv. & Loan v. Laroc*, 21 Misc. 3d 1124(A); 873 N.Y.S.2d 511 (Queens Cty 2008)

### Common law fraud/aiding & abetting fraud

- Elements of common law fraud
  - Material misrepresentation of a fact (omission is not fraud if no fiduciary relationship);
  - Knowledge of its falsity;
  - Intent to induce reliance;
  - Justifiable reliance;
  - Damages.
- Case examples: *Jones v. OTN Enterprises Inc.*, 31990/08 (Sup. Ct. Kings Cty. Jan. 10, 2010); *Grimes v. Fremont Gen. Corp.*, 933 F. Supp. 2d 584, 605-06 (S.D.N.Y. 2013)

## Potential defenses

### Unconscionability

- Law: An unconscionable contract is unenforceable because it is grossly unreasonable: absence of meaningful choice on the part of one party + contract terms that unreasonably favor the other party. Procedural unconscionability + substantive unconscionability
- Case sample: *Moore v. Wells Fargo Bank*, 470 B.R. 390 (Bankr. S.D.W.Va. 2012) (FHA insured loan)

### Negligence

- Law: Existence of duty + Breach of that duty + Injury + Breach of duty proximate cause of injury.

### Negligent Misrepresentation

- Requires: Existence of special/privity-like relationship imposing duty to provide correct info + incorrect information provided + reasonable reliance on information. However, "arms-length" borrower-lender relationship is not a special/confidential/fiduciary nature.

## Sources of Information

- How FHA Insurance works: The FHA Single-Family Mortgage Insurance Program: Financial Status and Related Current Issues, Congressional Research Service, Katie Jones, 12/20/2012, found at: <http://fas.org/sfp/crs/misc/R42875.pdf>
- FHA Mortgage Loan Limits for New York State: found at: <https://entp.hud.gov/idapp/html/hicost1.cfm>
- HUD Handbook 4060.1 REV-2 "FHA Title II Mortgagee Approval Handbook", 8/14/2006, found at: [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/handbooks/hsg/4060.1](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/hsg/4060.1)
- HUD Handbook 4000.1 "FHA Single Family Housing Policy Handbook, Title II Insured Housing Programs Forward Mortgages, Origination through Post-Closing/Endorsement," Issued 9/30/2014, effective for all case numbers assigned 6/15/2015, available at: <http://portal.hud.gov/hudportal/documents/huddoc?id=40001HSGH.pdf>
- "FHA Single Family Housing Policy Handbook, IV. Appraiser and Property Requirements for Title II Forward and Reverse Mortgages" (Draft), 8/27/2014 found at: [http://portal.hud.gov/hudportal/documents/huddoc?id=SFH\\_POLI\\_APPR\\_PROP.pdf](http://portal.hud.gov/hudportal/documents/huddoc?id=SFH_POLI_APPR_PROP.pdf)
- HUD Handbook 4330.4 REV-1, "FHA Single Family Insurance Claims" 4/28/1995 found at: [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/handbooks/hsg/4330.4](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/hsg/4330.4)
- HUD Handbook 4150.1 "Valuation Analysis for Home Mortgage Insurance" 3/15/1990 found at: [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/handbooks/hsg/4150.1](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/hsg/4150.1)
- HUD Handbook 4150.2 "Valuation Analysis for Single Family One-to-Four Unit Dwellings" 7/1/1999 found at: [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/handbooks/hsg/4150.2](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/hsg/4150.2)
- HUD Handbook 4155.1 "Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Unit Mortgage Loans" 3/24/2011 found at: [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/handbooks/hsg/4155.1](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/hsg/4155.1)
- HUD Handbook 4155.2 "Lender's Guide to the Single Family Mortgage Insurance Process" 3/24/2011 found at: [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/handbooks/hsg/4155.2](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/hsg/4155.2)
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