

EDITORIAL

Changing the Rules

EDWARD DEMARCO, ACTING DIRECTOR OF the Federal Housing Finance Agency, indicated in no uncertain terms at the recent SourceMedia Loss Mitigation Conference that the rules will be changing in the case of the government-sponsored enterprises and affordable housing.

Fannie Mae and Freddie Mac used to have to comply with stringent affordable housing quotas put on them by the Department of Housing and Urban Development. FHFA, though, has superseded HUD and has proposed having the two agencies conform to general market levels of affordable housing.

And instead of the Fannie and Freddie requirements, he suggested that the government consider direct assistance instead, lauding programs like the Federal Home Loan

Banks' Affordable Housing Program and the state Housing Finance Agencies.

Much as we like the AHP and the fine work many FHAs do in their respective levels, there is an aspect of circular thinking here.

For many years, Fannie and Freddie have set the market levels for affordable housing. To look for the natural market levels, they would be looking at themselves.

Now, however, much of the affordable housing effort in the country is being done by the FHA, as the GSEs' levels of loans to those with FICO scores under 700 has shrunk to 11%.

There is an unspoken assumption (and a spoken one, in many cases) that affordable housing mortgages were a big cause of the mortgage bubble and default crisis. Well, yes and no. Many affordable housing borrow-

ers were targeted by subprime and predatory lenders, and that book of business, it's true, is performing disastrously. But Freddie and Fannie conducted conforming affordable housing business since the early '90s, with no disasters.

However, Freddie and Fannie have lost more than \$200 billion between them, requiring a (to date) \$145 billion bailout from taxpayers. Mustn't those huge losses have been caused by low-mod lending?

Well, Fannie and Freddie participated in the housing bubble by buying hundreds of billions of dollars of securities backed by subprime loans for their portfolios. That is the likely source of the worst of the losses.

Well-underwritten loans to immigrants, the underserved and minority borrowers will be a key component in the housing recovery. Lenders need to look beyond their fearful credit squeezes and start funding this growth area of the business, unless they are happy with the business drooping along at its current depressed levels. ♦

OPEN FORUM

Surviving and Thriving in FHA's New Environment

By Clinton Rockwell and
Melissa Klimkiewicz

THE DOWNTURN IN THE HOUSING MARKET and the tightening of mortgage credit have lenders flocking to the FHA loan program. Poorly performing FHA loans originated from 2006 to 2008 have strained FHA's mortgage insurance fund. Inadequate HUD staffing during this period also reduced its ability to police lender compliance.

In response, FHA has announced several measures to limit risk to the mortgage insurance fund and strengthen FHA programs, including increased enforcement. The new enforcement focus has had an immediate (sometimes devastating) impact on FHA lenders. FHA withdrew its approval of 28 lenders in 2008, but in 2009 it terminated more than 350. We have seen a marked increase in FHA enforcement actions, including Quality Assurance Division audits, Credit Watch terminations, Mortgage Review Board and Office of Inspector General actions, and related indemnification demands. This may be only the beginning of a heightened enforcement culture at HUD, as the agency seeks to strengthen its authority to terminate lender approval and increase its demands for indemnification for loan losses.

Given this environment, some FHA lenders' most pressing concerns involve their own FHA compliance, the compliance of the third

parties with which they work, and responding to HUD inquiries and investigations.

Complying with FHA rules is difficult, but necessary. The rules are complex, and their proper application may be a matter of subjective interpretation. In addition, particularly due to recent efforts to strengthen the FHA program, the rules are a moving target. For example, lenders operating through wholesale channels face new compliance challenges following regulations that ended FHA approval of loan correspondents (brokers). Now,

Any deviation from FHA rules can be costly—in terms of financial impact, legal risk and reputational harm.

FHA-approved lenders must approve the brokers that they sponsor, and are liable for the brokers' activities. To minimize their liability, FHA lenders must monitor their sponsored brokers for compliance with FHA's rules.

Any deviation from FHA rules (even if seemingly insignificant and not directly tied to the risk related to the loan) can be costly—in terms of financial impact, legal risk and reputational harm. The potential penalties can put seemingly well-positioned lenders out of business in short order.

Given the consequences of noncompliance, FHA lenders should proactively review their FHA policies, procedures and practices. This may include, for example, conducting

detailed loan file reviews to assess compliance, review of individual loan originator and underwriter qualifications and performance, and quality control plan updates and revisions. Also, in light of sponsoring lenders' new obligations for supervision of third-party brokers, lenders must have programs in place to ensure the compliance of their brokers. Findings from ordinary course audits can be leveraged as the basis for targeted employee and/or broker training to prevent problematic practices from continuing.

To achieve accurate and reliable findings, lenders should consider engaging knowledgeable and experienced independent auditors, rather than relying exclusively on in-house personnel. Even well-intentioned internal underwriting and QC staffs can fail to detect critical issues—typically because they are unaware of FHA requirements or the manner in which HUD interprets them.

One of the most frequent deficiencies in internal loan file review is the use of "check the box" methodology, rather than a more nuanced risk-layering analysis. If the staff that originally approved the loan and the subsequent review team follow the same "box checking" approach, layered risk issues may go undetected. For a review to be as effective as possible, the reviewers must not only know the FHA rules inside and out, but also be well-versed in how HUD applies and interprets the rules. This knowledge base can be bolstered by engaging external FHA experts, both on the legal and program/underwriting levels.

If HUD has already instituted an inquiry or brought an enforcement action against a FHA lender, the lender must take swift action to formulate and execute an effective defense strategy. A defense strategy should incorporate these elements:

1. Assessment of the Validity of HUD's Claims

Lenders on defense should immediately

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492,800 properties in June (on a seasonally adjusted annualized basis), a 4.2% drop from 514,230 in June 2009. But sales were down 11.1% from May.

...the \$729,750 loan limit through September 2011.

The maximum \$729,750 loan limit for Fannie Mae, Freddie Mac and Federal Housing Administration loans in high-cost areas

Conversion Mortgage program. Without this credit subsidy, FHA would have to make deeper reductions in the loan proceeds that seniors receive in a reverse mortgage transaction.

to 47.8%—the lowest level since the second quarter of 2004. The Census Bureau also reported that the number of vacant homes for sale totaled 1.97 million in the second quarter, up slightly from 1.9 million a year ago. ♦

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assess the validity of HUD's claims. Such claims may involve, for example, underwriting standards do not meet HUD requirements, QC program is not sufficiently stringent, or employees or third parties for whom the lender is responsible have engaged in fraud or misrepresentation.

It is preferable to perform a targeted review of particular loan files and/or other issues that HUD has highlighted. As with ordinary course compliance audits, lenders can expect a more accurate and nuanced view of their risks if they engage independent FHA experts, as opposed to relying solely on their internal underwriting and QC staffs. Lenders may be able to shield their findings from disclosure by engaging FHA experts through legal counsel.

2. Development of a Response Strategy

Once the lender understands the nature and extent of its exposure, it should determine its strongest arguments and the optimal means of presenting them, as well as identify any weaknesses and the best ways to mitigate them.

If there were serious past deficiencies, the lender may argue that its practices have improved since the time of the claims at issue. However, before presenting this argument, the lender should sample its recent production to determine whether there has been actual, measurable improvement. Make no mistake—HUD will perform its own review and will not accept a lender's claims of improvements unless evidence supports that they have occurred. One regulatory compliance officer, speaking anonymously, said, "FHA lenders are best-positioned to face HUD if they proactively review the performance of their FHA portfolio, modify existing underwriting standards to address problematic performance trends, and are able to clearly demonstrate that the changes implemented resulted in an immediate and substantial improvement to loan performance."

3. Interface with HUD Personnel

Lenders may make arguments to HUD via formal written responses, or may approach HUD officials in informal conversations or through formal presentations. Considering the agency's present workload, it can be difficult to get the attention of decision-makers. Thus, an effective response strategy may involve engagement of individuals with established relationships with HUD officials.

An effective HUD communication strategy is especially important in the context of MRB actions. FHA lenders are sometimes surprised to learn that they may not directly present their case to the MRB, which meets in private. Lenders must make their cases through written responses or communications with HUD's enforcement staff in advance of MRB meetings. The staff is in a position to make favorable recommendations to the MRB.

4. Public and Internal Relations Responses

A collateral consequence of HUD enforcement actions is negative publicity which can harm lenders' relationships. A lender's response to negative publicity may include di-

rect communications with individual wholesale lenders, investors, borrowers, and/or employees, or press releases and comments to the media.

Sometimes, lenders find it helpful to involve public relations professionals with experience in FHA-related crisis management to handle communications. ♦



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