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Practice Group:

Consumer Financial Services

No More Mister Nice Guy: Indemnification Now Required by FHA Lender Insurance Regulations

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FHA mortgagees participating in the Lender Insurance ("LI") program will be required to indemnify HUD for self-endorsed loans that HUD deems ineligible for FHA insurance based on a final regulation published by the U.S. Department of Housing and Urban Development ("HUD" or "Department") on January 25, 2012.

The regulation finalizes changes to the LI regulations proposed in October of 2010 and will take effect on February 24, 2012. In addition to the significant changes to HUD's indemnification authority for self-endorsed loans through the LI program, the final regulation also: (1) amends mortgagee eligibility criteria to participate in the LI program, including acceptable default/claim rates; (2) amends the Department's authority to monitor lenders participating in the LI program; and (3) implements a process for FHA lenders terminated from the LI program to request reinstatement of their LI authority.

In announcing both the proposed and final versions of these regulatory changes, HUD made clear that these amendments are designed to improve and expand the risk management activities of the FHA and to strengthen the FHA Insurance Fund by limiting "unnecessary and inappropriate risks" to the Fund associated with loans that the Department determines should not have been endorsed through the LI program.[i] As HUD notes, this is the latest in a series of steps the Department has taken to strengthen the financial soundness of the FHA program and mitigate the risk of possible insolvency of the FHA Insurance Fund as HUD continues its efforts to increase FHA's capital reserve ratio to meet the Congressionally mandated threshold of two percent.[ii] The final regulation marks the most recent example of HUD's renewed emphasis on the safety and soundness of the FHA loan program and its efforts to transfer the risks associated with FHA-insured loans from the Department, and thus the American taxpayer, to FHA-approved mortgagees, particularly those participating in the LI program.

This client alert summarizes the provisions of the final regulation and provides our observations as to how the final regulatory changes will impact lenders that choose to continue to participate in FHA's LI program.

I. Background

The changes made by HUD in the final regulation have been a long time coming since HUD gained authority to delegate the insurance endorsement of FHA loans to FHA approved lenders. Notably, as a result of a 1996 statutory amendment, the National Housing Act gives the HUD Secretary the authority to delegate the insurance of mortgages to approved mortgagees, which HUD refers to as the LI program.[iii] Following this statutory change, HUD finalized an interim rule in 1997 to govern the LI process,[iv] but the Department did not begin approving FHA mortgagees to self-endorse FHA loans until late 2005. With the issuance of Mortgagee Letter 2005-36, HUD outlined the participation requirements for FHA mortgagees, including acceptable default and claim rates, as well as pre-

endorsement review requirements, necessary for a lender to self-endorse FHA loans. Effective January 1, 2006, approved LI lenders began using their delegated authority to conduct pre-endorsement reviews and issue mortgage insurance certificates for FHA loans, and, as of today, more than 80% of all FHA forward mortgages are insured by LI lenders through this self-endorsement process.[v]

With the issuance of the January 25, 2012 final regulation, HUD makes changes to the LI program for the first time since the Department began exercising its authority to delegate insurance responsibilities to lenders. However, as it relates to the indemnification provisions of the final regulation, lenders are soon to get a first taste of this authorized sanction. Despite the fact that HUD has had the statutory authority to *require* LI lenders to indemnify the Department since 1996 for LI-endorsed loans,[vi] HUD, until now, had never acted upon this authority (not including routine requests for indemnification as part of a settlement with HUD). Even after promulgating the 1997 interim regulation to govern the LI program, HUD did not define the requirements and procedures governing the indemnification of the Department by LI lenders, which is required by the National Housing Act.[vii]

Thus, on October 8, 2010, HUD proposed a regulation to "provide additional guidance on the statutory requirements" of the LI provisions of the National Housing Act, and: (i) proposed a timeline for the indemnification of an insurance claim; (ii) defined "serious and material" violations for which HUD would seek indemnification; and (iii) specified HUD's demand for indemnification.[viii] The October 2010 regulation also proposed: (i) changes to the acceptable default/claim rate for LI-approved lenders; (ii) a continual monitoring of LI-approved lenders' eligibility for participation in the LI program; (iii) new approval requirements for lenders in case of merger, acquisition, or restructuring; and (iv) revisions to existing regulations governing the termination of an LI lender's approval.

HUD's January 25, 2012 final regulation makes some modifications to these proposals, but otherwise finalizes these changes to the Department's LI program. In addition to revised eligibility and monitoring standards and new reinstatement procedures following termination from the LI program, HUD makes clear its intent to begin demanding indemnification from LI-approved lenders when the Department identifies ineligible or fraudulent loans endorsed by these mortgagees. That is a significant change to the benefits and costs of participating in HUD's LI program, which may result in LI lenders deciding to relinquish their LI approvals.

II. Required Indemnification for LI-Endorsed Loans

A. Indemnification for Serious and Material Violations

Under the final regulation, by insuring a mortgage using its LI authority, an LI lender will be required to indemnify HUD for an FHA insurance claim paid within five years of mortgage endorsement if the lender knew or should have known of a serious and material violation of FHA origination requirements that would have rendered the mortgage ineligible for FHA insurance, regardless of whether the violation caused the default.[ix] Section 203.255(g)(3) of the final regulation defines "serious and material violations" to include a lender's failure to, among others:

- Verify the creditworthiness, income, and/or employment of the mortgagor in accordance with FHA requirements;
- Verify the assets brought by the mortgagor for payment of the required down payment and/or closing costs in accordance with FHA requirements;

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- Address property deficiencies identified in the appraisal affecting the health and safety of the occupants or the structural integrity of the property in accordance with FHA requirements; or
- Ensure that the appraisal of the property serving as security for the mortgage loan satisfies FHA appraisal requirements, in accordance with § 203.5(e).[x]

The final regulation makes clear that this list is not exhaustive. If a LI lender knew or should have known of a serious and material violation of FHA origination requirements, which could include any violation HUD deems to make a loan ineligible, HUD could require the LI lender to indemnify the loan.

In addition, an LI lender will remain liable for indemnification for serious and material violations that render a loan ineligible for insurance should a claim be paid by HUD within five years of the date of mortgage endorsement. Despite public comments noting the fact that borrowers who default on their loans three or more years after origination typically default because of reasons unrelated to a lender's underwriting practices, HUD declined to shorten the period of time during which it could demand indemnification.[xi] HUD also made clear in the final regulation that it will demand indemnification regardless of whether the serious and material violation caused the borrower to default. Therefore, no causation between the deficiency and the loss need be shown. HUD simply needs to show that the deficiency made the loan ineligible for FHA insurance. HUD stated in the Preamble that its current practice for making indemnification requests does not rely on a causation connection, and such a standard is unnecessary when HUD will only demand indemnification in those cases where it should have never "incurred the insurance obligation in the first place."[xii]

B. Indemnification for Fraud or Misrepresentation

An LI lender also will be required to indemnify HUD for an insurance claim if the lender knew or should have known that fraud or misrepresentation was involved in connection with the origination of the loan.[xiii] While HUD amended the proposed regulation to impose a "knew or should have known" standard in the final regulation before triggering the indemnification requirement for fraudulent loans or loans involving misrepresentation, HUD is not restricted to a five-year period post endorsement for its indemnification demand in such cases. Regardless of whether the fraud or misrepresentation actually caused the borrower's default, the final regulation gives HUD the authority to demand indemnification from an LI lender if a claim is filed at any time after endorsement and HUD determines that a lender knew or should have known about the fraud or misrepresentation in the origination of the loan.

C. Procedures for Demanding Indemnification

Much like the proposed regulation, the text of the final regulation is silent with regard to the procedures HUD will follow in seeking indemnification from LI lenders, except to state: "The demand for indemnification will be made by either the Secretary or the Mortgagee Review Board. Under an indemnification agreement, the Lender Insurance mortgagee agrees to either abstain from filing an insurance claim, or reimburse FHA if a subsequent holder of the mortgage files an insurance claim and FHA suffers a financial loss."[xiv]

However, in response to public comments that LI lenders should have an appeals process to respond to HUD's demands for indemnification, HUD notes in the Preamble that it will use existing practices,

such as post endorsement technical reviews, quality assurance monitoring reviews, lender self-reports, Office of Inspector General ("OIG") audits, and other HUD investigations to identify loans for which HUD will demand indemnification.[xv] HUD assures lenders that these processes will afford lenders ample opportunities to submit additional information to HUD and have meaningful discussions regarding the loans at issue. Typically, when HUD or the OIG conducts these reviews, a lender is given a specified period of time to submit additional documentation or other information to HUD or the OIG to defend the lender's origination decisions and/or participate in informal discussions or exit interviews to explain the lender's position regarding allegedly deficient loans. Moreover, the final regulation gives HUD's Mortgagee Review Board ("Board") the authority to make indemnification demands of LI lenders,[xvi] in which case the Board will follow the regulatory procedures already established to govern its proceedings, including the opportunity to respond to Notices of Violation issued by the Board. Thus, LI lenders will have the opportunity to dispute whether a "serious and material violation" or fraudulent activity exists in a loan. But, if HUD disagrees with the lender, that conversation is likely to end quickly with the Department immediately proceeding with its indemnification demand.

Regardless of whether HUD makes demands for indemnifications through the Board or its more informal audits and reviews, we emphasize that such demands may only be made of lenders with LI approval. Although HUD has acknowledged that it is seeking a Congressional amendment to the National Housing Act to apply the indemnification provision to all FHA Direct Endorsement lenders,[xvii] without that amendment, HUD's indemnification authority does not apply to FHA-approved lenders that do not participate in the LI program.

D. Changes LI Lenders Should Expect Regarding Indemnifications

Based on the defined list of "serious and material violations," these items hit at the heart of subjective underwriting determinations, which HUD has delegated to Direct Endorsement mortgagees. Thus, lenders should prepare themselves for the possibility that a difference in opinion between HUD and a lender regarding the effect of a borrower's past derogatory credit could, perhaps, constitute a basis for HUD demanding indemnification from the LI lender.

Unfortunately, this is a standard that most FHA lenders already know well. As it is not unusual for HUD to request that FHA lenders indemnify the Department for a range of underwriting issues identified during the Department's monitoring reviews and audits, disputes over a borrower's creditworthiness, adequacy of income, documentation of assets to close a loan, and appraisal issues frequently constitute the basis for HUD's indemnification requests. So, how does the final regulation change the threat of indemnifications for LI-approved lenders?

Currently, HUD's Quality Assurance Division requests that lenders sign indemnification agreements as a way to resolve identified deficiencies in FHA loans. The Board also often agrees to accept indemnifications as part of a Board settlement to resolve allegations of underwriting deficiencies similar to those identified in the definition of "serious and material violations." However, upon the effective date of the final regulation, HUD will have the authority to automatically demand indemnification from a lender that knew or should have known that a loan endorsed by the LI lender contained "serious and material violations" of FHA requirements or fraud. That means the days of negotiating indemnifications are likely gone for LI lenders. If HUD demands that an LI lender indemnify a loan, and the lender refuses after it has defended its practices, HUD's next move could be to terminate the lender's FHA approval through a Board proceeding.

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III. Changes to LI Program Eligibility Criteria

A. New Requirements Regarding Acceptable Default and Claim Rates

The final regulation makes two important changes to the required acceptable claim and default rate a mortgagee must have to participate in the LI program. First, the final regulation amends the eligibility criteria for participation in the LI program to require lenders to have and maintain an "acceptable claim and default rate" in order to be eligible for LI approval.[xviii] Second, the definition of an "acceptable claim and default rate" also has been revised. Previously, HUD determined acceptable claim and default rates based on whether an LI participant's claim and default rate was: (1) at or below 150 percent of the national average for all insured mortgages; or (2) for mortgagees operating in a single state who chose to be measured as such, whether the lender's claim and default rate was at or below 150 percent of the state average rate for insured mortgages.[xix] The final regulation amends the definition of acceptable claim and default rate to a rate of claims and defaults that is at or below 150 percent of the average rate for insured mortgages in the state(s) in which the mortgagee operates.[xx] This change should more equitably compare regional lenders to other similarly situated lenders conducting business in the same states, rather than to lenders operating on a nationwide basis.

B. Exceptions from the Two-Year History Requirement for Acceptable Default and Claim Rate for Certain New Lenders

In general, to be eligible to participate in the LI program, among other things, a mortgagee must have an acceptable claim and default rate for a two-year period prior to its application for participation in the LI program.[xxi] The final regulation provides new exceptions from the two-year acceptable claim and default rate eligibility requirement under certain circumstances for new mortgagees resulting from merger, acquisition, or restructuring. Specifically, HUD may approve a mortgagee that is otherwise eligible for LI approval, but has an acceptable claim and default record of less than two years if:

- The mortgagee is an entity created by a merger, acquisition, or reorganization completed less than 2 years prior to the date of the mortgagee's application for LI approval;
- One or more of the entities participating in the merger, acquisition, or reorganization had LI approval at the time of the merger, acquisition, or reorganization;
- All of the lending institutions participating in the merger, acquisition, or reorganization that had LI approval at the time of the relevant event had an acceptable claim and default record for the two years preceding the mortgagee's application for LI approval; and
- The claim and default record of the mortgagee derived by aggregating the claims and defaults of the entities participating in the merger, acquisition, or reorganization, for the two-year period prior to the mortgagee's application for LI approval, constitutes an acceptable rate of claims and defaults, as defined under the final regulation.[xxii]

These changes provide necessary flexibility to LI participants involved in mergers, acquisitions, or reorganizations and will likely be welcomed by the industry.

IV. Changes to HUD's Monitoring of LI Program Eligibility

Along with the Department's new requirement that LI participants maintain an acceptable claim and default rate to continue to be eligible to self-endorse FHA-insured loans through the LI program, the final regulation authorizes HUD to implement increased monitoring of LI participants' claim and default rates.

Under prior regulatory requirements, HUD monitored a mortgagee's eligibility to participate in the LI program on an annual basis.[xxiii] The final regulation amends this provision to authorize the Department to monitor a lender's eligibility to participate in the LI program on an "ongoing basis."[xxiv] This language was amended slightly from the language in the proposed regulation, which authorized such monitoring on a "continual basis," in response to comments made by industry participants to the proposed regulation and in an effort to align the claim/default rate monitoring provisions for the LI program with those governing the Department's Credit Watch monitoring process.[xxv]

While neither the regulatory changes nor the Preamble discussion provide details as to the procedures HUD will implement to engage in such "ongoing" monitoring of LI participants' claim and default rates, the reference to the Credit Watch process and the amendments to the final regulatory language suggest that HUD likely will pattern its review of claim and default rates for LI participants on its Credit Watch program. If so, HUD is likely to review an LI participant's default/claim rates on a quarterly basis. Even with the Credit Watch program's procedural blueprint and an effective date of February 24, 2012 for the final regulation, it may take HUD additional time to establish a process for ongoing monitoring of LI participants' claim and default rates.

When HUD does begin to exercise its expanded monitoring authority of LI participants' claim and default rates, any increase in the frequency of such reviews from annual to quarterly or other ongoing basis as a result of these regulatory changes could result in more lenders being terminated from the LI program. Lenders terminated from the LI program would be required to submit paper case binders to HUD for FHA insurance endorsement, which could result in increased wait times for FHA mortgage insurance certifications, as HUD Homeownership Centers may be inundated with paper case binder endorsement requests. As noted by HUD in the Preamble to the final regulation, HUD expects that the changes regarding the acceptable claim and default rates will exclude 54 lenders currently participating in the LI program from continued eligibility for such participation.[xxvi] Moreover, as noted by HUD in its press release, "more than 80 percent of all FHA forward mortgage loans are insured by Lender Insurance lenders,"[xxvii] many of which constitute the nation's largest mortgage originators. Termination of a large number of LI participants or the LI approval of a large, nationwide originator of FHA-insured loans could significantly increase the costs associated with FHA insurance endorsements for both HUD and FHA lenders, as well as create delays in getting FHA loans endorsed.

V. New Reinstatement Process for Terminated LI Participants

While not included in the proposed regulation, the final regulation provides specific procedures for terminated LI participants to seek reinstatement in the LI program. These procedures are similar to those utilized by HUD in permitting lenders terminated by the Department through the Credit Watch program to request reinstatement of origination and/or underwriting authority.

Specifically, lenders terminated from the LI program must wait six months after termination before becoming eligible to apply for reinstatement of their LI authority.[xxviii] The reinstatement request must address the criteria for LI approval set forth in the regulations (*i.e.*, lender is unconditionally approved as a Direct Endorsement lender and meets HUD's new claim/default rate thresholds).[xxix] The

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application for reinstatement must also include a corrective action plan that addresses the issues resulting in the termination of the mortgagee's LI authority, along with evidence that the mortgagee has implemented the corrective action plan.[xxx] HUD may grant reinstatement of a mortgagee's LI authority if the application is complete and the Department determines that the underlying causes for the termination have been satisfactorily remedied.[xxxi]

Ultimately, as the final regulation provides a streamlined path to indemnification, LI lenders may soon find themselves the target of HUD's audits and monitoring reviews, which inevitably could result in increased time and resources devoted to fending off enforcement actions. At an unprecedented time of change in the mortgage industry, these additional costs may not be worth the privilege of self-endorsing FHA loans. If HUD uses its indemnification authority under the final regulation to target LI lenders and impose increased demands for indemnification, lenders are likely to be more conservative in their underwriting decisions and, ultimately, surrender their LI approvals. The result could be fewer FHA originations, which HUD may find itself manually reviewing prior to endorsement. That could wipe out the Department's hope for extending financing opportunities to more Americans and the efficiencies of the LI program for both HUD and FHA mortgagees.

If you have any questions about HUD's final regulation, participation in the LI program, or responding to HUD's requests for indemnification, please contact Phillip L. Schulman at (202) 778-9027 / phil.schulman@klgates.com, Krista Cooley at (202) 778-9257 / krista.cooley@klgates.com, Holly Spencer Bunting at (202) 778-9853 / holly.bunting@klgates.com, or Emily Booth at (202) 778-9112 / emily.booth@klgates.com.

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[i] See 75 Fed. Reg. 62,335 (Oct. 8, 2010); 77 Fed. Reg. 3,598, 3,599 (Jan. 25, 2012); Press Release, U.S. Dep't of Hous. and Urban Dev., FHA Announces Additional Steps to Limit Risk and Strengthen Finances (Jan. 20, 2012), available at http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2012/HUDNo.12-010.

[ii] Press Release, U.S. Dep't of Hous. and Urban Dev., FHA Issues Annual Financial Status Report to Congress (Nov. 15, 2011), available at http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2011/HUDNo.11-270.

[iii] Section 256 was added to the National Housing Act in 1996 by Section 427 of the Departments of Veterans Affairs and Housing and Urban Development and Independent Agencies Appropriations Act (105 Stat. 736 (1996)).

[iv] See 62 Fed. Reg. 30,222 (Jun. 2, 1997).

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[v] Press Release, U.S. Dep't of Hous. and Urban Dev., FHA Announces Additional Steps to Limit Risk and Strengthen Finances (Jan. 20, 2012), available at http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2012/HUDNo.12-010.

[vi] 12 U.S.C. §1715z-21(c)(1).

[vii] 12 U.S.C. §1715z-21(e); 24 C.F.R. 203.255(f)(4).

[viii] See 75 Fed. Reg. 62,335 (Oct. 8, 2010).

[ix] See 77 Fed. Reg. 3,598, 3,605 (Jan. 25, 2012).

[x] Id.

[xi] Id. at 3,599-3,600.

[xii] Id. at 3,600.

[xiii] Id. at 3,605.

[xiv] 77 Fed. Reg. at 3,605.

[xv] Id. at 3,600.

[xvi] Id. at 3,605 (citing 24 C.F.R. § 203.255(g)(5)).

[xvii] See 75 Fed. Reg. 62,335, 62,336 (Oct. 8, 2010).

[xviii] See 77 Fed. Reg. 3,598, 3,604 (citing new Section 203.4(b)(1)).

[xix] See 24 C.F.R. § 203.4(b).

[xx] See 77 Fed. Reg. 3,598, 3,604 (citing new Section 203.4(b)(3)). In the Preamble to the final regulation, HUD notes that, currently, a lender can obtain the compare ratio for all states in which it does business on Neighborhood Watch and can compare those claim and default rates to the overall claim and default rates for those states. See id. at 3,601. HUD also stated that it will update the Department's Lender Insurance Guide to provide further clarification regarding this measurement and to describe any enhancements to the Neighborhood Watch system necessary to accomplish this comparison for mortgagees operating in multiple states, but not on a nationwide basis. Id.

[xxi] See 24 C.F.R. § 203.4(b); see also 77 Fed. Reg. 3,598, 3,604 (citing new Section 203.4(b)(1)).

[xxii] Id. at 3,604 (citing new Section 203.4(b)(2) (emphasis added).

[xxiii] 24 C.F.R. § 203.4(c).

[xxiv] 77 Fed. Reg. 3,598, 3,604 (citing new Section 203.4(c)).

[xxv] Id. at 3,602.

[xxvi] See id. at 3,603.

[xxvii] Press Release, U.S. Dep't of Hous. and Urban Dev., FHA Announces Additional Steps to Limit Risk and Strengthen Finances (Jan. 20, 2012), available at http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2012/HUDNo.12-010.

[xxviii] See id. at 3,605 (citing new Section 203.4(e)).

[xxix] See id.

[xxx] See 77 Fed. Reg. at 3,605 (citing new Section 203.4(e)).

[xxxi] See id.

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