

PUBLICATION

Will the DOJ Kill FHA Loans Through Their Use of the False Claims Act?

April 20, 2016

The purpose of the Federal Housing Administration (FHA) is "to help creditworthy low income and first time homebuyers, individuals and families often denied traditional credit, to obtain a mortgage and purchase a home." This is achieved through the FHA guarantee provided to lenders who originate FHA backed loans, which provides the FHA will pay out the balance of a mortgage loan in the event of an uncured default. This significantly lowers and practically eliminates the risk of FHA loans to the lender, which then allows them to offer higher loan-to-value ratios and more attractive interest rates to borrowers who would normally not have access to similar terms. This system was successful and aided in achieving the FHA's goals of promoting home ownership, however this is changing as the DOJ has begun to bring investigations and actions against lenders under the False Claims Act.

When an originator participates in the FHA program they are operating under the Housing and Urban Development (HUD)'s FHA guidelines. As HUD cannot, and does not, check each and every loan guaranteed by FHA to confirm it was originated perfectly, they require a certification that the lender originating the file did so in compliance with the applicable guidelines. If the loan defaults, the lender submits a claim and the FHA will pay out the balance of the loan under the guarantee. The False Claims Act provides that any person who presents a false claim or makes a false record or statement material to a false claim, ". . . is liable to the United States Government for a civil penalty of not less than \$5,500 and not more than \$11,000 . . . plus **3 times the amount of damages which the Government sustains because of the act.**" The basic argument by the DOJ is that when a loan with *known* origination errors is certified by the lender to the FHA, with a subsequent claim submitted by the lender to the FHA after a default, the lender is in violation of the False Claims Act – because they knew or should have known the loan had FHA defects when they submitted their certification, and yet they still allowed the government to sustain a loss when the FHA paid out of the loan balance.

In the mortgage space the potential liability is astronomical because of the aforementioned penalties. The major issues in a False Claims Act violation can be boiled down to two major points:

1. What errors are the DOJ considering? Are they innocuous errors that are ever present in originating a large lender's portfolio, or egregious underwriting errors knowingly committed to increase production while offsetting risk through the FHA program? Obviously lenders are arguing the former.
2. What constitutes knowing the loans were defective under the DOJ's application? Prior to the DOJ's aggressive pursuit of these settlements, if the FHA identified an error in the underwriting the lender would simply indemnify the FHA and not process the claim, effectively making it a lender-owned loan. This was an acceptable risk to lenders, as they should be confident on their implementation of their underwriting guidelines and credit policies and an error in the origination process could not become such an oversized loss, the liability would be capped to any difference between what the borrower's total debt at the time of foreclosure sale and what the lender could recoup when the property was liquidated. The DOJ's use of the False Claims Act now triples a lender's risk when originating FHA loans by threatening damages that are triple the value of the amount paid out by FHA.

Criticism of the DOJ's approach is that the DOJ is using the threat of treble damages available under the False Claims Act to intimidate lenders into paying outsized settlements and having lenders admit guilt simply to avoid

the threat of the enormous liability and the cost of a prolonged defense. If the DOJ wanted to use this approach to go after bad actors in the space who are truly defrauding the government with dishonest underwriting practices or non-existent quality control procedures, then that would be acceptable to the industry. But the DOJ seems to be simply going after deep pockets, where the intentions of the lenders are well-placed and the errors found are legitimate mistakes. Case in point: as of December 2015, Quicken was the largest originator of FHA loans in the country, and they are currently facing a threat of a False Claims Act violation through their underwriting of FHA loans. To date they have vowed to continue to fight, and stated they will expose the truth about the DOJ's egregious attempts to coerce these unjust 'settlements.' In a Reuters article from late last year Quicken's founder and Chairman Dan Gilbert stated they are "[considering cutting the risk it takes in the program.](#)"

In his letter to all JP Morgan Chase (JPMC) shareholders last week, Jamie Dimon stated "we have dramatically reduced Federal Housing Administration (FHA) originations. Currently, it simply is too costly and too risky to originate these kinds of mortgages. Part of the risk comes from the penalties that the government charges if you make a mistake – and part of the risk is because these types of mortgages default frequently. And in the new world, the cost of default servicing is extraordinarily high." This perfectly illustrates how the DOJ is basically restoring all the lender risk to FHA-backed originations. Banks are left with two choices: they could price in the new risk of errors in underwriting into FHA loans and pass the cost to the end borrower, making the product so costly it becomes pointless to offer; or they will choose to cease or severely limit their FHA offerings. If lenders take either approach, the DOJ will have negated the purpose of the FHA by limiting borrower's access to credit they need with attractive terms.

Walking away from FHA lending is not as simple as it sounds. Most FHA borrowers tend to have lower credit scores and/or require lower down payments. Most FHA loans also tend to be for homes located in low- and moderate-income neighborhoods. As such, any decline in an institution's FHA offerings most likely will have a negative impact on an institution's CRA ratings. One has to think the DOJ is well aware of this fact and believes it will keep lenders in the FHA business even with the elevated risk, and can simply continue to strong arm lenders into settlements. If the DOJ continues to aggressively utilize the False Claims Act to recover from mortgage originators, the originators will be forced to evolve and create a product that they can keep as a portfolio loan or sell privately that can reach the same borrowers the FHA insured products currently do. Again here there is a high likelihood that these products will not have as attractive terms as the FHA loans borrowers are currently enjoying.

Large lenders will continue to step away from FHA originations, and smaller lenders who originate FHA loans should be strongly aware of the risk they are taking on by continuing to originate FHA loans and increasing their portfolio as the larger banks exit the FHA market. Many large lenders have faced or are currently facing these actions, and from the [Department of Justice's recent statements](#) it does not appear that they are slowing down with these claims anytime soon. Please take this opportunity to review your underwriting guidelines and the controls you have in place around your credit department, specifically around your delegated FHA underwriting. It would also be prudent to identify alternative products that can feed your CRA requirements, if found you are relying too heavily on FHA products for that role.