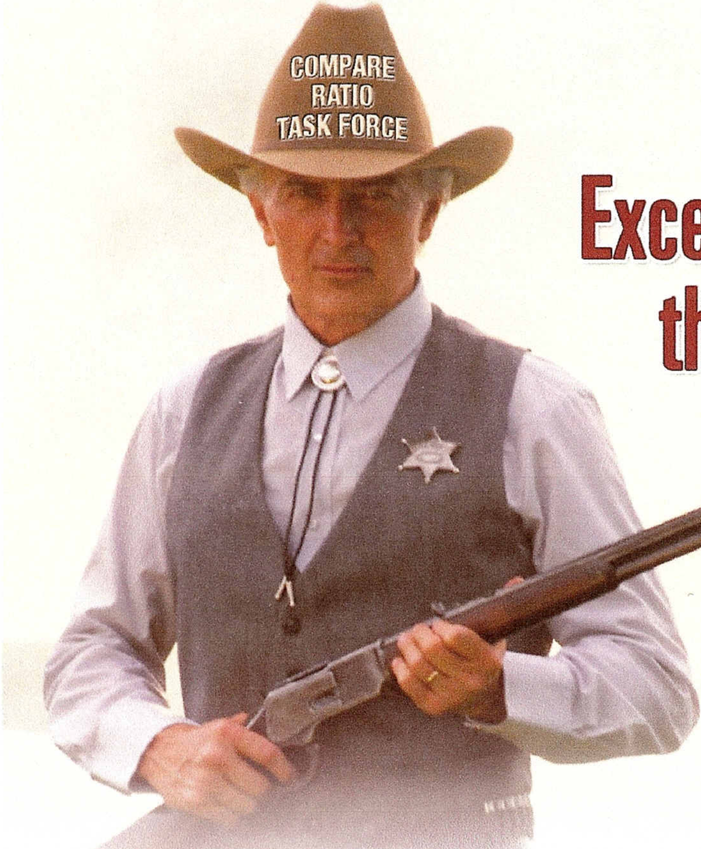

Excessive Defaults and the Future of FHA

By Jonathan Foxx

There's a new sheriff in town

There's a new sheriff in town. It's about time and none too soon! These folks mean business!

The U.S. Department of Housing & Urban Development (HUD) is determined to move forward with strong actions to reduce defaults and claims that are dragging down the Federal Housing Administration (FHA) mortgage insurance program. Guided by the firm resolve of its new HUD Secretary, Shaun Donovan, and FHA Commissioner, David H. Stevens, new ways and means are being implemented to put FHA's future on a much stronger foundation.

The FHA capital reserve ratio, which measures reserves held in excess of those needed to cover projected losses over the next 30 years, has fallen below the congressionally-mandated two percent threshold to 0.53 percent.[1] To give some sense of the steepness of this decline, at the end of 2007, the ratio was at 6.4 percent and at the end of 2008, it was at three percent and, at that time, forecasted to fluctuate through 2015 between 2.8 and 2.9 percent—with only a worst case scenario leading to a ratio below two percent.[2]

Obviously, the worst case scenario has arrived!

FHA currently has $31 billion in total reserves, triple in size from last year, due to taking on more risk as private industry sources for financing has dissipated. This amounts to 4.5 percent of total insurance-in-force. But with mortgage defaults at an all-time high, and other dispositive factors, FHA's capital reserve ratio is now at 0.53 percent[3]—the lowest in history. Clearly, the day of reckoning is here.[4]

HUD's Secretary Shaun Donovan and FHA Commissioner David H. Stevens have said there will be no request for congressional action to subsidize the rapidly depleting fund, even though under normal economic scenarios the ratio might rise to only 1.1 percent in fiscal 2010, but could dip to -1.03 percent if there is a significant drop in mortgage rates that cuts into premium revenue.[5] But, let us be clear: If FHA's cash reserves are exhausted, the federal government would immediately use taxpayer money to cover the losses, which would be the first time ever of a "bailout" for the FHA insurance program.

FHA moved forward in the last quarter of 2009 with plans to limit risk by bringing on its first chief risk officer, Robert Ryan, and sought to implement certain risk management methodologies, including revisions to seller-financed downpayment assistance, through Mortgagee Letters and the Rule Making Process, such as:[6]

Enacted via Mortgagee Letter, effective Jan. 1, 2010:

- Require submission of audited financial statements by supervised mortgagees
- Modify procedures for streamline refinance transactions
- Require appraiser independence in loan origination
- Modify appraisal validity period
- Enable appraisal portability

Pursued by rule-making process:

- Modify mortgagee approval and participation in FHA loan origination
- Increase net worth requirements for mortgagees

It should be mentioned, importantly, that without the seller-financed downpayment assistance loans—which began in 1999 and had grown to over 35 percent of all FHA-insured home purchase loans by FY 2007[7]—the capital reserve ratio for 2009 would have been two percent[8]—right at the threshold.

The FHA has pointed out that the actuarial review also showed that it has $31 billion in total reserves and, given the increased growth in 2009, that amount represents a 4.5 percent total reserve ratio on its total insurance-in-force, as indicated above. Under FHA's "Base Case" scenario,[9] the FHA maintains that it can cover projected claims on outstanding loans, with a $3.6 billion cushion. Nevertheless, the capital reserve ratio, which is the measure of excess reserves beyond the forecasted net claim costs on outstanding loans, is 0.53 percent.

Further impact on the capital reserves caused by other scenarios—such as a "Deeper Recession" than expected, "Up Rate Shock," "Down Rate Shock," "Higher Loss Severity," "Second Severe Recession" and "Depression"—would obviously lead to further depletion of capital reserves.[10]

Risks and reforms

I have mentioned, in part, some actions that the FHA has been taking to manage its risk in order to rebalance its insurance program and gradually bring it back to, and perhaps exceed the mandatory two percent threshold. The significant increase in its portfolio virtually demands an immediate and forceful response. Let's take a brief look at other remedies and reforms.

In response to the portfolio's growth, FHA is focusing on risk management throughout the agency, not only hiring Robert Ryan, as indicated above, but also by increasing staffing and technical capacity, and implementing new technology systems.[11]

To handle the threat of sub-prime lenders to using FHA as its "fallout" loan type, FHA has steeply increased enforcement, such as its suspension of Taylor, Bean & Whitaker Mortgage Corporation, the recent actions against Lend America, the increased funding for fraud tools, and promulgating policy changes affecting counterparty risk and credit risk management.[12]

FHA will institute measures to mitigate economic decline beyond the aforementioned "Base Case" scenario, by continuously monitoring of delinquency, default and economic conditions with improved data mining, tightening rules for appraisals, streamlining refinances and lender approvals, reducing cash take-out allowances on reverse mortgages, and adding FHA-HAMP to the loss mitigation program to prevent foreclosure.[13]

Finally, FHA will respond to borrower payment and default patterns that are significantly different in the current environment from their historic patterns, by monitoring changes in default patterns and net claim costs closely, and being prepared to respond quickly to any significant deviations from forecasts.[14]

But will all these remedies be enough to forestall a continuing decline of the capital reserves?

The perfect storm

FHA insures 30 percent of all home purchase loans today and nearly half of those for first-time homebuyers;[15] however, there is a rising tide of loans that are in default. About 9.1 percent of FHA borrowers are in default, having missed at least three payments as of December 2009, a statistic that has gone up from 6.5 percent a year ago—which is a 40 percent increase in this statistic in one year.[16] Although the FHA expects the tidal wave of defaults to gradually abate over time, assuming perhaps an "Earlier Recovery" scenario,[17] there are signs that the reduction in real estate values may also be contributing to the growing defaults and claims debacle.

New research shows that a borrower starts to consider walking away from the mortgage when the home value falls below 75 percent of the amount owed on the mortgage.[18] And, it should be noted, an estimated 4.5 million homeowners had reached this "tipping point" by the third quarter of 2009[19]—with projections of 5.1 million homeowners at this 75 percent exiting point by June 2010, equaling approximately 10 percent of all residential mortgages.[20]

FHA lenders who originated FHA loans in 2007 and 2008 believe that, although they abided by HUD's own product and underwriting guidelines at the time, those very same loans have become slow-paying technical defaults,[21] and eventually, are leading to claims against the insurance fund. Generally, it takes a two- to three-year timeframe after settlement for loans to begin to fail, so the existing onslaught of such loans is obviously being exacerbated by the current financial crisis.

It should come as no surprise, then, that HUD is finding high default rates on lenders that simply originated FHA loans in accordance with HUD's own guidelines. HUD's stated policy is to terminate a mortgagee's FHA approval if a lender has excessive defaults and claims, and is seeking legislative authority to increase enforcement to withdraw both originating and underwriting approval from an FHA lender nationwide on the basis of the performance of its regional branches.[22] Indeed, HUD will now "systematically review all Direct Endorsement (DE) underwriting mortgagees' defaults (loans 90 or more days' delinquent) and claim rates on loans during the initial 24 months from the date of the commencement of the amortization." And, at its option, HUD will "exercise its authority to terminate the underwriting authority of DE mortgagees with excessive default and claim rates."[23] How long HUD lets a lender with high defaults go on underwriting loans, without taking such actions, is HUD's determination to make.

There are unintended consequences caused by these measures taken against a lender with high defaults, because its investors also ascertain the high default rates associated with a specific lender, and, even if HUD has not yet terminated its relationship with the lender, or terminated the lender's underwriting authority, the investors often preemptively react by withdrawing their funding, which thereby imperils the lender's ability to originate new loans. The overall effects are to chill the market, reduce competitive pricing, leave otherwise competent and capable lenders with no financing outlets, and ultimately, deprive the consumer of the kind of local, responsible lender that may know them best. Sometimes, in going after the worst practitioners, some of the best ones may be caught in a regulator's net. Given the financial crisis and its effect on consumer and lender alike, HUD's daunting task is to be sure that it acts with fairness, resolve, and foresight.

Going after excessive default lenders

The single most important metric to identify poor performance with respect to defaults and claims is the statistic called the "compare ratio." Derived from the vast data in HUD's Neighborhood Watch—an "Early Warning System" that is part of HUD's "Credit Watch/Termination" initiative—this ratio provides a lender's percentage of originations which are currently in default or were "claim terminated" divided by the percent of originations which are currently in default or were claim terminated for the selected geographic area.[24] The compare ratio is the value that reveals the largest discrepancies between the lender's default and claim percentage and the default and claim percentage to which it is being compared.[25] The period bracketed to produce the ratio is the first two years after settlement. A higher ratio is indicative of an area (or lender) that has an unusually high default percentage in comparison with that region or lender's surrounding area. For example, if a lender has an eight percent default rate in California and four percent of all California loans defaulted, then the lender's compare ratio equals 200 percent.[26] The comparative metric uses performance data of various geographic areas, thereby comparing the performance of a particular lender to loan originations by nationwide, Home Ownership Centers (HOC), states, HUD's Field Offices, Metropolitan Statistical Area (MSA), counties, cities, and zip codes.

A higher ratio indicates an area (or lender) that has an unusually high default percentage in comparison with that region or lender's surrounding area.[27] For quite some time, the originating branch offices of a lender within a HUD office's jurisdiction with a compare ratio exceeding 200 percent have been at risk of receiving a proposed termination letter from HUD.[28] (To date, the special HOPE for Homeowners Program has not been included in HUD's performance analysis of a lender's compare ratio with respect to the CreditWatch/Termination initiative.)[29] HUD has continued to make strenuous efforts to address deficiencies in the mortgagee's performance.[30]

On Jan. 9, 2009, Phillip Murray, HUD's Deputy Assistant Secretary for Single Family Housing Programs, said to a meeting of the House Committee on Financial Services, that "FHA currently performs a quarterly analysis of the default and claim rate for each lender branch (approximately 25,000 branches), comparing it with average rates for all lenders located in each HUD field office jurisdiction. Those lenders with a relative compare ratio of greater than 200 percent are subject to proposed termination."[31]

According to FHA Commissioner Stevens' recent announcement, on Jan. 20, 2010, FHA now seeks "maximum flexibility" to establish separate "areas" for purposes of review and termination under the Credit Watch initiative.[32] The expanded authority permits FHA to withdraw originating and underwriting approval for a lender, nationwide, on the basis of the performance of its regional branches. On Jan. 21, 2010 FHA implemented this policy in a Mortgagee Letter, effective on that date. Previously, HUD exercised its authority to terminate only the loan origination approval authority of a mortgagee. Now, HUD will "systematically review all Direct Endorsement (DE) underwriting mortgagees' defaults (loans 90 or more days' delinquent) and claim rates on loans during the initial 24 months from the date of the commencement of the amortization. HUD, "at its option, will exercise its authority to terminate the underwriting authority (Authority) of DE mortgagees with excessive default and claim rates."[33]

The compare ratio is one of HUD's most powerful tools to identify the lenders with excessive defaults and claim rates. Every three months, HUD now plans to review the compare ratio of an FHA lender within the geographic area of the lender's field office and, allowing for mitigating factors,[34] will determine if the

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lender's underwriting approval will be terminated on the basis of particularly high rates of defaults and claims. The following table outlines the timeframe and termination thresholds:[35]

24-Month Period Ending Date	Termination Threshold
December 31, 2009	300%
June 30, 2010	250%
December 31, 2010	200%

Underwriting termination may occur if a lender's compare ratio exceeds both the national rate and 300 percent of the Field Office rate, as of Dec. 31, 2009. Using the same comparative statistics, underwriting termination may occur if a lender's compare ratio is 250 percent through June 30, 2010, and 200 percent through Dec. 31, 2010. After Dec. 31, 2010, the compare ratio will remain constant at 200 percent of the field office default and claim rate.

Using 2009 year-end data, approximately 10 percent of the mortgagees listed in Neighborhood Watch have compare ratios of 200 percent or more.[36] These lenders will be compared to their field office default and claim rate as well, with lenders that exceed the compare ratio threshold now subject to underwriting termination.[37]

Get down on it! Reducing excessive defaults and claims ...

So, what actions can a lender take to bring down the compare ratio, the specific adverse performance experience statistic, before HUD takes administrative action against it? Or, at least, what can be offered to endeavor to dissuade HUD from terminating a lender's underwriting approval if the compare ratio is too high?[38]

In response to this crisis of excessive defaults and claims, my firm, Lenders Compliance Group, developed a methodology to reduce the compare ratio gradually over time. We organized our Compare Ratio Task Force (CRTF) and staffed it in order to work closely with high compare ratio lenders, not only to bring down their defaults and claims rates but also to guide them in implementing ways and means to avoid this problem in the future. The CRTF is a process that stays involved with a lender's on-going compare ratio performance every single month.

I will provide an overview of the Compare Ratio Task Force, in order to demonstrate one viable approach to reducing excessive defaults and claims. We have found that this methodology is effective and it has been designed to comply with the requirements of federal and state banking laws.

Compare Ratio Task Force (CRTF): Seven step process to reduce high compare ratios

Step 1: Borrower eligibility review

Conduct a comprehensive review of existing defaults and claims for loss mitigation and loan modification eligibility. The lender gives us the list of all loans causing the high compare ratio and we administer a review, using documentation or LOS information. We utilize specially designed checklists and an automated application that looks at a wide variety of data fields, to determine the borrower's eligibility for loss mitigation or a particular loan modification program.

Step 2: Notify lender of borrower eligibility

We notify the lender of a borrower's eligibility for one or more loss mitigation resolutions. Of course, we also indicate which loans are unlikely to be eligible for loss mitigation.

Step 3: Notify borrower of possible eligibility

Lenders may choose two options at this point: (1) They may send a letter to the borrowers, notifying them about their loss mitigation eligibility, or (2) Call the borrower directly to discuss loss mitigation. Some lenders, in fact, prefer to send out to the borrowers a rather generic letter about possible loss mitigation eligibility in an effort to get them to call. Those borrowers who call back the lender, then, go through our Step 1 screening procedures.

Step 4: Refer eligible borrower to counsel

As a risk management firm, we have access to and use preferred legal counsel to assure nationwide coverage and representation for our clients. But not just any attorney can properly handle loan modification work. Many attorneys have jumped into the loan modification practice in the last two years, but only a few really know what they're doing. Extensive expertise is needed to achieve an opportunity for a positive outcome. Consequently, we review and approve all outside legal counsel and our own firm's lawyers determine the selected attorney's competency to handle loss mitigation and loan modification strategies.

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Step 5: Monitoring the process
The length of time to effectuate a loan modification pursuant to various loss mitigation guidelines can take three to six months. It is critical that the process be monitored objectively to ensure that the legal work is getting done and the application process is reaching timely completion.

Step 6: Contact with servicer
Substantive, time-sensitive reporting requirements are associated with reducing high compare ratios. For example, the servicer reporting when a trial modification has commenced, reporting payments during the trial period, and reporting when the permanent modification has occurred. This data must be entered in a timely manner into HUD's database in order for the compare ratio statistic to be credible and current. Unless the permanent modification is reported, the compare ratio is not appropriately adjusted in HUD's Neighborhood Watch.

Step 7: On-going review
As old defaults are reduced and the compare ratio gradually declines, new defaults and claims may be added. The two year timeframe continually moves forward, each month, and the compare ratio is recalculated for all defaults and claims that are added or remain. The best time to begin work on a default is as soon as a lender discovers it in Neighborhood Watch. Consequently, the sooner we get involved in implementing the Compare Ratio Task Force program, the more opportunity there is to make sure the compare ratio is not adversely affected.

"There is an immeasurable distance between late and too late"—Og Mandino

HUD will permit loans that closed or were approved before termination to be submitted for insurance endorsement, but cases at earlier stages of processing cannot be submitted for insurance by the terminated mortgagee (though they can be transferred to an approved mortgagee). Loan correspondents with a terminated mortgagee will have only 30 days to establish a new relationship with an approved sponsor and, failing that, will find their own FHA approval terminated. A terminated mortgagee may request to have its authority reinstated no earlier than six months after the effective date of the termination and only after HUD's Secretary determines that the underlying causes for the termination have been remedied.[39]

The termination of the authority to underwrite FHA-insured single family loans can devastate a lender. Waiting too long to resolve high compare ratios will surely lead to drastic consequences. If a lender has a high compare ratio and takes no action whatsoever to reduce its defaults and claims rate, it has passively placed itself in a position to be terminated. With affirmative and deliberate action, even though the process to reduce the high compare ratio takes place over several months, at least the lender can demonstrate to HUD its commitment to bring down its defaults and claims. Notwithstanding a lender's high compare ratio, it is at HUD's option to decide if a lender will be terminated. If a lender does nothing at all to reduce the rate of its defaults and claims, it may leave HUD no option but to terminate it.

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For more information on author Jonathan Foxx, visit Lenders Compliance Group on the Web at www.lenderscompliancegroup.com.

Footnotes

1—Prepared Remarks by David H. Stevens, Assistant Secretary for Housing and FHA Commissioner at the Exchequer Club, Washington, D.C., Wednesday, Jan. 20, 2010.

2—"FHA Insurance Fund Has Fallen 39 Percent," *Washington Post*, By Dina ElBoghdady, Dec. 3, 2008, sourcing an audit by Integrated Financial Engineering of Rockville, Md.; "FHA Reserve Ratio Falls to 0.53 Percent, Lowest in History," *Bloomberg News*, By Dawn Kopecki, Nov. 12, 2009.

3—Based on amortized loan balances, as of Sept. 30, 2009, see FHA Annual Management Report, Fiscal Year 2009, inter alia, p. 96, U.S. Department of Housing & Urban Development. Available in the Reports section of our Web site's Library (www.lenderscompliancegroup.com).

4—The findings come as part of FHA's annual independent actuarial study and reflect FHA's status at the end of its fiscal year 2009, which concluded in September 2009. Pursuant to the Cranston-Gonzales National Affordable Housing Act of 1990, FHA's Mutual Mortgage Insurance Fund must maintain sufficient capital to sustain a moderate recession, pegged at two percent. The Housing and Economic Recovery Act of 2008 (HERA) mandated the Secretary to submit an annual independent actuarial study to calculate this ratio.

5—Op. cit., 2, Bloomberg News.

6—"HUD Secretary, FHA Commissioner, Report on FHA's Finances," HUD No. 09-214, Nov. 12, 2009.

7—FHA Fiscal Year 2009 Actuarial Review Briefing, Nov. 12, 2009, p. 112. U.S. Department of Housing and Urban Development. Available in the Reports section of our Web site's Library (www.lenderscompliancegroup.com).

8—Op. cit., 7, p. 24.

9—Op. cit., 7, p. 8, "Peak-to-trough house price decline of 14 percent in the Federal Housing Finance Agency index. Includes an 8.6 percent decline from mid-2009 to mid-2010."

10—Op. cit., 7, p. 8, p10: "Deeper Recession" is total peak-to-trough decline equivalent to a 27 percent decline in the Case-Shiller.

11—Op. cit., 7, p. 28.

12—Op. cit., 7, p. 29.

13—Op. cit., 7, p. 31.

14—Op. cit., 7, p. 32.

15—FY 2011Budget, p. 4, Feb. 1, 2010, U.S. Department of Housing & Urban Development.

16—"Rising FHA default rate foreshadows a crush of foreclosures," *Washington Post*, By Dina ElBoghdady and Dan Keating, Feb. 2, 2010.

17—Op. cit., 7, p. 8: "Earlier Recovery" presumes that the national housing market is now finding its trough, and that there will be no further home price declines in 2010.

18—"No Help in Sight, More Homeowners Walk Away," by David Streitfeld, *New York Times*, Feb. 2, 2010.

19—Ibid.

20—Statistics on this trend can be found in *The Negative Equity Report*, Nov. 24, 2009, First American CoreLogic.

21—HUD defines a defaulted loan as one which evidences the inability to make timely monthly mortgage payments or otherwise comply with mortgage terms. A loan is considered in default when payment has not been paid after 60 to 90 days. The period used is the first 24 months after endorsement.

22—"FHA Announces Policy Changes to Address Risk and Strengthen Finances," HUD No. 10-016, Jan. 20, 2010.

23—"Mortgagee Approval for Single Family Programs: Extended Procedures for Terminating Underwriting Authority," Mortgagee Letter 2010-03, Jan. 21, 2010.

24—Data can be analyzed by three general categories: lender, location, and product type. The public can access the compare ratio and other data by visiting HUD's Neighborhood Watch at https://entp.hud.gov/sfnw/public/.

25—Neighborhood Watch/Early Warning System—Definitions and Explanations.

26—Ibid., FAQs.

27—"Neighborhood Watch provides loan performance data via the FHA Connection HUD," Mortgagee Letter 00-20, June 2, 2000, FAQs, p. 2.

28—"Mortgagee Approval for Single Family Programs: Elimination of Placement on Credit Watch Status—Superseding the references to Credit Watch in Mortgagee Letter 99-15," Mortgagee Letter 99-15, Oct. 12, 2001.

29—"HOPE for Homeowners Program: Comprehensive Guidance," Mortgagee Letter 09-23, Oct. 20, 2009.

30—For example, as provided in the HUD mortgagee approval regulations at 24 CFR 202.3. And, proposed rule revisions on April 1, 2003, at 68 CFR 15906, published as an interim rule on Dec. 17, 2004, effective Jan. 18, 2005; and the final rule that took effect on March 1, 2006.

31—"FHA Oversight of Loan Originators," Prepared Statement of Phillip Murray, Deputy Assistant Secretary for Single Family Housing Programs, U.S. Department of Housing & Urban Development, Meeting of the Committee on Financial Services United States House of Representatives, Jan. 9, 2009, p. 4.

32—Op. cit., 22.

33—"Mortgagee Approval for Single Family Programs: Extended Procedures for Terminating Underwriting Authority," Mortgagee Letter 10-03, Jan. 21, 2010.

34—Such as analyses of loans in terms of underserved versus served census tracts, compared to the performance in the Field Office average for similar loans.

35—Op. cit., 33, p. 2.

36—As of Dec. 31, 2009, there were approximate 3000 FHA mortgagees listed and given compare ratios in Neighborhood Watch, of which approximately 308 have compare ratios of 200 percent or more on a nationwide basis.

37—The recent probe into the excessive claims rates of 15 mortgagees seems to be just the tip of the iceberg, given the considerable percentage of mortgagees with defaults and claims, as reflected in their high compare ratios. See: "HUD Inspector General Probes Mortgage Companies with Significant Claim Rates," HUD. No. 10-005, Jan. 12, 2010.

38—There is an Appeal Process, which permits a mortgagee to request an informal conference within 30 calendar days of the date of receipt of the proposed termination notice.

39—Op. cit., 33, pp 3-4. To remedy, the lender must obtain an independent review, conducted by a CPA, of the terminated areas operation—identifying the underlying cause for the mortgagee's high default and claim rate. The mortgagee must also submit a written corrective action plan to address each of the issues identified in the CPA's report, along with evidence that the plan has been implemented. HUD may also impose additional requirements for reinstatement.