FHA Defect Taxonomy and the False Claims Act*

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While there is merit in the False Claims Act ("FCA") – false claims against the government should not be tolerated, of course – its questionable use in the financial services sector of the economy has resulted in negative social and economic consequences that could have easily been predicted. Balancing the merits of the Act with the need to provide services to the public by experienced lenders is essential, and while all of the issues surrounding the Act would be difficult to fix quickly, there are a few modest changes in regulations of mortgage lending that might get the reform moving in the right direction, all of which could be addressed administratively at HUD and DOJ.

Background and need for change

The False Claims Act imposes liability on anyone who knowingly submits a false claim to the U.S. government. Violations provide for damages three times the actual damages, plus penalties. Both the DOJ and private litigants can bring actions asserting violations of FCA, with the action of the private litigant a qui tam action in which the government can choose to intervene. There are hundreds of qui tam actions.

During 2016, the government collected more than $4½ billion in settlements and judgments under that Act. While health and government contracting were the major targets, financial services firms paid more than $1½ billion, primarily associated with suits based on false claims dealing with residential housing.

As a result of that and a variety of related issues, many of the traditional mortgage lenders have withdrawn substantially from FHA programs, leaving less traditional lenders to pick up the slack. And while many of those lenders would be able to withstand downturns in the economy, senior officials at HUD have expressed concern that the group as a whole might not be able to do so.[1]

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[1] ***The Mortgage Market's $1 Trillion Pocket of Worry***

Those who have stayed have added overlays on the loans so that the loans are priced at a level that detracts from the basic mission of the FHA.

FHA efforts to create more certainty

To create more certainty for lenders and, in doing so, assist them in their efforts to avoid the risks of suits under the FCA, FHA issued a new loan level certification and a Quality Assurance Defect Taxonomy. While changes in the loan level certification were welcomed and helpful, not as much can be said of the Defect Taxonomy. In fact, the FHA avoids saying anything comforting about the precedential value of the Taxonomy. In the words of the document itself, the Taxonomy "does not establish standards for administrative or civil enforcement action," nor "address fraud or misrepresentation in connection with any FHA-insured loan." Its effect, therefore, will be minimal on encouraging bank lenders to return to FHA lending.

The Taxonomy describes in fairly subjective terms the nature of errors that will place a loan in one of four levels of "severity," those in number one being the most severe and in number four the least. Those in levels one, two and three will be unapprovable, while those in four will be approvable.

The FHA could make minor changes in Level Three and Level Four that would be very helpful in generating increased interest in FHA lending.

Those in level three contain errors that, even if identified and corrected, would cause the loan still to be unapprovable, either because the loan would still exceed approval limits, albeit by a small margin, or because the loan would still fail to comply with loan guidelines, albeit by a small degree. That could be changed to provide a reasonable cure provision that makes the loans acceptable if after the cure they are within the approval limits and loan guidelines.

Those in level four, on the other hand, even if they contain errors that impact key calculations or inputs, would still be acceptable based on FHA limits and guidelines.[2] Said another way, the errors would not be material to the FHA. Nevertheless, absent greater expressed protection for those meeting the test of severity level four, lenders are forced to realize that the FHA is not offering a safe harbor from its own enforcement or suits brought by DOJ and qui tam plaintiffs under the FCA, even if the loans are properly classified as level four severity. FHA should make that explicit and encourage DOJ to publish a similar expression of intent.

The FHA should promulgate a rule that loans in Defect Taxonomy Level Four will be acceptable to the FHA and that those in Level Three, properly cured, will also be acceptable.

If an agency is prepared to accept a loan, document, application or other communication or agreement with a party, even if those instruments contain errors that impact key calculations or inputs, that should be made clear without equivocation. Therefore, to provide certainty to lenders, the FHA should modify its defect taxonomy and adopt a rule promulgated under notice and comment procedures, that loans that meet the criteria described in Level Four of the Defect Taxonomy are acceptable to it and approvable under the rules and regulations of the FHA, even though those loans contain errors that may impact key calculations or inputs.

[2] FHA's Single Family Housing Loan Quality Assessment Methodology (Defect Taxonomy), June 18, 2015, p.7.

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In addition, the FHA should promulgate a rule that says loans in severity level three will be acceptable to the FHA if they are cured so that they do not exceed approval limits or loan guidelines of the FHA.

DOJ should publish as a principle of federal prosecution that materiality under its guidelines will generally be absent in cases under the False Claims Act if the agency responsible for administering a federal law whose violation is the basis of the DOJ suit has concluded that the actions of a party are acceptable to it in its administration of that law, notwithstanding that there may have been mistakes or errors made by that third party in complying with the Act.

Actions are brought by the Department of Justice under the False Claims Act for false certifications or other false claims made against the FHA. In other cases, proceedings may be instigated by private plaintiffs under qui tam and the Department must decide whether or not to intervene. Actions by FHA that determine it will honor certain claims even though it knows there were errors in their origination will not bind the DOJ or private plaintiff. Nevertheless, lenders will be more willing to participate in FHA lending if DOJ issues a statement saying that its judgement errors are not material or the violation of an Act is not material if the agency administering that Act finds them immaterial.

Summary

To encourage traditional lenders to return to FHA lending, and in a way that assists the FHA in complying with its basic mission, FHA should buttress its recently issued loan certification changes with modifications in its Defect Taxonomy and a clear statement that loans in level four or level three (after cures) of the Taxonomy are acceptable and the errors that might exist within them are immaterial to compliance with the Act. A similar statement from DOJ that such errors are immaterial would be supportive and very helpful.

These changes can all be made administratively.

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