

To: Ed Golding
Principal Deputy Assistant Secretary for Housing
U.S. Department of Housing and Urban Development

From: Alys Cohen and Geoff Walsh, National Consumer Law Center
Steve Sharpe, Legal Aid Society of Southwest Ohio

Date: April 9, 2015

We are writing to urge HUD to immediately reverse its recent action that amended the FHA form note and mortgage by removing language incorporating loss mitigation regulations into the contract and by adding language stating that borrowers are not third party beneficiaries of the insurance contract. These changes will damage the MMI fund and promote unnecessary foreclosures without providing any significant benefit. We have conferred with Professor Alan White of CUNY School of Law who agreed with our analysis and concluded that the changes in the forms will seriously weaken homeowner defenses to foreclosure based on servicer non-compliance with FHA requirements.

For decades, HUD's form note and mortgage for FHA-insured single family mortgage loans has included contract terms incorporating federal regulations aimed at preventing unnecessary foreclosures. Paragraph 9 of the form mortgage has stated that "[i]n many circumstances regulations issued by the Secretary [of HUD] will limit Lender's rights, in the case of payment defaults, to require immediate payment in full if not paid. This Security Instrument does not authorize acceleration or foreclosure if not permitted by regulations of the Secretary." Paragraph 6 of the note has included similar text. Despite their stable place in HUD's form documents for decades, it appears that the agency has removed the terms protecting against unnecessary foreclosures from the forms without providing any notice, explanation or opportunity to comment. In addition, HUD has added language to the new model mortgage that courts may misconstrue as completely limiting homeowners' ability to avoid foreclosure based on lender non-compliance.

Removal of this language, while the country is still recovering from its worst foreclosure crisis, undermines the strength of the MMI Fund and sets up roadblocks for homeowners seeking FHA loss mitigation by making it easier for servicers to ignore FHA loss mitigation requirements while pursuing foreclosures. Moreover, it will have a significant impact in communities of color, where FHA-insured mortgages finance approximately half of all home purchases made by African American and Latino homeowners.¹ Servicer performance during the financial crisis and even now still leaves many homeowners facing expensive delays and subject to avoidable foreclosures.

While implementing forms similar to those used by Fannie Mae and Freddie Mac may create streamlined closings and somewhat decrease lender costs, FHA lending is substantially different from GSE lending—in its goals, terms and benefits, and any savings are far outweighed by the costs these changes will impose on the MMI fund, homeowners

¹ United States Department of Housing and Urban Development, Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2013, pg. 18 (December 13, 2013).

and communities. Moreover, while HUD is adopting a new quality assurance program, which we applaud, such efforts can in no way replace the real-time responsiveness a homeowner needs when a foreclosure is looming and a servicer fails to comply with clear HUD requirements. In light of all of these factors, HUD must reverse its decision.

The Removed Contract Language Has Benefitted the Fund by Promoting Compliance

Courts have used the removed contract language to ensure that HUD guidelines are followed. Several cases upholding the mandatory nature of HUD's regulations have focused on the contract language.² This language has been especially important in non-judicial foreclosure states.³

By providing courts with a clear basis for applying and enforcing HUD's important loss mitigation rules, the language assists HUD in protecting its MMI fund. The current regulatory framework does not bar a lender that completes foreclosure without following the loss mitigation rules from seeking a claim payment (although the lender could be subject to other penalties).⁴ However, a lender that cannot complete foreclosure because a court has found a violation generally cannot proceed through the claim process. Therefore, the homeowner's ability to raise non-compliance has a practical benefit to the fund in individual cases. In addition, lenders who lose court cases may change their practices in order to ensure compliance in the future.

HUD contends that language in the revised mortgage stating that it is governed by "applicable law" provides similar rights. However, unlike the former language, the "applicable law" provision does not refer specifically to acceleration or foreclosure and does not directly refer to the loss mitigation regulations that apply. This lack of clarity will lead to unnecessary foreclosures.

The Language Change is a Long Standing Reversal of FHA Policy

Historically, HUD has defended the inclusion of contract language. In 1989, HUD issued a response to a lender raising the homeowner's use of contract language in court:

A commenter made specific suggestions to eliminate language referring to regulations issued by the Secretary in the default section of the mortgage instrument as well as other similar references. The commenter noted that such language would create foreclosure proceedings that would be more time consuming and expensive. The borrower's attorneys could commence exhaustive discovery to determine whether the lender met all of the servicing requirements. We rejected the

² BAC Home Loans Servicing, LP v. Taylor, 986 N.E.2d 1028, 1034 (Ohio Ct. App. 2013); Wells Fargo v. Phillabaum, 950 N.E.2d 245, 246 (Ohio Ct. App. 2011); ABN AMRO Mortg. Grp v. Tullar, 770 N.W.2d 851, *3 (Iowa Ct. App. 2009).

³ Mathews v. PHH Mortgage Corp., 283 Va. 723, 733, 724 S.E.2d 196, 200 (2012); Pfeifer v. Countrywide Home Loans, Inc., 211 Cal. App. 4th 1250, 1266, 150 Cal. Rptr. 3d 673, 686 (2012); Fonteno v. Wells Fargo Bank, N.A., 228 Cal. App. 4th 1358, 1370, 176 Cal. Rptr. 3d 676, 686 (2014) ("To be clear, we are being asked to permit enforcement of a contract, not a statute."); Mullins v. GMAC Mortgage, LLC, 2011 WL 1298777, at *2 (S.D.W. Va. 2011).

⁴ 24 C.F.R. 203.500 ("Failure to comply with this subpart shall not be a basis for denial of insurance benefits, but failure to comply will be cause for imposition of a civil money penalty, including a penalty under § 30.35(c)(2), or withdrawal of HUD's approval of a mortgagee.")

commenter's suggestions that the references to regulations by the Secretary will impair the lender's ability to successfully defend a suit. HUD does not intend to create a conflict between the mortgage language and regulations, and there should be no adverse impact of informing the borrower that some regulations procedures exist which limit a lender's rights to foreclose.⁵

HUD's defense of the contract language in 1989 is even more relevant today in the aftermath of the foreclosure crisis.

The addition of the third party beneficiary language in Paragraph 20 of the form mortgage is unnecessary and may further limit compliance. The note and mortgage are contracts between the lender and the homeowner, and they set out the rights and responsibilities of the parties to the contracts. The language could be used by lenders to evade compliance with federal requirements.

Furthermore, the language promotes an overly narrow view of FHA insurance that places the lender as the only beneficiary. By statute, FHA insurance is in place "to meet the housing needs of the borrowers that the single family mortgage insurance program under this subchapter is designed to serve."⁶ The program does not exist to subsidize banks; rather, homeowners are key stakeholders in the program and are partners with FHA in holding counterparties responsible for compliance.

A Policy of Alignment with Fannie Mae and Freddie Mac Forms Does Not Justify the Change

In response to our initial inquiry into the change, HUD stated that the revised note and mortgage are now more in alignment with Fannie Mae and Freddie Mac forms. Presumably, such alignment may somewhat increase efficiency for the loan originators and agents that prepare closing files. However, the removal of the language comes with significant costs to FHA that would not apply to Fannie Mae and Freddie Mac loans. FHA directly and fully insures the loans, in contrast with the guarantee structure used by the GSEs. The loans insured by FHA come with federal regulations that govern counterparty conduct.⁷ Moreover, homeowners obtaining FHA loans have paid an additional premium to gain access to FHA loan terms, servicing options and overall benefits. Most homeowners do not even know if they are obtaining a GSE-guaranteed loan.

The difference in the regulatory structure is grounded in the distinct mission of FHA's program. FHA-insured loans are specifically targeted to a different demographic than Fannie Mae and Freddie Mac loans. FHA-insured loans assist a less financially stable set of homeowners, and these homeowners are more likely than homeowners with Fannie Mae and Freddie Mac loans to need loss mitigation. As a result, there has been more in place to promote lender compliance.

Finally, the alignment, in fact, will provide very little in efficiency savings for lenders. Although the new forms are closer to the Fannie Mae and Freddie Mac forms, they are not

⁵ United States Department of Housing and Urban Development, Requirements for Single Family Mortgage Instruments, 54 FR 27596-01, 27599 (June 29, 1989).

⁶ 12 U.S.C. 1708(a)(7).

⁷ 24 C.F.R. 203.600 - .606.

identical. Lenders will still need to use separate forms for FHA-insured loans. With lenders having to use separate forms in any case, the cost of unnecessary foreclosures outweighs any benefits.

The Contract Language was Changed without Notice or a Comment Period

HUD's removal of the language from the forms without any notice or opportunity for comment stands in stark contrast with the importance of the contract language protecting against unnecessary foreclosure and its stable place in the forms. The form note and mortgage have been attachments to HUD Handbook 4155.2.⁸ In December of 2013, HUD issued a draft of a revised handbook on single family loan origination and asked for comments. There was no indication in the draft handbook that HUD was planning to remove the language. HUD released the final version of the handbook on September 30, 2014 (effective June 2015).⁹ The final handbook draft mentions mortgage and note forms and also mentions that FHA loans have specific requirements, but it does not provide any specific details about the forms.¹⁰ Instead, there is a link to a website that includes the updated mortgage and note forms. It is on this website, which was not promulgated in any fashion and which appears to be subject to amendment at any time, that the forms are now included.¹¹

Despite the potential impact on homeowners and the Fund, and despite the long-standing presence of the language in the contracts, HUD made no announcement of the change and asked for no comments on it. The agency has a goal of promoting stable homeownership and neighborhoods yet it failed to properly notice these revisions, or to publically seek any input at all. It is relevant to note that HUD recently engaged in changes to closing documents for multi-family housing loans and addressed these changes through the Federal Register.¹² No similar process was afforded in this case. Moreover, in the past, HUD has announced its intentions to process changes in its single family mortgage forms through the Federal Register instead of through an informal process.¹³

HUD must reverse its policy in order to protect the Fund and to prevent unnecessary foreclosures. The language has existed in the single family mortgage forms for decades and it has helped both homeowners and the MMI fund. HUD must reverse course.

cc: Kathleen Zadareky, Associate Deputy Assistant Secretary, Single Family Housing

⁸ United States Department of Housing and Urban Development, Handbook 4155.2 at ch 12-A-2, 12-A-16 (March 24, 2011).

⁹ United States Department of Housing and Urban Development, Handbook 4000.1 (September 30, 2014).

¹⁰ *Id.* at 219 (“The mortgagee must develop or obtain a separate mortgage and Note that conforms generally to the Freddie Mac and Fannie Mae forms in both form and content, but that includes the specific modification required by FHA set forth in the applicable Model Note and Mortgage.”).

¹¹ http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/handbook_references

¹² See Federal Housing Administration (FHA) Multifamily Rental Project Closing Documents: Notice Announcing Approval of Revised Documents, 79 FR 40131-01 (July 11, 2014).

¹³ United States Department of Housing and Urban Development, Mortgagee Letter 2002-3 (January 16, 2002) (“FHA also expects to issue a Notice of Proposed Rulemaking, inviting comments on possible changes to the FHA Model Mortgage document.”).