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Straining the FHA's umbrella

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A District nonprofit organization that says it helps cash-strapped homeowners avoid foreclosure is under federal investigation for instead helping lenders make high-risk loans that leave the government on the hook if they go bad, according to sources familiar with the probe. Federal officials say they are concerned that the Rainy Day Foundation could be thwarting government efforts to weed out mortgage lenders that make too many precarious loans.

The Federal Housing Administration, which encourages homeownership by guaranteeing mortgages made by qualified lenders, has long struggled to keep companies from slipping risky loans under its protective umbrella. The agency has done this in part by barring lenders if too many of their borrowers default.

The Rainy Day Foundation advertises that it can help lenders remain in the FHA's good graces. For a fee of about $600 per borrower, paid by lenders, home builders and real estate firms to cover the cost of making mortgage payments for distressed borrowers, the group promises to limit defaults during the two years after a loan is made, the period watched most closely by the FHA. Rick Del Sontro, chief executive of the Rainy Day Foundation, said in an interview that his group provides an important service to borrowers and lenders.

But some lenders and housing experts say this kind of "payment protection program" postpones rather than prevents defaults and allows lenders to make riskier loans.

The Justice Department has alleged, for instance, that the Rainy Day program was used by a major FHA lender, Lend America, in an attempt to conceal fraud. In a civil lawsuit filed against Lend America in October, the Justice Department charged that the company secured FHA guarantees for loans based on fraudulent underwriting, then paid Rainy Day to hide defaults by some borrowers. The suit said that the FHA is

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likely to lose millions of dollars as the borrowers eventually default.

"The purpose of the Rainy Day Foundation was and is to conceal borrowers' inability to keep up with mortgage payments during the first two years of the loan, the period of time that HUD monitors its Direct Endorsers' delinquency and default rates," the suit said. "Rainy Day purports to be a financial counseling program but on information and belief it is a mortgage lender-funded slush fund."

The Justice Department, which sought to keep Lend America from making more FHA loans, won a permanent injunction against Lend America in December. HUD withdrew the firm's FHA approval the same month. Lend America, which is no longer in business, repeatedly denied the Justice Department's allegations that it defrauded the FHA.

The Justice Department is conducting an investigation into the Rainy Day Foundation, according to sources familiar with the matter. They declined to speak on the record because the investigation is ongoing.

According to federal tax rules, a tax-exempt nonprofit such as the Rainy Day Foundation cannot be operated for the benefit of private interests or shareholders, and earnings must be reinvested in the charity. But employees of the group can benefit from fees it collects through pay and other compensation.

Rainy Day's marketing materials tell lenders that its mortgage payment protection helps reduce delinquencies and "assists in managing HUD Neighborhood Watch statistics," the official default figures maintained by the Department of Housing and Urban Development. The FHA is part of the department.

Officials at HUD are disturbed by this marketing, said a source familiar with HUD's concerns. The source said the department is now studying payment protection plans to determine whether they pose a risk to the FHA's insurance fund, which is used to cover failed mortgages guaranteed by the agency. The source declined to speak on the record

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because the agency is concerned about discussing the drafting of potential new regulations.

FHA Commissioner David Stevens said in a written statement earlier this year: "I'm deeply troubled at the suggestion that mortgage protection programs are marketed as a vehicle to disguise otherwise risky loans."

In a separate statement this month, Stevens said that the "FHA is policing our lender community as never before and the message is being heard loud and c lear. While we must fulfill our public m ission to extend homeownership opportunities to underserved communities, we refuse to sacrifice the health and safety of the FHA insurance fund to do so. If we discover that a lender is cooking the books to mask risky behavior, we'll take immediate action."

Del Sontro said in the interview that his nonprofit benefits borrowers, lenders and the FHA by helping people deal with unexpected financial setbacks.

"The first financial challenge that hits [borrowers] can be potentially disastrous," Del Sontro said. "And that's why we created the Rainy Day program."

Del Sontro did not respond to subsequent voice-mail messages requesting comment on Rainy Day's marketing techniques and on the Justice Department's allegations about the group. In response to one of three text messages sent to him by a reporter, he wrote, "I am not familiar with the allegations so I can't really comment on them."

HUD ruled in 1992 that lenders can pay to enroll borrowers in payment protection programs, and a HUD spokesman confirmed that that rule remains in effect. A 2005 report by a HUD consultant questioned whether coverage had any value for borrowers, but shortly thereafter, a HUD official affirmed the department's policy.

The official concerns over payment protection programs are part of a wider debate over the health of the FHA insurance fund and whether the agency should tighten lending standards, for instance by requiring larger down payments for the loans it guarantees, in

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an effort to reduce projected losses. The FHA program is funded by fees paid by borrowers but is running low on money, prompting some experts to predict it will need a taxpayer bailout.

To quell such speculation, HUD has touted a recent decline in the rate of early defaults. The department says it is actively monitoring lenders whose default rates on FHA loans are higher than average.

Some observers of the FHA warn that the recent improvement in default rates could prove deceptive because of the services offered by Rainy Day, which claims that it has enrolled about 15,000 FHA borrowers over the past three years, and similar programs offered by other groups.

"Keeping problematic lenders in the FHA business longer than they would otherwise is clearly going to end up costing the FHA more," said Mark A. Calabria, director of financial regulation studies at the Cato Institute.

Until 2007, Rainy Day operated under a different name: the Home Downpayment Gift Foundation. Run by Del Sontro, it was one of several nonprofits engaged in the practice of taking money from home sellers and giving it to home buyers to cover down payments. Congress banned the practice in 2008 on the grounds that it encouraged mortgage borrowers to take out loans they couldn't afford. The FHA estimates that seller-funded down payment assistance will ultimately cost its insurance fund as much as $11 billion as the agency is forced to cover losses on mortgages that never should have been made. At the time, Home Downpayment Gift Foundation marketed payment protection as an additional service.

After Rainy Day stepped up its promotion of its payment protection service in 2007, the mortgage arm of the home-building giant Lennar was among the first large companies to embrace the program, seeing it as a marketing tool. Lennar partnered with Rainy Day to offer potential buyers a "Peace of Mind" guarantee: "Your mortgage payments will be made in the event you experience an involuntary loss of income." A Lennar spokesman said its participation in the program ended last year.

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Other companies followed, including the local real estate firm Long & Foster and its mortgage arm, which signed up to work with Rainy Day in early 2009. At the time, the company was led by Stevens, before he became an FHA commissioner. Long & Foster said it had suspended the program.

Allied Home Mortgage, one of the nation's largest originators of FHA-guaranteed loans, launched its partnership in November 2008. The company's president, Jim Hodge, said he saw the program as a marketing tool and did not track how many borrowers eventually needed help. "For the amount of money, we felt it was a pretty good deal," Hodge said.

Del Sontro said in an interview that from the beginning he regarded Rainy Day's services primarily as a way for lenders to reduce defaults, particularly during the first two years after a loan was made, the critical period tracked by HUD in its database of lender performance. Del Sontro said his group's services were also valuable to lenders for another reason: because loans often were sold to investors with the promise of a reimbursement in the event of an early default.

"We thought of the program as a risk mitigation tool for lenders," Del Sontro s aid. Before launching his nonprofits, Del Sontro worked as senior vice president of franchise and sales development for Cendant Real Estate, a unit of the New York-based conglomerate Cendant Corp. That company split up after disclosing accounting irregularities in 1998.

But Rainy Day's program afforded some lenders an opportunity to take greater risks.

Mortgage broker William Ford said he and colleagues at First Alternative Mortgage Corp., a former FHA lender in New Rochelle, N.Y., were encouraged by executives at the firm to enroll riskier borrowers in the Rainy Day program. "The way it worked was if you had a borrower whose credit was a little shaky, we would enroll them in the Rainy Day fund," said Ford, who left the company in September and became an independent mortgage broker. "You wanted it for the first year to keep HUD off your back."

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First Alternative is no longer in business. Its founder and president could not be located for comment.

Among those whose payments were covered by Rainy Day was Robert Boyer of Anderson, Ind., who refinanced with L end America in January 2009, only to lose his job at a warehouse in July. For a few months, Boyer made mortgage payments from savings and unemployment benefits. Then he applied to Rainy Day for help.

In January, Rainy Day sent checks to Boyer to cover his mortgage payments for the next six months.

But Boyer said that once the checks run out, he will not be able to avoid f oreclosure unless he can find a new job. "I believe in working and paying for what you get, and if it don't happen, you got to do what you need to," he said.

In its lawsuit against Lend America, the Justice Department alleged that the company used the Rainy Day program in an attempt to conceal fraud, citing four specific loans as evidence. The Justice Department alleged that Lend America used Rainy Day as its "proxy and agent" to make the payments on behalf of borrowers.

The lawsuit said that in one instance, Lend America submitted a $322,452 loan for an FHA guarantee in December 2007 with documents claiming to show that the borrower made $98,800, which was almost twice the actual annual salary. The borrower defaulted after only six months of payments, including four months paid by Rainy Day.

By doing this, the suit alleged, Lend America "fraudulently delayed" the appearance of the loan "on HUD's Neighborhood Watch list of delinquent loans, thereby making Lend America's default rates on the loans it originated look better than they were, and preventing HUD from enacting its routine controls."