

FHA's Distressed Asset Sales and Loss Mitigation
Should Be Reformed to Maximize Sustainable
Homeownership Solutions

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HUD's FHA Loan Sales Fail to Promote Home Retention

Since its inception in 1934, the Federal Housing Administration (FHA) has insured more than forty million single-family home loans. FHA, now a division of HUD, has played a critical role in the growth of homeownership for middle class families. Now, unprecedented numbers of these government insured loans are facing foreclosure. As of April 2012, 9.5% of FHA insured loans were in seriously delinquent status.¹ 25% of FHA loans originated in 2007 and 2008 are in seriously delinquent status.²

While the government insures these loans, private banks own and service them. The banks decide when to foreclose and when to work with a borrower to attempt to avoid foreclosure. A few large banks service most FHA loans. Today, five banks service 557,295 FHA-insured loans that they report as seriously delinquent and eligible for foreclosure.³

A core feature of the FHA-insured loan program has always been its requirement that the private owners and servicers of insured loans consider specific alternatives to foreclosure when a borrower is behind in payments. These alternatives to foreclosure, such as loan modifications and other changes to repayment terms, are set out in HUD's published "loss mitigation" rules for FHA-insured loans.⁴ Servicers of FHA loans routinely proceed with foreclosures without complying with FHA's loss mitigation rules, however.

Under a new expanded program, instead of foreclosing FHA lenders can choose to assign defaulted mortgage loans to FHA. FHA then sells the loans to private investors. HUD is currently planning to sell about 9,000 of these loans on September 12 and 27, 2012.⁵

These loans will be sold to private investors in two types of pools. Most loans (about 5,000) will be sold in pools that do not require buyers to take any action to sustain future ownership by the

¹ "Seriously delinquent" means three or more full monthly payments in arrears. HUD Quarterly Report to Congress on FHA Single Family Mutual Mortgage Insurance Fund Program, Quarterly Report to Congress FY 2012 Q2 (May 21, 2012) p. 15, available at http://portal.hud.gov/hudportal/documents/huddoc?id=MMIQtrlyQ2_2012Final.pdf.

² *Id.* at p. 16.

³ Bank of America NA, Wells Fargo Bank NA, JPMorgan Chase Bank NA, CitiMortgage Inc., and US Bank NA,, U.S. Dept. of HUD Neighborhood Watch database as of July 31, 2012. Loss Mitigation Total Delinquent Loans Reported. Available at <https://entp.hud.gov/sfnw/public/>.

⁴ 12 U.S.C. § 1707u(a); 24 C.F.R. §§ 203.500, 203.501, et seq.

⁵ HUD's sale announcement is available at

http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/comp/asset/hsgloan

properties' current owners. HUD's hope is that, despite the lack of any requirements, buyers will have a financial incentive to modify the loans in ways that will prevent foreclosure. The reason for HUD's optimism is that these sales are structured so that the buyers will receive a good return on their investment if the loans start performing again, even if that means reducing the principal balance so that the monthly payment is more affordable for the homeowner. This is certainly possible, and HUD's interest in promoting loan modifications that include principal reduction is welcome. However, no particular process or outcome is required on any of the loans in the unrestricted sales. Without safeguards, there is a high risk that these homeowners will lose their homes.

The remaining loans will be sold in pools as part of HUD's new "Neighborhood Stabilization Program." This pilot program is designed to sell specially designated pools of loans to buyers such as community-based organizations who agree to meet certain goals regarding foreclosure avoidance for the loans in the pool. This program has the potential to benefit many homeowners and communities, but the goals the buyers must meet could still allow a majority of the homes to be lost to foreclosure.

HUD should be commended for exploring alternatives outside of the existing FHA servicing rules that may produce more affordable options for homeowners. As currently structured, however, its plan to sell off FHA-insured loans raises many concerns about how this program fits in with HUD's overall role in supervising private lenders who own FHA-insured loans and HUD's accountability for dispositions of these loans

Recommendations

Strengthen FHA's enforcement of its existing loss mitigation rules. FHA sales to outside investors are predicated on the assumption that adequate FHA loss mitigation has been pursued and has been unsuccessful. However, for decades, HUD has failed to enforce its own loss mitigation regulations. A recent report by the GAO highlighted the deficiencies in HUD's current servicing practices and recommended a major refocus on achieving more sustainable outcomes under the existing FHA servicing program.⁶

HUD's National Servicing Center routinely defers to mortgage servicers when borrowers dispute servicers' compliance. Delays and errors by servicers lead to denials of viable options and unnecessary foreclosures. When servicers delay more than twelve months in evaluating a borrower for certain loss mitigation options under FHA rules, such as a partial claim, the borrower loses eligibility for the option. HUD must sanction servicers who allow these delays to occur.

FHA should modify its loan modification guidelines to mandate more affordable terms through lower interest rates and prompt intervention to prevent accrual of burdensome arrearages that

⁶ GAO Report to Congressional Addressees: Foreclosure Mitigation: Agencies Could Improve Effectiveness of Federal Efforts with Additional Data Collection and Analysis (GAO Report 12-296 June 2012) at 54-60, *available at* <http://www.gao.gov/assets/600/592028.pdf>.

unnecessarily increase unpaid principal balances. FHA should also revise its standard form contract to explicitly affirm a homeowner's right to enforce FHA loss mitigation rules.

Require clear proof of compliance with FHA loss mitigation rules before a loan is referred to auction. If a lender has not complied with FHA's loss mitigation rules and HUD pays off the lender's insurance claim in full before sending the loan to auction, HUD simply rewards non-compliance. Prior to allowing any referral to auction, HUD must require that the lender document its compliance with each step of the FHA loss mitigation protocol.

Defer further unrestricted sales of FHA loans. The majority of loans HUD plans to sell in its upcoming sale will be sold with no requirements that the purchasers attempt specific homeownership retention options. These loans are essentially being written out of the FHA servicing program. No reporting requirements, incentives, or disincentives apply to these purchasers. At most, the rules require a six-month delay of foreclosure after a sale. A foreclosure deferment without substantive servicing requirements does not benefit homeowners. HUD is abdicating its statutory responsibility for oversight of these loans. Sales should be deferred until controls can be implemented.

Monitor the results of the pilot Neighborhood Stabilization Program. HUD's pilot program for allowing community-based organizations who agree to meet certain home retention goals for the loans has the potential to benefit homeowners and communities. There is a tension, however, between making the program flexible enough to attract community-based organizations and setting high enough expectations so that the goal of preserving homeownership is accomplished. HUD should monitor the results of the program closely to determine whether it is working, and whether additional requirements need to be imposed.

Establish sustainable post-sale requirements for all sales. For-profit investors who buy loans should be required to commit to post-purchase guidelines at least as strong, if not stronger, than those required of the community-based organizations participating in the Neighborhood Stabilization Program. Private investors must be required to meet standards for affordable modifications, such as net present value tests, to ensure that unnecessary foreclosures do not occur. Sales to owner-occupants must be under terms that ensure long-term occupancy by homeowners. Private investors who thwart program objectives must be subject to significant penalties.

Require detailed public reporting on status of loans from past and future sales. Data collection and reporting are essential to public accountability. Particularly for loans sold to for-profit investors, HUD must not rely on self-reporting by the loan purchasers to evaluate the outcomes of these sales. HUD should actively oversee post-sale activities and provide the public with detailed reporting of the ultimate dispositions of all loans and properties sold at auction. Given that sales of smaller pools of FHA loans have been going on since 2010, HUD should report the current status of those loans, including data by investor, census tract, and protected characteristics.

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