

**FHA's Distressed Asset Sales & Loss Mitigation:
Recommendations**

Aug. 31, 2012

On July 18, 2012, HUD announced more details of an expanded auction sale program for defaulted FHA-insured single family home loans. The first sale under this new program is scheduled for September 12 & 27, 2012. Two aspects of the sale are significant. First, it will offer a much greater number of former government-insured FHA loans for sale to private investors than similar sales HUD conducted over the past three years. Second, this auction will launch HUD's new Neighborhood Stabilization Program, designed to sell specially designated pools of loans to investors who agree to meet certain goals for disposition of loans in the pools. Although the precise numbers have not yet been released, it appears that approximately 40% (3,600) of the 9,000 loans to be sold on September 27, 2012 will be sold subject to these new program requirements. Investors who buy pools of loans subject to these rules agree to achieve specified loss mitigation results for half the loans in a pool. The remainder of the loans expand FHA's program of selling loans with no restrictions at all.

Following are recommendations for improving both pre-sale FHA loss mitigation and increasing sustainable homeownership outcomes as a result of the sales.

Strengthen enforcement of FHA's existing loss mitigation requirements. Instead of adding to the volume of unrestricted sales, and before selling any loans to private investors, HUD should be enforcing its existing servicing guidelines effectively. FHA-insured loans are routinely processed through foreclosure by mortgage servicers who lack a minimal knowledge of FHA loss mitigation guidelines. HUD's National Servicing Center defers to mortgage servicers and consistently fails to hold them accountable for failing to follow current HUD loss mitigation guidelines. The distressed asset sale program rewards those servicers and private owners by paying off their claims early, saving them the time and expense of completion of foreclosures in compliance with FHA rules.

HUD should take the following steps to strengthen FHA loss mitigation:

- Withhold insurance claims when servicers have delayed processing loss mitigation requests from borrowers, based on specific guidelines.
- Require documentation of loss mitigation review from servicers as a condition to insurance payment.
- Create an appeal and review procedure for loss mitigation decisions using neutral decision-makers, similar to the reviews available under the RHS direct loan program.
- Impose meaningful financial penalties on servicers who disregard existing FHA loss mitigation guidelines.

Create effective loss mitigation guidelines under the existing statutory framework. HUD must promulgate rules and administrative revisions that allow for maximum flexibility in structuring loan modifications and other loss mitigation options under the existing terms of the National

Housing Act. HUD can make many improvements to its guidelines and promote sustainable alternatives to foreclosure. As the GAO recently noted, HUD's current practices fail to structure loss mitigation options with the goal of promoting long-term sustainable options that promote the interests of both homeowners and the public investment in the FHA program. Improvements by HUD should include:

- Requiring servicers to document an evaluation comparing the likely recovery to the government from an affordable loan modification with the likely recovery from foreclosure before proceeding with foreclosures. Foreclosures that unnecessarily expose public funds to loss must not be tolerated.
- Direct FHA loan modifications to include interest rate reductions similar to those allowed under the HAMP program, as low as 2%. There is no statutory restriction on interest rate reduction for modified FHA insured loans. Current rules tied to the Freddie Mac weekly rate allow a reduction to barely below 5%. Further rate reductions would have a major impact on affordability and decrease re-defaults on modified loans, as demonstrated by HAMP's results.
- Mandate a sustainable modification waterfall with designated steps that builds on recent HAMP success. These are well-developed under other loan modification programs but strikingly absent from the current HUD guidelines. Success under the Neighborhood Stabilization Program guidelines is not measured by, and does not ensure, long term achievement. Loss mitigation should be keyed to affordability.
- Change partial claim rules to allow greater forbearance and eliminate the twelve-month arrearage limitation to make the repayment timeframe affordable. If HUD cannot eliminate the twelve-month limit, it should require servicers who unduly delay loss mitigation reviews to pay amounts needed to bring the arrearages within the twelve-month range.
- Adjust the debt to income ratio guidelines under FHA-HAMP to a level more in line with industry standards, including the Treasury HAMP guidelines.
- Take direct assignments of loans to HUD and reduce principal balances to the extent allowed under current federal statutes.
- Ensure REO properties are handled in an equitable and sustainable manner.

Apply the goals of preserving homeownership to all loans sold by HUD. Investors who purchase formerly insured loans acquire them at great discounts, well below the current market values of the properties. There is no justification for selling increasingly large numbers of these loans without any post-sale monitoring and accountability. For the loans sold in Neighborhood Stabilization pools, all loans in the pool must be subject to duties to maintain homeownership by the current borrowers whenever feasible. The sale of increasingly larger quantities of FHA loans free of any restrictions on future disposition is a disturbing trend accompanying the initiation of the Neighborhood Stabilization Program.

- All loans sold through the NSP program should be subject to homeownership retention measures and the trend at FHA should be toward selling more loans through this program rather than through unrestricted sales.

Impose effective monitoring over loans sold to private investors. Before HUD sells defaulted loans to private investors, HUD must have in place an effective oversight and enforcement structure, including:

- Detailed reporting beyond the Ex. B-1 form to the CAA agreement, showing levels and nature of payment changes, etc.
- Financial penalties for substantial noncompliance with reporting requirements and contract terms.
- Immediate public release of all post-sale management reports and supporting documentation.
- Borrower outreach both by HUD and through use of outside advocacy groups and housing counselors to document borrower complaints and to seek redress where appropriate.
- An effective review system consistent with due process to handle borrower complaints about conduct of post-sale servicers and owners.
- Transparent and fair guidelines for determining which defaulted loans are sold.

Eliminate Permissible Neighborhood Stabilization Outcomes that are vague and hide abuses. From among the countable outcomes, investors will often choose sale of the property to a purported owner-occupant and collection of payments from an existing borrower for six months. According to the guidelines, the credit for sale to an owner-occupant goes to any transaction involving a buyer who states he or she will live in the home for one year, without ensuring longer-term owner occupants are involved. Credit for maintaining a loan in current pay status goes to any payment arrangement that produces six monthly payments, regardless of how those payments were achieved or what happens after those six months. These provisions do not ensure that sustainable loss mitigation will be provided to struggling homeowners.

These provisions must be revised to ensure transparency and accountability:

- Loan modifications and other payment schedules must be based on an objective waterfall analysis that looks to proven long term sustainability features of a loan modification. These designated steps should apply to loans sold to investors as well as to routine FHA loss mitigation. A rule rewarding arrangements with six months of payments does not meet this standard.
- The vague provisions for sales to owner-occupants invite calculation and fraud by investors and speculators and should be revised to ensure that genuine owner-occupants benefit from such sales. The guidelines must provide for a longer period of oversight and reporting to ensure sustained owner occupancy.
- The guidelines provide no remedies for borrowers who are abused or misled by servicers of the acquired loans. The guidelines should be revised to provide for private remedies and for administrative enforcement that includes effective monetary penalties.

Delay further sales until the results of the September 2012 sale have been fully evaluated and program changes have been implemented. The public must have the opportunity to investigate the outcomes of the initial sale before more sales take place. HUD should take the following steps:

- Delay further sales until the results of the September 2012 sale have been fully evaluated.
- Consider all suggestions for strengthening the reporting and accountability provisions of the bidder participation agreements and implement reform measures prior to initiating further sales.
- For future sales, experiment with bidding limited to local non-profit and governmental entities, excluding private commercial investors entirely.
- Pursue reform of current FHA loss mitigation concurrently with the sale program.
- Terminate the program if it cannot be proven effective.

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