

EXECUTIVE SUMMARY

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The U.S. Department of Housing and Urban Development's (HUD's) program for selling defaulted Federal Housing Administration (FHA) loans is the largest auctioning off of government-insured home mortgage loans in the nation's history, and it directly impacts low- and moderate-income homeowners. As a result of this series of auctions, known as the Distressed Asset Stabilization Program (DASP), many homeowners have lost the government backing of their loans, along with a wide array of tools that provide help in times of financial stress. To date, under DASP, HUD has sold off mortgage loans with unpaid principal balances totaling over \$17 billion. While HUD has justified the sales as being a win-win for homeowners and its own insurance fund, the reality is that, in many cases, loans sold through the sales would have fared better and cost the insurance fund less if basic FHA rules were applied to address the defaults and loan sales were avoided. What's more, the DASP sales have provided financial benefits to the same servicers (many of them large banks) who sidestepped FHA's rules, absolving them of any responsibility for the servicing problems they created. Instead, HUD allowed the loans to be used as a source of profit.

DASP's launch coincided with HUD's improvements to its loss mitigation options for homeowners facing financial hardship. Because many loans were processed through DASP without completion of FHA's loss mitigation review requirements, DASP undermined HUD's own home retention guidelines. Many homeowners who have sought loan modifications after their loans were sold have found that the speculators who bought the loans offered few to no affordable options. A more balanced approach of enforcing the FHA loss mitigation rules and resorting to loan sales only after the options under the rules are exhausted would yield better outcomes for homeowners, communities, taxpayers, and the FHA program.

National Consumer Law Center's (NCLC) review of cases during a short time period in 2014 found a pattern of homeowners having their loans sold through DASP even though they were in the process of working with a major FHA servicer, Bank of America, to obtain loss mitigation reviews. In fact, 23 Philadelphia homeowners with FHA-insured loans serviced by Bank of America were appearing for court-supervised settlement conferences when their loans were sold; several of the homeowners had met numerous times with the bank's representatives, some of them for five, six, or even as many as nine conference sessions. Neither Bank of America nor HUD informed the homeowners that their loans were going to be sold or that their protections under FHA rules would no longer be recognized. The homeowners discovered the facts only after the sales took place. The DASP sales happened while Bank of America's representatives were continuing to request information and process forms for FHA loss mitigation options. None of the homeowners received a final decision as to whether they qualified for FHA loss mitigation assistance. None of them ever received an FHA loss mitigation option.

Through the FHA Single-Family Mutual Mortgage Insurance Fund (the Fund), HUD insures private mortgage lenders against losses in order to encourage the lenders to make loans to low and moderate income households. HUD operates the Fund with a mandate from

Congress “to meet the housing needs of the borrowers that the single family mortgage insurance program under this subchapter is designed to serve.” In exchange for the insurance, FHA-insured lenders must satisfy specific loss mitigation rules created to avoid unnecessary foreclosures. HUD has designed specific alternatives to foreclosure that lenders and their servicers must consider before they proceed with foreclosures.

Historically, mortgage lenders have only received FHA insurance proceeds *after* completing the foreclosure sale process, and evaluation for loss mitigation was always a precondition to foreclosure. DASP changes the timing of the insurance pay-out in an important way. Under DASP, HUD takes over ownership of the loans and pays off the FHA insurance claims *before* foreclosure takes place. The claims cover losses the loan’s owners incurred as a result of the homeowners’ default. So far through DASP, HUD has used the Fund to pay off claims for over 105,000 FHA-insured mortgage loans. None of these loans went through foreclosure before HUD auctioned them off. The private equity firms and hedge funds that bought most of the loans at DASP sales acquired them at significant discounts.

DASP is a fire sale that did not have to take place. The actions of a few large mortgage servicers, primarily Bank of America, Wells Fargo, and JP Morgan Chase, caused the long foreclosure delays that led HUD to implement DASP. HUD could have held these servicers accountable for the unprecedented delays they created, delays that harmed homeowners and threatened the soundness of the FHA insurance fund. HUD had ample legal authority to make its servicers review borrowers for loss mitigation and follow reasonable foreclosure time frames. Instead, HUD paid off the servicers’ claims early in order to avoid even greater future losses from delayed foreclosures. In the end, the big winners were the same large mortgage servicers that created the problem. Through DASP, HUD paid off the servicers’ claims and absolved them of responsibility for years of flouting the agency’s mortgage servicing rules. Meanwhile, homeowners and their communities are left to struggle with the consequences.

In 2012, when HUD began DASP, it was facing an insurance fund threatened by the burgeoning costs of the foreclosure delays that its servicers were orchestrating around the country. In addition, HUD’s outdated loss mitigation protocols were unsuited to the demands of an unprecedented foreclosure crisis. Auctioning off defaulted loans to financial speculators was one option available to HUD for restoring the health of the insurance fund. However, strengthening loss mitigation oversight would also have reduced losses to the fund. A loan modification, for example, avoids a post-foreclosure insurance claim entirely by replacing a loan in default with a performing loan. During 2012 and 2013, HUD announced a long-overdue restructuring of its loss mitigation options. HUD began to implement modification protocols more in line with those available under other government-insured and guaranteed loan programs. Effective implementation of these new FHA options, beginning in 2012, would have significantly reduced losses to the insurance fund. Instead, HUD opted to sell tens of thousands of loans that were in the foreclosure pipeline, making these loans ineligible for the improved FHA loss mitigation options.

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In implementing DASP, HUD accepted at face value its servicers' rationales for the unprecedented foreclosure delays that began in 2010. In many cases, these delays extended over several years. According to the servicers, the delays were due to either new state laws that made foreclosures more time-consuming, or else to the servicers' ramped-up efforts to help borrowers through reviews for loss mitigation. In reality, the state laws created during the foreclosure crisis did not impose burdensome new obstacles on foreclosing parties, and the servicers' reviews for loss mitigation were haphazard at best.

Certain state laws implemented in the wake of the financial crisis require that mortgage servicers review homeowners for loss mitigation before foreclosing. These laws have the potential to strengthen and reinforce compliance with HUD rules. For example, mediation laws make FHA servicers show that they followed FHA guidelines before they are allowed to foreclose. Unfortunately, DASP undermines the impact of these helpful laws. Through DASP, FHA servicers can simply transfer the loans to new owners who then assert they are no longer bound by FHA rules. HUD pays the insurance claims to the pre-sale FHA servicers and allows them to avoid any obligation to show a court that they complied with FHA loss mitigation rules. In one telling instance involving Philadelphia homeowners discussed in this report HUD paid off insurance claims for 23 FHA-insured loans while all the homeowners were in the middle of mediations over loss mitigation. In HUD's view, the DASP sales remove all FHA protections from a loan, even where the former FHA servicer did not comply with FHA rules. HUD's lack of proper oversight and use of DASP has aided servicers in routinely selling off FHA-insured loans in order to get FHA insurance benefits without following either FHA requirements or state laws.

HUD's claims of cost savings due to DASP necessarily assume two things: first, that the servicers conducted a thorough review for foreclosure alternatives for each loan before a DASP sale; and second, that all the borrowers were truly ineligible for any alternative to foreclosure under FHA's guidelines. The examples of the homeowners abruptly pulled out of the FHA program by DASP sales while in the middle of mediations clearly show that HUD's assumptions were wrong. Ignoring loss mitigation also entails costs. Any cost savings due to DASP cannot be evaluated without considering the costs of needless foreclosures and the resulting unnecessary insurance claims.

One critical goal of HUD is to help borrowers who could not otherwise achieve homeownership to stay in their homes. Private equity firms and hedge fund operators, the primary purchasers of the defaulted loans through DASP, are under no obligation to further this goal.

HUD's contention that DASP helps homeowners is based on an abstract theory: That if you sell distressed loans to financial speculators at prices that seem like good deals to them, the speculators who buy the loans will modify them, reduce principal balances owed, or take similar steps to help the homeowners stay in their homes. The speculators will do this because they intend to sell the loans to someone else in a few years. At resale, the defaulted loans may bring in higher prices if they have turned into "performing" assets. The theory also assumes, of course, that whatever deal the speculator offers the homeowner after a DASP sale is better than any option the homeowner would have received had the loan remained an FHA loan serviced by a competent servicer.

HUD's theory suffers from two major problems. First, Congress directed HUD to manage the FHA program to further certain policy

goals. One critical goal is to help borrowers who could not otherwise achieve homeownership to stay in their homes. Private equity firms and hedge fund operators, the primary purchasers of the defaulted loans through DASP, are under no obligation to further this goal. HUD, on the other hand, has an obligation to ensure its protocols are followed in order to satisfy this objective. Second, even the limited available data about the status of loans after DASP sales, including data provided by HUD, does not demonstrate that post-sale outcomes generally benefit homeowners. There is no evidence from the sales over the past four years that the speculative investors gave homeowners loan modifications that reduced the principal of the loans at any significant rate or that sustainable modifications were provided in substantial numbers. HUD has not produced any data showing the structure of modifications in the small number of cases where HUD claims loans were modified after DASP sales.

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In reality, investors do not need to modify loans to make them “performing” after a DASP sale. There are much easier ways to tack a “performing” label on a loan. Common practices of the DASP purchasers include offering borrowers’ five-year “interest only” payment agreements that then revert to the original loan terms. These agreements do not modify basic loan terms. Instead, they simply postpone an inevitable re-default.

HUD’s own data show that in most cases the speculative DASP buyers did not modify the loans, and did not turn them into performing loans. Instead, they foreclosed or arranged short sales. HUD more recently began requiring speculators to offer borrowers “HAMP-like” modifications after DASP sales. However, HUD has not defined this requirement or described how it will be enforced. Unless HUD enhances oversight of its servicers and commits substantial resources to rigorous enforcement, there is little likelihood that HUD can capably enforce this kind of requirement against non-participants in the FHA program.

HUD has long-standing rules that authorize it to assess penalties against servicers who exceed reasonable diligence time frames for the conduct of loss mitigation reviews and completion of foreclosures. Similarly, HUD may penalize servicers that fail to demonstrate compliance with the requirements to review for all options under the FHA loss mitigation guidelines. HUD should use this authority. Failure to document compliance with HUD’s loss mitigation protocol must act as a complete bar to any loan sale. If HUD continues to conduct DASP sales, it must require that a servicer give the borrower clear advance notice of the intent to sell a loan. Borrowers must have an opportunity to raise and resolve with HUD servicers’ unfounded claims of compliance with HUD’s loss mitigation rules.

Since DASP’s inception almost four years ago, HUD has released vague and incomplete data that obscure essential outcome trends. The absence of reliable data allowed HUD to portray DASP as providing a benefit for homeowners. At the same time HUD has minimized the problems that occur when it cuts off FHA loss mitigation reviews through DASP sales. More recently, HUD has suggested it took concrete steps to address servicers’ inappropriate referrals of loans to DASP. However, HUD did not provide any clear, written explanation of these steps. Any such actions have not been effective. HUD should not continue to reply to criticism of DASP with periodic announcements of reforms that contain no specific details.

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The note sale program should only continue if it can be transformed to benefit homeowners, communities, and the Fund while preventing FHA servicers from escaping their obligations under FHA's rules and avoiding accountability under state law for their conduct.

Historically, HUD has excluded homeowners from any role in the oversight of FHA servicers' loss mitigation performance. DASP has only aggravated this problem. Note sales under DASP are completed before homeowners are aware their loans are sold. They lose the protections of the FHA program before they can raise objections. Effective enforcement of HUD's loss mitigation rules with borrower participation through advance notice of sales and adherence to reasonable foreclosure timelines are the best ways to safeguard the FHA insurance fund from the costs of unnecessary or unduly delayed foreclosures. These changes must be prerequisites to any continued note sales.

The American homeownership rate is at a 20-year low. The ongoing erosion of homeownership from low-income families is likely to be of long duration, and for some families will be permanent. Low- and moderate-income communities have been substantially altered by mass foreclosures. In recent decades, FHA loans have been the primary means for African-American and Hispanic families to achieve homeownership. The unnecessary loss of FHA homeownership forces these households into the rental market. As rents around the country rise, the families pay increasingly higher percentages of their income for housing, often 50% or more, while losing out on accruing wealth through homeownership. Instead of being pillars of stable communities, former homeowners must flee to wherever they can temporarily afford the rent. In a substantial number of cases, these outcomes are avoidable.

Vigorous enforcement of HUD's loss mitigation rules would preserve homeownership and stabilize communities better than essentially unrestricted sales of the loans, often to financial speculators. To date, however, HUD has not held its major servicers accountable for their non-compliance with HUD's own servicing rules. In the end, the mortgage servicers who caused the crisis for the FHA insurance fund walk away the winners. HUD pays the servicers' inflated claims and the servicers often evade state laws meant to promote sustainable homeownership. The note sale program should only continue if it can be transformed to benefit homeowners, communities, and the Fund while preventing FHA servicers from escaping their obligations under FHA's rules and avoiding accountability under state law for their conduct.