Providing Alternatives to Mortgage Foreclosure: A Report to Congress

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U.S. General Accounting Office

Many organizations not listed here were also contacted in the course of this study. While they were not able to provide direct input, they often provided leads to persons and organizations that could. The Department is indebted to them for their support.

List of Figures

List of Tables

Executive Summary

Introduction

Section 918 of the Housing and Community Development Act of 1992 requires the U.S. Department of Housing and Urban Development (HUD) to conduct a study of mortgage foreclosure alternatives. This report fulfills that legislative mandate. Congress specifically requested a review of the foreclosure avoidance procedures used by institutions handling federally related mortgages, with special emphasis on how HUD is using its current statutory authority to provide relief from foreclosure to borrowers whose loans are insured by the Federal Housing Administration (FHA).

This report documents the great strides that have been made in the mortgage industry to understand how large-scale foreclosure avoidance efforts are beneficial to borrowers and lenders alike. It also documents areas in which improvements are still necessary. For the mortgage industry as a whole, the primary improvements sought for here are increasing the number of borrowers offered loan workout options and creating more uniform foreclosure laws. The need for these is highlighted throughout the report.

The Department's main recommendations include options for obtaining greater uniformity among State foreclosure laws, a call for agencies to provide better incentives for loan servicers to initiate loan modifications and forbearances, and a new statutory basis for HUD borrower relief efforts.

The Problem of Foreclosures

The percentage of U.S. homeowners with serious delinquency problems has been at chronic levels since 1983. Not since the Great Depression has homeownership been so tenuous, with homeownership rates actually declining for most of the 1980s. Correspondingly, single-family home foreclosure rates have been on the rise. HUD estimates that total foreclosures rose from less than 100,000 in 1981 to a peak of more than 300,000 in both 1991 and 1992. On the dark side, the statistics of the past 15 years represent 3 million American families who not only faced the financial and emotional specter of being forced from their homes, but who also suffered loss of access to credit. Additionally, they may have also experienced tax liabilities or court orders to repay lender losses on disposition of their homes. On the bright side, the severity of the foreclosure problem in the 1980s caused mortgage market organizations to look more deeply into ways in which foreclosure can be avoided. The innovations that have taken root in the mortgage industry since 1986 are bearing fruit. It is now widely understood that alternatives to foreclosure are beneficial to all parties involved: homeowners, lenders and loan servicers, mortgage insurers, and Federal guarantee agencies. Innovations now being used include methods of helping some borrowers retain their homes and others to leave them with dignity. To date, the chance of a troubled homeowner having to face foreclosure has been reduced by 10-to-15 percent from what it was 10 years ago. It is quite possible that over the next 5 years the total reduction from levels of the early 1980s can be doubled. This report outlines the issues that must be resolved to make this a reality and provides suggestions on regulatory and statutory changes that could assist the process of change.

Managing Delinquencies

While mortgage loans are legally in default when a scheduled monthly payment remains unpaid for 30 days, no court would allow foreclosure for such an infraction. State foreclosure codes have inherited the English system of an equity-of-redemption that provides a longer period of time over which nonpayment must persist to verify the borrower's unwillingness or inability to cure the default. Loans in nonpayment status are referred to as *delinquent*, and those whose delinquency extends past 90 days (three missed payments and a fourth one due), and for which foreclosure is a real possibility, are known in the mortgage industry as *seriously delinquent*.

Between 70 and 80 percent of homeowners who become 90 days delinquent on their mortgages can still cure the problem on their own in an additional 30-to-60 days. While a cure is in the best interest of lender and borrower, there is no industry consensus on how to best approach borrowers at this stage of delinquency. The universal approach up until the 1980s was to turn the case over to a foreclosure attorney who would let the borrower know the gravity of the situation: either bring the loan current immediately or else foreclosure proceedings would commence. This approach has the advantage of leveraging reinstatement from borrowers whose delinquency is strategic (i.e., hoping to dispose of an asset that is no longer worth the loan amount) rather than arising from financial difficulties. As highlighted in two court cases in the early 1970s, it has the distinct downside of making reinstatement harder for conscientious borrowers because they then must not only cure the default but must also pay all attorney and court fees associated with the foreclosure processing.

Current Practice in Foreclosure Avoidance

Today it is common practice for loan servicers to gather financial information from delinquent borrowers in an attempt to ascertain whether a true hardship does exist and, if so, what the best option may be for the borrower. Options commonly offered today include forbearances and repayment plans for borrowers with temporary losses of income, loan modifications for those who have had to accept lower paying jobs, preforeclosure sales to relieve financially strained borrowers of the costs of selling a home when they must relocate but their property value has fallen, and voluntary deed conveyances for extreme hardship cases.

Except in the case of portfolio lenders, loan servicers do not make the final decisions on foreclosure alternatives for borrowers who cannot cure delinquencies on their own. Loan servicers are agents of the ultimate bearers of credit risk on the loans, the mortgage insurers and Federal credit agencies. Through the chartering of Federal mortgage insurance funds at the Departments of Agriculture, HUD, and Veterans Affairs, and federally related guarantee agencies (Ginnie Mae, Fannie Mae, and Freddie Mac), the U.S. Congress has not only assured a consistent flow of mortgage funds to all regions of the Nation, but has also set in motion a system that greatly influences the operation of mortgagor foreclosure relief efforts. These organizations are joined by private mortgage insurers who work very closely with Fannie Mae and Freddie Mac to establish and enforce policies with regard to handling mortgage defaults. These bearers of credit risk, who must pay the losses incurred in foreclosures, now understand the tremendous benefits they receive from helping borrowers to avoid foreclosure. The cost of helping a borrower cure a default is minimal compared to the interest expense, legal fees, and property management cost associated with foreclosure. Even alternatives that allow borrowers to voluntarily give up their homes provide significant cost savings over foreclosure. The current challenge facing the mortgage industry is providing proper training and incentives for loan servicers to act so as to benefit both borrowers and credit-risk bearing organizations.

Loss mitigation is now the industry buzzword. It means finding a solution short of foreclosure for seriously delinquent borrowers. Large loan servicers have their own workout departments that combine the expertise of consumer counselors with that of corporate cost cutters. Workout personnel attempt to design foreclosure alternatives that fit both borrower needs and insurer/guarantee agency requirements. They then present their recommendations to the insurers and guarantee agencies for approval, modification, or rejection. Some insurers bypass servicer workout departments by having their own specialists (who directly contact individual borrowers) develop workout plans. As it stands today, large servicers with sophisticated workout departments argue that the insurer and guarantee agencies do not take enough risk with foreclosure alternatives, while those credit-risk bearing organizations argue that many servicers, especially small ones, do not do enough on their own to reinstate borrowers.

This tension comes to a head with loan modification and forbearance options. Loan modifications have required that someone first purchase loans out of their security pools before making any modification.[1] Loan servicers are often not equipped to hold loans in portfolio; they therefore prefer the guarantee agency to repurchase from them any loans that are bought out of security pools and restructured to fit a borrower's new payment abilities.[2] Having started as a portfolio operation, Fannie Mae has for a long time readily repurchased modified loans and placed them in its retained portfolio. Freddie Mac, however, began as a securitization operation, and so has only recently begun to provide this option. The Department of Veterans Affairs (VA) purchases loan modifications, but is constrained in its abilities to reach troubled borrowers because it uses its own workout counselor staffs that are too small to reach more than half of the seriously delinquent borrowers who do not cure by the end of the fourth month of delinquency. HUD's insurance agency, FHA, can only repurchase defaulted loans when it takes assignment, and there it must provide up to three years of forbearance on loan payments. Securities agreements used by all three guarantee agencies--Fannie Mae, Freddie Mac, and Ginnie Mae--explicitly prohibit modifying loans in MBS pools in order to protect investor interests.

In the area of forbearances, servicers are currently expected to finance the security pass-through payments to the guarantee agencies if they offer a period of payment reduction to troubled borrowers. They are, therefore, generally unwilling to undertake forbearance/repayment plans of more than 3-to-6 months. Along with loan modifications, long-term forbearance/repayment plans are the most underutilized foreclosure avoidance tool currently available in the industry.

[1]This is a requirement of the guarantee agencies rather than a statutory limitation on handling loan defaults in mortgage backed securities. MBS products are bond-like instruments where interest rates are guaranteed, though the life of the security is subject to prepayment speeds that can vary.

[2]This holds even when private mortgage insurers will continue to insure the modified loan. The issue is not the credit risk as much as it is whether or not loan servicers must have portfolio funding capabilities.

The foreclosure alternative that has gained rapid acceptance as the premier vehicle for addressing incurable delinquencies is the short- or pre-foreclosure sale. Here the servicer assists the borrower in obtaining a realty agent and marketing the property for sale at the as-is appraised value. The insurer or guarantee agency then, having approved a sale, accepts responsibility for any deficiency in the proceeds when applied against the outstanding indebtedness. This tool now accounts for 50 percent of all loan workout attempts in the conventional market. It is popular with borrowers who must relocate to find new employment and those who require lower cost housing. It is, however, not costless to the homeowner. Either the insurer has the borrower sign a promissory note to pay back all of the sale costs, or else interim Internal Revenue Service Regulations require that the net costs born by the insurer be reported as discharge-of-indebtedness income for tax purposes.

Federal Guaranty and Insurance Programs

This study concentrated on the interplay of mortgage servicers, insurers and guarantee agencies in handling mortgage defaults. Such a focus meant that only the government sponsored mortgage insurance offered through FHA and the VA Loan Guaranty Program were included. The Farmers Home Administration (FmHA) has, until recently, been a self-contained lending, securitizing, and servicing operation that did not interact with other segments of the mortgage industry. Given its unique organizational nature, distinct role in supporting rural development, and small size, its practices were not included in this study.

HUD's principal borrower relief program is loan assignment. This is where HUD purchases both the investment interest and the servicing of defaulted loans that meet certain criteria. HUD then structures forbearance and repayment plans that provide up to 3 years of reduced or suspended payments for troubled borrowers. It is a costly program that has a low success rate in helping borrowers regain fiscal solvency after a period of hardship. Of loans currently in the program's initial 36 month forbearance period, more than 40 percent are not current on their forbearance obligations, and more than 50 percent of those in the program more than 36 months are still not likely to ever financially recover. One fourth of that 50 percent (12 percent of the entire portfolio) are currently in foreclosure processing and many more are in danger of foreclosure. Still more will find it difficult, if not impossible, to pay back fully their accumulated forbearances and underlying loan, even with an extended mortgage term.

Statutory and judicial mandates have created a system whereby it is difficult for HUD to implement foreclosure prevention measures other than assignment, even those now standard in the mortgage industry. First, the National Housing Act, as amended, narrowly defines the types of foreclosure prevention measures HUD may use. Then judicial interpretations of a 1979 Consent Decree signed by HUD have restricted HUD's use of other tools. While HUD may first offer other forms of relief that allow a mortgagor to remain in their home, the right to assignment application exists at the point of any subsequent defaults. Likewise, before HUD can offer a relief measure that allows a mortgagor to leave their home, such as a preforeclosure sale, borrowers must first voluntarily waive their right to apply for loan assignment. Otherwise, the mortgagor has the right to first apply for assignment, be denied, and then apply for the other relief. This process requires that HUD finance costly delays in default resolution. It is especially onerous given that 50 percent of assigned loans will continue to accrue delinquencies until eventual foreclosure or HUD's sale of the mortgages in-lieu-of foreclosure.

Forbearance plans for FHA loans sponsored by the loan servicers are also restricted because such borrowers would also qualify for loan assignment, which is an effective entitlement to those who can qualify under the 1979 standards. Assignment guarantees the option of up to 36 months of forbearances plus a lengthy repayment period, whereas lender plans require total reinstatement within 12 to 18 months.

While the Department is currently working on ways to improve its menu of foreclosure relief options within the current statutory and judicial framework, it also understands that to match current industry standards and to have the ability to adapt to market changes in the future will require new legislation that either explicitly prescribes the role of mortgage assignments vis-a-vis other relief efforts or else eliminates it altogether. Information now available on the history of loan performance in the assigned portfolio suggests that elimination and replacement is the preferred option. It has been a costly program in which many borrowers are saddled with increases in indebtedness which they cannot repay.

The former option of prescribing the role of assignment was the intent of the 1980 Congressional authorization of the Temporary Mortgage Assistance Program (TMAP). Under that legislation, HUD was first to screen borrowers for payment assistance while their loans remained with their lender/servicers, and then to use loan assignment as a back-up program only for the most severe hardships. However, in ruling on the implementing regulations, the District Court judge overseeing the 1979 Consent Decree said in his *Ferrell v. Pierce* decision that TMAP was not permissible unless it offered monthly payment plans as near to and exactly the same as assignment as possible. This effectively ruled out any Departmental flexibility to offer lower-cost protections to borrowers with lesser needs.

VA has more flexibility than HUD when dealing with borrower defaults. The courts have consistently upheld its discretionary ability to match relief to borrower needs as it deems best. It has, however, chosen to use its own in-house workout counselors rather than rely on loan servicers to tailor foreclosure alternatives to individual borrower situations. VA is able to provide alternatives to 25 percent of borrowers otherwise destined for foreclosure, and has estimated the value of its loss mitigation staff at $220,000 per person annually in avoided insurance claims. A 25 percent foreclosure avoidance rate is astonishing given that restrictions on personnel hiring means that they can only make personal contact with 55 percent of seriously delinquent borrowers. Thus they help save from foreclosure nearly half of those loans for which they can make contacts. VA could increase foreclosure alternatives and reduce the overall cost of running its insurance program if it were given authority to increase its hiring of loan counselors. This same flexibility to hire additional personnel who save the agency money would also be beneficial to HUD.

Foreclosure Law

There is substantial variation in borrower protections offered by State foreclosure laws. In some States foreclosure can occur in as little as 6 weeks, while in others it can take 18 months. Clearly lenders and insurers have more incentive to negotiate relief for borrowers in lengthy foreclosure States, while borrowers have more incentive to initiate the negotiations in quick foreclosure States. HUD recommends that the President's National Partners in Homeownership develop a uniform foreclosure statute that addresses the need for balanced incentives and fair treatment of lenders and borrowers. Specifically, HUD recommends taking the foreclosure portion of the 1985 Uniform Land Security Interest Act (ULSIA) developed by the National Conference of Commissioners on Uniform State Laws and amending it with the following:

- Require that no Notice of Intent-to-Foreclose (NOI) can be sent until day 90 of a delinquency. This ensures that no foreclosures take place until day 150 (end of month 5) of a delinquency.

- Allow for accelerated foreclosure times if the NOI is not sent until after day 150 of a delinquency. This reduces the cost to lenders of negotiating alternatives with borrowers and allows more time for borrower cures.

- Move up the date-of-default by one month for every full contractual payment made during a delinquency. Limitations on this could include expedited foreclosure at day 150 if the loan is still more than

60 days in arrears, at day 180 if the loan remains more than 30 days in arrears, and at 210 days if the loan is still not fully cured.

- A special provision that would require an "as-is" appraisal performed at day 90 for loans meeting certain criteria, to protect borrowers with significant equity in their homes.[3] If the appraisal shows 30 percent or more gross equity in the home (appraisal less loan balance), then foreclosure cannot be initiated until day 180. If the default is due to a loss of household income and new sources of income are obtained, then up until 10 days before foreclosure the borrower would be given the additional right to a 12-month repayment plan. Any breach of this repayment contract could allow an immediate initiation of foreclosure.

HUD then recommends that Congress encourage the States to adopt more uniform foreclosure laws, patterned after such a modified ULSIA procedure.

Regulatory and Legislative Recommendations

As a result of this study, HUD has several suggestions for how the processes triggered by mortgage default can be made more equitable to borrowers and to the mortgage industry. The first recommendation involves more uniform and equitable treatment of involved parties across States. This matter was discussed above.

The second recommendation aims to increase the number of loan workouts attempted. It is a call to credit-risk bearing agencies to review their implementation of loan modifications and forbearances to find ways of doing this. There may be ways to either leave modified loans in securities pools or to at least resecuritize modified loans that perform for a number of months while held in agency portfolios. Such changes in agency regulations to make loan modifications a reality for more troubled borrowers was the number one request made by loan servicers to HUD in the course of this study. Fannie Mae has traditionally been receptive to repurchasing modified loans to hold in its retained portfolio. During the

[3] Such criteria could be a combination of equity at loan origination, seasoning of mortgages to allow for 30 percent equity based on origination value, and house-price movements in the locality since loan origination. As discussed in the body of the report, the typical foreclosure process has a total cost of around 20 percent of the house value, thus "significant" equity must be defined so as to allow lender protection when extending mandatory forbearances.

course of this study, Freddie Mac implemented the first ever policy of repurchasing defaulted loans from security pools for modification and placement in its retained portfolio. HUD and FHA have not pursued such a course because of the present entanglement of the assignment program with other forms of borrower relief. At present, HUD does not have authority to pay a claim in order to take any loans into portfolio except through assignment with its 36 month forbearance period.

On a related front, increasing the use of servicer initiated forbearances will require that agencies make servicers more responsible for what happens to loans that are not recommended for agency/insurer relief programs. This may require provisions for agencies and insurers to reinsure servicer capacities to finance securities pass-throughs in the event of regional economic declines when defaults rise above a certain threshold. Research on the issue of how much risk can be profitably undertaken with respect to loan modifications and forbearances suggests that the credit-risk bearing agency can profitably offer these options even when success rates are lower than 30 percent. This comes from analysis that shows that cost savings on each foreclosure-alternative success are so large as to be able to finance the extra costs associated with more than three failures. It appears that the industry has not yet begun to approach the level of workout attempts that would be in their best interests to do. Fannie Mae, however, has now begun an effort that attempts to exploit this potential.

In terms of FHA programs, HUD is currently reviewing all aspects of its borrower relief efforts. Changes are underway with respect to better utilizing of servicers and counseling agencies and developing loss mitigation operations in the new FHA Single Family Service Centers. An intensive study of the strengths and weaknesses of the mortgage assignment program is also being performed, and HUD implemented a nationwide preforeclosure sale program at the beginning of fiscal year 1995.

To provide the most effective loss mitigation and borrower protection possible, HUD requires a new statutory basis from which to operate. Such a framework would hold the Secretary accountable for activities designed to assist FHA insured borrowers maintain their homes through times of temporary financial difficulties, while providing broad discretion in how that is accomplished. The current statutory and judicial framework in which HUD operates makes it difficult to properly safeguard the safety and soundness of its insurance funds, or to maximize the welfare of its homeowner clients who experience financial difficulties. By emphasizing loan assignment as the premier relief effort, the Department is required to place large amounts of resources into managing only one-fifth of its seriously delinquent insured loans, to the neglect of the other four-fifths that cannot cure on their own. Of the smaller amount that is currently assisted through assignment, those which can be helped maintain their homes could all be assisted with less costly tools.

Providing the Secretary broad legislative authority to implement cost-saving foreclosure avoidance strategies while being responsible for social performance goals would both fulfill the spirit of the National Housing Act and the Government Performance and Results Act of 1993 and give it the flexibilities it requires to develop and maintain a modern loss mitigation borrower relief program. It could then assist more insured borrowers to maintain their homes and others to transition to lower cost housing without the use of property foreclosure.

HUD has two statutory mandates with respect to FHA programs that currently conflict with each other: to provide an actuarially sound mortgage insurance product through its Mutual Mortgage Insurance Fund, and to protect insured borrowers from loss of their homes when they experience temporary financial hardships. These two can only be made fully compatible if borrower relief is either constrained to those measures that are cost-saving to the Department, or such relief is made an insurance product in its own right. Offering the traditional package of insurance to lenders against default with a new program of insurance to homeowners against temporary hardships beyond their control would remove the conflict between HUD's fiduciary responsibility and its protection-of-homeownership responsibility. HUD commits to examining the feasibility of developing a mortgage credit insurance product that would be mandatory for first-time and other FHA mortgage borrowers at higher risk of default.

Chapter 1

Introduction to the Study

1.1 Legislative Mandate

Sec. 918 of the Housing and Community Development Act of 1992 mandates the following with regard to this study of foreclosure alternatives:

a) IN GENERAL.--The Secretary of Housing and Urban Development shall conduct a study to review and analyze alternatives for homeowners whose principal residences are subject to federally-related mortgages (in connection with federally-related mortgage loans, as such term is defined in section 3 of the Real Estate Settlement Procedures Act of 1974) under which the homeowner is in default. In conducting the study, the Secretary--

(1) may consult with any appropriate Federal agencies that make, insure, or guarantee mortgage loans relating to 1- to 4-family dwellings and with the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Government National Mortgage Association, and the Federal Agricultural Mortgage Corporation; and

(2) shall review and assess the adequacy, with respect to providing alternatives to foreclosure, of--

(A) the temporary mortgage assistance payments program authorized under section 230 of the National Housing Act;

(B) the authority of the Secretary to modify interest rates and other terms of mortgages transferred to the Secretary under section 7(i) of the Department of Housing and Urban Development Act; and

(C) any authority pursuant to Debt Collection Act of 1982 to reduce interest rates on outstanding debt to the borrowing rate for the Treasury of the United States.

The Secretary shall evaluate alternatives to foreclosure based on fairness of the procedures to the homeowner and reducing adverse effects on the mortgage lending system.

(b) REPORT.--Not later than March 1, 1993, the Secretary shall submit a report to the Congress regarding the results of the study conducted under subsection (a). The report shall contain a detailed description and assessment of each alternative to foreclosure analyzed under the study and a statement by the Secretary regarding the intent of the Secretary to use any authority available under the provisions referred to in subsection (a)(2) to avoid foreclosure under mortgages (and any reasons for not using such authority). The report may also contain any recommendations of the Secretary for administrative or legislative action to assist homeowners to avoid foreclosure and any loss of equity in their mortgaged homes that may result from foreclosure.

1.2 Impetus for the Legislation

State foreclosure laws provide numerous protections for mortgaged homeowners so that their property rights are not unduly jeopardized by short-term cash-flow problems, yet there is a tremendous variation in that protection across States. Agencies and corporations that bear mortgage-credit risk also have procedures in place which attempt to minimize the incidence of foreclosure. While these procedures are primarily designed to protect the financial interests of the risk-bearing agencies, they too serve as safeguards for the equity interest of mortgaged homeowners.

Even with foreclosure mitigating policies and statutes in place, some homeowners with financial difficulties may face unnecessary loss of their mortgaged properties. This concern prompted Congress to commission HUD in the Housing and Community Development Act of 1992 (HCDA of 1992) to provide a review of the policies and procedures of both HUD and the broader mortgage industry with respect to foreclosures of single-family properties. In particular, concerns have been raised that there may exist structural deficiencies in the interplay of mortgage market players--lenders, servicers, insurers, courts--that either allow for loopholes in homeowner protection statutes or give lenders incentives to process foreclosures rather than explore potential remedies with borrowers. If such exists, it is most grievous if incentives to foreclose increase for properties with positive equity where lenders can more easily cover the costs of foreclosure via sale of the property.

Section 918 of the HCDA of 1992 requires HUD to review and assess the adequacy of existing programs authorized in previous legislation to help FHA borrowers avoid foreclosure. Specifically, these are the FHA Mortgage Assignment Program (TMAP), the Temporary Mortgage Assistance Program, and use of any general Departmental authority to adjust interest rates on its receivables (which includes loans held in portfolio). HUD is further charged to review the spectrum of alternatives to foreclosure being used with other federally-related mortgages. The legislation solicits recommendations on regulatory and legislative changes that could both reduce the incidence of foreclosure and provide stronger protections for recovery of home equity by borrowers whose mortgages are foreclosed.

1.3 Foreclosure

Mortgage foreclosure is a tragic and traumatic event for any homeowner. It involves involuntarily relinquishing rights to a property due to the inability to maintain financial obligations involved with homeownership.

Foreclosures become more prevalent during times of national or regional recessions when those who lose their jobs find it difficult to obtain new ones. When the local job base is shrinking, the demand for housing decreases and house prices fall. Many homeowners with mortgaged properties then find they do not have the wherewithal to remain current on their loan obligations, but they also cannot sell at prices high enough to cover their outstanding loan balances. This dilemma can be particularly acute for first-time homebuyers and young families who may have little in the way of other assets to draw on in times of financial stress.

All mortgage market organizations have a financial incentive to avoid foreclosure. Not only is it the costliest way to resolve borrower difficulties, but there are also a number of significant uncertainties in the process. Foreclosure laws are State specific, and in many cases make it difficult to remove a nonpaying borrower from a property for up to 2 years. A defaulted borrower can file for bankruptcy court protection up to the day of a foreclosure sale and, in some cases, can challenge a foreclosure through bankruptcy up to 1 year after it takes place. There is also the problem and cost of having to manage and market the property after obtaining it through foreclosure. Foreclosed homes generally sell at a discount, and the firm selling it must be careful not to jeopardize the values of other properties in the locality that it also holds in portfolio, either as servicer, insurer, or security guarantor.

Likewise, foreclosure can be costly for mortgaged homeowners. Its effects on a family's credit rating can last 5-to-10 years, and they may be liable for a deficiency judgment that includes not just the unrecovered debt but all of the foreclosing firm's legal and property management fees as well. If the deficiency is not pursued, there is a discharge-of-indebtedness that must be reported as current income for Federal income taxation.[4] Therefore, losing their homes in foreclosure is not the end of troubles for financially embattled families.

1.4 Mortgage Market Organizations

The U.S. Congress and individual State legislatures have historically been concerned with maintaining the stability of homeowners through difficult economic times. The Federal Housing Administration (FHA) was established in the National Housing Act of 1934 to recreate a mortgage market out of the ashes of the nationwide foreclosure epidemic of the Great Depression. Through the FHA, the Federal government began insuring lenders against borrower default on home purchase loans. This gave lenders the confidence needed to provide mortgage funds to a broad

[4]Except in States where deficiency judgements are outlawed. In those cases the discharged indebtedness is included in the basis of the property when computing capital gains or losses on its transfer (see Chapter 7.3).

spectrum of aspiring homeowners, particularly those with modest incomes and wealth. During that same time period, many States enacted emergency moratoriums on foreclosures in order to protect the home equity of families trapped in a period of unemployment or, in cases of banks calling in debts, under the financial system stress of depositor cash withdrawals.

Mortgage markets have changed dramatically since that time. First, the early success of FHA was an example for the introduction of a similar program for military veterans at the close of World War II. The expanding population and homeownership rate that began in the post-war period then spawned a viable private mortgage insurance industry that has now replaced FHA for many types of business. Second, maturation of the secondary mortgage market, brought about by the popularization of mortgage-backed securities in the 1980s, lessened the dominant role of thrift institutions and community bankers, since having the funds to hold mortgages in portfolio was no longer of primary concern for loan origination.

Today any discussion of alternatives to foreclosure must consider a diversified marketplace with several groups of players. First there are the lenders. They may or may not hold any loans in portfolio, but they often still retain servicing rights to the loans they originate. Loan originations themselves can be through direct retail outlets or purchases from correspondent brokers. Lender/servicers still play a vital role in the default/foreclosure process because they are the first line of defense in preventing foreclosures. They maintain the payment histories of each borrower, are the first to know when delinquencies appear, will be the first to make contact with troubled borrowers, and ultimately must process foreclosures.

Next there are the mortgage insurers, both private corporations and government agencies (FHA and VA).[5] They bear the top credit risk in the event of loan default and issue guidelines to servicers telling them when and how to intervene to minimize losses. Last in line are the guarantee agencies, Ginnie Mae and the so-called government sponsored enterprises (GSE) Fannie Mae and Freddie Mac. They assure timely payment to the ultimate investors who own the rights to the mortgage loan cash flows. They too bear some credit risk, generally the bottom portion after what is covered by the insurer, and so they also provide guidelines to servicers for

[5]The Farmers Home Administration (FmHA) is a division of the U.S. Department of Agriculture that makes farm and rural-home mortgage loans. They are a very specialized lender (roughly 2 percent of all home mortgages) that has only recently begun to interact with other segments of the mortgage market through a Loan Note Guarantee insurance program. FmHA has historically acted as loan originator, investor, servicer, and even securitizer through the Federal Agricultural Mortgage Association, or Farmer Mac. Because of their separation from the rest of the market, FmHA programs are not discussed in this report.

handling loan defaults.[6,7]

All three groups--lender/servicers, insurers, and credit agencies--have a financial interest in what happens to troubled borrowers. A large percentage of lender/servicer operating costs involve handling delinquent accounts: insurers face the prospect of claims covering undersecured properties and legal costs of foreclosure and guarantee agencies must finance delinquent accounts. Yet these lines of demarcation are not firmly fixed. Depending on the contractual arrangements, any one of the three groups may manage and sell foreclosed properties, and any one may bear a portion or all of the loss due to default. In addition, the guarantee agencies have product line menus that which also allow the lender/servicers who are selling them loans various options in regard to who will bear responsibilities for interest pass-throughs to security holders when borrowers miss payments.

1.5 HUD's Approach to the Study

This study highlights areas of current practice that need to be addressed by Congress, the States, and the mortgage industry to make the processes and procedures involved with handling defaulted single-family mortgage loans more equitable to responsible homeowners and less costly to the mortgage industry. Analysis used in this report took the form of investigating agency and insurer guidelines for foreclosure prevention and the actual use and success of these in practice. HUD held discussions with representatives of FHA, VA, Fannie Mae and Freddie Mac, private mortgage insurers, mortgage bankers, lawyers, portfolio lenders, and consumer interest groups. Aggregate data was gathered from them to help understand the extent to which current policies and practices serve to protect the interests of troubled borrowers and those who bear mortgage credit risk. Because systematic use of foreclosure alternatives has, as a practical matter, only been developed over the last 10 years, detailed information on the use and success of these programs is generally not yet available. All major firms have, however, now begun to track them on a systematic basis.

HUD's mortgage assignment program posed a unique set of challenges. Its implementation and use have been clouded by protracted litigation. HUD has initiated contracts to perform thorough financial and management

[6]There are a growing number of private companies involved in securitizing "jumbo" (above size limits for Fannie Mae and Freddie Mac) and commercial loans. Their role in the single-family mortgage market is one of absorbing the demand for lender liquidity at the very top end of housing markets.

[7]Ginnie Mae differs from both Fannie Mae and Freddie Mac in that it does not buy any loans directly but only guarantees securities issued by others. It does not assume the lower portion of credit risk (after insurance coverage) as do the other two, but only assumes the risk of servicer bankruptcy. In the case of FHA loans in Ginnie Mae security pools, FHA covers 100 percent of the credit risk on each loan. With VA loans in Ginnie Mae pools the issuer must accept any risk not covered by VA.

evaluations of accepting mortgage assignments. The review included in this report reflects aggregate analyses based on data available at the time of writing.

1.6 Overview of Report

In Chapter 2 the mortgage delinquency problem is outlined. There the issue of how homeowners typically get behind on payments and how lender/servicers respond during the first 90 days is addressed. Then in Chapter 3 the concept of loss mitigation is introduced. This is the effective working mode for mortgage market participants once a delinquency extends beyond 90 days. The 90-day-plus time frame is of primary interest in this study because it involves what is done when foreclosure becomes a viable option. Next the differences and similarities between insurer and agency guidelines for loan management by servicers are outlined in Chapter 4, which includes special sections for current innovations and loan servicer concerns. The FHA and VA mortgage programs for foreclosure prevention are outlined in Chapter 5. Chapter 6 turns to discussions of foreclosure and bankruptcy laws and Chapter 7 delineates potential regulatory and legislative changes that could improve market efficiency and overall consumer welfare.

Chapter 2

Mortgage Delinquency and Foreclosure Magnitudes

This chapter provides an overview of what happens in the first 90 days of mortgage loan delinquency and discusses the number of 90-day delinquencies that result in foreclosure. Contracts written in the United States generally stipulate that payments are due on the first of each month, with late penalties assessed on payments made after day 15. While a loan is technically delinquent after the first of the month, the account is not considered in a non-payment status until the next payment is due on the first day of the following month. This is 30-days delinquency. At that point the borrower has missed one payment and the next is due. Legally, this is the point of loan default.

2.1 Definitions and Dimensions

A borrower is legally in default on a loan obligation whenever there is failure to meet any one of the contract terms. All mortgages and deeds-of-trust[8] have clauses that permit lenders (mortgagees) to accelerate the terms of the promissory note, i.e., demand immediate payment of the entire debt, whenever default occurs. The typical case of default is that of a missed payment. But in deference to the homestead nature of principal residences, modern foreclosure laws do not permit immediate acceleration of the note. Common law practice requires that time must elapse to show sufficient evidence that the homeowner borrower (mortgagor) cannot or will not bring the loan current within a reasonable period of time before the lender can have the property sold to repay the debt. Once the lender makes an election to accelerate the note, additional time is given to allow the borrower one last chance to reinstate the loan. This product of sixteenth century English law is called an equitable redemption period. Redemption is exercised when the borrower makes all missed payments plus penalties and lender costs. Failure of the borrower to reinstate the loan within the redemption period permits the lender to sell the collateralized property to recover the outstanding debt.

In common practice default has come to mean the point at which foreclosure is a viable option and the equity of redemption begins. This is at 90-days delinquency, when 3 consecutive monthly payments have been missed and a fourth is now due. Loans at this stage are also called "seriously

[8]The actual legal instrument used to collateralize the debt obligation depends on the State in which the property resides, but the effects of using either are the same.

delinquent." The subtle difference between delinquency and default, in modern usage, is the difference between failure of a borrower to make timely payments of mortgage obligations and persistent neglect of those payment obligations. Mortgage loans are considered "in default" after 90 days of delinquency, the point at which the courts would seriously entertain a foreclosure petition.[9]

The magnitude of delinquency rises and falls with the economy in general, but with some lag. Delinquency cycles are typically regional rather than national phenomena. Since 1980, the United States has experienced rolling and overlapping regional recessions, with each one taking its turn in holding up national delinquency rates. First there was the farm- and industrial-belt recession of the Northcentral States in 1981-82. That was followed by recessions in the energy-producing and mineral-extracting States in 1986-88, the Northeast States during 1987-91, and now one in southern California. Interestingly, the national recession of 1991-92 was not as significant a factor as were regional effects on delinquencies because that contraction of spending was primarily due to households consolidating existing debts, often finding they could refinance their home mortgages from 30-year to 15-year terms to lower their long-term debt burdens.[10,11]

Figure 2.1 highlights the changing pattern of regional delinquency rates from 1980 through 1993. Delinquencies match unemployment rates, which lag the general economy, so they generally rise and peak after the recessions have ended.

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[9]Lenders must maintain consistency in their approaches or else a borrower could legally contest a foreclosure by pointing out inequities in the lender's handling of defaults. For example, if a lender has previously allowed a borrower to make up missed payments the next month, it cannot in a new context require that missed payments be paid-in-full before the next payment is due. Lenders must then set internal rules on at what point in a delinquency they will initiate foreclosures based on probabilities of borrower self cures and costs of foreclosure proceedings.

[10]The 1991-1992 recession was considered atypical. It developed largely through a drop in consumer confidence which led to the consolidation rather than expansion of spending in general and debt in particular. DRI/McGraw Hill's monthly *Review of the U.S. Economy* highlighted this phenomenon as it developed. See, in particular, "Why Do Consumers Feel so Blue?" in the December 1991 issue (p. 33), and the regular "Consumer Income and Spending" section of each monthly *Review*. In addition, data collected by the Federal Reserve Board (see monthly *Federal Reserve Bulletin*) show a significant contraction in automobile debt throughout 1991, which brought down overall consumer installment indebtedness.

[11]Issues regarding changes in bank lending practices following the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and stricter capital requirements on real estate loans have not significantly impacted single-family residential lending. Likewise, the takeover of insolvent lenders by the Resolution Trust Corporation and its parent, the Federal Deposit Insurance Corporation, did not cause additional loan accelerations and foreclosures. The national presence of secondary mortgage market agencies has maintained a steady flow of single-family mortgage funds to lenders.

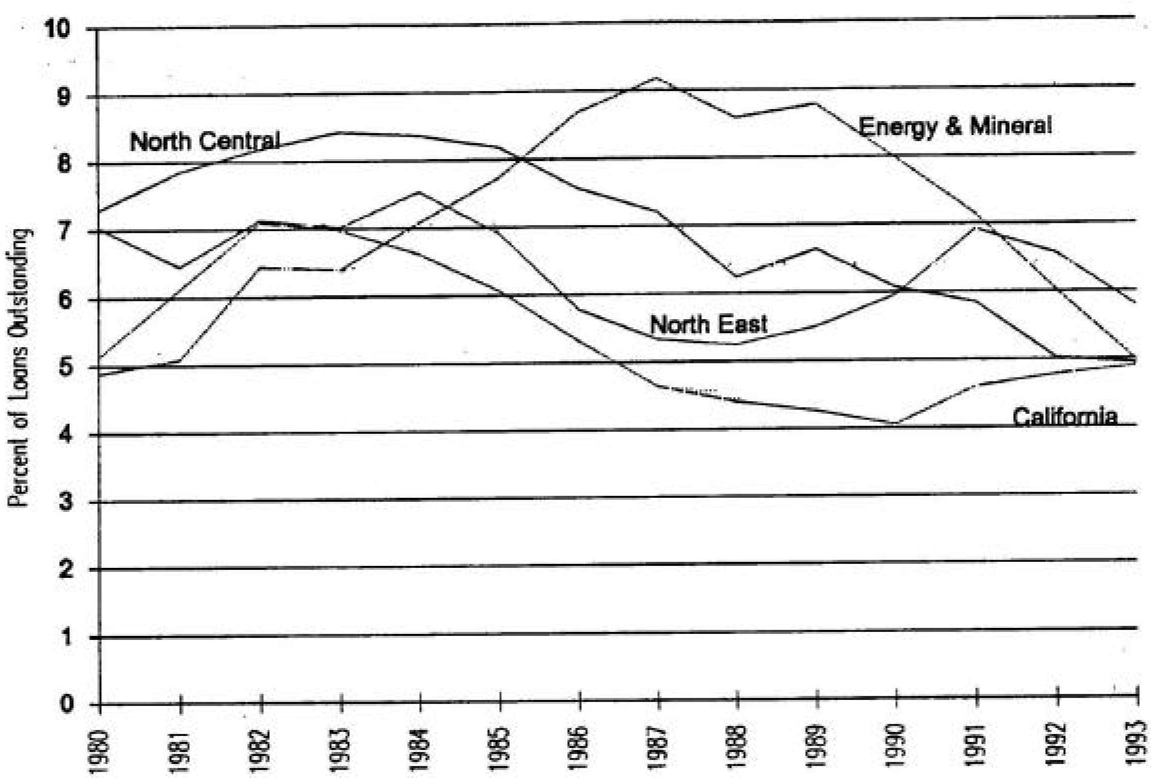
2.2 Becoming Delinquent

Delinquency by itself does not alarm lenders, although they do monitor it for changing patterns. Many loans will become delinquent for one or two months at some time during their term. Some have regular, even predictable patterns of delinquency. The most common cause of non-recurring delinquency is financial stress, whether it be from a spell of unemployment, major unexpected expenses (house repairs, medical, etc.), or an overextension of consumer credit. Non-financial family stress is another cause of delinquency. Here we refer to both divorce and death. Divorce situations are difficult for servicers to manage, since the parties involved, who are likely to be co-borrowers, are often at odds with each other and may allow a mortgage delinquency to continue, even through foreclosure, to inflict harm on one another.

Regular, recurring delinquents include seasonal workers (e.g., construction trades and agriculture), families that overextend themselves buying holiday gifts each year (especially at Christmas), and others who live with precarious finances and make their mortgage payments days or weeks after the due date each month.

Figure 2.1

Regional Mortgage Delinquencies[a]



[a]This counts all loans 30 or more days delinquent, including those in foreclosure processing.

Source: Mortgage Banker's Association, National Delinquency Surveys, 4th quarter of each year. North East and North Central are U.S. Census regions, Energy & Mineral includes Census South West and Mountain regions.

The final category of delinquency is the non-hardship case, where borrowers with negative equity in their properties stop making loan payments, and sometimes abandon their homes, in attempts to escape the financial obligation of an asset that is "under water." Mortgage finance institutions have different approaches to dealing with this group of borrowers. Some will offer alternatives to foreclosure in order to minimize their own loss exposure, while others will, on principal, threaten foreclosure and a deficiency judgment against the borrower in order to leverage reinstatement. Abandonment combined with non-payment allows faster acceleration of the mortgage note, generally starting at 60-days delinquency (2 missed payments). The courts are more lenient in initiating and curtailing equities of redemption in these cases because the borrower has given up interest in the property.

2.3 Delinquency Monitoring and Intervention

Conventions for how servicers respond to delinquent borrowers are fairly uniform throughout the industry. Because each servicer may handle loans for all guarantee agencies and with many or all mortgage insurers, new approaches instituted by one secondary market organization can have spillover benefits to loans owned or insured by others. A study of portfolio lenders by researchers at the University of Mississippi found that nearly 50 percent of their loans conformed to agency criteria for sale into the secondary market.[12]

Nearly all mortgages in the United States have monthly payment schedules and stipulate that payments are due on the first of each month, with late penalties imposed on payments made after the fifteenth day. Rarely will a servicer intervene before the fifteenth day. The exception is for borrowers who have consistently paid on or near the first of the month because even a 7-10 day delay may signal problems for them.

The servicer's first step is to either send a postcard reminder or make a phone call to the borrower in the 15-20 day period. If no payment is made by the 30th day, the due date of the next scheduled payment, then a letter is sent which explains the importance of curing the delinquency and

[12]This study, Edmister (1991), reviewed the portfolios of 29 savings & loan associations in three states--Arkansas, Louisiana, and Mississippi. Portfolio lenders do not necessarily keep all loans they originate. Many are approved seller/servicers for Fannie Mae, Freddie Mac, and/or Ginnie Mae in order to maintain liquidity options with respect to their existing portfolios. Edmister's work also shows that portfolio lenders tend to use the secondary market for high loan-to-value (LTV) products. Their nonconforming loans, which cannot be sold, tend to have LTV ratios below 80 percent; relatively few of them have ratios at 90 percent or above. This suggests that they do little in the way of self-insuring high LTV ratio loans through higher interest rates. Their lack of geographical diversification and stricter capital requirements for taking credit risk on loans makes such operations unattractive.

avoiding a default on one's credit rating.[13] In the past, servicers have been required by law to send a notice outlining the availability of HUD-approved counseling agencies to assist the homeowner to find a way to retain their home. In practice, those who follow the statute send the HUD brochure "Avoiding Foreclosure", HUD-426-H(12).[14] The perspective of servicers and insurers is that these counseling agencies are not fully equipped to deal with resolving mortgage problems. Housing counselors are still learning about the loss mitigation process and the availability of assistance through the servicer or insurer.[15] As a result they may approach loan servicers from an adversarial stance, not expecting them to be cooperative. This is not surprising given that recent changes in insurer and guarantee agency willingness to assist troubled borrowers has been gradually implemented by servicers over the course of the past three or four years.

Perhaps the most delicate stage comes in the 45-60 day interval, before the third payment is due. Industry sources indicate that a high percentage of loans in this stage of delinquency will still eventually cure themselves, so servicers do not want to unnecessarily scare homeowners with the prospect of foreclosure or suggest that they are in serious need of counseling. Yet servicers need good information on borrower circumstances to rank delinquencies by potential for self-cure and to provide guidance for borrowers. Some agencies require that servicers have face-to-face meetings with borrowers at this stage to assess their financial situation and the condition of the property. What is most important is that servicers convince borrowers to work with them toward a solution.

The final stage of short-term delinquency management is for loans in the 60-90 day period, between the due dates of the third and fourth payments. At this point servicers explain the very real possibility of foreclosure and attempt to steer borrowers toward short-term cures. "Short" generally means bringing a loan current within 3-6 months. Surveys administered by the Mortgage Bankers Association of America show that the number of

[13]With the advent of the 3 percent downpayment conventional loan in late 1993 came a different approach to loan delinquencies. Borrowers who are able only to provide a very modest downpayment are considered most susceptible to short-run cash-flow difficulties becoming longer term problems. Therefore, mortgage insurers offerings these products require more intensive servicer (or counselor) interventions at the initial 15-day delinquency mark.

[14]The authorizing statute is section 169 of the Housing and Community Development Act of 1987, which amends 12 USC 1701x and can be found at 101 Stat. 1865. There are no existing penalties for noncompliance. Amendments made in 1990 (104 Stat. 4239) require that HUD monitor and report to the Congress on compliance. While HUD requests that the banking regulatory agencies report compliance to it, the Department does not have personnel to manage and report on this. The sunset for the legislation was extended twice and finally expired on September 30, 1994.

[15]Payment for such services, though extremely valuable to borrowers, is not a direct part of HUD's statutory authority with respect to payments to counseling agencies.

delinquencies which get to this stage to be roughly one-fourth of all that are initially 30-days delinquent. Data on Fannie Mae loans suggests that another fourth of original delinquents will already be in a servicer-sponsored short-term repayment program by the 90-day mark; the remaining half would have already self-cured.[16]

2.4 The Magnitude of Foreclosures

The percentage of seriously delinquent loans for which foreclosure actions had been started increased throughout the 1980s as regional recessions overlapped and structural changes in employment patterns made job losses and house-price declines more severe. The erosion of underlying house-price-inflation trends meant that fewer troubled homeowners could sell their properties without incurring excessive losses. Data from the Mortgage Bankers Association's National Delinquency Survey shows that from 1982 to 1985 foreclosures were started on only 25% of 90-day-plus delinquents. That percent rose to roughly 33% in the 1986-88 period, and then to the current 40% by 1990. The actual increase was moderated by more sophistication on the part of mortgage finance institutions with regard to foreclosure alternatives. The sheer increase in the number of loans in default made it imperative for them to increase the size and training of staff for managing delinquent accounts and mitigating losses resulting from loan default and foreclosure. Figure 2.2 tracks the percent of single family mortgage loans in process of foreclosure from 1980 to 1993.[17] The 1980-1981 rates compare with those of the 1960s, while those since 1984 have been at post-war highs. By contrast, foreclosure initiation rates were historically low in the 1950s and again in the 1970s.[18] How defaulted loans are handled is discussed more thoroughly in Chapters 3, 4 and 5.

Of loans approved for foreclosure, only a fraction will complete the process, although exact numbers are not known. The Mortgage Bankers Association surveys only ask for foreclosures *in process*, not foreclosures completed. There can be considerable fallout due to borrower reinstatement and insurers and/or guarantee agencies offering workouts to borrowers. Industry sources suggest that the foreclosure completion rate is high for

[16]Fannie Mae data for 1990-1992 is summarized in *Inside Mortgage Finance* (1993, p. 89-91). The balance of in-relief (lender sponsored repayment plan) to not-in-relief has improved over the past few years. See Financial World Publications (1989, p. 30) for 1988 data.

[17]Actual numbers of foreclosures cannot be derived from these percentages. They represent loans in all stages of foreclosure at one point in time. Some of these will be new and have high cure rates, while others will be fast approaching the foreclosure sale.

[18]For a discussion of delinquency and foreclosure-in-process rates from 1945-1965 see Herzog and Earley (1970). The Mortgage Bankers Association began tracking foreclosure processing rates in 1962, but their sample of lenders was not fully representative of the entire mortgage market until the early 1980s.

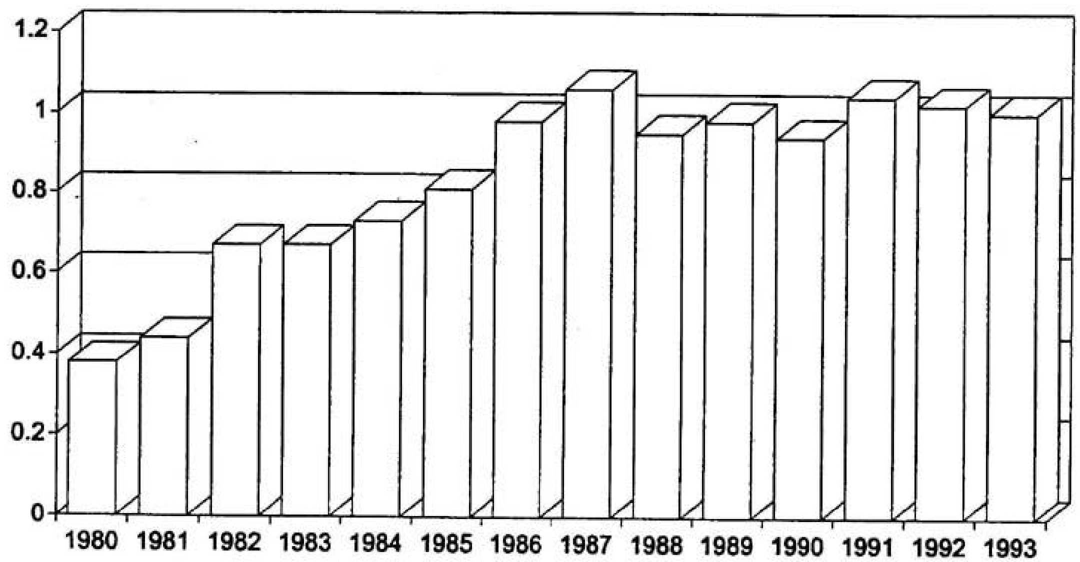
higher loan-to-value loans which are not likely to have the equity to sell properties on their own, and much lower for other loans.

Table 2.1 is provided in order to understand the dynamic nature of how loans move in-and-out of default and foreclosure processing. It follows one cohort of loans, those in Fannie Mae's portfolio and MBS pools in January 1990, for three years, tracking the long-run outcome of borrower circumstances at that point in time.[19] In terms of ultimate foreclosures, note that only 45 percent of those in foreclosure processing in January 1990 were actually foreclosed on, while another 2.6 percent cured but then had recurrent problems that led to a new

[19]Note that the path from January 1990 status to February 1993 status is not necessarily linear. Some borrowers become delinquent and cure numerous times. Some of these become eventual foreclosures and others either sell properties, refinance or continue to maintain their mortgages.

Figure 2.2

Percent of Single Family Mortgage Loans in Foreclosure Processing



Source: MBA National Delinquency Surveys

Table 2.1

The Movement of Loans In-and-Out of Delinquency and Foreclosure Processing Over a Three Year Period

Status in February 1993	Status as of January 31, 1990 (number of loans)			
	Current (4,396,973)	In Servicer Relief[a] (3,878)	Three or more months delinquent (13,109)	In foreclosure processing (9,713)
Foreclosed	0.8%	22.5%	25.5%	45.0%
Loan paid off or repurchased by Fannie Mae	44.4	28.8	42.7	35.6
Current	52.6	29.4	16.7	9.5
1 month delinquent	1.4	6.6	4.8	2.2
2 months delinquent	0.3	2.0	1.9	0.7
3+ months delinquent	0.1	1.1	1.4	0.5
In Servicer Relief[a]	0.1	4.2	1.1	0.6
Bankruptcy	0.1	2.8	3.3	3.3
In Foreclosure Processing	0.2	2.6	2.6	2.6

[a]relief corresponds to a servicer initiated forbearance and/or repayment plan.
Source: Fannie Mae

foreclosure initiation. Only 22.5 percent of those in lender forbearance or repayment plans failed and lost their homes in foreclosure, and 25.5 percent of homeowners 90 days delinquent were unable to find a way to avoid foreclosure. So foreclosure is not inevitable for borrowers who find themselves three or more months delinquent on their home mortgages.

HUD is unaware of any existing attempts to estimate the number of actual single family foreclosures that occur in the United States. Therefore, an estimation technique was developed for this report. The crucial element is estimating a completion rate for foreclosures started. This is done by loan type (conventional versus government insured) and original loan-to-value ratios (above and below 80 percent). The weighted-average completion rates derived here range between 55 and 59 percent for 1981-1993.[20] Using these ratios, the total number of single-family loan foreclosures in the United States can be estimated from data published by the Mortgage Bankers Association and the Federal Reserve Board.[21] Figure 2.3 reports these estimates for 1981-1993.

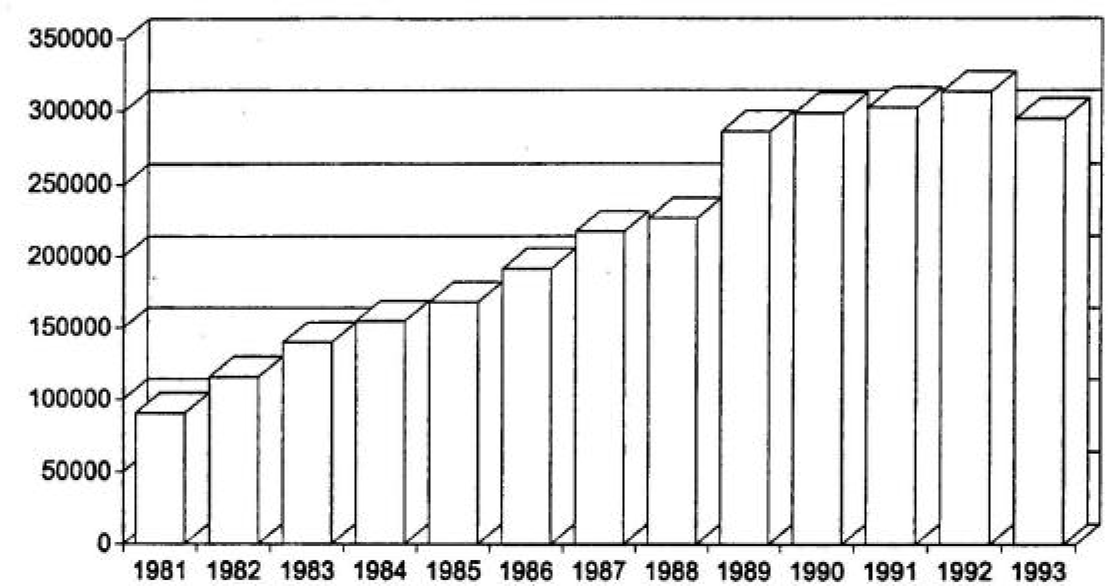
It appears that foreclosures have more than tripled over the past thirteen years, starting at 90,000 in 1981 and peaking at over 313,000 in 1992. In 1993, national foreclosures eased to a total of around 295,000.

[20]While no one in the mortgage industry tracks this information for all loans, a private insurer indicated a 76 percent completion rate on their above 80 percent loan-to-value mortgages, and Fannie Mae provided a 45 percent figure overall (this was for loans in foreclosure at one point in time), with 40 percent of foreclosure initiations being high loan-to-value product. A low loan-to-value completion rate of 25 percent was backed into from these numbers. For government insured loans we use an 85 percent completion rate for high loan-to-value loans (95 percent of insured loans) and a 40 percent completion rate for ones with low loan-to-values.

[21]Specifically, we divide loan volume numbers reported by the Federal Reserve by average loan sizes in Mortgage Bankers Association (MBA) survey data (divide total survey volume by number of loans surveyed) to obtain total number of loans outstanding. MBA foreclosure initiation rates for government and conventional loans are multiplied by loans outstanding to obtain number of loans in foreclosure process. Completions are obtained by multiplying foreclosures initiated by weighted completion rates (see footnote 13), and are attributed to future quarters according to the frequency distribution of state foreclosure times (see Table 6.2). These are then aggregated into calendar years.

Figure 2.3

Estimates of Annual Single-Family Mortgage Foreclosures[a]



[a]see footnote 14 for computation methods; aggregating quarterly foreclosures into annual.
Sources: HUD estimates using data from the Mortgage Bankers Association of America and the Federal Reserve Board

Chapter 3

Loss Mitigation and the Decision to Foreclose

Loss mitigation in the mortgage industry means attempts at avoiding foreclosures. Property foreclosure is the most costly means of remedying a mortgage default, so as default numbers have risen over the past 10 years, the industry has become more sophisticated in its approach to delinquent borrowers. During eras in which foreclosures were uncommon events, it was standard practice to merely turn 90-day delinquent accounts over to attorneys for foreclosure. While there are instances in which this still occurs, insurers and guarantee agencies can no longer afford that luxury. In the process of finding ways to avoid the costs associated with foreclosure, they have discovered that loss mitigation is generally a win-win proposition; it is in both the lender's (or insurer/guarantor) and borrower's best interest to negotiate a settlement short of foreclosure.

This chapter chronicles development of default and foreclosure strategies of the U.S. mortgage industry in the post-Depression era. It concludes with a discussion of the merits of modern loss-mitigation strategies.

3.1 History and Development: 1940-1970

In the 1940-1970 period, there were two types of lending institutions: mortgage bankers, who originated government-insured loans, sold them to Fannie Mae, and retained the servicing rights; and depository institutions that originated loans to hold in portfolio and to service.[22] The latter group was dominated by savings and loans, who were assisted in financing their loans by borrowing ("advances") from regional Federal Home Loan Banks. Private mortgage insurers entered the picture beginning in 1957.[23] They provided portfolio lenders with the type of protection FHA and VA provided for mortgage bankers and Fannie Mae. National coverage by the new private mortgage insurers encouraged regulators to allow lenders to offer non-government insured loans with debt ratios above 75 percent,

[22]There was also some minor activity by mortgage banks originating conventional loans and selling them to portfolio lenders and insurance companies.

[23]1957 saw the chartering of the Mortgage Insurance Guaranty Corporation in Milwaukee, Wisconsin. This was the dominant private firm well into the 1970s (see Rapkin, et al., 1967). There were mortgage insurers prior to 1930, but they consisted mainly of thinly regulated title companies that insured second trusts with reserves reinvested into real estate. They all collapsed and disappeared in the 1930s (see Rapkin, et al., 1967, Ch. III).

thereby allowing them to compete with FHA for first-time moderate-income buyers.[24] Until allowable loan-to-value ratios climb above this level there is little risk of loss from foreclosure because, unless the property is badly damaged or a general depression exists, loans would have sufficient collateral to cover both the debt and selling costs. Because of this, lenders did not usually have systematic procedures for foreclosure avoidance. The basic tools, however, were there: house sales, loan modifications, short- and long-term forbearances, and accepting voluntary conveyance of properties. How lenders used these tools was primarily an individual matter, but through experience, each came to a fairly common set of operating rules even though they often had no written policy manuals.[25] In general, resolving problem loans was the responsibility of the originating loan officer. Separate divisions for handling troubled loans were not in existence until the 1974-5 recession (Dunaway, 1992, '2A.07).

Because this was an important, yet unknown side of mortgage lending, the Federal Home Loan Bank Board commissioned Touche Ross & Co. to study how savings banks were handling seriously delinquent loans (Touche Ross, 1975). Touche Ross studied practices in six firms representing savings institutions in three States--Texas, California, and Illinois--during 1973 and 1974. These States represent the spectrum of foreclosure law time frames--fast, moderate, and prolonged, respectively. Touche Ross found that the cost of foreclosure itself, which is a product of these State laws, did not influence the *decision* to foreclose (Touche Ross, 1975, p. 22).[26] This is because foreclosures, no matter what the law, are always more expensive to lenders and borrowers than are its alternatives. This fact is highlighted at the end of this chapter, where examples of the magnitudes of cost differences today are provided.

Touche Ross found that the number one alternative suggested by lenders was for borrowers to sell their properties. Every lender in their survey expressed disappointment in how often troubled borrowers refused to heed

[24] Prior to this time, portfolio lenders specialized mainly in the trade-up market where higher income households had sufficient equity to buy with downpayments in excess of 25 percent (see Semer & Zimmerman, 1975). The other option of portfolio lenders is to self-insure high loan-to-value products by increasing the interest rates. This is only plausible for large institutions with some geographical diversity.

[25] Exceptions to this commonality have to do with the time and cost necessary to complete a foreclosure in each State. In States with short foreclosure periods, lenders had little incentive to attempt voluntary conveyance of deeds in-lieu-of foreclosure.

[26] The Touche Ross study, however, counted voluntary conveyance of property (deeds-in-lieu of foreclosure) as a type of foreclosure. From the lender's perspective it is almost as bad because it requires subsequent property management and disposition.

this advise and allowed their properties to go to foreclosure.[27] Touche Ross also found that portfolio lenders used short-term repayment plans of under 3 months, and capitalized missed payments (including late charges) into loan balances. Lenders, however, were unwilling to either modify loans through extended terms or refinancing to a lower interest rate. The former was unacceptable because it created a scheduled item on their balance sheets, and the latter because it would involve breaching prudent underwriting standards by accepting a bad credit risk as a new loan.[28] These limitations on assisting troubled borrowers still have not been fully resolved even today.

FHA-insured borrowers had no more protection against foreclosure than did conventional borrowers. Even though a system to provide additional protections had been created in 1959, it was not implemented until the late 1970s.[29] Foreclosures were a matter strictly left to the discretion of the loan servicers. Guidelines issued by both public and private insurers for mitigating foreclosures were suggestions rather than mandatory operating requirements. This was standard industry practice. As a result of protracted litigation in the 1970s, FHA was thrust to the forefront of mortgage insurers on the issue of having mandatory guidelines for servicers choosing when to foreclose. (See the *Brown* and *Ferrell* cases discussed in chapter 5.)

3.2 History and Development: 1970-1985

What might be termed the modern age of mortgage finance began in 1970. That year saw the issuance of the first Ginnie Mae mortgage-backed

[27]Many defaulted borrowers do not believe foreclosure will actually happen to them, even up to the day of the auction. As each month goes by they continue to believe that they will somehow come up with the money to reinstate the loan (see Cook, 1983, Ch. 2). This phenomena is called post-decision bolstering, whereby individuals who have made a difficult decision then attempt to filter out any negative information that comes to them to maintain a belief in the correctness of their decision. In this case, once a borrower in default commits to saving the house, he tends to only accept information that bolsters that decision. The tension at the point of decision is the *cognitive dissonance* first identified by Leon Festinger (1957, 1962), and first used to explain economic decisions by Akerlof and Dickens (1982). The case of borrowers allowing their homes to go to foreclosure is parallel to that of entrepreneurs who allow their businesses to go to final bankruptcy court liquidation (see Capone and Capone, 1992, for an application to home builders and for other references).

[28]"Scheduled items" are footnotes on balance sheets that suggest a potential liability that will denigrate the credit rating of the firm. Bank examiners do not look favorably on portfolio lenders retaining such unfunded liabilities.

[29]As will be discussed in Chapter 5, legislation in 1959 provided FHA with the ability to take assignment of mortgages into its own portfolio to allow the borrower time to cure the default, and authorized it to pay lenders any losses on their own attempts to allow borrower cures through forbearance periods. Regulations to implement these were issued in 1964, but they were not mandatory procedures for lenders and so were rarely used.

security, authority for Fannie Mae and Freddie Mac to securitize conventional loans, and the final increase in allowable loan-to-value ratios on conventional loans made by federally chartered institutions to 95 percent.[30]

The period 1970-1985 saw the increasing dominance of secondary-market guarantee agencies with respect to policies and procedures of lenders and servicers. Traditional portfolio lending in the conventional market gave way to a retail/wholesale approach where depository institutions began to act more and more like mortgage bankers, holding fewer and fewer loans in portfolio and specializing more and more in originations and servicing. From 1940-1980, savings institutions with community real-estate-lending mandates dominated the mortgage industry. Their portfolio lending operations in single-family mortgages held a market share of around 50 percent of all originations in 1980. But then, as the market for securitizing nongovernment loans came of age, the savings bank market share fell to 27 percent of loan originations by 1990. In 1992, with refinancings dominating loan originations, the market share of savings institutions slipped even further, dropping to 20 percent.[31] Not only did they play a smaller role vis-a-vis commercial banks and mortgage bankers, but even they had cut their portfolio business down to roughly 50 percent of their own originations. Many who survived the industry fallout of the 1980s purchased mortgage-banking subsidiaries to originate loans for them.

After 1970, mortgage bankers, who traditionally specialized in FHA/VA loans because of the secondary-market outlet, could take advantage of Fannie Mae and Freddie Mac purchases of conventional loans to broaden their product offerings. The growth of Fannie Mae and Freddie Mac securitization of conventional loans then led to sizeable increases in the business of the private mortgage insurers.[32]

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[30] Fannie Mae was given authority to purchase conventional loans in section 201(a) of the Emergency Home Finance Act of 1970 (84 Stat. 450), the same law that created the charter for Freddie Mac, the Federal Home Loan Mortgage Corporation (see sec. 301 at 84 Stat. 451). Freddie Mac, in its inception, was designed to provide a secondary market to enhance liquidity of savings institutions. The Act further specified that any loan purchases by Fannie Mae or Freddie Mac with loan-to-value ratios in excess of 75 percent (relaxed in 1974 to 80 percent) must have private mortgage insurance. Other significant actions permitting 95 percent loan-to-value ratios with private insurance included the Comptroller of the Currency, acting on behalf of banks in 1970, and the Federal Home Loan Bank Board, raising limits for Savings Associations in 1971 (See Semer & Zimmerman, 1975).

[31] HUD, Office of Housing, mortgage origination surveys.

[32] The biggest break for these insurers came much earlier, in 1958. It was in that year that the savings and loans were attempting to convince Congress that they needed their own equivalent to FHA. The "Home Loan Guarantee Corporation Act" was introduced into the House of Representatives and hearings were held (see Hearings before the Subcommittee on Housing of the House Committee on Banking and Currency, 85th C., 2nd Sess, July 17-18, 1958), but vehement opposition by the Administration and others in the lending community prevented the bill from ever leaving the Committee. See Semer and Zimmerman (1975) and Rapkin, et al., (1967) for discussions of the history

The increasing presence of national players, both insurers and guarantee agencies, set the stage for greater standardization of the ways in which mortgage defaults were handled. Their influence over lender procedures was just beginning to crystalize in the recession of 1981-82. Lenders were already independently developing troubled loan departments, but this often meant increased efficiency in processing foreclosures rather than working out long-term solutions to help borrowers. Seriously delinquent accounts would be turned over to attorneys who would press for borrowers to cure their deficiencies while contracting title searches in preparation for foreclosure proceedings (see Dunaway, 1992, ' 2A.07). Resulting problems for troubled borrowers became apparent in the case of *Brown v. Lynn* (385 Fed. Supp. 986 (1974)). This case involved FHA-insured borrowers who were making good faith efforts to cure delinquencies, but who found that lender foreclosure attorneys were difficult to work with. In particular, these attorneys would not accept anything less than full reinstatement in one payment, where that payment included delinquent interest, principal, escrows, late fees, and all attorney's fees associated with collections and foreclosure processing. It was this last item that often made it impossible for borrowers to cure their defaults. Many court cases emanated from *Brown,* producing a lasting legacy for the operations of FHA (see discussion in chapter 5).

3.3 History and Development: 1985-present

By 1985 the mortgage industry was feeling the effects of several impinging events: an interest-rate mismatch from the Federal Reserve Board's October 1979 decision to crimp the money supply to fight inflation and allow interest rates to freely rise;[33] foreclosures coming out of the national recession of 1981-82 and a prolonged farm-and-industrial belt depression; a new economic environment in which rapid inflation could no longer be counted on to support troubled homeowners with low-downpayment mortgages; and a bevy of new and untested mortgage products developed to help portfolio lenders cope with volatile interest rates, but whose default risks were appearing to be higher than those of traditional level-payment mortgages.[34] All of this led to higher loan defaults and then stricter and more standardized underwriting requirements by agencies and insurers in

and development of the private mortgage insurers. Had the savings industry been successful in obtaining another government insurer, the private industry would be much smaller than it is today.

[33]The issues leading up to the collapse of the savings and loan industry are well documented. See Kane (1990) for a historical overview.

[34]These new products included innumerable variations on the theme of adjustable interest rates, payments, and amortization plans, as well as seller-financed interest-rate buydowns.

1986.[35]

With the collapse of the oil-patch economy in 1986 came more defaults and foreclosures and even the insolvency of several private mortgage insurers. FHA's flagship Mutual Mortgage Insurance Fund also experienced a level of stress that caused Congress to raise premiums to recapitalize it.[36] This marked the beginning of large scale efforts to understand and mitigate the problem of single-family foreclosures by national institutions. By 1991, as the foreclosure problems of the oil-patch and Northeastern States were passing their peaks, mortgage finance institutions had in place serious and wide-sweeping loss-mitigation policies with loan servicers. These basic approaches continue to undergo fine-tuning, but the changes that have now taken place are without precedent.[37] In the six years from 1986 to 1991, the industry first developed the idea of workout specialists (who would understand when to step in and attempt an alternative to foreclosure), and then workout counselors (who would work to make the borrower a partner in the process). The rest of this chapter is devoted to providing a general view of what loss mitigation means to the mortgage industry today.

3.4 Loss Mitigation

Industry sources suggest that 70-80 percent of all loans arriving at 90-days delinquency can still reinstate without assistance. Borrowers must be encouraged in that direction while lenders explore other potential options. At that point, however, with four monthly payments and associated late penalties due, the ability of borrowers to reinstate loans on their own does start to decline.[38] The greatest danger is that the borrower will give up

[35]A good example of the problems of the early 1980s and the industry's response is found in The U.S. Department of Housing and Urban Development's *1986 Report to Congress on the Federal National Mortgage Association*, Chapter IV. Fannie Mae's problems in the early 1980s were a result of the same factors that affected all portfolio lenders: interest-rate term-structure mismatch between purchased loans and funding sources, and the introduction of new product types in attempts to quickly address the problem of negative earnings on the loan portfolio.

[36]Some of the private firms were bought out and recapitalized by others; the FHA Fund is being capitalized under auspices of the National Affordable Housing Act of 1990. According to the most recent actuarial review, the Fund had regained long-term solvency as of the end of fiscal 1992 (Price Waterhouse, 1993).

[37]Even in Great Depression when foreclosures were epidemic, sympathetic lenders relied almost exclusively on suspension of principal payments to assist troubled borrowers (Skilton, 1943, p. 376f).

[38]As an example, note that at 90-days delinquency the borrower owes 4 payments and 3 late charges. If monthly payments are 28 percent of gross income, late fees are 5 percent of the payment, and income taxes (including Social Security and State income taxes) are 25 percent of gross income, then the total amount due is equal to 1.55 months worth of net income. This is rarely an insurmountable problem. If the account reaches 150-days delinquency (2 more months), the total becomes 2.33 months of net income. But if the delinquency was due to a 50-percent reduction in household income, these figures jump to 3.10 (90 days) and 4.67 (150 days) of monthly net income. In this latter case, the increase in amount necessary to reinstate the loan when delinquency extends to day 150 can make self-curing a

hope or panic, and either walk away from the property or use the legal system to forestall what they believe to be an inevitable foreclosure. Workout counselors walk a fine line because they neither wish to scare the borrower in that direction nor make it seem too easy to get monetary assistance.

When a borrower delinquency extends past day 90, the servicer must change from delinquency management and borrower relief to loss mitigation. After 3 months of loan delinquency the organization bearing the credit risk faces a potential for some type of loss, and foreclosure and property management is the most costly possibility. Loss mitigation means finding some resolution short of foreclosure. These resolutions are typically called *workouts*. The least costly workout options are those that keep borrowers in their homes; the next best are those which assist borrowers in getting out of the now burdensome financial responsibilities of homeownership.

Perhaps the most important lesson the industry has learned concerning loss mitigation is to be flexible. Because each borrower's situation is unique, one can only establish broad guidelines to follow and then make case-by-case decisions on which workout option to pursue. This system works well enough that when we asked servicers to rank reasons for why workouts do not work for some borrowers, insurer inflexibility came in far behind borrower unwillingness to cooperate. Indeed, the biggest hurdle to overcome is gaining borrower trust. There is currently disagreement in the industry on how best to do this. Some insurers and guarantee agencies will rely on the servicer, who has developed a relationship with the borrower over time, and who hopefully can draw upon that rapport to encourage cooperation. Others hire their own workout counselors because of a perception that borrowers may see their servicers as adversaries, only wanting them to come up with cash, and fast.[39] Having workout counselors at the servicer and insurer levels is not a bad thing, however, because borrowers are not homogeneous, some trust their servicers and others do not.[40]

The relevant question may very well be one of proportions, with insurer specialists being called in for cases that involve blemished histories of

very difficult task.

[39]Insurers that do not have their own counselors maintain smaller staffs of workout specialists who review the workout proposals made by servicer staff.

[40]The issue of approaches to workout management will be discussed more thoroughly in chapter 4.

borrower-servicer relations. There is no one answer for the industry as a whole because while some servicers are nationwide and can hire and train workout staffs, others are small and/or local and only have part-time or occasional needs for workout specialists. There is room in the market for consulting firms specializing in this type of activity that would handle troubled-account workout negotiations for a fee.[41]

The most critical issue in developing a strategy to assist troubled borrowers is determining whether or not their situation is truly one of economic hardship. Borrowers desiring assistance must complete a household finance worksheet, which is used by workout specialists to tailor a program to match each individual circumstance. Servicers indicate to us that this is an important screen to filter out non-hardship cases. Such borrowers simply refuse to complete the worksheet and will most likely reinstate on their own or else allow foreclosure to proceed.

The remainder of this section discusses the types of workout options insurers and guarantee agencies presently make available for servicers to offer defaulted borrowers.

Staying in the Home

The option used for homeowners with truly temporary, one-time difficulties is the advance claim. Here the insurer pays the servicer the amount of the delinquency in return for a promissory note from the borrower. The mortgage loan is then made whole and the insurer can collect part or all of that advance from the borrower over time.[42] This option is currently only available through private mortgage insurers.

Forbearance

The next option for helping keep borrowers with temporary problems in their homes is a forbearance plan. This is used for borrowers with a reduction in income who have good long-term prospects for increases in income that could again sustain the mortgage obligations. It is also used when troubled borrowers are working to sell the property on their own. The forbearance period can extend from 6 to 18 months or longer, depending on borrower circumstances. During this time borrowers may be

[41]Freddie Mac has started to use these firms to handle accounts for poorly performing servicers.

[42]It is called an advance claim because if the loan does go to foreclosure it will be netted out of the total claim amount requested by the servicer. The amount to be repaid by the borrower depends solely on the ability to pay, as determined by the insurer. Insurers are careful not to overburden the borrower because that would only increase the chance of foreclosure. Borrowers usually pay back the advance without interest charges.

permitted to make reduced monthly payments, but will be expected to make increased payments to cure the delinquency by the end of the forbearance period.[43] These are not technically considered "workouts" by the industry because they are to be financed solely by the servicers, which makes them "relief." But they are long-run solutions which, if not in place, would cause homeowners to relinquish properties either in sale or foreclosure.

Research for this study has shown that, because insurers and agencies typically consider these a servicer matter, they are very rare in practice, leading to homeowners having to give up their homes unnecessarily.[44] What makes the industry uneasy about long-term forbearances is that they would generally involve unemployed borrowers. Agency guidelines require that the borrowers show regular income to qualify for a servicer-financed forbearance. They are not willing to take the risk that an unemployed worker will find work in the area within even 3-6 months. So a borrower without some present source of income who defaults can either sell the property or risk foreclosure.[45] Even in States with long foreclosure times, borrowers who do find new work before the foreclosure sale will have accumulated such a large deficiency that they no longer qualify for continued forbearance while they get back on their feet.

Loan Modifications

For permanent reductions in income, the only way to assist troubled borrowers to keep their homes is through loan modification. Loan documents can be modified in any way, but the two most common are interest rate reductions and term extensions. Loans with above-market interest rates can be refinanced to the market rate and borrowers charged whatever portion of the standard origination fee they can afford. If the interest rate is already at or below the current rate, then monthly payments can be permanently reduced by extending the term of the mortgage, even starting a new 30-year amortization schedule.

Such modifications can be done quickly and inexpensively for portfolio loans, and in recent years they have become easier for those in mortgage-backed security (MBS) pools. Fannie Mae and VA readily agree to allow

[43]Very short forbearances of under 3 months duration are sometimes referred to as indulgences or repayment plans. The term forbearance generally carries the connotation of a significant amount of time and/or money.

[44]The exceptions to this occur when insurers use their own counselors to develop workout plans.

[45]Note that this is predicated upon borrower default. Those receiving unemployment insurance or other sources of income and can maintain their mortgage payments during periods of unemployment do not face this dilemma.

servicers to buy qualifying loans out of MBS pools, modify them, and then sell them back to the agency to hold in its retained portfolios.[46] Freddie Mac, because it has a security structure that differs from that of Fannie Mae, performs the purchase itself after the servicer completes negotiations with the borrower.[47] FHA technically allows loan modifications, but it lacks legal authority to purchase them from lenders.[48] Ginnie Mae does not hold a loan portfolio, and therefore has no provisions for taking investment positions in modified loans. Because nearly all FHA loans are placed in GNMA MBS pools, modifications are then very rare for FHA borrowers.

No mortgage security guarantee agency has yet to allow in-pool modifications because of fear of adverse reactions from investors who buy into pools with established loan coupon rates. Yet the industry has not closely examined the potential for in-pool loan modifications to cure defaults. There are two essential issues: protecting the tax-exempt status of pass-through conduits, and protecting investor interests.

Pass-through security structures are established to provide tax-free conduits of funds to the holders of the various classes of securities written on whole loans or, as is often the case with REMICs, on pools of single-class MBS products. The Internal Revenue Service has defined non-taxable investment trusts to only include such organizations that have "no power under the trust agreement to vary the investment of the certificate holders" (26 CFR Ch. 1, ' 301.7701-4). Section 860F of the U.S. Tax Code explicitly prohibits REMIC conduits from managing the underlying loan pools. This includes significant modification of loans. However, IRS regulations

[46]There are certain cases, however, in which Fannie Mae will not repurchase modified loans. These have to do with the type of servicing rather than the type of loan.

[47]Freddie Mac, because it has historically held a much smaller retained portfolio than Fannie Mae, did not begin these efforts in earnest until December 1993. However, under guidelines issued in September 1994, their program is now more attractive to servicers than is Fannie Mae's. With Freddie Mac, servicers do not have to provide warehouse funding for loans repurchased from security pools. This difference stems from the fact that Freddie Mac is the pooler of loans for its PC security pools, while Fannie Mae will securitize pools formed by third parties. The authorities for purchasing loans in default out of security pools lies with the pooling entity or their designee. For the borrower, the difference is invisible. To them the loan gets modified and stays with its original servicer regardless of who initiates the repurchase. The loan will also become a part of the guarantee agency's portfolio in either case. The only difference for the borrower would be if the required warehouse funding decreased the servicer's willingness to engage in a loan modification. Fannie Mae has effectively dealt with this issue by providing cash incentives for servicers to initiate loan workout plans rather than allow defaulted loans to proceed to foreclosure. The servicer also has an incentive to modify qualifying loans because it then gets to retain the servicing rights. Chapter 4 covers such servicer issues in more detail.

[48]FHA can only repurchase the loan for purposes of taking assignment. This is a complicated process that removes the loan from the servicer as well as the investor. Assignment does not modify the terms and make the loan whole, but rather provides a 36 month period of forbearances on the original mortgage contract. The issues surrounding FHA authorities to assist borrowers in default are discussed more fully in chapter 5.

expressly exclude from this prohibition any modifications involving "default or a reasonable foreseeable default."[49] At-risk loans can then be modified in any form necessary and still remain in the MBS pool that supports the REMIC securities, without jeopardizing the tax-exempt status of the trust.[50]

The second issue for guarantee agencies is what effect such a policy would have on security prices and, subsequently, the cost of credit to borrowers. This would require discussions with investment bankers on security structures and per pool limits that might need to be imposed to provide required investor safeguards. Such a change would necessitate a new security prospectus, so it could only be made for new issuances and not for outstanding MBS products.

The importance of a well functioning secondary market for mortgage loans requires that the issues involved here be studied carefully before recommendations can be made. Very clear tradeoffs would face investors should in-pool modifications be used to prevent loan terminations. The first tradeoff is that modifications lower yields but the resulting termination prevention increases the duration of the pool, providing a counter effect. Consideration would need to be given to the number of loans per pool that would potentially be affected. Candidates for loan modifications are borrowers with long-term income reductions, but who can maintain their homes with smaller mortgage payments. They cannot refinance because of their loan default. The number of loans that meet this criterion will be highest during times of low interest rates, when other loans are refinancing. When contract interest rates are reduced to market levels, modification in-lieu-of-termination saves the transactions costs of reinvesting, however, it also removes the freedom to choose an alternative investment vehicle. Again, a distinct tradeoff. Investor perceptions of the balance between these will be important for determining acceptability of in-pool modifications. Investors will also want to know the stability of modified loans. Fannie Mae has extensive experience with taking modified loans into its retained portfolio, and could provide valuable information on their performance.

[49]See IRS Regulations '1.860G-2(b)(3)(i) for REMICS and Rev. Rul. 73-460 (1973-2 C.B. 424) and Rev. Rul. 78-149 (1978-1 C.B. 448) for single class MBS.

[50]What is prohibited by the IRS is managing (i.e., changing) the assets in the pool via buying and selling, particularly when such actions could be construed as taking advantage of changes in market conditions to improve the value of the investments.

Other Options

Some large servicers have agency contracts that give them sole responsibility for dealing with defaulted loans. Servicers with these *recourse* agreements must be equipped to hold loans in portfolio. But taking recourse on loan sales has lost its allure because risk-based capital requirements count partial-recourse loans the same as portfolio loans, i.e., they are treated as though the servicer retains all credit risk rather than just a portion. When recourse does exist, servicers must buy loans out of pools, make the modifications, and then either continue to fund them from internal sources of capital or attempt to sell these "new" loans into the secondary market. Such a sale will be difficult because the borrowers now have bad credit histories and may not meet agency underwriting criteria for MBS pools. So in the case of lender recourse, the final decision on modifications lies with the servicer and not the guarantee agency.

The last option currently in use for helping troubled borrowers retain their homes is the concurrent purchase of the loan by the insurer and the provision of an extended forbearance. The loan then becomes the sole responsibility of the insurer, which then acts as loan servicer and investor and can make modifications at any time. Because these often involve worst-case loans, with significant borrower hardship and lesser likelihood for ever achieving full reinstatement of the loan, they can be costly and are only offered by government agencies. VA calls this "refunding" while FHA refers to it as taking "assignment" of loans from the lender/servicers. This option is used only as a last resort before lender/servicer foreclosure. VA will also use refunding to modify loans of conscientious borrowers. Programs of FHA and VA are discussed more fully in chapter 5.

Relinquishing Rights to the Property

In many cases borrowers are better off getting out of their existing homes. There may be a need to find employment elsewhere, a divorce settlement that requires selling the property, reduction in income that necessitates moving to lower cost housing, or a borrower has died and the estate's assets must be liquidated. Whatever the reason, there are three options currently available. The first is selling the home with a loan assumption. This is valuable if the mortgage carries a below-market interest rate that would make its sale more attractive, and in cases in which the assumption permits the purchaser to obtain a higher loan-to-value ratio than could otherwise be attained.[51] Credit agencies will waive the due-on-sale clause of fixed-rate

[51]Some private insurers will pay an advance claim to lower the mortgage balance to where the loan-to-value ratio is at or below 100 percent for the purchaser/assumptor. This is a loss mitigation tool that can be very cost effective. The purchase price will be more than that of an REO (real estate owned) property, and all of the costs of foreclosure

mortgage contracts as needed to assist troubled borrowers sell their properties and avoid foreclosure.

Preforeclosure Sales

Borrowers who must move, and who have negative equity in their properties may be eligible for short- or preforeclosure sales. Here the insurer or guarantee agency helps the borrower market the home for sale and covers any loss at the time of settlement. Borrowers can be asked to contribute to the loss according to their abilities. This has become the number one loss mitigation tool of the 1990s. Industry sources indicate that preforeclosure sale prices are generally at least 5 percent higher than those for homes with foreclosure labels on them, and all of the costs and uncertainties associated with foreclosures and property management are eliminated. Borrowers avoid the indignity of a foreclosure and can potentially escape any discharge-of-indebtedness income that would otherwise be subject to taxation after a foreclosure (see chapter 7).[52]

Preforeclosure sales also affect some borrowers who would rather retain their homes, but are currently without income. Because the properties have little or no positive equity cushion, offering forbearances to such unemployed borrowers is fairly risky for the insurer or guarantor. Other than the previously mentioned programs of FHA (assignment) and VA (refunding), the Pennsylvania Housing Finance Authority (Authority) is currently operating the only ongoing effort to take a risk with such borrowers.[53] The Authority provides cash assistance in the form of a loan cure and monthly mortgage supplements for up to 3 years. It then capitalizes the forbearance amounts into a second lien on the property. The experience of this program and its lessons for the mortgage industry and national public policy are discussed in chapter 5.

Deeds-in-Lieu

The last option short of foreclosure is for the borrower to voluntarily convey property rights to the lender/servicer. As this involves the homeowner signing over the deed to the property, it is called a deed in-lieu-

and property management are avoided.

[52]Historically, the Internal Revenue Service did not require that lenders report any debt discharge resulting from lender assisted property sales while it has required this for deed transfers and foreclosures. Interim regulations issued in December 1993 do, however, require reporting on all effective debt discharges. This is discussed more in chapters 6.4 and 7.3.

[53]Connecticut recently passed legislation to establish a similar program.

of foreclosure, or simply a deed-in-lieu. It has several advantages over foreclosure for homeowners but significant risks for lenders. Borrowers get out with less damage to their credit rating, may have a reduced or eliminated deficiency judgment, and stop accruing property-tax liabilities. Still, there are several reasons why it is the last option pursued for borrowers.[54] First, it is more costly to the borrower in terms of credit rating. Second, there are moral-hazard problems with using deeds-in-lieu in regions where there have been widespread property-value declines. Once word spreads that borrowers in these areas can readily turn over their keys to the bank, it can reach epidemic proportions. A third consideration is that, unlike a foreclosure, a deed-in-lieu does not eliminate any junior liens on the property. Secondary-lien holders must agree to be bought out, usually at quite nominal rates, before a clean title can result.[55] Then fourth, the property must be managed and marketed just as with a foreclosure.

Thus the value to the servicer and insurer of taking a deed-in-lieu rather than foreclosing depends on the length of time it takes to process a foreclosure in each particular State. The deed-in-lieu allows a potentially faster way to obtain property titles, especially in States with lengthy foreclosure time frames. It also prevents the backlash of last-minute bankruptcy stays during foreclosure processing, but it is more susceptible to post-transfer bankruptcy annulment. If a borrower can, subsequent to a bankruptcy filing, prove that this transfer caused an insolvency, or occurred at the time of an insolvency, and that the value of the property was greater than the debt, bankruptcy courts may choose to annul the transfer of title.[56]

Mortgage insurers and credit agencies have used their nationwide experience to develop profiles matching workout options to typical borrower situations. As an example, profiles used by one private insurer have been replicated in Tables 3.1 and 3.2. Table 3.1 is a decision tree showing the process involved, and Table 3.2 details the typical cases eligible for each workout.

3.5 The Foreclosure Decision

Servicers must generally prove to insurers and credit agencies that they have provided a good-faith attempt at helping borrowers to cure loan defaults before initiating foreclosure. Still, the burden of proof remains on

[54]See Boneparth (1991) for a discussion of the legal issues surrounding use of deeds-in-lieu.

[55]See Dunaway (1992, vol.1, Ch. 5) for a complete discussion of the downside of deeds-in-lieu.

[56]See chapter 6 for more detail of the use of bankruptcies by homeowners in foreclosure. Dunaway (1992, 15.04(6)) can be consulted on the issue of post-transfer bankruptcy annulments.

the alternative to foreclosure, which must prove itself worthy of consideration. Insurers and credit agencies generally must approve applications for workouts but not servicer denials of workouts to borrowers in default. In addition, the agencies concentrate their loss mitigation efforts in areas of the country experiencing the worst problems, so that servicers in other areas have less incentive to pursue workouts. There are some notable exceptions to this situation, such as Fannie Mae grading servicer performance in curing defaults against regional averages, and both Fannie Mae and Freddie Mac waiving approvals if there will be no cost to them. In addition, VA and some private insurers rely on their own workout counselors to develop loss mitigation plans, thereby avoiding the potential issue of a servicer not making good-faith efforts at loss mitigation.

Table 3.1

Workout Process Decision Tree

Understand the Problem		
• Reason for default	• Borrower's financial capabilities	• Property value

▼

Analyze the Problem			
• Confirm reason for default and determine borrower's intention	• Financial statement, tax returns, check stubs, and credit report	• Current appraisal, Broker's Price Opinion	• Deficiency rights

▼

Resolve the Problem

HARDSHIP | **NON-HARDSHIP**

Willingness, but no ability	Willingness with potential ability	No willingness, but ability
▼	▼	▼
• Pre-Sale, Deed in Lieu	• Modification, Forbearance, Repayment Plan	• Foreclosure with deficiency
▼	▼	
• Foreclosure	• Pre-Sale, Deed in Lieu with or without contribution	
	▼	
	• Foreclosure, foreclosure with deficiency	

Source: Mortgage Guaranty Insurance Corporation

Table 3.2

Workout Option Borrower Profiles

Option	Description	Borrower Profiles
Temporary Indulgence	Short-term forbearance either to cure loan or until house sells.	Eproperty sale pending Ecash expected soon (e.g., insurance settlement) Eassistance from social agency expected
Repayment Plan/ Advanced Claim	May be servicer initiated or, if arrearage is substantial, insurer makes servicer whole and takes promissory note from borrower.	Enew job pending or strike ending so that soon regular payments can begin plus repay arrearages over time Eloan must be brought current for a needed modification but borrower does not have the funds
Forbearance	Borrower can make reduced or even no payments for a period of time. There is evidence for ability to fully recover.	Etemporary reduction in income, with expectation of increase in the near future Einsurance settlement pending Edeath of a primary contributor toward mortgage payment
Loan Modification	Restructure note terms so that monthly payments are permanently reduced.	Eborrowers who can make regular payments but who have no ability to repay arrearages Ecurrent period of negative cash flow requires that borrower reduce debt service

Table 3.2
(continued)

Option	Description	Borrower Profiles
Preforeclosure Sale	Property sale to avoid foreclosure and where insurer or guarantor must contribute cash to make the investor whole.	Eborrower cannot maintain mortgage or must move, but sale proceeds will not cover the mortgage balance and borrower has insufficient other funds to pay off loan
Deed-in-Lieu of Foreclosure	Lender accepts voluntary conveyance of property title from borrower to avoid foreclosure.	Eborrower cannot maintain the loan nor sell property Edeath of borrower Eafter a Chapter 7 bankruptcy liquidation

Source: Mortgage Guaranty Insurance Corporation

Insurers are not always more lenient with borrowers than are servicers. While insurers say that small servicers often do not do enough to help borrowers, large servicers say that insurers often do not accept enough of their workout proposals. The crux of the matter is that it is always a judgment call. Both the servicer and insurer--and often the credit agency too--are looking at the same set of facts, and each must weigh these facts against their own experience to attach a probability of success to the workout plan. There is no one right answer. Because there is no guarantee of success, and many borrowers go from one workout option to another before a cure is secured, each workout specialist attempts to balance the probability of success they will attribute to the borrower against the minimum probability of success their organization is willing to accept. Every offer of a workout involves risk. Loss mitigation is risk management, and each firm has its own tolerance for risk based on its own experience and financial ability to absorb potential losses. Those bearing the most credit risk--usually the insurer--can be expected to be most risk averse. This may be different in the case of government insurers--FHA and VA--because they have social mandates and do not have to cover all costs.[57] A failed workout that leads to eventual foreclosure is always more costly than foreclosure without any attempt at a workout.

There is a tension between wanting to give servicers time to develop an optimal workout program and the desire not to delay foreclosure. All attempts at a workout must cease once a judicial request of foreclosure is filed because the failure of that workout could jeopardize the legal standing of the case to foreclose.[58] If they did not cease, the servicer would not be considered acting in good faith during the workout negotiations or not truthful about the need to accelerate the note.[59] But delays in initiating foreclosure are costly. The insurer will have to pay interest on the outstanding debt for a longer period of time and there is increased exposure

[57]The issue of a government agency having to break even is a difficult one. While the FHA Mutual Mortgage Insurance Fund, which supports nearly all of the single-family owner-occupied loans insured by FHA, is required by law to be capitalized to cover its risks, workout decisions are made by field office staff who do not have direct fiduciary responsibilities for the portfolio and who were, until 1994, not under the direct authority of FHA headquarters.

[58]Not all States require judicial action to process a foreclosure. As will be discussed in Chapter 6, some allow a power-of-sale foreclosure, in which case the servicer simply files or posts an intent to foreclose at the courthouse and advertises the property for sale. There are States, like Maine, that expressly permit lenders to work toward borrower reinstatement even during judicial foreclosure proceedings (see West, *Maine Revised Statutes Annotated*, Title 14, '6200).

[59]If the lender/servicer has allowed late payments in the past, then not accepting them in the present case is sufficient grounds for a borrower to plead with the court for an estoppel of foreclosure, claiming the lender did not have the right to accelerate the note.

to property damage and deterioration. Homeowners facing foreclosure and eviction do not continue to maintain properties and they sometimes cause deliberate damage. Abandoned properties lack maintenance and are subject to vandalism.[60]

The amount of tension between providing time to develop a workout and conserving time-to-foreclosure is in direct proportion to the length of foreclosure timetables in each State. Insurers and credit agencies have, however, avoided State-specific limits on when servicers must initiate foreclosures, although they do give State-by-State guidelines as to how long it should take to actually complete a foreclosure.

3.6 The Cost Effectiveness of Workouts

Contrary to popularly held myths, mortgage finance institutions lose money on nearly all foreclosures. Not only that, but they lose more on a foreclosure than they do on any workout option. In addition, the lender/servicer has already incurred costs of servicing the delinquency and processing the foreclosure, which make the opportunities for profit even more remote.[61] Foreclosure auctions are not operated so as to promote access to owner-occupant buyers or to maximize potential sale price. Properties purchased by third-party investor are bought for less than market value because they rehabilitate, manage, and market the properties, and they must contend with the "foreclosed" label that discounts potential sale prices by at least 5 percent. Foreclosure is therefore only pursued when evidence suggests that no other option is workable.[62] Finding alternatives to foreclosure is a positive-sum game that benefits both borrowers and lenders.[63] When borrowers are unwilling to cooperate with these efforts it

[60]A middle-ground position on the issue of when to start foreclosure is taken by Freddie Mac. It requires servicers to hedge their positions by doing the preparatory work for foreclosure filings while pursuing workouts with borrowers. That generally means hiring an attorney and completing a title search on the property. The title search can take 4-to-6 weeks, so the underlying assumption is that either a workout will be in place or foreclosure is certain by the end of that time. The cost effectiveness of this strategy is a function of the frequency of workout success and the attorney and title search fees. Immediate foreclosure initiation does restrict the opportunities for employing second-best workout strategies when a first option fails. Still, a title search is necessary for preforeclosure sales and deeds-in-lieu, since any second-lien holders must be made aware of the sale or else they must not exist if there is to be a voluntary conveyance of title.

[61]U.S. General Accounting Office (1991) provides an aggregate picture of the costs involved in taking and disposing of foreclosed properties for the Federal insurers, FHA, VA, and the FmHA.

[62]This does not include loan repurchases (VA refundings and FHA assignments) performed for social-safety-net reasons rather than for direct loss mitigation.

[63]Dunaway (1992, at 2.02 and 2A.01) discusses the incentives borrowers and lenders have to negotiate a settlement short of foreclosure.

is often due to lack of financial hardship or a repeated history of defaults and foreclosures.

Studies purporting to show how mortgage finance organizations profit from foreclosures are misleading. The most prominently cited study is that by Wechsler (1985). The shortcomings of this work include mixing commercial and residential properties, picking a time frame in which foreclosed properties were sold with high rates of inflation (1980), and ignoring all of the costs associated with holding and selling properties. Wechsler acknowledged his profit estimates may be overstated, but only in (two) footnotes.[64] This subtle confession was not picked up by others citing his work as evidence that foreclosures are profitable opportunities for lenders. Profits on individual foreclosures, when they do occur, nearly always result from lender efforts to rehabilitate properties prior to disposition.[65]

Table 3.3 replicates a standard cost sheet provided by a lender/servicer. This shows that even on loans with 20 percent downpayments in markets with no price depreciation, foreclosures are costly. The lack of any general market price appreciation shown there is to compensate for the effect of the "foreclosed" label on the property value. Losses escalate for high loan-to-value mortgages, declining housing markets, and States with expensive and time consuming foreclosure originated, loss rates, as a percent of outstanding loan balance, range from 30 to 60 percent.

[64]These are note 194 on p. 885 and note 201 on p. 886. In Wechsler's survey of lenders, they all claimed to never make a profit on foreclosures (see note 19 on p. 853).

[65]One portfolio lender that provided HUD with firm data for this study showed that out of 81 properties taken into inventory (62 foreclosures, 19 deeds-in-lieu) over a 5-year period (1986-90), 11 netted a profit. The average profit on each of these was $1,842, whereas the average loss on the other 71 was $18,634.

Table 3.3

Typical Cost of Foreclosure

Values at Loan Origination	
House Price	$ 100,000
Loan Amount	80,000
Values at Loan Default (36 months after origination)	
House Value (after rehabilitation)	100,000
Loan Amount (9%, 30 yr., fixed rate loan)	78,200
Gross Equity	21,800
Expenses That Are Independent of Holding Period	
Property Rehabilitation (8% of full house value)	8,000
Attorney, Title, and Transfer Fees (3.2%)	3,200
Realty Commission on Final Sale (6%)	6,000
Contribution Toward Buyer Closing Costs (3%)	3,000
Total Cost	20,200
Add Expenses That Vary With Holding Periods	
Minimum holding period: 5 months from delinquency to foreclosure, 3 months from foreclosure to property disposition	
Lost interest	4,692
Property taxes, hazard insurance, and maintenance (0.21%/mn)	1,680
Holding Period Costs	6,372
Total Cost	26,572
Loss on Foreclosure	$ 4,772
Average Holding Period: 10 months from delinquency to foreclosure, 5 months from foreclosure to property disposition	
Lost interest	8,798
Property taxes, hazard insurance, and maintenance (0.21%/mn)	3,150
Holding Period Costs	11,948
Total Cost	32,148
Loss on Foreclosure	$10,348
Long Holding Period: 18 months from delinquency to foreclosure, 7 months from foreclosure to property disposition	
Lost interest	14,663
Property taxes, hazard insurance, and maintenance (0.21% per month)	5,250
Holding Period Costs	19,913
Total Cost	40,113
Loss on Foreclosure	$18,313

Attempted workouts are risky. If they succeed, there are cost savings over foreclosure, but if they fail and foreclosure must be pursued anyway, default resolution has greater costs. That means that the entire decision about whether or not to offer foreclosure alternatives, from the credit-risk-bearing firm's perspective, comes down to understanding two probabilities: the break-even probability of workout success and the probability of an individual borrower succeeding in a workout. A break-even probability tells how many workout offers must succeed for the total cost of all workouts (successes and failures) to equal the cost of immediate foreclosure on all loans.[66] If the individual's success probability exceeds the break-even level, then it is financially prudent to offer that person a workout. This concept has been formalized by Ambrose and Capone (1993, 1996). There are indications that the mortgage industry is beginning to understand its importance. In its 1989 audit of the VA workout program, the U.S. General Accounting Office (GAO) calculated the break-even probability of "refunding" loans (becoming the lender/servicer) to be 20 percent.[67] Actually, their calculation was the inverse of this, what might be called the *support* ratio: each successful refunding saves enough money (vis-a-vis straight foreclosure) that it can support 3.9 failures, a 3.9:1 support ratio. United Guarantee Residential Insurance Company estimates a 25 percent break-even probability on their short-term repayment plans, and profitably offers long-term repayment (beyond 6 months) with success rates as low as 10 percent. That implies support ratios of 3:1 and 9:1, respectively.[68] Whitacre (1992) calculates from the actual experience of mortgage bank Carl I. Brown Company that the break-even probability for FHA on forbearances is just 7 percent. The implied support ratio for forbearance attempts on FHA loans is then over 13:1.[69]

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[66]A break-even probability is calculated as the ratio of the cost savings of a successful workout to the increase in cost of a failed workout to a successful one:

$$\frac{\text{cost of immediate foreclosure - cost of successful workout}}{\text{cost of failed workout - cost of successful workout}}$$

See Ambrose and Capone (1993) for a more detailed discussion.

[67]U.S. G.A.O. (1989, p. 40, note j).

[68]Long term plans can have a lower break-even probability than short term plans because they have a larger cost difference between success and failure. That does not mean that the long term plan is always the best one to pursue. The choice depends on individual borrower probabilities of success under each plan.

[69]Purely lender initiated forbearances were allowed with FHA loans from 1975-1991. The Carl I. Brown forbearances were principally done in the late 1980s. FHA program experience will be discussed in more detail in Chapter 5.

While workout attempts are risky, only a minority of them need to succeed for such operations to be profitable to the credit risk bearers. The key to success lies in the abilities of workout specialists to categorize defaulted borrowers within cohorts according to their perceived chances of success. Unfortunately, industry data collections with reference to post-default events is still in its infancy. It will be several more years before a systematic study of borrower success probabilities can be undertaken.

All borrowers with individual probabilities of success in excess of a firm's break-even probability can be profitably offered workouts. But this decision involves probabilities and so it requires a large enough number of workout offers to assure that a program will be profitable. The smaller the program--in terms of numbers of foreclosures handled each year--the greater must be the difference between the average-probability-of-success-of-workout-offers and the break-even-probability, to protect against the possibility of losses from a workout program.[70] That is, because this decision involves probabilities rather than certainties of events, large numbers of workouts are needed to eliminate the risk that actual experience may prove workouts to be a losing venture.

The point is that it is profitable to offer workout alternatives to all borrowers whose probabilities of successful completion are greater than a level that would make the expected costs of trying the workout equal to the expected cost of an immediate foreclosure. Such an "eligibility" criterion first presupposes that the borrower is suffering a true financial hardship, and then requires incentives for the borrower to want the workout to be successful.[71] Because there is strong evidence that break-even probabilities tend to be well below 50 percent, borrowers whose chances of success are less than 50-50 should still be given a workout opportunity. As noted above, this depends upon the credit-risk bearer having enough defaulted loans that the observed frequency is very close to the theoretical probability. Thus national insurers and agencies are in prime positions to remove this risk from small lenders and servicers. This is especially true because, even for larger lenders and servicers, defaults and foreclosures in

[70]For example, let us take a firm that has three defaults in a year. Their individual success probabilities are 30 percent and the break-even probability is 25 percent. If only one succeeds they will save money by offering workouts rather than immediate foreclosure. But each has an independent probability of success of 30 percent. The probability that none will succeed and there will be even greater losses than under immediate foreclosures is 34.3 percent (via a binomial distribution). This may be too much of a risk for a small firm to take. If, however, the firm has 100 defaults per year, with the same probabilities, then there is only an 11.3 percent chance that work attempts would not pay for themselves. If the firm with a 25 percent break-even probability and 100 defaults per year limited workout attempts to individuals with 40 percent chances of success, then the probability of net losses falls to 0.06 percent.

[71]If there is no true hardship, then borrowers can reinstate on their own and do not need supplemental help by the insurer or credit agency to maintain or sell the home.

healthy markets will be relatively few. By dealing with larger total numbers of defaulted loans, the national organizations can profitably offer workouts even to households with success probabilities very near the break-even levels.

The Ambrose-Capone study is instructive as it simulates break-even probabilities for four major types of workouts: loan modifications, forbearances, preforeclosure sales, and deeds-in-lieu. It also takes into consideration uncertainties with respect to foreclosure and property sale times, looks at a number of economic environments and initial loan-to-value ratios, and accounts for borrower opportunities to cure defaults.[72] Their results are shown in Figures 3.1 and 3.2, which can be summarized in the following points:[73]

- In circumstances in which housing prices are either stable or have experienced some decline, modifications have the lowest break-even probabilities (18-25 percent). That means that lenders can take the most chances with these workouts. Each success can cover losses from around 4 failures so that the support ratio is 4:1.

- Depending on house price changes, forbearance break-even probabilities range between 22 and 33 percent, preforeclosure sales between 28 and 38 percent, and deeds-in-lieu between 28 and 50 percent. Their support ratios are then around 3:1, 2:1, and 1.5:1, respectively.[74]

- In areas where there has been no housing-market downturn, preforeclosure sales have the lowest break-even probability (20 percent), and modifications have the highest (42 percent). Deeds-in-lieu and forbearance break-even rates are each around 30 percent.

[72]The economic environments used are based on house price appreciation before and after default: normal (15 percent before, 5 percent per year after); stagnant (none before or after default); beginning to decline (0 percent before, -10 percent per year after); middle of downturn (-10 percent before, -10 percent per year after); market bottom (-20 percent before, 0 percent after); and initial recovery (-20 percent before, 5 percent per year after).

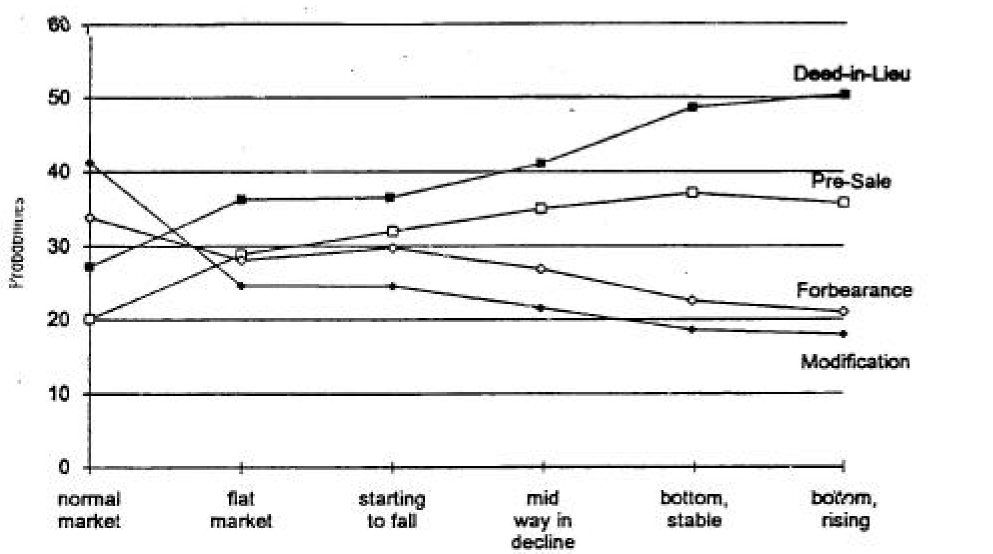
[73]These are for loans where the initial downpayment was 10 percent. Break-even rates for 5 percent downpayment loans will be a few percentage points higher, and those on 20 percent downpayment loans will be a few percentage points lower. Foreclosure time frames include possibilities for delays and extend from 2 months to 18 months, with a mean time of 6 months. Simulations done with the Ambrose-Capone model show that for options that keep borrowers in their homes, break-even probabilities only rise by 5-to-10 percentage points in quick foreclosure States (consistent 2 month period to complete foreclosure). But break-even levels for deeds-in-lieu and preforeclosure sales rise substantially when foreclosures can be consummated quickly, with deeds-in-lieu break-even rates rising by 40 percent and those for preforeclosure sales rising by 20 percent.

[74]Ambrose and Capone use a 6 month no-payments forbearance that starts at day 120.

- Lenders are best off waiting until day 120, rather than day 90, to negotiate workouts. This is because of the high chance of self cure in the 90-120 day period. Initiating workouts while cure rates are still high increases the break-even probabilities of each workout option. For borrowers with no chance of curing their loans, break-even probabilities fall dramatically. Modifications can have break-even rates as low as 7-to- 12 percent, implying support ratios of 13:1 to 7:1. (This is not shown in Figures 3.1 and 3.2.)

Figure 3.1

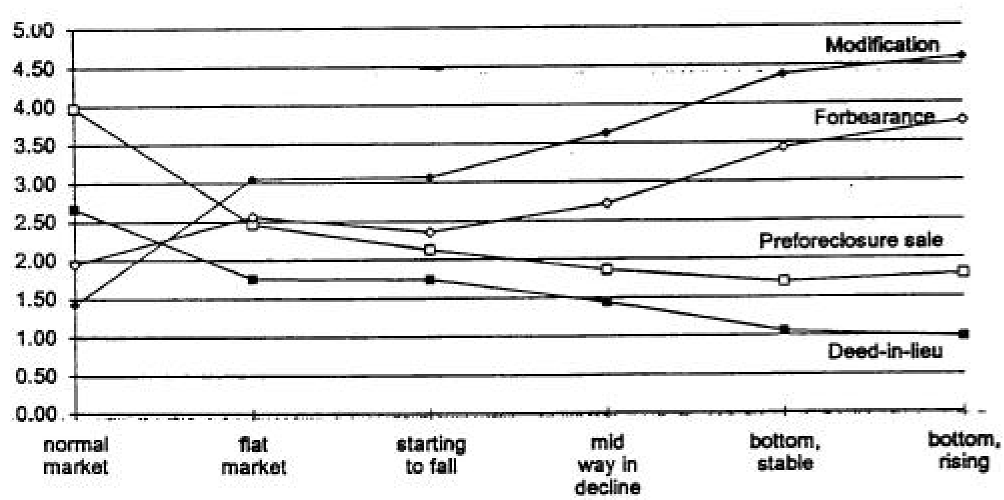
Break-Even Success Probabilities for Workout Options In Various Economic Climates[a]



[a]Definitions of these six climates are provided in footnote 46.
Source: Ambrose and Capone (1993)

Figure 3.2

Workout Option Support Ratios Implied by Break-Even Success Rates[a]



[a]A support ratio gives the number of failures that can be financed by the savings from one success.
Source: HUD calculations using Ambrose and Capone (1993) model

The only cases in which the Ambrose-Capone model shows that lenders could actually make money on *successful* workouts--rather than just mitigate losses--was for 20 percent downpayment loans in normal housing markets (continuous appreciation of prices), and only for *successful* deeds-in-lieu and preforeclosure sales. Failure of these options is still more costly than immediate foreclosure, and so financial risk in offering them continues to exist.

3.7 Protecting Borrower Equity

Borrowers who allow their loans to go into default have three things at risk: their investment in the house, their credit rating, and a potential tax liability. Equity in the property may have very little to do with the actual investment made by the homeowner. That investment value of a home depends on local market conditions. Money spent on owner-occupied housing--downpayment, purchase costs, maintenance and improvements--can only be recaptured if there has been sufficient price appreciation.[75] In a market with moderate house-price appreciation, a borrower with only a 5 percent down payment can have enough equity in the home to cover the 8-10 percent total selling costs within 2 years. It will take several more years before the initial investment can actually be recouped. If there has been little or no appreciation in market price, then that same homeowner after 2 years would have negative net equity, and they would have to pay money at closing to sell the house on their own.

Once a homeowner is in default on the mortgage, the only way to protect any positive net equity is to cure the default. Long-term workout options offered to troubled borrowers cannot fully protect that investment, even if they keep the borrower in the home. A long-term forbearance will cause the homeowner to accrue an additional indebtedness that could erode all equity in the property. It may or may not be best for the household involved, depending on the alternatives. If the monthly mortgage payment is about the same as an alternative rental payment, then the forbearance saves selling and moving costs.[76] But if there are substantially less expensive housing alternatives, then a house sale and household move could be best. The second long-term option for keeping a home is loan modification. This is a form of capitalizing delinquencies into mortgage balances. They should generally be less costly to a homeowner than selling the house. The other long-term solutions, preforeclosure sales and deeds-in-lieu, are only offered if there is already negative equity in the

[75] Also, the costs of most major remodeling efforts are not fully recovered in the increased value of the house.

[76] Tax deductions from interest and property taxes could disappear under a forbearance plan, either because the lender is advancing them or the household has insufficient income to take advantage of them. So gross monthly payments need to be measured against alternative rental housing costs.

property.

Loan foreclosures are mostly a problem of declining house values. One lender that contributed to this study expressed a view that many defaulted borrowers with negative equity in their homes make rational economic decisions: if the delinquency is greater than the cost of moving, they allow foreclosure and move. Many other mortgage market participants related to us that this phenomenon is exacerbated in States that do not allow deficiency judgments. In those States, the borrower cost-benefit calculation also includes free rent from staying in the mortgaged property until foreclosure and eviction, which only serves to increase the chance of the borrower allowing lender foreclosure.[77]

Loan workouts benefit borrowers by substantially reducing the credit cost associated with foreclosure. A foreclosure stays on credit records for at least 7 years. In addition, a foreclosure combined with a bankruptcy filing will severely damage access to affordable credit. It is this, along with the threat of deficiency judgments or taxation of debt discharge resulting from uncollected debt in foreclosure, that prevents most nonhardship cases from allowing foreclosure.[78] These factors also give those with true hardships valuable incentives to negotiate solutions with their lender/servicer.

[77]The increase in foreclosure when cost to borrowers is reduced was verified by Jones (1993).

[78]Deficiency judgments are discussed more thoroughly in chapter 6.4; taxation of debt discharge is covered in chapter 7.3.

Chapter 4

Insurer and Guarantee Agency Relationships With Loan Servicers

The types of workout options used for single-family mortgages are now fairly standard across insurers and guarantee agencies.[79] Their application, however, depends on the sophistication of servicer workout departments and incentives given by the insurers and agencies to assure that their policies are carried out. How to provide these incentives is an area in which the mortgage industry is still working toward consensus. This chapter begins with an exposition of what is happening today with regard to servicer relations, and then continues with sections on the perspectives of loan servicers and portfolio lenders. The chapter ends with a discussion of what changes in workout programs servicers would most like to see.

4.1 Approaches to Servicer Relations in Loss Mitigation

Each insurer and guarantee agency depends vitally on the performance of loan servicers to assure protection of their collateral interests and homeowner equity. There are many opportunities for overlapping relationships because any one servicer may handle loans insured and/or guaranteed by a number of these secondary market players. Information on new approaches to loss mitigation and loan workouts can, therefore, spread fairly quickly through the industry. In addition to these interrelationships, there are industry trade publications that often

[79] As used here, insurers refer to FHA, VA, and the private mortgage insurers. Guarantee agencies is used only to refer to Fannie Mae and Freddie Mac. Ginnie Mae does not intervene in cases of loan defaults except when the solvency of a security issuer is at stake. Even in those circumstances, FHA indemnifies Ginnie Mae for losses on individual loans.

highlight new approaches to handling nonperforming loans.[80]

Among the seven agencies and insurers contacted for this study, there are two general approaches to servicer relations with a third now emerging (see Table 4.1). Typically, either the servicer has primary responsibility for developing workout offers or the agency/insurer takes this upon itself. In each case, servicers are given very similar instructions on when workout options are allowed and when to process a foreclosure. These have been developed since at least 1986 and are now firmly in place. As loan servicers increase in their sophistication with workouts, a third approach is emerging. This is where the servicer not only makes a recommendation on workout plans but is actually given authority to implement plans without agency approval. The success of this hinges on providing the proper financial incentives for servicers to look after the insurer or guarantor's interests.

Servicers do not bear much of the cost of foreclosures, so they do not have the same level of incentives to promote workouts as do those who bear primary credit risk. However, in working with nonperforming loans, servicers face direct operating costs that are not covered by insurance claims.[81] They will only incur these costs of continuing to forbear while attempting a workout solution as long as they do not exceed the value of future servicing rights to the mortgage. The insurer or guarantee agency, on the other hand, is looking at the prospect of large and immediate losses in foreclosure. So the servicer and insurer have separate and distinct financial interests.

There is then a classic principal-agent, or *agency* problem in which what is in the best interest of the servicer may not be in the best interest of the insurer. Agency, as it is used in this context, refers to one who acts as an "agent" of another. The classic example of an *agency* problem is that of a firm's manager who acts as an "agent" of the owners, with the fiduciary responsibility to maximize the owners' equity in the business. The *agency* problem is then one of establishing the proper incentives so that the

[80]These include *Real Estate Finance Today* and *Mortgage Banking*, two publications of the Mortgage Bankers Association of America; *Savings & Community Banker*, the magazine of the Savings & Community Banker Association; and *American Banker*, published by the American Banking Association. There are also many mortgage market publications not affiliated with trade groups.

[81]Working with delinquent loans involves a good deal of direct servicer activity. The cost of this monitoring is covered only by the usual servicing fee on all loans. Ginnie Mae, because it pools more risky FHA and VA loans, provides a higher servicing fee than do Fannie Mae and Freddie Mac. FHA only reimburses servicers for two-thirds of foreclosure expenses (attorneys, court costs, appraisals, title searches, etc.), and only reimburses unpaid interest at the government debenture rate rather than the mortgage note rate.

Table 4.1

General Approaches to Insurer/Guarantor Relations With Servicers

Approach Class:	I	II	III
Description of Approach:	Servicer develops plan subject to final review and approval by agency and/or insurer (agencies require that insurers give approval first).	Agency/insurer uses own workout staff to develop plan for servicer to implement.	Servicer given latitude to develop plan with minimum approvals by agency.
Interpretation:	*Agency* problem can be controlled but not completely overcome with proper incentives.	*Agency* problem cannot be overcome in a cost-effective manner.	Either no *agency* problem exists, or it has been fully resolved.
Agencies/insurers using approach:	Fannie Mae Freddie Mac, Mortgage Guaranty Insurance Corp., FHA (pre 1995).	VA, General Electric Mortgage Insurance Corp., United Guaranty Insurance Corp, Freddie Mac using workout contractors for caseload of small servicers.	FHA (1995), Fannie Mae experimenting (1995).

manager will truly seek the owner's best interest.[82] In the case at hand, we note that mortgage insurers and guarantee agencies are trying three different methods for controlling *agency* problems with servicers. A simple classification scheme is outlined in Table 4.1.

There is no one right way of approaching this relationship and, because emphasis on workouts is still relatively new, it will likely be a few more years before one approach dominates or some blending of them emerges. On one hand, it has yet to be shown whether small, local servicers can be expected to develop the same workout expertise as larger national ones, and whether that expertise can be sustained during a period of normal house-price appreciation when defaults are relatively rare. It might be that it is more cost effective for the national organizations to maintain loss mitigation staffs and perhaps reduce servicing fees accordingly.[83] In Chapter 3 it was mentioned that it might also be possible to require small servicers to contract out loan workout functions if they cannot justify having trained staff in house.

On the other hand, incentives for servicers to act so as to maximize the net return from loss mitigation efforts have not been fully exploited. For example, only the new insurer, Amerin Guaranty Corporation, is experimenting with a system that directly rewards lenders for minimizing claims.[84] While this approach affects underwriting as well as delinquency monitoring, it could easily be expanded to provide a type of "profit sharing" on the cost savings from loss-mitigation efforts over-and-against the average cost of loans that go to foreclosure. This could then be a test of whether *agency* problems could be effectively eliminated. In 1995, Fannie Mae began to test such a system with the loans it guarantees.

The following section provides examples of how the industry is working to resolve *agency* problems with servicers.

[82]See Jensen and Meckling (1976) for the seminal work outlining this universal problem among all firms. Ambrose and Capone (1993) provide a more detailed look at this for servicers and insurers.

[83]This would be fairly straightforward for the guarantee agencies, but would require some creative innovations by insurers to vary premiums by servicer.

[84]Amerin's strategy is to charge insurance premiums to the lender rather than to the borrower. Lenders with better than expected performance across their insured portfolios earn reduced out-year premiums. This is a new and somewhat controversial approach. Public policy questions exist with respect to possible lender incentives to circumvent community lending requirements in order to minimize insurance costs.

4.2 Innovations

Class I

Class I organizations act as if *agency* problems can be controlled with proper incentives. They do not act as though the problem has been overcome because they still scrutinize servicer workout requests and must give final approval before the servicer can make an offer to a borrower.[85]

Both Fannie Mae and the Mortgage Guaranty Insurance Corporation (MGIC) have well developed training programs to teach servicer personnel how to think and respond to typical distressed-borrower situations. MGIC's program, *Preserving Homeownership*, was finalized in 1991 and provides a full-day of instruction on borrower counseling, matching workout plans to borrower needs/situations, and Fannie Mae and Freddie Mac guidelines. It is complete with case studies that review tax returns, household finances, and use of Fannie Mae and Freddie Mac reporting forms.[86]

Fannie Mae is at the vanguard of testing various incentives for servicers to initiate workouts. Their initial philosophy was best spelled out in a mortgagee letter dated May 17, 1991.[87] There, Fannie Mae introduced the carrot-and-stick approach in which they would offer monetary payments for completion of foreclosure alternatives and, at the same time, rate each servicer's use of workouts against the performance of others in their regions. By midyear 1993 they had reached the goal of having servicers prevent one out of four potential foreclosures, and surpassed 50 percent foreclosure avoidance in 1994. While industry data on historical performance is sketchy, these were clearly precedent setting accomplishments. In 1995, Fannie Mae embarked on the next generation of servicer relations that will may one day put them squarely in Class III (see comments below).

Rather than attempting special incentives for servicers, Freddie Mac traditionally chose to encourage fast cooperation by borrowers by requiring that servicers initiate foreclosure at 90-days delinquency. In the 90-120 day period, property-rights-terminating workouts and foreclosures are processed on parallel tracks, with borrowers given rights to reinstate the mortgage up

[85]Fannie Mae and Freddie Mac now have exceptions for instances in which there will be no cost to them and the insurer and borrower will cover all losses.

[86]MGIC is now in the process of releasing a revised *Preserving Homeownership II*.

[87]See Engelstad (1991).

to 5 days before foreclosure.[88] This, however, is now changing. In 1994 the Corporation staffed a new Single Family Loss Mitigation Department with responsibility for designing and implementing workouts and corporate strategy toward servicer incentives. It has also initiated its own program of servicer training in loss mitigation techniques, and has recently introduced more complete incentives for servicers to avoid foreclosure. Its current goal is that workouts increase from 30 percent to 50 percent of cases in which borrowers cannot cure their defaults.

Class II

Class II organizations generally operate in a way indicating that *agency* problems cannot be mitigated in a cost-effective manner. While they rely heavily on servicers to at least initiate and gather financial information from defaulted borrowers, they do not rely on them to propose any specific offers of workout assistance. While some large servicers have sophisticated loan-workout programs, many smaller ones still do not even consider workouts important. General Electric Mortgage Insurance Corporation (GEMICO) has found that as they expand their servicer training on how to handle delinquents, servicers send them more borrower financial packages to analyze. Because emphasis on workouts is all very new to servicers, it is taking time to get training to all who need it. GEMICO has also developed a computer system to flag loans that may benefit from a workout but were not given workout-information packets by servicers.

An additional role for insurer counselors occurs when there is animosity between servicer and borrower due to past or present difficulties. As a "neutral" third-party, the insurer can often more easily gain trust and develop a workout solution. This tactic is used successfully by the United Guaranty Residential Insurance Company (UGI) and the VA. UGI notes that, because servicers process foreclosures, borrowers see them rather than the insurer as the adversary. Coming in as a borrower advocate also allows the insurer to process workouts when borrower circumstances change late in the foreclosure process. This is a valuable role for the insurer. If the servicer worked on ways to reinstate the borrower while processing a foreclosure it would jeopardize the legal case for foreclosing. In addition, private insurers gain leverage to encourage servicer participation by sometimes contacting the appropriate guarantee agency to solicit its support for a workout.

Servicer counselors may tire of hearing the same old stories from a borrower and not want to give them another chance. Because they do not

[88] As mentioned in chapter 3, the servicer would jeopardize the foreclosure by simultaneously offering incentives to reinstate the loan. So with Freddie Mac loans, these must all be accomplished before the 90-day mark.

bear the direct costs of foreclosure but do incur servicing costs on recurrent delinquencies, it is easier for them to want to go to foreclosure. The insurer's counselors are not wearied by the past relationship and can perhaps look at the costs and benefits of a workout more objectively. In the case of the VA, there is a pre-existing and ongoing relationship between agency and military personnel that gives its counselors an enhanced ability to elicit borrower cooperation.

It is interesting that MGIC started with a Class II approach in the mid 1980s, but then switched to Class I. It discovered that the more counseling it did, the less effort servicers put into delinquency management of their loans, choosing instead to put their resources to work on other nonperforming loans. This may have been due to the staffing crisis that occurred when the oil patch economy went bad in 1986 and delinquencies escalated. Whatever the cause, MGIC has since developed a highly-respected Class I program. In some cases it even sends its workout guidelines directly to troubled borrowers.

Class III

As mentioned earlier, Fannie Mae is poised to enter Class III.[89] It is certifying servicers for delegated endorsement of workout plans without any prior approvals from Fannie Mae. Financial incentives will make loss mitigation a clear profit center for servicers, thus giving them a direct stake in the outcome of each case. New computer systems will allow faster approval of workout requests by servicers not certified for delegated endorsement, and will expedite Fannie Mae's internal reviews of servicer performance.

FHA is also in the process of moving from Class I to Class III status. A severe staffing crisis and government budget restrictions have led to providing servicers with broader authority. They now have complete authority to authorize preforeclosure sales and make positive recommendations on assignment applications. HUD staff only intervene to grant program exceptions and to review negative assignment recommendations.[90] However, FHA cannot upgrade to require that servicers analyze other foreclosure avoidance and loss-mitigation efforts until it has the authorities to use them.

[89]Fannie Mae's new policy is spelled out in Engelstad (1995).

[90]Because of the entitlement status of loan assignment for borrowers who meet the technical qualifications, HUD must provide its own review of servicer recommendations against taking assignments. The role of loan assignment vis-a-vis other loss mitigation techniques is a product of a long statutory and judicial history--one that will be discussed fully in chapter 5.

FHA takes a different tact from others with respect to providing monetary incentives. While private insurers require that borrowers put some of their own cash into workout agreements, FHA does not; it offers cash incentives to encourage borrowers to make workouts successful. Payments to borrowers are a relatively new invention and are available for deeds-in-lieu and preforeclosure sales. The preforeclosure sale payments made by FHA vary with the quickness of the sale, and deed-in-lieu payments are a flat $500. It is not that defaulted borrowers walk away with cash in their pockets. Rather, these are used by borrowers to make their expected contributions to cover miscellaneous transactions costs. With respect to preforeclosure sales, borrower incentive payments help to finance the closing costs of property sale. These include prorated taxes, buyer discount points and property repairs. While other agencies and insurers may implicitly provide the same level of debt relief, HUD has a unique approach of giving some cash to borrowers so they can actively assist in the process of selling or transferring the home. FHA then avoids the private insurer problem of gaining initial cooperation from the borrower.

At the same time, FHA discourages foreclosures by making them costly to servicers. FHA will only repay servicers for two-thirds of out-of-pocket costs (attorneys, title searches, court costs, etc.), and does not fully reimburse interest costs paid by the servicer through Ginnie Mae on securitized loans.[91] The attempt to overcome the agency problem by making servicers bear a portion of the foreclosure costs did not work for FHA in the past because the only viable alternative to foreclosure was assigning loans to HUD. Assignment acceptances were out of the control of servicers and in the hands of HUD field offices.[92] This should change as servicers are given more responsibility and are held more accountable for promoting loss mitigation and foreclosure avoidance.

Wrap-Up

There is no one right way for all credit-risk-bearing agencies to manage servicer performance. All approaches, however, include at least one of these essential elements in the process: training servicer personnel, making financial incentives to mitigate *agency* problems, giving borrowers incentives to quickly cooperate with servicers, and providing workout counselors who can mediate between servicer and borrower when that relationship is strained or not functional. The innovations introduced since 1986 are all valuable, and each is bearing fruit. One reason each agency and insurer can successfully specialize in one or two facets of the process

[91]FHA does, however, reimburse all expenses if the loan is assigned to HUD.

[92]Issues surrounding HUD assignments are discussed in chapter 5.

is that servicers interact with many or all of them and learn from each type of relationship. Specialization in the secondary market may then serve to increase the efficiency of the overall mortgage-market's program of providing alternatives to foreclosure.

The lines of demarcation between Classes are not solid. For example, VA allows servicers to establish forbearances without their approval, a Class III characteristic. MGIC will, when necessary, allow its counselors to step in and mediate problems between servicers and borrowers, a Class II attribute. General Electric Mortgage relies more and more on major servicers to perform comprehensive pre-screening of workout proposals before submitting them to its in-house staff, giving them a stake in Class I type efforts. Detailed data on the value of each approach and each borrower option is generally not available today. Many organizations just started collecting data on servicer use of workouts in 1992, and all are still refining their data collection efforts to better understand these issues. Although it will be a number of years before the industry fully understands the costs and benefits of the various facets of servicer relations, the commitment to understanding the many dimensions of loss mitigation and foreclosure prevention is clearly there. Thus the innovations spoken of here should lead to more innovations and new approaches to servicer relations in the near future.[93]

The largest strides made over the past 5 years have been in identifying profiles of the types of borrowers that can benefit from each type of workout (see Chapter 3). Presently, insurers and guarantee agencies are working to teach servicers to think about workouts as good things for all parties involved. The next step should be to take borrowers fitting each workout profile and attempt to rank them according to their perceived chances of success. Only then can the system maximize net social benefits from having workout programs by expanding the pool of troubled homeowners who can avoid foreclosure while enhancing industry profits in the process.

4.3 The Servicer Perspective

The first sections of this chapter dealt with insurer and credit-agency perspectives on motivating servicers to protect their interests. Now we turn to the servicer perspective on the flexibility granted to them to provide

[93]One exception among the seven agencies and insurers contacted for this study is United Guaranty Residential Insurance Corp. They have a system that provides a good understanding of the success probabilities of various workout offers and the resulting cost effectiveness of its workout staff. Servicers also report that they keep very close track of the resolution of all delinquencies. Some have even been thinking about the break-even success probabilities outlined in chapter 3 (see Whitacre, 1991). The research community is likewise just beginning to focus on this issue. Clauretie (1987) was an early advocate of such research, and Ambrose and Capone (1993) may have been the first to systematically look at the issue of to what extent it is profitable to extend workout offers to defaulted borrowers.

workout options for troubled borrowers. The MBA solicited input for this study from 10 member firms whose serviced portfolios range from $50 million to $24 billion. Some are subsidiaries of depository institutions, while others are traditional mortgage bankers that only service loans owned by other investors. Many of these have successfully implemented their own workout departments. In addition to these members of the MBA, input was received from a savings bank turned mortgage banker ($1 billion in portfolio loans and $4 billion in loans serviced for others), and a traditional community lender originating loans only for portfolio.[94] The following is a compilation of information received from these twelve firms.

Borrower Responsiveness

Servicers have found borrowers to be fairly responsive to their counseling efforts. They report that making telephone contact and establishing a one-on-one rapport garners much better response than just mailing form letters. During the first stages of contact, the servicer is trying to understand what the borrower wants to do (stay or leave the house) and what resources are available for self-curing the loan. Once the delinquency progresses past day 90, and workout options are explored, from 65-90 percent of borrowers still in arrears cooperate in finding a solution. The two most commonly mentioned reasons for noncooperation were lack of financial hardship--shown in refusal to complete financial worksheet--and hostile divorces. Servicers believe that they, in tandem with the insurers and credit agencies, have developed workout approaches to a level where they can discern between borrowers with real hardships and those without them nearly 90 percent of the time. Approximately 5 percent of those who eventually receive workout offers refuse them because they want more assistance than the insurer is willing to offer.

Insurer and Guarantee Agency Standards

All servicer respondents indicated that there exists no *agency* problem in their relationships with insurers because they approach workout operations from the perspective of a portfolio lender. Indeed, the line between servicer and lender is blurred today by depository institutions that maintain mortgage bank subsidiaries. Their servicing portfolios are often larger than their investment portfolio, and they claim to treat all defaults alike. Some go so far as to submit workout proposals they believe are sound, even knowing that they will likely be rejected by the insurer/guarantor. In the

[94] In the course of research for this study, HUD solicited input from trade groups representing portfolio lenders with community-banking mandates. Unfortunately, they were not able to provide information that would make it possible to discern any differences in approaches they use from those used by traditional mortgage bankers who do not bear the credit risk of holding whole loans.

past few years insurers have been encouraging servicers to submit any proposal they deem prudent, without regard to chances of an ultimate approval. That is, it is made plain to them that the approval level will not be a factor in future business relationships. However, servicers tend to see the insurers as having very high thresholds for approval, on the order of an expected success probability of 75 percent or more. They say this because of intense scrutiny given to workout applications, even after servicers have completely reviewed the borrowers' financial situations. Such scrutiny on the part of HUD effectively shutdown the FHA forbearance program because the lack of sufficient processing staff created fatal delays. Recently updated regulations have now removed that restriction.

Servicers believe that the industry is converging in terms of profiles of successful applicants for workouts. Eight of the ten firms in our survey agree that insurers now have similar criteria for the types of borrowers they will extend workouts to, and all agree that the credit agencies--Fannie Mae and Freddie Mac--readily sign off on recommendations approved by insurers.

Success Rates

Servicers view insurer/guarantor required success rates as being above 75 percent, but they report an 85 percent success rate in practice. This suggests that the secondary market is extremely risk averse in their application of looking for a "reasonable" chance of success from each workout offer.

The largest number of failed workout attempts comes from preforeclosure sales. These appear to account for around 50 percent of all industry workouts and 75 percent of all workout failures. Their success rate is then between 75 and 80 percent, and the success rate for other workout options (forbearances, deeds-in-lieu, loan modifications) is between 90 and 95 percent.[95] The most common reasons given for preforeclosure sale failures are buyers either withdrawing offers due to approval delays or being unable to qualify for financing. Approval delays are most prominent with FHA-insured loans because of the inexperience and lack of personnel in HUD field offices. This is an issue that must be resolved before the program goes national. Failures in other types of workouts are generally attributed to borrowers wanting more assistance than the insurer is willing to offer.[96]

[95]If 75 percent of all failures are preforeclosure sales, and total failures are 15 percent of all workouts, then failed preforeclosure sales are 0.75*0.15 = 11.25 percent of all workout attempts. Because only 50 percent of workout attempts are preforeclosure sales, the conditional failure rate is then 11.25/50 = 22.5 percent, yielding a preforeclosure sale success rate of 77.5 percent. The calculation for the success rate of all other workout attempts is analogous.

[96]One servicer distinguished between "reasonable" and "unreasonable" offers by borrowers. Presumably, unreasonable ones are from borrowers who want more help than the servicer would recommend to the insurer. They

Current Bottlenecks

As the front-line defense against default and foreclosure, servicers must deal with delays on two fronts: borrower submissions and insurer/agency approvals. They report that delays with borrowers occur in cases where there is no cooperation until foreclosure has been initiated. The worst problems occur when borrowers seek legal counsel, and that counsel advises them not to cooperate. These cases generally result in bankruptcy filings immediately preceding foreclosure sales, adding more legal and interest expense to the outstanding debt, and making it more difficult--and less desirable--for borrowers to reinstate. In most cases of borrower default it is possible for the servicer to petition the court for release from the stay on collections and proceed with foreclosure.[97] So borrowers who refuse to cooperate only make matters worse for themselves as well as increase costs of mortgage credit to others. Many servicers and insurers indicated that attorneys advertising debt consolidation often mean only to take households into bankruptcy.

Delays in the responses of insurers and agencies appear only to be a significant problem with preforeclosure sales. Potential buyers want quick responses to their bids while approval can take up to 30 days or more. This is especially true when the purchase offer includes an assumption or assumption/ modification which complicates the approval process.

There is also indication from servicers that delays in HUD processing of assignment applications lessens the likelihood of success. In those HUD field offices where approval can take up to 6 months, the borrower's balance of unpaid interest and escrow items can be escalating even before a forbearance agreement is in place. The greater the accumulated deficiency, the less the likelihood of a timely and complete reinstatement. This problem is one of the reasons for the current move toward servicer processing of FHA borrower relief applications.

indicated that, in their experience, 50 percent of borrower offers are reasonable, and of those proposals the insurer approval level is around 90 percent.

[97]While there are broad grounds for continuing to process foreclosures when borrowers have sought bankruptcy protection (see chapter 6), the success in receiving a release from the bankruptcy stay on collections varies among district bankruptcy courts.

The Portfolio Perspective

The term *portfolio lender* does not have the same meaning it did 10 or 20 years ago. As discussed in Chapter 3, the increased use of loan securitization has led to a majority of depository institutions separating their operations so that servicing departments handle both loans held in portfolio and those sold into the secondary market. Research by Edmister (1991) suggests that savings banks are using their deposit base and capital to finance lending for loans that do not conform to Fannie Mae and Freddie Mac underwriting criteria, while selling their conforming loan products into the secondary market. They tend to require higher downpayments on the more risky nonconforming loans in order to reduce potential losses from default. Edmister's work, based on 1990 servicing portfolios of savings banks, showed delinquency rates that were almost identical for conforming and nonconforming products.[98] Given that the nonconforming product had much lower loan-to-value ratios, this confirms that community lenders use their portfolio operations to make loans available to households with credit problems unacceptable to the conforming loan market.

The ease or difficulty of reclaiming a property through foreclosure does affect the availability of private (not government insured) credit. In those States with lengthy and/or costly foreclosure processes, portfolio lenders are not as lenient toward borrowers with existing credit deficiencies in making mortgage loans. Such marginal borrowers will be required to have larger down payments and likely face higher interest rates in States with costly foreclosure processes. State legislatures ostensibly are protecting these borrowers by giving them many opportunities to cure defaults before foreclosure, but they make it more difficult for these borrowers to attain homeownership because of the more stringent credit standards that result to protect lender interests. Those households that are able to secure mortgage funds will most likely have to use an FHA program to insure the lender against possible default costs. Because FHA is designed for higher-risk participants it has significant protections against foreclosure. State foreclosure laws are covered more completely in Chapter 6.

Portfolio lenders are more apt to take a hard line with borrowers to attempt to force reinstatement when the borrower is not suffering from a genuine hardship. Their experience has shown that borrowers with initial credit blemishes are more likely to have repeated delinquencies, and will take advantage of any softness they sense in their friendly community banker. This clientele does not have as high a regard for credit ratings, and will therefore be more ruthless in allowing foreclosure if it is in their immediate financial interest.[99] These considerations generally mean that lenders

[98]The number of foreclosed properties was so small as to lack any statistical significance.

[99]That is, foreclosure occurs when the costs of curing the loans exceeds moving costs. This causes lenders to put

initiate foreclosures at 90 days delinquency and make potential deficiency judgments and/or tax liabilities very clear to borrowers. Experience from the oil patch bust of the mid 1980s showed many that, if they do not take a hard line, they can be made insolvent by borrowers wishing to rid themselves of property with negative equity. In particular, this means deeds-in-lieu of foreclosure are to be avoided except in dire situations.[100] Taking a hard stance is easier when the property is in the same town as the lender. Then it is easier to monitor property value and know the true circumstances of the borrower. So the community banker does not have to be quite as sophisticated as the national servicer in the process of acquiring information and discerning the true hardship cases from those looking for an easy out.

Future Options

What changes would servicers like to see in the processing of workouts? The information we received suggests that better access to loan modifications is a top priority. The universal role of loan securitization has made modification difficult in most circumstances. Yet modifying loan terms is the least costly of all workout alternatives, and it can help a sizeable percentage of defaulted borrowers. At present, private insurers are eager to see modifications when borrower circumstances warrant them. Fannie Mae is very responsive to servicer requests to buy loans out of securitized pools. Fannie Mae will then repurchase the modified loans to place in their own portfolio.[101] Freddie Mac has now released guidelines that will make modifications more readily available for loans in its securitized pools.[102] Upon servicer recommendation, and with Freddie Mac concurrence, Freddie Mac will make a direct purchase of a loan from a security pool to have it modified and hold it in portfolio. VA will buy loans out of Ginnie Mae pools and modify them when the borrower cannot reinstate but can resume contractual payments. FHA's current policy is to allow servicers to buy loans out of Ginnie Mae pools for modification, but it does not have authority to pay insurance claims to then repurchase them for its own portfolio. Therefore, modifications for FHA loans are very rare.

The argument against modifications and interest rate reductions is that

more effort into loan management at the start of delinquency than is necessary for higher-quality conforming loans.

[100]Even Fannie Mae and Freddie Mac will generally only take deeds-in-lieu when there has been a failed attempt at selling the property.

[101]Fannie did tighten eligibility requirements in early 1995 to exclude mortgages on second homes or investor-owned properties. Experience with modifying these loans was less than satisfactory.

[102]See *Freddie Mac Bulletin* 94-13, September 15, 1994.

nonperforming loans should not be given special privileges not available to performing loans. This is a difficult issue for both servicers and insurers: loss mitigation procedures favor modifications, while fairness considerations do not. Mortgage firms walk a fine line with defaulted borrowers because they want to reinstate the loan, but not be so generous that there develops a moral hazard of increasing default rates as a result. That is why they place primary emphasis on verifying borrower hardship before offering foreclosure alternatives.

HUD has an additional, statutory hurdle for borrowers seeking relief, namely circumstances-beyond-the-borrower's-control. It involves the same tension between fairness among borrowers and loss mitigation considerations. Fairness suggests that only those having unfortunate circumstances thrust upon them should receive workout assistance, whereas loss mitigation criteria would have one proceed regardless of the circumstances. The crucial element for the interests of the insurer is whether or not the borrower is cooperative and has the desire to make the deal work. The typical case of a borrower bringing default on him or herself is where the household has too much debt. There are some in the mortgage industry who will go so far as to perform a debt consolidation refinancing to help these borrowers when there is enough equity in the property to protect their interests. Unfortunately, it is often the case that borrowers in this position have multiple subordinate liens on their properties, making it more difficult for the mortgage holder to assist them and still maintain the first-lien status of the mortgage loan.

Chapter 5

Federal Mortgage Insurance Through the Federal Housing Administration and the Department of Veterans Affairs Mortgage Guaranty Service

FHA single-family insurance began as part of a Roosevelt-era program to reinvigorate a depressed national housing market, while the VA mortgage guaranty for veterans and active duty military personnel arose from the need to assist the transition of military personnel to civilian life following World War II.[103] HUD has a Congressional mandate to assist low- and moderate-income families gain decent housing, which has led to progressively lower down payment requirements on FHA loans to home buyers. VA has maintained a popular zero down payment option where sellers finance the interest rate discount points charged by lenders on VA loans.[104,105]

Today, the FHA and VA mortgage insurance programs both maintain portfolios of loans that are at greater risk of default and foreclosure than those in the private market. Figure 5.1 compares FHA and VA foreclosure processing rates with those of the conventional (not government insured) market. Both delinquency and in-foreclosure rates are generally twice as high for FHA and VA loans as for conventional ones.[106]

[103]See Fisher and Rapkin (1956) for a complete discussion of the early development of the FHA insurance program authorized under Section 203 of the National Housing Act of 1934. The VA mortgage guaranty was authorized in the Servicemen's Readjustment Act of 1944 (38 USC 1801).

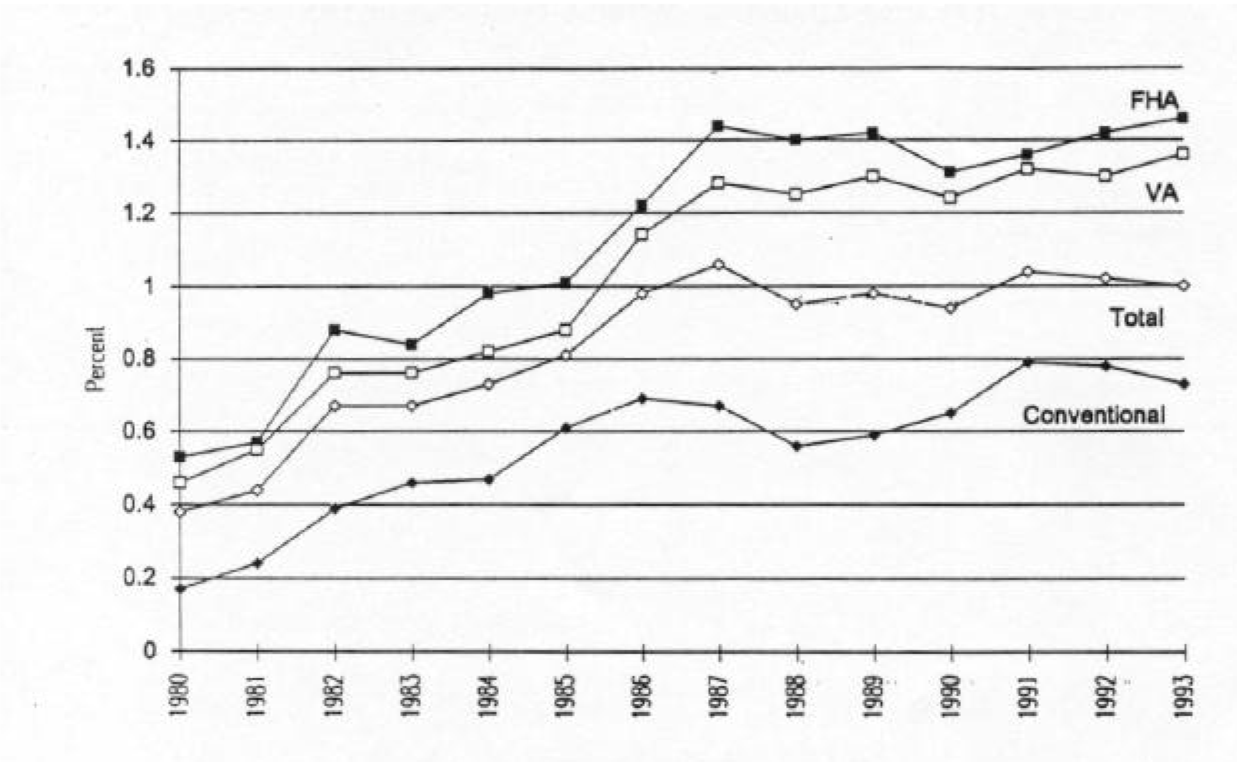
[104]In fiscal year 1993, 84 percent of VA loan originations had no downpayments.

[105]The Veterans Home Loan Program Amendments of 1992 (106 Stat. 3633) allow for a three year demonstration of market interest rates with negotiable discounts that can be paid by the veteran borrower.

[106]This relationship began in the early 1960s (see Herzog and Earley, 1970, Chart 6) when FHA loan-to-value ratios began to rise considerably. In 1960 the average loan-to-value of FHA endorsements first exceeded 90 percent. It stayed near 93 percent until 1990 and then moved above 95 percent. Debt ratios on conventional loans, however, have remained close to 75 percent on average.

Figure 5.1

Percent of Outstanding Loans in Foreclosure Processing



Source: Mortgage Bankers Association National Delinquency Surveys, fourth quarter of each year.

This chapter explores ways in which these two Federal agencies have dealt with their social roles of assisting borrowers who have trouble maintaining their mortgages, while still providing for prudent management of the inherent risks. Primary emphasis here is on HUD and FHA because the mandate for this report specifically calls for an accounting of what HUD is doing to assist borrowers in default who are unable to resolve problems on their own.

5.1 The Department of Housing and Urban Development, Federal Housing Administration

HUD has passed through two distinct epochs with respect to foreclosure avoidance. Until 1976 HUD maintained a hands-off approach to defaults and foreclosures, effectively leaving policy decisions to each individual mortgagee. Since that time HUD has operated a program whereby it takes assignment of qualifying loans in default and provides direct servicing and forbearances. Now, in the spirit of reinventing government, HUD is committed to developing a modern loss-mitigation program that is customer friendly, utilizes the strengths of partner agencies and organizations, and attempts to use most efficiently the limited resources of a budget constrained era. This chapter chronicles the history of HUD programs, their current status, and the important strides being taken to create a modern loss-mitigation program within FHA.

Borrower Foreclosure Relief

The National Housing Act, as amended, provides HUD with authority to offer four specific types of relief to borrowers in default (see 12 USC 1715u and 12 USC 1710(a)). These are Temporary Mortgage Assistance Payments, mortgage assignment, lender forbearance, and preforeclosure sales.[107] The essential problem facing HUD here is twofold. First, by narrowly defining what it can do, the statutes preclude other possibilities. Second, judicial rulings over HUD sponsorship of relief have limited HUD's discretion even in the use of statutory programs.

By way of background, loan assignment occurs when HUD agrees to buy a nonperforming loan from its current holders with the explicit purpose of providing a period of forbearance until the borrower's circumstances

[107] A fifth that is not under the auspices of HUD's insurance funds and that would require Congressional appropriations to implement involves conventional mortgages. It is direct insurance of forbearances made by lenders to defaulted borrowers as authorized in the Emergency Homeowners' Relief Act of 1975 (89 Stat 249). The Act would also permit HUD to make direct forbearance loans to borrowers, a provision which now exists for FHA loans in the Temporary Mortgage Assistance Program (TMAP). At present, HUD only insures lenders against failure of good-faith forbearances on FHA-insured loans.

improve. This and HUD-supported lender forbearances were first permitted in 1959 and made effective through regulations issued in late 1964. TMAP was designed by HUD in the late 1970s to allow a period of government-sponsored forbearances without having actually to buy loans to hold in portfolio. Under TMAP, HUD would forward monthly forbearance amounts to each borrower's loan servicer and place a lien on the property to secure future repayment. TMAP was enacted by Congress in 1980, but implementation of the program was thwarted by continuing litigation over what HUD should be doing to assist borrowers in default.

History of FHA Programs

In the early FHA program a mortgagee Guidebook was provided to instruct servicers on how to avoid foreclosure. Its provisions, however, were merely suggestions and without the force of law.[108] Servicers were expected to follow "acceptable mortgage practices of prudent lending institutions." Yet, as discussed in chapter 3, this typically meant turning over 90-day delinquent accounts to attorneys for collection or foreclosure. This became a more severe problem when HUD began to actively promote low-income housing in the 1960s.

While conventional delinquency and foreclosure rates remained fairly constant throughout the 1960s, those for FHA loans more than tripled. The rapid rise in FHA foreclosures was a product of higher loan-to-value ratios and fraud and abuse in the low-income insurance programs operating under sections 221(d)(2) and 235 of the National Housing Act. The abuse arose because, in attempts to protect the homebuyer, first Congress then HUD itself after 1968, mandated interest rate ceilings on FHA loans. This led to a system of lenders charging fairly steep loan origination fees (known as discount points) to obtain their required interest rate yields.[109] If the loan was paid-off early, these up-front charges became extra profits for the lenders. One way to force early payoff was to make loans to individuals who could not afford them. HUD would pay for all subsequent foreclosure expenses, including interest payments during the time of delinquency, allowing unscrupulous lenders to earn easy profits.[110]

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[108] The final in this series was the *HUD Guidebook, Administration of Insured Mortgages,* FHA G 4015.9 (1970). In 1974 this became Handbook 4191.1 and then carried the force of regulation. Still, language on foreclosure avoidance in that first handbook was not obligatory.

[109] Interest rate ceiling provisions found in Section 315 of the National Housing Act (12 U.S.C. ' 1709-1) were repealed in Section 404 of the Housing and Urban Recovery Act of 1983 (97 Stat 1208, 1983).

[110] See Wilson, Jr., Harry B., "Exploiting the Home-Buying Poor: A Case Study of Abuse of the National Housing Act," *Saint Louis University Law Journal* 17 (1973):525-571. To maintain the affordability of homes with FHA insurance, discount points were to be paid by the sellers of homes, but it has always been well known that these affect buyers through higher purchase prices. The abuse extended beyond loan brokers (acting as agents for lenders) and mortgage companies

Until this time, little attention had been given by HUD to the plight of low-income homeowners. FHA's charter established an insurance operation to assist the housing construction industry and to provide a viable market for moderate-and middle-income mortgage loans by protecting lender interests. The lenders, who at that time were also the loan servicers even if they sold their investment interests in loans, were trusted with prudent underwriting and default management.

The issue of HUD's continued responsibility to families relying on its mortgage insurance programs to make them homeowners surfaced in the courts in the 1960s, and it came to a head in the case of *Brown v. Lynn* (385 Fed. Supp. 986 (1974); 392 Fed. Supp. 559 (1975)). The District Court considered recent rulings holding the Secretary liable for fulfilling Congressional mandates, and allowed the suit on the grounds that the National Housing Act provides for the Secretary to be sued for violation of duty under provisions of the Act (12 U.S.C.A. ' 1702).[111]

The courts did not hold loan servicers liable for any damages caused by not following voluntary mortgagor relief provisions of the HUD Guidebook, but did find HUD liable for not making the relief mandatory. In *Brown*, the Court reasoned that HUD's policies of accepting foreclosures rather than overseeing loan workout schemes was in direct violation of its National Housing Act charter "to facilitate progress in providing decent homes, suitable living environments, and properly developed communities." The Court ruled that HUD was engaged in statutory programs designed to assist low-income homeownership, and thus it was responsible for continued assistance to those families over time. The participants in FHA insurance programs were deemed to have "protected interests" under the National Housing Act and as such were judged to have been wrongfully deprived of their homes by the (in)actions of HUD officials.[112]

In 1976 HUD signed a settlement that set forth loan assignment as the principal means of foreclosure relief. It would require that servicers not initiate foreclosure until HUD had an opportunity to judge the merits of each case for assignment. This was approved by the Court on July 29,

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to realtors and home builders selling substandard homes. This led to HUD's suspension of subsidized single-family insurance programs in January 1973.

[111]See especially *Commonwealth of Pennsylvania v. Lynn*, 501 Fed. 2d. 848,855 (1974), which relies on other Court rulings in 1970 and 1971.

[112]Here the Court relied on the precedent from the Appeals Court decision in *Davis v. Romney*, 490 Fed.2d, 1360 (1974), which established that participants in subsidized housing programs are protected parties under the Housing Act.

1976. While HUD officials were not pleased with the assignment approach, they saw it as the best immediate solution. The assignment program put HUD in the position of becoming a major mortgage servicer, something it was not equipped to do. However, the alternative was to enforce lender forbearance periods. That was seen as an unacceptable alternative because typical repayment plans called for borrowers making one and one-half payments per month to catch up. Such large payment increases for already financially strapped households would inevitably cause many secondary defaults and eventual foreclosures.

In the meantime, the plaintiffs in the *Brown* case, now known as the *Ferrell* case, brought charges of contempt against HUD because of inconsistent application of assignment program entry criteria across field offices.[113] HUD headquarters admitted to problems in obtaining program uniformity and entered into an Amended Stipulation in 1979. This new consent decree had three essential changes:

- HUD would reprocess all cases rejected during the time the initial consent decree was in effect (except for two field offices where proper program administration was documented).
- HUD would operate the assignment program in compliance with its new Handbook 4191.2 (January 1979) without "any modification which would curtail the basic rights of mortgagors under the program" for 5 years.
- After the 5 year period, HUD would operate either "the present assignment program or an equivalent substitute to permit mortgagors in default on their mortgages to avoid foreclosure and retain their homes during periods of temporary financial distress."

TMAP

Recognizing the need to study alternative forms of providing borrower relief, HUD's Office of Policy Development & Research, in 1975, initiated a contract to study the costs and benefits of alternative approaches to borrower relief. Out of this effort came a demonstration of a Protective Insurance Payments (PIP) program from May 1976 to October 1979.[114] PIP

[113]Along with the changing of plaintiffs named in the class-action suit, the HUD secretaries also changed. The case has been known, at various times, as *Ferrell v. Hills*, *Ferrell vs. Harris*, *Ferrell v. Landrieu* and, finally, *Ferrell v. Pierce*.

[114]The final report can be found in BE&C Engineers, Inc. (1980).

was designed so that HUD would make partial mortgage payments to servicers on behalf of borrowers with income reductions. At the end of the forbearance period, all arrearages and the PIP payments would be recast into a second mortgage with payments tailored to individual abilities to pay. The success of this demonstration led to the enactment of TMAP in 1980.[115] TMAP was enacted in Section 341 of the Housing and Community Development Act of 1980, amending 12 USC 1715u.[116] It was designed to save HUD the expense of paying full insurance claims to lenders and having to service the loans, as it must do with loan assignment. Under TMAP, HUD would cure each loan by paying lenders advance claims in the amounts of the delinquencies, and would then make monthly assistance payments, where needed, directly to servicers. According to the enacted legislation, defaulted borrowers would first be screened for TMAP eligibility, then those deemed ineligible would be further screened for assignment eligibility. The forbearance available to borrowers would have been essentially the same under either program, but under TMAP both private servicers and investors would retain their positions with regard to the mortgages.

The District Court denied a motion by HUD to modify the Amended Stipulation based on the 1980 statute giving authority for TMAP as the primary form of borrower relief. It ruled that the 1980 statute did not override the 1979 decree, but that HUD's proposed TMAP regulations did violate that Amended Stipulation (see *Ferrell v. Pierce* (560 Fed. Supp. 1344 (1983)).[117]

The essence of the matter for the Courts was that HUD was proposing to implement TMAP in such a way as to lessen the effective relief provided to distressed homeowners below that provided in the Amended Stipulation

[115]The demonstration was restricted to unemployed borrowers in three sites. It conclusively found that PIP/TMAP was less costly to HUD than assignment, with equivalent forbearance amounts. The demonstration benefit period, however, was restricted to 9 months plus an initial 3 months from the lender for a total of 12 months. It was found that borrowers generally did not enter default until at least 6 months after loss of employment. Thus the program provided a minimum 18 months to regain employment. Nearly all of those that did regain employment in this time were able to pay off their PIP/TMAP loan in under 5 years while their first mortgage continuously amortized during the entire period. With assignment, by contrast, the first mortgage stops amortizing from the date of default until all arrearages and forbearances are paid off, which could be many years. This is discussed in more detail later in this chapter.

[116]The statute also codified certain of the assignment program regulations, the most important of which was the circumstances-beyond-borrower's-control criteria for foreclosure relief. While this eligibility criterion is meant to safeguard the system from abuse, it provides no discretion for the Secretary. It effectively prevents HUD from offering help to borrowers who cause their own problems but who are repentant and willing to work out a solution.

[117]HUD appealed, but the 7th Circuit Court of Appeals upheld the District Court ruling in 743 Fed. Rep., 2nd, 454 (1984).

and under the existing assignment program. Borrowers would not be offered assignment unless they were first denied TMAP, and TMAP could mean higher interest rates on accruals and less generous repayment schedules. Thus the proposed regulations would not preserve plaintiff class "basic rights" under the Amended Stipulation. The TMAP program would therefore not be an "equivalent substitute" as required by the Amended Stipulation to which HUD had agreed in 1979.

The equivalency doctrine enunciated in *Ferrell v. Pierce* meant that regulations implementing the legislation would have to provide the same level of monthly payments and level of forbearance accruals to borrowers as did the existing assignment program.[118] Indeed, any new mortgagor assistance program proposed by HUD would have to be as nearly identical as possible to mortgage assignment in every way in which it had an effect on borrower forbearances and monthly payments. Though this ruling was predicated on paragraph 3 of the Amended Stipulation, it was not just a provision for the term of that decree (which expired in 1984). The Court recognized that the consent decree included a lasting constraint on the Department in paragraph 14:

> The termination of the Department's specific obligations under this Amended Stipulation shall not diminish or compromise the Department's obligation construed under the National Housing Act as amended … to provide foreclosure avoidance relief for mortgagors in temporary financial distress, and the Department shall provide assistance or relief in the form of the present assignment program **or an equivalent substitute** to permit mortgagors in default on their mortgages to avoid foreclosure and to retain their homes during periods of temporary financial distress. (emphasis added)

In defining equivalency in terms of monthly payment schedules the Court wanted to force HUD to provide "quality relief." Unfortunately, the performance of the assigned portfolio suggests that this has not been the result. While borrowers have avoided immediate foreclosure, 70 percent of them have never recovered to the point where they could pay off their mortgages and accumulated forbearance debts.[119]

[118]Judge Will wrote at one point that he was "satisfied that Congress…did not intend the amendments [of the 1980 legislation] to supersede the Amended Stipulation's requirement that HUD continue to provide relief "equivalent" to the mortgage assignment program."

[119]The equivalency doctrine enunciated in *Ferrell* was not anticipated by HUD. In his earlier *Brown* ruling, Judge Will made it clear that his concern was that HUD require mortgagees to use the tools at their disposal to avoid foreclosure, where assignment was the last option and therefore the one which would be used least often. The original issue was, therefore, maintaining homeownership and not treating all defaulted borrowers the same.

Disposition of Loans in 90-day Default

Before discussing the details of the assignment program itself, let us take a look at what currently happens to FHA loans that reach the point of 90-day delinquency.

Table 5.1 provides data on all FHA insured single-family loans that became 90-days delinquent in calendar years 1991-1993. The numbers shown in Table 5.1 are not completely independent of one another. Of the nearly 900,000 defaults reported in that period, only 450,000 -- roughly half -- were single entries; another 20 percent represent borrowers who defaulted 2 to 4 times; and the remaining 30 percent are from borrowers who, in that 3-year period, defaulted, on average, more than 6 times. So these 900,000 defaults represent only 555,000 borrowers.

Around 60 percent of these defaults were cured and the borrowers are now current on their obligations. Another 6 percent had the equity and/or cash necessary to sell their properties. The last set of columns in Table 5.1 highlight the present situation of borrowers who remain active but troubled. The trend here appears to be that a significant number of these borrowers seek Bankruptcy Court protection as other options are closed off. Many of these cases still end in foreclosure.[120] The point to note here is that loan assignment provides relief for only a small percentage of borrowers who cannot cure their deficiencies, but it has been the only viable option used for assisting those in default. When the borrower does not meet the stringent entry requirements for loan assignment, bankruptcy becomes the only means of gaining time for solving financial problems. Among borrowers defaulting in 1993, nearly 28 percent (4,000) more were under bankruptcy court protection in mid 1994 than had been admitted into the assigned portfolio.

Assignment

Before a servicer can initiate foreclosure against a borrower, that borrower is given the opportunity to petition HUD to take assignment (ownership) of the loan and provide forbearance. To do this HUD pays a full insurance claim to the note holder--outstanding principal, accrued interest, and other servicer costs.[121] Once HUD accepts an assignment it becomes a traditional portfolio lender, both financing and servicing the loan. The difference of

[120]Unfortunately, many of these borrowers use bankruptcy filings to stall inevitable foreclosures. See chapter 6 for a description of the role of bankruptcy law in mortgage foreclosure.

[121]See HUD Handbook 4330.4(1992), Chap. 3, for a complete discussion of claim payment on assigned loans.

course is that these are troubled loans, and servicing them is a very labor-intensive process.

What HUD does know so far about those that enter assignment is not good. Recent estimates show that only about 30 percent of defaulted loans coming into this portfolio come out whole. Most of the remainder are foreclosed on: 17 percent within 3 years, another 25 percent before 6 years have elapsed, and another 8 percent after that. The costs of supporting borrowers making partial or no payments for 3 years and more, combined with the

Table 5.1

Current Status of Past Defaults by Calendar Year of Default[a]

as of May 31, 1994

Present Status	All Defaults[b]			Loans Active But Not Cured[c]		
	1991	1992	1993	1991	1992	1993
number (percent)	297,238 (4.2%)	308,214 (4.2%)	275,992 (3.9%)	9,193	19,546	57,546
reinstated	65.4%	60.8%	56.6%			
property sold[d]	6.5	6.6	5.6			
deed-in-lieu	0.3	0.3	0.3			
delinquent over 90 days	0.4	1.0	7.5	13.7%	15.4%	35.9%
loan assigned to HUD	2.6	4.6	5.2			
bankruptcy[e]	1.9	3.6	6.7	62.3	56.4	32.1
foreclosure in process	0.7	1.8	6.7	24.0	28.2	32.1
foreclosure completed	22.1	18.5	11.4			

[a]The exact number of separate loans involved is estimated at 557,000. The Single Family Default Monitoring System generates status reports by calendar year rather than fiscal year.

[b]Defaults are defined here, as throughout the report, as loans reported as 90-days delinquent. There are, however, some servicers that report defaults at 60-days delinquency and these will be mixed in here. [c]This includes defaulted loans that cured and subsequently defaulted again.

[d]properties sold includes loan assumptions. These are less than 10 percent of the totals reported in this row.

[e]These numbers are estimates based on relationships found in a special report generated 1 year earlier (same time lags used here).

Source: U.S. Department of Housing and Urban Development, Single Family Default Monitoring System high foreclosure rate over time, means that assignment, as it is now designed, is not a cost saving program. There is no "break-even" success rate here as there are with other foreclosure avoidance measures. This raises the question of the cost effectiveness of this form of assisting families with their housing needs versus other types of programs, including helping some to transition to more affordable residences.

To understand why loan assignment has failed to assist many troubled borrowers requires a closer look at how it functions.

How Assignment Works

After the 90th day of delinquency and before initiating foreclosure actions, the servicer must evaluate whether or not the borrower qualifies to have the loan assigned to HUD. If it chooses not to recommend assignment, it must notify the borrower that foreclosure proceedings may commence unless he/she personally applies for assignment to HUD.[122] Obviously, there is every incentive for borrowers in this position to petition HUD. Around 65 percent of borrowers facing foreclosure (those who do not cure defaults or sell homes) do petition, but historically only 22 percent of these were accepted.

Processing assignment applications is very labor intensive and, with a 22 percent overall approval rate, an expensive screening device. For the 12 month period of June 1993 through May 1994, field office staff spent 380 work years processing 62,032 requests, for an estimated personnel cost of $14.4 million.[123] The average case took over 11 hours to evaluate, at a cost of $230. The approval rate of 22 percent meant a processing cost of over $1,050 per acceptance.

The eligibility criterion for assignment has six parts, the two most critical of which are: default due to "circumstances beyond the mortgagor's control," and a "reasonable prospect" of resuming full contractual mortgage

[122]The letter used was in HUD Handbook 4330.2 REV-1 (1991), Appendix 3. All procedures and correspondences have been updated for the new Handbook 4330.02 REV-2 (1995). Borrowers are no longer required to make applications on their own.

[123]Calculated at a $20 per hour labor cost, including fringe benefits. The high labor costs include duplicate reviews by managers in order to assure compliance with eligibility criteria. The high level of scrutiny follows from the case reprocessing that was part of the 1979 Amended Stipulation. Reprocessing involves identifying and locating previous borrowers who were wrongfully denied program acceptance and either reinstating them in their former homes or providing comparable homes for them. Some field offices regularly put new applications through three complete reviews in order to protect themselves from the potential of costly and time consuming reprocessings in the future.

payments within 36 months.[124] Using circumstances-beyond-borrower-control helps to prevent abuse, but also, as seen in Table 5.1, results in a large number of borrowers resorting to the bankruptcy courts for an alternative form of assistance. On the other hand, the circumstances to be considered are only those immediately preceding the default. HUD is not allowed to consider other factors such as the borrower's previous record of defaults. In addition, the subjectivity of the reasonable prospects criterion makes it difficult to administer and leads to continued variations in acceptance rates across field offices.[125]

When evaluating petitions, HUD personnel are instructed to err in the borrower's favor. For example, a chemical or drug dependency is considered beyond the borrower's control, and cannot render them ineligible as long as there is a "reasonable prospect" of recovery in 3 years. While enrollment in a rehabilitation program can be a plus here, nonenrollment cannot be held against the applicant.[126] In addition, an unemployed individual with a good work history could meet the "reasonable prospects" criterion even if there has been a major reduction in local employment opportunities (e.g., major industrial plant closing). That is because this criterion is predicated only on the borrower's willingness and ability to work, not the local economy.

Once HUD accepts an assignment, it initiates forbearance agreements with borrowers for a 36-month period. Each agreement is for 12-month periods when at least partial payments are being made, or for just 6 months in the case of zero payments. Agreement terms are adjusted after each of these periods to reflect any changes in borrower income. When the 36-month forbearance period ends, HUD will have established a number of accounts receivable according to funds forwarded on the borrower's behalf and interest accruals. These are to be paid off within 10 years of the expiration of the original mortgage document. But payoff becomes more difficult if complete reinstatement does not occur within the first years in the portfolio. Once repayment begins, HUD attributes all payments to one receivables account until it is paid off, and then begins with the next account. The sequence is: interest on advances (taxes and other property assessments paid

[124]The four secondary criteria are lender intent to foreclose, delinquency of at least 3 months (dollar amount rather than elapsed time), mortgage on borrower's principal residence, and borrower has no other FHA-insured loans. The circumstances beyond borrower's control element was codified in the Housing and Community Development Act of 1980 as part of the TMAP legislation in Section 341.

[125]This was the primary factor leading to the Amended Stipulation consent decree of 1979. The continued persistence of these discrepancies over time, combined with the increasing sophistication of private loan servicers in workout plans, led to HUD's transfer of primary responsibility for application screening to the loan servicers.

[126]See U.S. Department of HUD (1991, p. 2-6, 2-9).

on borrower's behalf), the advances themselves, late penalties issued by the original lender, accrued mortgage interest, current mortgage interest, then mortgage principal. Mortgage interest continues to accrue on the outstanding loan balance at the time of assignment until amortization of principal begins.[127]

For a borrower who has made less than full payments for 3 years, it is difficult to ever completely pay off accrued interest and the outstanding loan balance without substantial payment increases. Those who are diligently making monthly payments on their accumulated forbearances can easily be discouraged by seeing no amortization of loan principal year after year.

Table 5.2 highlights how serious this is. A borrower receiving a typical forbearance rate of around 25 percent for 3 years will have difficulty repaying their mortgage loan in the 40 years allowed by the program (the remaining mortgage term plus 10 years). In this example, the borrower initially stopped amortizing the underlying principal at the end of year 5, and so has 25 years of principal payments remaining. If they start to make full mortgage payments again in year 9, they do not begin principal amortization again until year 24, leaving only 16 years to pay off the underlying loan. So this borrower can go for up to 18 years without seeing any amortization of the underlying principal balance of the loan. Anecdotal evidence suggests that this is an important reason for foreclosures of loans in the portfolio for more than 4 or 5 years: they give up hope of ever paying off their original mortgage loan.

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[127]This system of "vertical" payment applications was introduced in 1983 with the Single Family Mortgage Notes System. When HUD began loan servicing in the early 1970s, it was primarily for purchase-money mortgages issued to finance the sale of homes in the HUD-held post-foreclosure inventory. The accounting system was an industry standard "horizontal" system where monthly payments were distributed across all categories -- escrow, interest, and principal. But with the advent of the court consent decree involving mortgage assignment in 1976, assigned notes quickly made up nearly 80 percent of the portfolio. An audit performed by GAO in 1979 (FGMSD-79-41) warned that using a horizontal payment application system for these loans risked HUD not collecting on tax advances, and it violated the U.S. Rule, which dictates that interest accruals be completely met before any payment dollars could be applied to principal amortization. This Rule was established in early U.S. case law culminating in *Story v. Livingston* (38 US 13 Pet. 359). For Government agencies, it is now a part of the Federal Claims Collection Standards (4 CFR II 102.13(f)). In response to this audit finding, HUD developed the vertical payment application system noted here in the text. There has been some internal debate in HUD concerning the effects of this system on assigned mortgages and whether it actually increases the potential size of receivables. Analysis performed by HUD's Office of Policy Development and Research has shown the system that is better for a borrower -- horizontal or vertical -- depends on the relationship of the mortgage contract rate to prevailing interest rates at the time of assignment. In stable interest rate environments, the horizontal system, as embodied in a TMAP-type program, may be most beneficial. However, for borrowers with mortgage rates below current market rates, the vertical system embodied in the assignment accounting system is preferred. In environments where interest rates have fallen since loan origination, horizontal is again preferred but is itself overshadowed by the benefits of a complete recasting of principal and receivables into a new market-rate loan. However, the interest rate reduction must be more than 1 percent before horizontal schemes and recastings are better than the vertical system.

Once the initial 36-month forbearance period has ended, borrowers must pay at least the contractual mortgage amount, though this all goes first to pay off forbearance receivables. Field office servicers determine how much more each borrower can pay in order to amortize both receivables and the loan. Increased payments can extend until all accounts receivables are extinguished or longer if necessary to pay-off the loan within the term-plus-10-years time frame. Borrowers who do gain increases in income over time have a greater chance of fully amortizing their loans through increased payments, but then may never take advantage of the tilt factor imbedded in fixed-rate mortgage contracts.[128] The last column of Table 5.2 shows how much more quickly arrearages can be amortized when borrowers increase monthly payments by 10 percent above the contractual rate. Even then it takes 7 years for the borrower with a 25 percent forbearance to pay off arrearages and begin amortizing the loan balance.

The Department knows that it is costly to hold and service the assigned portfolio, and it is currently overseeing contracts to analyze the costs and benefits of accepting various groups of borrowers into the system. These studies will provide an intensive investigation of the workability of eligibility criteria, probabilities of successful reinstatement of loans (by type, length, and depth of forbearance), and the actuarial cost of

[128]The "tilt" of fixed-payment mortgages occurs because as borrower income increases over time, the fixed monthly payment burden becomes a smaller percent of that income. Thus default risk declines over time as discretionary income increases, making it easier to finance unforeseen events such as medical expenses and home repairs. The structure of the assignment program precludes such risk reductions for a number of years by requiring payments that are a fixed percent of income until all arrearages are repaid.

Table 5.2

Dynamics of Loan Arrearages in Assignment[a]

Depth of monthly forbearance[b]	Initial arrearage at assignment[c]	Arrearage after the 36-month forbearance period	Years of repayment at 100% of contract amount before payoff of receivables[d]	Years of repayment at 110% of contract amount before payoff of receivables[d]
10%	$ 3429	$ 4325	9	4
20		6297	13	6
25		7283	15	7
30		8269	17	8
40		10241	21	10
50		12213	25	10

[a]This case takes a 30-year fixed rate loan with an original mortgage amount of $57,000, interest rate of 10 percent, default after 5 years, then 6 months of no-payment status between default and assignment.
[b]For simplicity of analysis, this is assumed to be evenly distributed across the 36-month forbearance period. Results here are insensitive as to actual timing of the forbearance amounts.
[c]This includes back interest, taxes, and late charges but not unpaid principal. Hazard insurance is kept outside of the assignment program (HUD does not escrow for this).
[d]The total time over which loan principal has not amortized equals this amount plus the 3 year initial forbearance period and the 6 month delinquency prior to assignment.

Source: U.S. Department of Housing and Urban Development

admitting various cohorts of borrowers into the program. The U.S. General Accounting Office is performing a separate study (with HUD assistance) on the performance of loans in the portfolio.[129]

With the actual success rate in producing ultimate cures in assignment estimated at around 30 percent, and other cases building significant arrearages before foreclosure, the current program costs more than immediate foreclosure and thus cannot be considered a loss-mitigation technique for FHA. The most recent estimate developed by the Department shows that, given current probabilities of success and failure over time, the present value cost of each assigned loan is $5,600 more than a direct foreclosure. Since loss mitigation tools all cost less than foreclosure, the true cost of running the assignment program instead of other tools now common in the mortgage industry is much higher than $5,600. It could easily be over $10,000 per case. With assignments running at $15,000-16,000 per year, this adds up to $84-160 million present value cost per entry cohort.

The Dimensions of the Portfolio

In spite of the small percentage of total borrowers assisted by assignment, their absolute numbers have increased at a rapid pace over the last several years. As seen in Table 5.3, fiscal year 1992 applications increased 33 percent and acceptances rose 56 percent over their 1989-91 averages. In 1992 the dollar volume rose almost 50 percent. That same level of activity continued through fiscal year 1994. At the beginning of fiscal year 1995, there were over 82,000 mortgages in the portfolio, with a dollar volume close to $3.8 billion.[130] Details of the status of loans in the system as of July 1994 are provided in

[129]The principal HUD study involves recreating loan histories for borrowers assigned since 1984. Because the current accounting system came on line in 1983, pre-1984 data is incomplete and not considered reliable. A second study will examine differences between loans that do not apply for assignment versus those that apply and are accepted and those that apply and are not accepted. The GAO study is limited to assigned loans and records currently in the on-line system. These date back to October 1989.

[130]An additional 17,000 loans in the Secretary-held portfolio were insured under section 221(g)(4) of the National Housing Act. Such loans can be assigned by their investors to HUD in the 20th year. Assignment for them is a means of liquidating a portfolio of low interest-rate loans. These loans must be current before assignment is accepted. Including them brings the total Secretary-held single-family portfolio to 99,000 loans (July 1, 1994), with an aggregate dollar balance of close to $3.9 billion. Most of the 221(g)(4) loans have been sold off since that time.

Table 5.3

Five-Year Trend of Mortgage Assignments

Fiscal Year	Applications	Acceptances	Acceptance Rates
1989	47,818	7,943	16.6%
1990	49,049	10,523	21.0
1991	44,671	8,832	19.7
1992	61,515	14,222	23.1
1993	67,560	14,427	21.4
1994	66,360	17,590	26.5

Source: U.S. Department of Housing and Urban Development

Tables 5.4 and 5.5.[131]

To understand the risks involved in holding this portfolio, note that there are nearly 41,000 that have been in the portfolio for more than the initial 36 months. Of this number, 34 percent are current on their forbearance repayments, and only another 14 percent have paid off their forbearances and are current on their mortgage contract payments. Many of the 34 percent current on forbearances are likely to be making payments that equal or exceed the regular mortgage contract payments, but all payments are applied first for forbearances so that their accounts show up as delinquent under the mortgage note. That still leaves a 52 percent majority that show little promise of regaining solvency. After 36 months of forbearances they still cannot make monthly payments equal in amount to their mortgage contract payments, which is what the program minimally requires. Add to this the 16 percent foreclosed on during the initial 36-month period, and it appears that over 70 percent of all assignees do not really have reasonable prospects of full recovery.[132] For conscientious borrowers who want to make good on their obligations, and who find themselves continually unable to pay their expected mortgage payments and still facing ultimate foreclosure, it would have been better if HUD had helped them transition to less expensive housing rather than taking loan assignments.

A secondary factor contributing toward the inability of assignment to cure a significant percent of distressed loans is that HUD has been unable consistently to provide the level of servicing they require. Unlike private servicers, HUD operates under Congressionally mandated hiring ceilings which means that FHA cannot adjust its staffing level to accommodate changing caseloads. As the portfolio grows, so too does the caseload of the servicing personnel. Consequently, the attention given to each account is reduced. HUD auditors continue to point to this side effect of Congressionally mandated agency hiring caps as a significant material weakness. For loans placed in the assigned portfolio, it is difficult to foreclose for nonperformance. As seen in Tables 5.4 and 5.5, at the time

[131]These figures are supported by data on the historical experience of the portfolio now becoming available though HUD's evaluation of the portfolio's performance over time.

[132]A more limited view would count loans foreclosed either during the initial forbearance period or immediately after. These add up to 32 percent of all assignments.

Table 5.4

Status of Assigned Mortgages in the System Less than 36 Months
July 1994

	Type of Payment Required					
Status	None	Partial	Full	Increased	No Agree-ment[a]	Row Totals
Current[b]	1964	14968	4602	4848	0	26382
col. %[c]	45.4	66.0	51.6	49.9	0	57.2
row %[d]	7.4	56.7	17.4	18.4	0	
cell %	4.3	32.4	9.4	10.5	0	
Delinquent	2366[e]	7727	4321	4859	492	19765
col. %	54.6	34.0	48.4	50.1	100	42.8
row %	12.0	39.1	21.9	24.6	2.5	
cell %	5.1	16.7	9.4	10.5	1.1	
column totals	4330	22695	8923	9707	492	46147
row %	9.4	49.2	19.3	21.0	1.1	100

[a]This column represents loans being reviewed because of failure to perform under previous forbearance agreement.
[b]Current status represents current on expected monthly payments under forbearance agreements.
[c]Column percent gives percent of loans with a particular forbearance type that are either current or delinquent.
[d]Row percent gives the percent of total current or delinquent loans represented in each forbearance type.
[e]These are loans that were previously required to make some payment but worsening circumstances prohibited them from doing so.

Source: U.S. Department of Housing and Urban Development

Table 5.5

Status of Assigned Mortgages in the System More than 36 Months
July 1994

Status	Count	Percent
Current on forbearance payments	13,933	34.2%
Forbearances paid off and making regular note payments	5,759	14.2
Not making required monthly payments (foreclosures in process)	21,006 (11,157)	51.6 (26.1)
Total	40,698	100

Source: U.S. Department of Housing and Urban Development

of writing this report there were nearly 41,000 nonperforming loans in the portfolio of which 11,000 were in foreclosure processing. There may have been as many as 10,000 more which were immediate candidates for foreclosure.[133] HUD will generally not foreclose on borrowers who make some attempt at paying their mortgage obligations. Still, evidence to date suggests that only 30 percent of those admitted into the program today will make HUD whole either through property sale or other loan payoff over time.[134]

Those that accumulate substantial amounts of forbearance and then go to foreclosure anyway can be saddled with the tax burden of discharge-of-indebtedness income and/or a deficiency judgment. It is HUD policy to seek deficiency judgments only against investors, repeat defaulters, and "walkaways." However, the Internal Revenue Service (IRS) will tax the forgiven debt as current income to the extent that the borrower is solvent.[135] HUD is now experimenting with helping troubled borrowers avoid this by selling their homes and having HUD absorb the loss ("compromise" offer) in a preforeclosure sale of the property, and by having some refinance their notes in the conventional market and leave HUD with a second lien for the forbearances. These second liens would be payable at property sale and only to the extent that the property collateral can support them. Even in these foreclosure alternatives, interim IRS regulations require the same tax implications as with foreclosures (see chapter 6).

Borrowers considering applying for loan assignment need to be made aware that its promise of forbearance relief is not without cost. While HUD is providing forbearances, the household is essentially accumulating debt that will have to be paid out of future income. Forbearances must be repaid out of future earnings that will also be required to support the full cost of housing at that time. The point here is that the household accepting assignment forbearances will, unless their income prospects are quite a bit better than past experience, have a significantly higher housing-to-income expense ratio in the future in order to pay back the accumulated arrearages. Many who are technically eligible for assignment under the current rules would be better served by selling their properties and moving to less

[133]During 1994, HUD was still working off a backlog of foreclosures that began in 1991. At that time, problems with national foreclosure contracts led to a decentralization of authority to the individual field offices. Significant delays in each field office securing contracts and funds for services, and an initial lack of resources at the Department of Justice to handle the HUD caseload of judicial foreclosure cases, meant that relatively few foreclosures were performed in 1991 and 1992.

[134]Historically, about 3 percent of loans current under their loan notes have sold their homes and paid off their mortgages each year. Others sell under compromise offers.

[135]The dynamics of taxation of debt forgiveness are discussed more fully in chapter 6.4.

expensive housing until their income prospects improve.[136]

Current State of HUD Relief Efforts

HUD is now moving forward in a proactive way to develop a full menu of options for assisting borrowers with financial difficulties. While some of these can be implemented administratively, others will require legislative action. The current statutory language narrowly defines what HUD can do, and excludes many other measures which could benefit borrowers facing temporary financial difficulties. Judicial interpretations of the 1979 consent decree (the Amended Stipulation) have limited what HUD can do without new legislation by establishing loan assignment as the standard. This means that HUD requires Congressional action for any changes in basic eligibility criteria, the position of other relief efforts vis-a-vis assignment, and the type of forbearances offered to borrowers.

HUD's first steps toward a new beginning with assignment began in fiscal year 1993 with a series of roundtables. The product of these discussions is a redesign of the way assignment applications are handled. Participants included mortgagees, housing counselors, legal aid attorneys, and HUD field office and headquarters personnel. The application system in place since 1979 left little incentive for mortgagees to involve themselves because assignment was the only relief measure required, HUD performed all application processing functions for it, and borrowers could apply directly to HUD. Now, under procedures being finalized as this report goes to print, mortgagees will be responsible for working with delinquent borrowers to discuss their eligibility. They will be responsible for completing assignment applications and forwarding them to HUD with up-or-down recommendations. Field Office personnel will screen positive recommendations only for completeness. Applications with negative recommendations will be reviewed more closely to provide either a concurrence or non-concurrence with reasons for denial given by the mortgagee.

In addition to improving application processing, HUD has been moving forward with many new and modified approaches to borrower relief. General descriptions and the current status of each one are summarized below:

[136]The decision needs to be made with reference to balancing the transaction costs of selling and moving against the essentially unfunded (no income to support) forbearance liability that will have to be repaid somehow. The larger the required forbearance, the more likely it is that the household would be better off selling their property. Also, if the house has sufficient equity to pay selling costs, the homeowner could be better off selling than having to repay forbearances in the future because there may be no additional income generated to cover these expenses.

Lender Assisted Refinancings

Homeowners who want to refinance mortgage loans with FHA must generally be no more than 2 months in arrears. But there are cases in which borrowers lose their sources of income for a few months, get behind on their mortgage payments, then start earning new income but cannot make up the arrearages. HUD will now allow streamline refinancings in such cases. The loan servicer must pay one month of arrearages, while the rest -- including closing costs -- may be capitalized into the new loan balance.[137]

This can reduce the number of new assignments by over 2,000 loans per year and may reduce the number of borrowers filing for Bankruptcy Court protection by an even larger number. It does not assist all borrowers who experience reductions in income, but it is a significant step forward.

Loan Sales

A sizeable portion of the Secretary-held portfolio has been made up of loans originally insured under Section 221(g)(4) of the National Housing Act, which provides that lenders may automatically assign them to HUD after 20 years of seasoning. This is very attractive to note holders when current interest rates are above those on the mortgage notes. In the open market, such loans would sell at a discount from par, but on assignment the lender can be paid par by HUD. Over the past few years, this cohort of loans in the portfolio had grown to over 32,000. They are well seasoned and cannot have delinquencies at the time of assignment. There is no reason that HUD must keep them in its servicing portfolio. In June 1994 HUD successfully sold nearly 15,000 of these loans to private investors.

The June 1994 auction also included a small group of non-performing loans that had been assigned due to default. The sale price was above HUD's expected recovery on foreclosure and also saved holding costs that would be incurred up to foreclosure and during property disposition. This encouraged the Department to consider the sale of other assigned loans. A second auction occurred in September 1994, and another one is pending in March 1996.

[137]See Mortgagee Letter 94-30, June 28, 1994. The servicer's contribution is to show a commitment to the borrower, and to maintain the repayable arrearages at a manageable level. Other arrearages may be paid off through a premium interest rate or a second lien, rather than being added to the principal balance of the new primary mortgage.

Recasting Refinancings

As mentioned earlier in this chapter, it is difficult for assigned borrowers to payoff their forbearance arrears. Many of these loans have interest rates in excess of 10 percent, and they would benefit from a recasting of principal and arrearages into a new loan at a lower interest rate. In the spring of 1994, HUD initiated legislation that would allow a window of opportunity during which a streamline refinancing procedure could be used to effect such recastings and return loans to the insured portfolio. The housing legislation this was a part of was not passed by the Congress.

The plan would have allowed up to 20,000 borrowers who had been in the assigned portfolio beyond the 36-month forbearance period to streamline refinance out of the Secretary-held (and serviced) portfolio and back into the insured (and privately serviced) portfolio. The reduced risk of foreclosure that would result, because of lower monthly payments, would generate credit score surpluses for the HUD budget from each loan refinanced in this way. These borrowers would have seen monthly payments go down immediately and begun to experience the "tilt" effect of lessening payment burden over time.[138]

Special Forbearances

HUD, like other insurers and guaranty agencies, allows servicer forbearances of up to 18 months. Its programs date back to the 1964 implementation of the enacting legislation.[139] Unlike the others, though, HUD offers a special incentive for servicers to take on this risk by paying all costs in any resulting foreclosures, including interest reimbursement at the mortgage note rate and 2 extra months interest.[140] While this should be adequate incentive for servicers to pursue forbearances, other factors have made it unworkable.

For servicers, problems include the out-of-pocket cost of making Ginnie Mae pass-throughs, eligibility criteria which are nearly identical to those for assignment, and the requirement of HUD review and approval of typical plans.

[138] While in the assigned portfolio, required payments increase with borrower income. Refinancing back into the insured portfolio with fixed-rate mortgages will allow for constant payments into the future.

[139] See 29 FR 12629 (Sept. 5, 1964) and or 24 CFR 203.1 *et seq*.

[140] Normally, HUD only reimburses two-thirds of most foreclosure expenses and only reimburses interest costs at the government debenture rate rather than the note rate (see HUD Handbook 4330.4 (1992) p. 1-19).

The first problem is lessened because, over the past 5 years, servicers have been increasing their sophistication with respect to loan workouts. They now understand that it is in their interest, as well as the insurer's, to avoid foreclosures and so are becoming more willing to finance the monthly pass-throughs. While the eligibility criteria are nearly identical to assignment, forbearances can technically be entered into before a determination of foreclosure is made. That could prevent the need for assignment applications for these borrowers, but borrowers are still notified of assignment availability before 90 days of delinquency.

To address the concern over the delay caused by HUD field office approvals of lender forbearances, HUD recently issuing a new policy of allowing servicers to initiate special forbearances without HUD field office review.[141] This will save precious time in the relief process.[142]

The issue of separating mortgagee forbearances from assignment is one that cannot be fully settled without new legislation. By the time a forbearance agreement is discussed at 90-days delinquency, borrowers have already received information on the HUD assignment program. Because assignment offers protection against secondary defaults for at least 36 months, borrowers can be expected to prefer it over servicer forbearances and hold out for this. Also, because secondary defaults must be evaluated for assignment on their own merits, so that borrowers would effectively gain even longer protections against foreclosure. Therefore, HUD cannot promote lender forbearances without also accepting that it would then be guaranteeing forbearances for up to 54 months (18 months in lender program, then 36 in HUD portfolio) rather than 36 months in direct assignment.[143,144]

[141]These regulations can be found at 60 FR 57676, Thursday, November 16, 1995. These regulations also lifted the 18-month restriction on time until final cure.

[142] Servicers were permitted to initiate forbearance/repayment plans without HUD approval from 1975-1991. Even then, because of the nascent state of workout divisions, it was not used much. New guidelines issued in 1991 reinstituted the HUD approval requirement in response to a celebrated case in which one servicer was aggressively pursuing forbearances, 30 percent of which still went to claim. Both HUD and the Office of Management and Budget were then concerned about adequate controls over the cost of the program and removed servicer discretion in implementing them. As was discussed in Chapter 4, concern over a 30 percent failure rate was justified in light of common industry practice. But as was highlighted in Chapter 3, evidence is mounting that the break-even success rate for workout options is much lower than the industry has previously understood. For forbearances and loan modifications it can be far below 50 percent. The relevant question for HUD, when given a viable menu of workout options, would be at what level of predicted success probabilities would borrowers be steered to longer term solutions such as TMAP or assignment.

[143]As it stands, the 1979 Amended Stipulation and the 1983 *Ferrell* judicial standard require HUD to make assignment fully available to borrowers even after other forms of relief have been attempted, should those borrowers be unable to fulfill the terms of the first relief measure, though the *Ferrell* court provided some flexibility for borrowers who do not initially require forbearances (i.e., they quickly obtained new sources of income which allow

If HUD could allow unencumbered mortgagee-sponsored forbearances it could reduce the number of assignments by up to 1,000 per year. Such plans can be more attractive than recast-refinancings for borrowers whose loan interest rates are lower than current market rates.

Preforeclosure Sales

The Stewart B. McKinney Homeless Assistance Ammendments Act of 1988 gave HUD authority to pursue preforeclosure sales in lieu of foreclosure of defaulted mortgages.[145] Because there was little data available on the types of approaches used by other insurers and guaranty agencies or their success rates, the Department began its efforts with a demonstration in 1991. By the time intake of new applicants under the demonstration ended in September 1994, over 2200 borrowers in six primary demonstration sites had successfully completed "short sales" of their properties for which FHA paid insurance claims to lenders for indebtedness above the net sales proceeds. A demonstration evaluation performed by HUD in the spring of 1994 showed that it was netting savings of $2900 per loan accepted for participation. Because of changes being made for national implementation, savings are expected to rise to $5,300 per participant.[146,147]

This marks a significant step in HUD's efforts to develop a modern loss-mitigation program. Preforeclosure sales now account for half of all loan workouts in the conventional market, and they are a valid cost-effective

them to start to repay their arrearages). This removes the discretionary nature of multiple relief measures provided in 12 USC 1715u(a)(1). Providing a guaranteed 36 months of forbearance relief in assignment has itself proved costly and relatively ineffective. To provide this after a 6-to-18 month period of alternative relief would not be in the best interests of the Department or its insurance funds.

[144]Like assignment and TMAP, lender forbearances are also statutorily constrained to only those borrowers whose difficulties are due to circumstances beyond their control. This was codified in the original 1959 authorizing statute (73 Stat. 662).

[145]In particular, it is Section 1064 of the Act (102 Stat. 3275), which amended 12 USC '1710(a).

[146]See Charles A. Capone, Jr., *Evaluation of the Federal Housing Administration Preforeclosure Sale Demonstration*. Washington, DC: U.S. Department of Housing and Urban Development, Office of Policy Development & Research, Research Utilization Division (June 1994). National implementation is expected to have higher savings because of a shift in responsibility from HUD field offices and contractors to the mortgagees, and because national foreclosure losses are higher than those in the demonstration sites. Savings per participant are a weighted average of savings from successful sales and extra costs from failed efforts. Those that fail to find buyers are often given the option of voluntary deed transfer. Uncooperative cases are referred back to their mortgagees, who generally initiate foreclosure proceedings.

[147]Details of the national implementation strategy are published at 50136 Fed. Reg. 59 189, Friday September 30, 1994.

strategy that benefits both the borrower and the insurer/guarantor (see chapter 3).

Information from the demonstration suggests that many financially troubled borrowers are in positions in which they do not want to keep their current homes but cannot afford to sell them either. Among all applicants for preforeclosure sales, 70 percent willingly waived their rights to assignment consideration in order to participate. The other 30 percent were first denied loan assignment. Of the former group, HUD was relieved of the time and cost involved when many of them would have otherwise applied for loan assignment in efforts to buy themselves more time searching for a solution to their housing problems. The latter group, who did apply for assignment but were denied, are also important preforeclosure sale participants because they would have likely ended up as foreclosures in the absence of the preforeclosure sale option. It is safe also to say that, in the absence of this option, many of the assignment-ineligible borrowers would have sought Bankruptcy Court protection.

Baseline national projections provided in the demonstration evaluation look for close to 7,000 preforeclosure sales per year in a fully implemented national program. This would save the Department $58 million and free up 88 full-time equivalency personnel to work in other areas of single-family servicing.[148] Given the momentum provided for preforeclosure sales in the conventional market since the FHA demonstration, it is anticipated that a much larger number of borrowers can be assisted with this tool.

As mentioned earlier, there is a large contingent of currently qualifying assignments that HUD could identify as technically eligible but not good risks. Were HUD to have its discretion in program eligibility restored, it could assist an additional 2,000 to 3,000 homeowners per year to transition into lower cost housing, versus providing an extended forbearance period and an almost guaranteed subsequent foreclosure.[149]

Interest Rate Reduction Authority

HUD received specific statutory authority to modify assigned loans, including interest rate reductions, in the Housing and Urban Development Act of 1970 (42 U.S.C. 3535(i)(5)). Use of this authority was not an issue of concern until high-interest-rate loans originated in the early 1980s began to default and come into the assigned portfolio in large numbers in the late

[148]Baseline estimates were arrived at using foreclosure rates in early calendar year 1994.

[149]These numbers are taken from current rates of early foreclosures. HUD will be able to pin point particular cohorts of currently assigned borrowers at the conclusion of its current portfolio evaluation contract.

1980s. An internal HUD review by the Chief Financial Officer concluded, in June 1992, that reducing interest rates on assigned loans would not pose a significant risk. The U.S. Comptroller General then issued a decision in July 1992 that said the Debt Collection Act of 1982 did not preclude HUD's use of this authority.[150]

However, just as the Department began to implement this program in the field, the Office of General Counsel recognized that amendments to the authorizing legislation passed in October 1992 required that such interest-rate reductions were "subject to the availability of amounts provided in appropriation Acts."[151] A ruling that there was not a need to provide credit-scoring budgetary requests under the Credit Reform Act of 1990 was provided by the Office of Management and Budget in late 1993. While it was determined that HUD did not need to provide credit-scoring estimates on these actions, the 1992 amendments further restricted use of interest-rate reductions to cases in which it "is necessary to avoid foreclosure on the mortgage."

In December 1993 HUD reimplemented use of this tool, but with the limited statutory scope of assisting borrowers in imminent danger of foreclosure.[152] It applies to loans that have been in portfolio for more than 36 months, and interest rate reductions are to the current market rate for 30-year fixed rate loans.

In April 1994, Section 104 of the Multifamily Housing Property Disposition Reform Act of 1994 (108 Stat 363) removed the restrictive language of the Housing and Community Development Act of 1992 and returned the preexisting authority to modify loans held in portfolio. Implementation of this new authority can have a substantial impact on the rate at which interest rate receivables accrue during forbearances. It could thus greatly affect the ability of assisted mortgagors to regain solvency during periods of declining interest rates.

Summary of HUD Initiatives

The Department has passed through two epochs with respect to foreclosure avoidance strategies, and it is poised to enter a third one. The first, lasting from FHA's inception to 1976, involved a hands-off policy of allowing

[150] The Debt Collection Act (96 Stat. 1755), Section 11(e)(3), only prohibited interest-rate reductions on loan agreements or contracts that "explicitly fix interest or charges that apply to claims involved."

[151] Section 902(b) of the Housing and Community Development Act of 1992, at 42 USC ' 3535(i)(5).

[152] See HUD Notice H 93-91 (December 8, 1993).

lenders to make individual determinations on extending forbearances. The second epoch began in 1976 with the signing of a court consent decree which began the mortgage assignment program. Now, HUD is entering a third era in which it is committed to developing a first-rate, customer friendly approach to loss mitigation which emphasizes tailoring solutions to individual needs.

The innovations now underway at HUD include:

- Involving all stakeholders -- mortgagees, counselors, field offices, and Legal Aid attorneys -- in discussions of program changes.

- Redesigning relief application processes to involve mortgagees.

- Providing more information and counseling to defaulted borrowers on their options and on what programs best match their circumstances.

- Streamline refinancing of loans in default more than 90-days where borrowers have regained income so that long-term forbearances are not necessary.

- Preforeclosure sale options for borrowers with involuntary financial difficulties who cannot afford to sell their current properties.

- Encouraging mortgagees to provide forbearances rather than allowing delinquencies unnecessarily to extend to where foreclosure is imminent and loans can be assigned to HUD. While this is not fully free of assignment eligibility restrictions, HUD expects to still reduce the number of loans being assigned.

- Allowing assigned loans that have been in the portfolio beyond the initial 36-month forbearance period and can make full mortgage payments to refinance back into the insured portfolio. Unfortunately, legislation to implement this measure was not taken up in the 1994 Congressional Session and it cannot be implemented administratively. It would recast loan balances and forbearance receivables, homeowners could receive the benefits of reduced market interest rates, and HUD could reduce the workload burdens of its servicing personnel.

- Assist borrowers with assigned loans who still cannot make full payments after 36 months by reducing their mortgage interest rates.

- Selling off seasoned loans in the assigned portfolio in order to allow HUD's limited servicing personnel to focus their energies on managing accounts with forbearances and forbearance repayment plans.

- Evaluation of the potential for, and benefits from contracting out the servicing of assigned mortgages to remove these operations from Department-wide employment ceilings. Current restrictions on providing adequate staffing have been cited as a serious material weakness by the HUD auditors.

- Using new Single Family Service Centers to begin the process of building true lender monitoring units that can focus on loss mitigation and borrower relief.

Next Steps

While each of these items represents a significant step forward in offering relief to FHA-insured borrowers with financial difficulties, there remain numerous issues that need to be resolved before the transition to a modern loss-mitigation effort is complete. The most serious of these is that current statutory authority for relief is limited to very specific programs. Judicial rulings on HUD's discretion under Court consent decrees agreed to in the 1970s, which were based on these programs, further limit HUD's flexibility. This operating framework makes it difficult to respond to new information regarding the effectiveness of existing programs or to adopt innovations in borrower relief developed by the private sector.

The 1970s regulations were initiated through the courts because it was deemed that HUD was not fulfilling its National Housing Act mandate to assist its insured homeowners. These homeowners were considered to be a protected class under the National Housing Act and therefore HUD could not be passive with respect to any financial difficulties which put them in danger of foreclosure (see discussions at the beginning of this chapter). To properly meet this responsibility, while managing the safety and soundness of its insurance funds and maintaining reasonable premium rates for all FHA insured borrowers, the Secretary must be given much broader and more general authorities to implement foreclosure avoidance and loss mitigation strategies than are currently in place.

The Secretary and the Federal Housing Commissioner need the flexibility to respond quickly to changes in the mortgage market. The need to respond quickly to changing market conditions and technologies is one reason why the Secretary and the President have agreed that the FHA needs to attain the status of a government corporation.

Below are examples of tools currently used in the mortgage market but which are unavailable to HUD.

Additional Tools Still Needed

Advance Claims

An advance claim is where the insurer advances funds to the servicer to cure a default in the event that the borrower can resume making payments but cannot immediately cure the delinquency (see chapter 3, section 4). They will have the borrower sign a promissory note to repay the funds over time. It is called an "advance" claim because should a claim be necessary in the future, this will be subtracted from the insurance payment to the servicer. This is used by private mortgage insurers in cases of temporary reductions of income where homeowners can catch up slowly over time. There are many FHA-insured homeowners who would benefit from having similar options. They do not need ongoing forbearances and so do not need loan assignment. Some of these borrowers will benefit from HUD's new program of allowing refinancings of delinquent mortgages, but others would be better served with advance claims.[153] Authority for HUD to do this is found in the TMAP statute, but the *Ferrell* Court decision precludes use of this tool by itself.

Loan Modifications

Loan modification is a tool currently offered for mortgagee use, but it is not utilized. It is intended to assist households with permanent reductions in income who could still maintain their mortgage obligations after reducing their interest rates, reamortizing the outstanding balance (including arrears), or otherwise changing the terms to make lower monthly payments. Like streamline refinancings, these are most beneficial in environments where interest rates have fallen over time. HUD would require statutory and budgetary authority to pay claims for this purpose, that is, without having also to provide up to 36 months of forbearances. Upon modification, the loans would be made whole and could then be repooled and sold for securitization.

HUD has taken what steps it can under existing authorities by allowing mortgagees to enact streamline refinancings for borrowers in default. However, homeowners must pay the refinancing fees and at least a part of their arrearages. The conventional market has found that while it is valuable to have such policies in place, there are still significant numbers of

[153]The advance claim is preferred in situations where prevailing interest rates are higher than the note rate, so that a refinancing could lead to higher than necessary monthly payments. It is also beneficial in situations where it would be prudent to avoid the costs of refinancings, or simply to repay the arrearages over a shorter period of time, e.g., 1 to 5 years. The rules issued to implement the new HUD streamline refinance procedure (Mortgagee Letter 94-30) make qualification difficult for borrowers with unseasoned loans, i.e., recent home buyers, who made limited downpayments. These borrowers could also benefit from a policy allowing short term "advance claim" loans.

borrowers for whom these cash requirements -- even if most of them are financeable -- make the refinancing infeasible. Therefore, it is important to also have the option of enacting true loan modifications when needed.

Personnel resource constraints faced by the Department mean that any program involving loan management is very costly. To avoid placing undue burdens on limited HUD staff, servicing functions would have to be kept with existing mortgagees or given to one common contractor.

Managing the Secretary Held-Portfolio

HUD is presently restricted in how it manages its portfolio of assigned loans. It cannot effectively screen applicants by likelihood of successful loan repayment, nor can it be flexible with payoff plans.

The need is highlighted by a recent agreement (in April 1994) between HUD and the Office of Management and Budget on the value of allowing loans in the assigned portfolio which had passed their initial forbearance period, and were current on their payments, to refinance back into the insured portfolio. This was highlighted earlier in the chapter. The change was deemed to be beneficial both for HUD and for the homeowners and was included in housing legislation offered to the Congress. The broader legislation was not enacted during the 103rd Congress so 15,000-20,000 borrowers were left with higher monthly payments and a greater likelihood of foreclosure. A better outcome for all parties could have occurred if the Secretary had had more general authorities for managing loans in HUD's portfolio.

Temporary Mortgage Assistance Payments Program

As mentioned earlier, TMAP was not implemented because of protracted litigation over its initial regulations. In 1987, HUD amended the program outline to make eligibility and type-and-length-of-relief identical to assignment. However, since that time, a number of factors have led to a rethinking of the TMAP concept. First, it had originally been envisioned in an era of steadily rising house prices. The second-lien approach would be more costly in today's markets where regional house-price declines jeopardize even the first lien. Where sale prices are high enough to pay off the first mortgage, but not any second liens, the TMAP lien could by itself cause a borrower to default on the first mortgage. TMAP liens would then be "soft" second loans that would be wiped out in foreclosure.

The second problem is that, while TMAP was hoped to eventually eclipse assignment, servicers do not have to participate and co-borrowers do not have to sign the TMAP lien. These additional considerations mean that the assignment program would not diminish in importance, leaving HUD with two parallel relief programs, two separate accounting and servicing-support systems, and two sets of regulations and guidelines for mortgagees and HUD staff. Originally envisioned cost savings over taking assignments -- that is, not having to buy loans out of Ginnie Mae pools or pay full insurance claims -- would then not materialize. Given these problems, the Department turned its focus away from TMAP.

However, a TMAP-type program could be better for borrowers in times of stable interest rates and some house price appreciation. The repayment plan might be more attractive to borrowers than that offered by loan assignment. To understand how this could happen, one must understand the nature of the accounting systems involved. Loan assignment uses a vertical payment application system, as discussed earlier in this chapter (see footnote 25). No principal is amortized until all interest arrearages are paid in full. In contrast, a TMAP program would employ a standard horizontal payment application structure, whereby the borrower's loan is amortizing even during the period of payment assistance. The effect of this is that once forbearances stop and repayment begins, the TMAP borrower pays off the first mortgage for a shorter time (remaining mortgage term) and the arrearages over a potentially longer time (up to 10 years beyond mortgage term). The assignment program requires a shorter time of increased payments (to pay off arrearages) and a longer time paying off the underlying mortgage (up to 10 years beyond the contract term). In effect, assignment requires post-forbearance monthly repayments which can be smaller initially than under TMAP, but which will eventually become larger and for a longer period of time.

Because the TMAP idea still makes sense in certain circumstances, HUD is looking closely at the experience of a Pennsylvania TMAP-type program that has been operating for over 10 years.

Pennsylvania Homeowners' Emergency Mortgage Assistance Program

The Pennsylvania Homeowners' Emergency Mortgage Assistance Program (HEMAP) has been in place since 1984, and received permanent status in 1992.[154] It does exactly what TMAP was designed to do by curing delinquencies and, when necessary, extending forbearances to borrowers with truly temporary difficulties. Advances are secured by property liens, and interest is charged on outstanding balances once borrowers begin their repayment periods. The general eligibility criteria are nearly identical to those of TMAP and FHA mortgage assignment: borrowers must be owner-occupants, have reasonable prospects of making full mortgage payments

[154] The authorizing statute is found in Article IV-C of the Pennsylvania State Code (35 Pennsylvania Statutes '1680.401c-1680.411c). Recently updated regulations can be found in the *Pennsylvania Bulletin*, vol. 24, num. 27, July 2, 1994, 3224-3244.

within 36 months of the delinquency, and the default must be due to circumstances beyond the borrower's control. However, the Pennsylvania Housing Finance Agency (the "Agency") has greater flexibilities than HUD to restrict what these mean in practice.

All homeowners in the Commonwealth who are 60 days delinquent on their mortgages are sent notice of HEMAP availability. They then have 30 days to meet with a qualified counseling agency to discuss their situation. The counselor's first priority is to attempt to negotiate a repayment plan with the loan servicer. If this fails, the counseling agency has 30 days (from meeting with the borrower) to file an application along with an up-or-down recommendation to the Agency, which then has 60 days to make a final determination. By the end of 1993 they had received 54,796 applications and accepted 16,304 (30 percent) into the program. About 39 percent of program participants only received assistance in curing their existing delinquency. The remaining 61 percent received continuing monthly assistance beyond the mortgage cure. Overall, the average dollar amount of assistance -- one time or ongoing forbearance -- is just over $10,000 per case.

Of those that receive only one-time assistance to cure their delinquencies, 48 percent have been able to begin repayment immediately, and 35 percent of those who entered the program prior to 1989 have been successful in paying off their assistance within 5 years. For homeowners with ongoing assistance (up to 36 months), 42 percent have been able to begin repayment at the conclusion of their forbearance, and 23 percent of those that entered HEMAP before 1989 were been able to repay their assistance within 5 years.

Foreclosure rates have been low, with only 4.9 percent of all loans ending in foreclosure. This is surprisingly low, given that lenders can initiate foreclosure if borrowers miss any payments once received into the program. It speaks well of the Agency's ability to administer the circumstances-beyond-borrower's-control and reasonable-prospects criteria. The Agency reports that this has not been easy, but they have developed workable standards over the course of their 10 years experience. One key to their success is looking at the borrower's past employment and regard for credit, including a 5-year mortgage credit history, in the application screening process. By eliminating borrowers with histories of repeated defaults, they are able to only assist those who have shown an ability to manage the costs of their present home.[155]

[155] There are exceptions for cases like those of displaced homemakers. In those cases the Agency looks at marketable skills or availability of training that would provide marketable skills that could lead to enough income to support the mortgage (with other income sources such as child support) within three years.

In contrast, the present FHA mortgage assignment program does not give the Department such latitude when screening eligibility. HUD can only look at the present default when screening applicants. As a result, foreclosure rates out of the assigned portfolio are high (see Table 5.5).

The existing HUD assignment program has also been encumbered by direct applications from borrowers. These are often incomplete and disorganized, and confused borrowers do not respond to inquiries concerning the need for additional information. In contrast, applicants to the Pennsylvania HEMAP program must go through a counseling agency that prepares the application and is responsible for sending it and a recommendation to the Agency. This both expedites processing of cases and assures that borrowers receive adequate consideration for program participation. (HUD is now moving to loan servicer application preparation.)

The Agency is fairly lenient when collecting on HEMAP liens once the assistance period ends. Out of 3,158 individuals currently required to pay back assistance received, 65 percent are delinquent. The historical average has been in the 60 percent range. Not all borrowers are required to pay back their assistance immediately following the initial 36 month period. The Agency only requires repayment when a homeowner's monthly housing expenses are less than 35 percent of net income.

The Agency has been successful in recovering at least part of the assistance when properties are sold and then establishing payoff periods for the remaining debt. In the interest of serving its public purpose, the Agency does not actively pursue collection efforts that might lead to property foreclosure. Once a property has been sold, and all liens released, the Agency does not aggressively pursue persons who either refuse to sign promissory notes for the outstanding assistance balance, or those who sign them but sooner or later stop making payments.[156] Its approach is one of trust with citizens, and thus it writes off uncollectible accounts as bad debts in its business.

Overall, the HEMAP program is expensive, as it costs approximately $300 in subsidies per participant per month to run. It appears then that even a well-run long-term forbearance program is expensive. Moneys are earmarked in the State budget for this program.[157]

[156]For example, they have chosen not to report discharge-of-indebtedness income to the Internal Revenue Service or seek authorization to garnish State income tax returns. The Agency seeks to collect as much as it can when a property is sold because, once its lien is released, it has little success in making further collections based on the good faith of borrowers.

[157]The Commonwealth also provides a business tax credit for contributions, but this has not been used since 1985.

By engaging counselor agencies in the application process, the Agency ties households into credit counseling, family budgeting, and information on availability of other public support programs. The counselors are also involved in annual recertification of program participants. The Agency does note, however, that coordination among independent credit counselors has been difficult.[158]

Wrap-up

Because of the size of the risk involved in providing relief for over 12 months and the burden of assuming ownership of loans, the HUD Assignment program has turned out to be very costly. This is especially so because it has been the principal borrower relief tool utilized to mitigate foreclosures.

The ability of HUD to offer a comprehensive menu of loan workout options for defaulted borrowers necessitates a new statutory base from which to operate. This would have to either define the role of any assignment type program vis-a-vis other loss mitigation and borrower relief measures, or leave it undefined. Indeed, Judge Will, in his 1983 *Ferrell v. Pierce* decision, recognized that new legislation along these lines would be necessary for any substantive programmatic changes from that agreed to in the 1979 Amended Stipulation (560 Fed. Supp 1360).

HUD now knows that a new program structure with multiple options could provide benefits more than equivalent to the current assignment approach, where "equivalency" is defined as the ability to assist troubled homeowners either to retain their homes or to dispose of them in a means less costly to the borrower and to the Department than foreclosure. Continuation of the current equivalency-of-monthly-forbearance standard serves only to preclude Departmental efforts to take advantage of the innovations and flexibility that have now taken root in the private sector. It also keeps the Department in a position of expending a large quantity of resources focusing on only one subset of seriously delinquent loans. The National Housing Act goals under which HUD operates could be better served if the Secretary were given broad authority to implement loss-mitigation and foreclosure avoidance strategies. This fits within the rubric of the Government Performance and Results Act of 1993 (107 Stat 285).

An additional requirement of a new standard for borrower relief is rethinking and redefining the circumstances-beyond-borrower's-control and

[158]HUD is now increasing its promotion of the use of housing counseling agencies by defaulted mortgagors, but cannot require them to undergo counseling as a prerequisite to assistance.

reasonable-prospects standards. There are many borrowers who are willing to make good on their mistakes and can be helped by loss mitigation techniques that are also cost effective for FHA, but they do not qualify for loan assignment. Currently they either end up in a Bankruptcy Court repayment plan or have their property rights foreclosed. At the same time, the current Assignment entry criteria are overly generous to those whose experience shows that they do not have the capability to maintain their current homes, and to those who have not shown respect for their mortgage obligations in the past.

HUD can design procedures to monitor the work of servicers implementing loss mitigation strategies on its behalf. Establishing a separate workout department within FHA is essential for this strategy to work. Workouts are a very specialized area of mortgage servicing that require the attention of fulltime, permanent personnel solely devoted to the task. They require personnel who can review servicer workout proposals, provide training and advice to servicer personnel, and develop new strategies for getting borrowers involved in loss mitigation efforts. One private mortgage insurer indicates that each workout counselor on their staff saves them over $400,000 per year in foreclosure expenses. Workout departments serve not only to mitigate losses to insurance funds, but also to increase the number of defaulted loans which are rehabilitated and thus avoid ultimate foreclosure.[159]

An Additional Concern: **Repayment of Forbearances**

Even if HUD were to receive a new charter for providing foreclosure avoidance and borrower relief, and it developed an efficient system of directing defaulted borrowers to those options best suited to their individual needs, there remains one lingering question: Is it possible to devise a forbearance system that does not over-burden the modest-means homeowner that FHA typically serves?

The current assignment evaluations being undertaken by HUD will answer the question, how much is too much? At what point do forbearances become too overwhelming to manage? As mentioned earlier in this chapter, the problem with using any forbearance plan to help a borrower maintain their home is that it becomes a claim on future income; there is no current income generated to support the growing forbearance debt. Forbearances are a form of borrowing, and as such they must be paid back out of future income. But future income will have to support the full cost of housing --

[159]The issue of how best to provide borrower workouts -- through servicer efforts or direct insurer efforts -- is still an open question, as was discussed in Chapter 4. Efforts to strengthen the role of loan servicers in workouts would still require a specialized loan-workout department within FHA for servicer training and monitoring.

mortgage, taxes, utilities, maintenance -- as well as repay the accumulated arrearages.

At various points in time, there have been initiatives started in the Congress to provide some form of forbearance that would be paid for by someone other than the distressed borrower. While most individuals would agree that it is good to assist homeowners with temporary financial difficulties that were caused by circumstances beyond their control, the more difficult question remains, who will pay for it?

Mortgage Credit Insurance

The most direct answer to this question is to use the FHA insurance system not only to insure mortgagees against the costs of default, but also to insure mortgagors against temporary financial hardships. Section 109 of the Housing and Urban Development Act of 1968 called on the Secretary to work with the private insurance industry to seek such protection for FHA borrowers. This followed a decade in which twenty-three separate FHA-borrower foreclosure moratorium bills were introduced into the Congress.[160] A task force of insurance industry officials was formed to examine the feasibility of such a public-private plan. The task force concluded that it could be done, but that the adverse selection problem of insurance could only be avoided if it were offered at mortgage origination and was in some form mandatory to a large-enough group of borrowers.[161]

The most direct method of assisting FHA-insured borrowers to avoid foreclosure is to provide a comprehensive insurance program that covers mortgagees and mortgagors. Credit insurance could be made part of the regular insurance premium paid by borrowers. It could be made mandatory for first time homebuyers and/or those with initial loan-to-value ratios above a certain threshold, say 90 percent. A standard package could provide assistance for a maximum dollar amount, say 6 to 9 months of mortgage payments, over a given period of time, say up to 18 months. It could be limited to households with unemployment or disability extending more than 3 months, and limited as to usage over a given time interval, for example, no more than once every 5 years.

Such a system would be self supporting either through the FHA Mutual Mortgage Insurance Fund (MMIF) or a group policy purchased by HUD from borrower paid premiums. It would alleviate both the problems of borrowers accumulating unmanageable forbearances and of HUD having to

[160] These are listed in Appendix E of Insurance Technical Assistance Group (1969).

[161] See Insurance Technical Assistance Group (1969).

maintain a portfolio with high levels of servicing needs.

The most recent independent actuarial review of the FHA MMIF shows that at current insurance premium levels, the Fund will generate capital reserves well in excess of Congressionally mandated targets for future years.[162] It is possible that a credit insurance program could then be enacted for FHA borrowers with little increase in the premiums already charged to them. In fact, many of the expenses of such a program are already being incurred through the more expensive loan assignment program. With credit insurance, loans would not have to be assigned, and borrowers would not accumulate receivables that would have to be repaid. Because of changes now made in handling assignment applications, mortgagees are equipped to assist in screening borrowers for eligibility in other relief programs.

5.2. Department of Veterans Affairs Loan Guaranty Program

The VA has a unique position in the mortgage market because of the nature of its constituency. To be eligible for a VA guarantee on a mortgage loan, an individual must be on active duty or have been honorably discharged from military service.[163] The VA provides a guarantee that is more generous than private insurers, which typically cover the top 25 percent of a loan, but less generous than FHA, which provides 100-percent insurance coverage.[164] VA coverage ranges from 50 percent of the loan amount for small valued loans to 25 percent at the upper end, with a portfolio average of 33 percent.[165] Like private insurers, it reserves the right to pay its maximum claim and avoid taking title to the foreclosed property. This is known in the industry as the VA "no-bid" because the VA does not instruct the servicer on bidding for the property at foreclosure.

Servicers are expected to make all prudent efforts to reinstate loans up to the ninetieth day of delinquency. They may institute any form of repayment or forbearance without approval from the VA.[166] At day 105 the VA's own default tracking system sends out letters inviting borrowers to call its

[162]Price Waterhouse (1995).

[163]The VA does accept nonveterans on loan assumptions.

[164]FHA covers 100 percent of the loss on indebtedness, but only pays two-thirds of most servicer expenses related to foreclosure processing. See HUD Handbook 4330.4 (1992) for more detail.

[165]The current loan limit is $203,000, with a maximum claim payment of $50,750.

[166]Servicer guidelines are published at 38 CFR 36 (58 FR 29114, May 19, 1993).

counselors. The counselors, who will attempt to call if they are not contacted first, act as facilitators between borrowers and servicers. This direct intervention is considered the centerpiece of the VA loss-mitigation strategy. It is designed first to see if there is any way to help borrowers reinstate loans (cure the delinquency), and, second, to find other methods of helping keep borrowers in their homes. The VA will generally not recommend or approve alternatives to foreclosure until after the 150th day unless a borrower does not cooperate with intervention efforts. When negotiations over forbearances and reinstatements have come to a standstill, the VA establishes a "cutoff" date after which it will not honor servicer claims for lost interest income. This effectively forces the servicer to start foreclosure processing. At this point the VA will, when necessary, negotiate with the borrower a less-than-full deficiency payment in return for a preforeclosure sale or deed-in-lieu. The preforeclosure sale is always preferred because the VA avoids having to handle property disposition. VA allows full assumption of its loans to any qualified buyer (not necessarily a veteran) and will pay lender fees when needed to facilitate this.

The VA seeks to recoup insurance claims through deficiency payment agreements with borrowers on a case-by-case basis, depending on borrower abilities. They can be paid back over 5 years. The VA estimates that only 3 percent of all deficiencies from defaulted, non-reinstated borrowers are ever collected.[167]

In cases where attempts at forbearance have failed and borrowers cannot reinstate, but where they can likely resume payments in the future, the VA will "refund" the loan. This is analogous to HUD's assignments. Like HUD, the VA performs its own servicing for these loans, but the VA will modify them once they are bought out of Ginnie Mae MBS pools.[168] Unlike FHA, however, the VA has a discretionary refunding program. It has the freedom to offer this when they believe it is in the best interest of the borrower, without having to invite all 90-day delinquents to apply for a refunding.[169] The general guidelines used by VA Loan Guaranty Officers in deciding eligibility are:

[167]All loans guaranteed prior to 1990 stipulate that the borrower is fully obligated on the debt, which means a full deficiency judgment for repayment is always sought after foreclosure of these loans.

[168]Servicers must buy them out of the pools, but then VA immediately buys them from the servicers, keeping the original loan intact.

[169]For case law supporting Secretary discretion in refunding VA guaranteed loans, see *Rank v. Nimmo*, 677 F.2d 692 (9th Cir. 1982), *Gatter v. Nimmo*, 672 F.2d 343 (3d Cir. 1982), and *First Family Mortgage Corp. of Florida v. Earnest*, 851 F.2d 843 (6th Cir. 1988). Such precedents would likely also have been set for HUD if it had had a viable program in place without court supervision.

- Loan servicer is unwilling to continue forbearing.
- Veteran desires to retain and occupy the property.
- Veteran has shown an ability to care for and maintain the property.
- Veteran has present or potential ability to satisfactorily resume regular payments within a reasonable time and to repay the loan.
- The loan would not be a "no-bid" if it would otherwise go to foreclosure, that is, the potential loss to VA is no greater than its maximum claim.

Table 5.6 shows the resolution of reported defaults on VA loans for fiscal years 1991-1993.

The numbers in Table 5.6 show that nearly 80 percent of VA borrowers going to 90 days delinquency have been able to retain their homes. Of the other 20 percent, only a small fraction avoid foreclosure. The VA believes more could be done to assist these borrowers but, like FHA, it does not have budgetary authority to hire and train additional loan counselors needed to make contact with all defaulters. At present they concentrate efforts on first-time defaults. Their current estimates are that each counselor has an annual value of around $220,000 in reduced claims payments.[170,171,172]

In 1987 the VA estimated that the refunding program had a 50 percent success rate, meaning that half of refunded loans avoided eventual foreclosure. A program audit performed by the U.S. General Accounting Office that year estimated that the break-even success rate is only 20 percent. GAO concluded that the VA could more liberally apply its eligibility criteria and assist more veterans and save the Department even

[170]In fiscal year 1989 the VA initiated a pilot in Houston where they increased the number of loan service representatives to gauge their marginal value in that environment. Gross savings from interventions with lenders to find alternatives to foreclosure were estimated at $11 million, while the cost of additional servicing personnel was $310,000. The VA believes that the net savings figure of $10.7 million understates total savings because there were many cases in which loan servicing prevented delinquencies from getting to the point of potential foreclosures. There were many other cities that could have benefited in a similar manner were increases in personnel permissible.

[171]This dollar amount is what economists refer to as marginal revenue product. In order to maximize total cost savings from servicing personnel, the VA would need to hire additional loan counselors until the marginal revenue product of hiring the last one just equaled their marginal cost of employment (salary, fringes, etc.).

[172]In research for this study it was found that many groups believe that VA does nothing to help veterans in financial difficulties. This is because they regularly come across individuals who have gone to foreclosure without any contact from the VA. The VA regrets that this is one side effect of having a shortage of loan counselors; they have to make hard choices as to whom to assist. In fiscal year 1994 the VA piloted customer satisfaction surveys and an outreach program for military personnel affected by base closings in order to better target its resources into areas where they will do the most good in preventing potential foreclosures.

more potential claims costs.[173] VA refunding is more flexible than FHA assignments because it often involves some type of loan modification to reduce contractual monthly payments, thereby reducing the amount of accruals during any forbearance period. This makes eventual, full reinstatement by the borrower more likely.

[173]See U.S. GAO (1989, 40 note j). The 20 percent rate is implied by their 3.9:1 break-even success-to-failure ratio. The idea of a break-even success rate is outlined in chapter 3 of this report. It means that each borrower with a potential success probability of more than 20 percent, i.e., if the loan is refunded there is at least a 1-in-5 chance of curing the default and avoiding a foreclosure, can prudently be offered a refunding. While the GAO analysis is not as sophisticated as that of Ambrose and Capone (1993), their results match the type of break-even success probabilities for forbearances found in the simulations made with the Ambrose-Capone model and included here in chapter 3.

Table 5.6

VA Default Resolutions, 1991-1993
(percent of total in parentheses)

Year	90-day delinq-uencies[a]	cure on own	cure with VA inter-vention	refund loan	prefore-closure sale[b]	deeds-in-lieu	foreclo-sures
1991	158,895/ 166,945	117,330 (73.8%)	5,959 (3.8%)	783 (0.49%)	450 (0.28%)	1,757 (1.11%)	33,066 (20.8%)
1992	159,990/ 153,389	121,303 (75.8%)	5,029 (3.14%)	920 (0.57%)	691 (0.43%)	1,959 (1.22%)	30,779 (19.24%)
1993	145,146/ 142,196	116,137 (80.0%)	5,141 (3.54%)	1,102 (0.76%)	1,315 (0.91%)	1,895 (1.31%)	29,022 (20.0%)

[a]The first number is defaults processed (resolution completed) during the calendar year, and the second number is defaults reported during the year. The percentages given elsewhere in the chart are based on the first number of this column.
[b]The VA refers to these as compromise claims whereby a less-than-full claim is paid since the properties do not come into the VA or servicer investor.

Source: Department of Veterans Affairs, Loan Guaranty Service

Chapter 6

Foreclosure and Bankruptcy Law

A study of mortgage foreclosure alternatives would not be complete without discussion of the legal environment in which foreclosure occurs. The United States has a strong federalist heritage with regard to property rights issues and so foreclosure laws are unique to each State. This network of State statutes is then overlayed with the Federal Bankruptcy Code, which in turn supersedes State law with regard to lender rights to foreclose. Lender ability to obtain property through foreclosure is therefore dependent on both State law and chances of borrowers filing for bankruptcy court protection. While these laws do not necessarily impact the decision to foreclose, they impact the time and cost involved for the lender and the incentives of borrowers to either cooperate or not cooperate with their lenders in foreclosure avoidance.

The issues involved are complex, and there are no easy answers. Laws designed to protect borrowers from quick and unnecessary foreclosures do help some households retain their homes. However, they also allow others to abuse the system by lengthening the time of free rent received before foreclosure and eviction. This chapter explores the ways in which foreclosure and bankruptcy laws impact mortgage borrowers and lenders.

6.1 State Foreclosure Laws

Property Rights Issues

Federal statutes and case law leave property-rights issues to the States absent a countervailing Federal interest. The Rules of Decision Act, as amended (28 USC 1652), requires that even actions brought in Federal courts use State law as the "rule of decision" for civil actions such as foreclosure.[174] The States have each developed separate procedures for

[174] For the property-rights precedent see *In re* Roach, 824 F.2d 1370, 1374 (3d Cir. 1987) (citing *Butner v. United States*, 440 U.S. 48, 54 (1979)). Exceptions to the Rules of Decision Act rule were outlined by the Supreme Court in *Erie Railroad Co. v. Tompkins*, 304 US 64 (1938). These exceptions involve cases in which there are either basic rights created by the Federal government, or there is a Federal interest in the case. Yet what poses a Federal interest that should over-ride State law is still not settled today. The landmark cases of *United States v. Shimer* (367 U.S. 374, 1961) and *United States v. Kimbell Foods, Inc.* (440 U.S. 715, 1979) failed to provide clear and consistent guidance to the courts (See Alexander, 1993). However, clarity exists when Congress passes explicit legislation like the Multifamily Mortgage Foreclosure Act of 1981 (95 Stat. 422), which allows HUD to use power-of-sale foreclosure on FHA-insured multifamily properties where mortgages are first assigned to HUD. The Congress acted to override State law again in the Housing and Community Development Act of 1987 (101 Stat. 1948), which preempted borrower statutory rights of redemption on loans foreclosed out of the Secretary-held portfolio. For an historical analysis of

foreclosing on defaulted borrowers' interests in real property. One thread common to nearly all of these statutes is that they promote sale of properties to satisfy outstanding liens (claims). A completely free-and-clear title is then obtained by buyers at foreclosure sales. All junior liens are either paid off by the foreclosure-sale proceeds or else canceled. The irony of this approach is that, more often than not, the mortgage lender (or servicer) is the successful (often sole) bidder at the sale and must then market the property to liquidate the asset and recover its claim. The foreclosure sale, as presently practiced in the U.S., does not directly accomplish its stated objective of liquidating properties to satisfy liens. This is a failure to which much criticism has been leveled, and which will be discussed further throughout this chapter.

History of State Laws

The current patchwork of foreclosure laws used in the U.S. comes from State attempts to remedy deficiencies in 17th-century English law inherited by the American colonies.[175] The States sought both to sharpen creditor's remedies to default and give legal safeguards to borrowers. Foreclosure by sale was an invention of these early 19th century efforts. It was designed to cut off mortgagor rights to redeem properties and allow lenders to take possession.[176] Under previous English common law, mortgagor redemption periods could be extended by the courts for as long as 15 or 20 years. The new approach of selling the property established a point after which there would be no possibility of borrower reinstatement.[177] Each State adopted its own version of foreclosure by sale, with the exception of Connecticut and Vermont. Today these two States retain the original English tradition of (strict) foreclosure whereby the court grants the lender title to the property and a deficiency judgment against the borrower is established without sale of the property.

Most commentators agree that having a plethora of legal frameworks impedes efficiency in mortgage markets. Insurers, guarantee agencies, and many lenders and servicers operate on a national scale. Even community bankers utilize mortgage insurers and secondary-market opportunities. In addition, the mobility of modern society leads to property transfers

court cases involving Federal preemption of State property-rights law see Nelson and Whitman (1985, '11.6) or Alexander (1993).

[175]One exception to the British origins of U.S. foreclosure law is the State of Louisiana, where law is based upon the Napoleonic Code.

[176] This approach also appeared in England at about the same time.

[177]See Skilton (1943) and Tefft (1937, p. 580).

regularly occurring among participants from differing States. In this environment, State-specific laws require training and hiring support personnel and contractors who are familiar with each State's processes.

Some commentators have gone so far as to recommend that we need superseding Federal statutes.[178] A Federal Mortgage Foreclosure Act was introduced in the Senate in 1973, 1974, and again in 1980.[179] If enacted, it would have authorized use of the relatively quick power-of-sale foreclosure on all federally insured or guaranteed mortgages, and superseded State laws regarding borrower safeguards.[180]

In its fiscal year 1995 appropriations, HUD received authority to supersede State law and use power of sale foreclosure on all secretary-held mortgages. This does not extend to FHA insured mortgages, but only effects loans that were either made directly by HUD to sell properties out of its inventory or were assigned to HUD in order to prevent a foreclosure by the lender/servicer.[181] The same concerns which prompted Congress to allow HUD to circumvent State judicial foreclosure proceedings still exist for other Federal agencies and the mortgage industry as a whole.

Understanding the Foreclosure Process

Detailed discussions of individual State laws can be found in many sources.[182] The most commonly practiced approaches to foreclosures in the United States are power-of-sale (non-judicial) and judicial action.[183] These

[178]See Nelson and Whitman (1985, ' 7.3 & 8.8) and Sanders (1992).

[179]See 119 Congressional Record 32175 (1973).

[180]Specifically, redemption rights would be honored up until the time of the foreclosure sale (by a "foreclosure commissioner" appointed by the mortgagee), but there would be no post-foreclosure redemptions. See section 6.3 of this Chapter for a discussion of such statutory redemption periods. It could be possible for Congress to expand a Federal foreclosure law to all federally related mortgages and still potentially meet the criteria of the Decision Act and the *Erie* doctrine (see footnote 1 for a discussion of these).

[181]This was the "Single Family Mortgage Foreclosure Act of 1994," 12 USC 3751 *et seq.*, Title VIII of the authorization bill S. 2281, July 13, 1994, which was included by reference in HUD's fiscal year 1995 appropriations bill, P.L. 103-327, 108 Stat. 2298, September 28, 1994. It not only gave authority for power of sale foreclosure but also eliminated any post-foreclosure redemption periods allowed by State law.

[182]Durham (1985) provides a good overview. Klein and Ryan (1993) give a good discussion of the range of approaches used, comparing them with the idiosyncratic Massachusetts law. Dunham (1992) provides an encyclopedia of all facets of foreclosure law.

[183]There are two other, less common, approaches. The first, strict foreclosure, involves the lender taking title to the property without a sale. It has survived only in Connecticut and Vermont. The second approach is that of foreclosure by entry. There the lender obtains a court-approved right of entry and takes possession of the property

approaches to foreclosure have three essential parts: A notice of intent to foreclosure; a period in which the borrower can reinstate the mortgage and/or redeem the property (called an equity of redemption); and a procedure for selling the property to satisfy the lender's claim. To meet due process standards, each State's procedures must be followed according to the letter of the law or else the foreclosure sale can be invalidated. In addition, the requirements of State law can be met but the defaulting borrower can still sue to reclaim the property under Federal bankruptcy law.[184] This adds an element of uncertainty to obtaining marketable title at foreclosure. While it provides an incentive for mortgage finance institutions to seek alternatives to foreclosure, the risk of a Federal court reversing a foreclosure judgment causes borrowers to pay more for credit and causes depressed third-party bidding at foreclosure sales. Neither of these results is beneficial to homeowners.

The American Bar Association maintains standing committees that work on developing uniform codes for State adoption. During the course of this century, their work has produced three prototype statutes dealing with foreclosure laws. The most recent of these is found in the The Uniform Land Security Interest Act (ULSIA), completed in 1985.[185] No States have adopted any of these measures. The ULSIA does not introduce new concepts into foreclosure law practice, but rather attempts to meld the benefits of existing codes and eliminate the inefficiencies.

Table 6.1 provides a side-by-side comparison outline of power-of-sale, judicial, and ULSIA approaches to foreclosure. Part 5 of the ULSIA, which deals with mortgage default, is included as an Appendix to this Chapter.

Criticisms of Current Law

The most common criticism leveled against current law regards lack of competitive bidding at foreclosure sales.[186] These are typically held either

through direct eviction. This is permitted in a small number of States, but is not used as a primary method of foreclosure.

[184]See section 6.6.

[185]The two preceding models were the Uniform Land Transaction Act, 1977, and the Uniform Real Estate Mortgage Act, 1927. Copies of the full text of the ULSIA can be obtained from the National Conference of Commissioners on Uniform State Laws, 676 North St. Clair Street, Suite 1700, Chicago, IL 60611.

[186]See Berger (1987) and Goldstein (1992) for examples of this. It has almost become a part of American folklore that lenders buy properties at foreclosure sales for far less than market value and then resell them for substantial profits. This apparently had some truth during the Great Depression when typical first loans were for only 60 percent of original property value (see discussion in Rueter (1981, p. 279). During that time, second mortgages often made effective loan-to-value ratios above 100 percent as these lenders capitalized interest into the loan balance to avoid conflict with State usury laws (see U.S. President's Conference, 1931, 11-12). Therefore, no real equity existed in

at the property or the county courthouse, are not listed in industry-standard publications or databases used by realtors and homebuyers, do not involve realty agents who can make access available to potential buyers, and require purchasers to have substantial cash at the time of sale and the balance within a short period of time. Properties at foreclosure are not usually purchased by owner-occupiers. Typically, the only bidders other than the lender's agent are speculators. Even they must contend with multiple unknowns regarding property condition, must be able to finance their investments in the properties until final sale or rental, and have to bid low enough to cover two sets of transaction costs (buying and selling) and still earn a profit.

most foreclosed properties even though first mortgages were small. Research for this report found that profits on foreclosed properties are very rare today. Cost examples provided in section 3.6 show why.

Table 6.1

Major Types of Foreclosure Processes

Steps	Power-of-Sale	Judicial Action	Uniform Land Security Interest Act
Intent to Foreclose	Send notice of intent-to-foreclose (NOI) to borrower citing the complaint and the borrower's right to challenge this in court. The NOI may also be filed with the county clerk and sent to junior lien-holders.	File complaint with the county court. NOI is given to borrower and all junior lien holders.	A very detailed written "notice of intention" to foreclose notifies the borrower of the problem, potential remedies, rights as the debtor, and potential actions of the lender. This can be sent 5 weeks after legal default (30-days delinquency).
Hearing	In a small number of States a county clerk must hear the evidence and declare that a foreclosure may take place. Otherwise, the lender appointed trustee simply proceeds with arranging the sale.	A judge will hear all claims to the property and any defenses the borrower may want to present. Upon making a judgment in favor of the lien holders, the date for a court-supervised foreclosure sale is set.	The ULSIA encourages power-of-sale while permiting judicial foreclosures.
Notice of Foreclosure Sale	Each State has requirements for advertising the foreclosure sale (posting, newspapers, etc.), and the length of time it must be advertised.	Same as for power-of-sale method.	Same as for power-of-sale.

Table 6.1 (continued)			
Steps	Power-of-Sale	Judicial Action	Uniform Land Security Interest Act
Equity of Redemption	During the period between the notice-of-intent and the actual sale, borrowers have various potential remedies. One is the right to cure the default, another is the right to redeem the property by buying out the lender's interest.	Same as for power-of-sale method.	Owner-occupiers must be given 5 weeks to respond to the notice of intent before a sale can take place. Borrowers can cure or redeem property up until the foreclosure sale.
Foreclosure Sale	Auction held by the property trustee at the property or on the Courthouse steps.	Auction held by the county Sheriff or his appointee on the Courthouse steps.	Same procedures as in current power-of-sale and judicial foreclosure sales.
Statutory Redemption	Right of borrower to redeem the property after foreclosure is not generally required with power-of-sale actions. But if lender elects a judicial foreclosure in States that encourage power-of-sale, statutory redemption periods then take effect.	Begins at the time of the foreclosure sale. Borrower can generally purchase the property for the foreclosure-sale price plus accrued interest. This time period is determined by State statute, whereas the equity of redemption is a development of case law (see Table 6.2).	None allowed. There is an interest in providing the purchaser with good title to assure an adequate price at the sale.

Table 6.1
(continued)

Steps	Power-of-Sale	Judicial Action	Uniform Land Interest Security Act
Deficiency Judgment	Generally available but many States require judicial sale to establish property value before a deficiency can be determined.	Established, where available, once court determines property value, which is usually the sale price at foreclosure or a current appraisal.	Allowed on all but purchase-money mortgages (made by seller) for owner-occupied dwellings.
Major Benefits	Can often be completed within 6-10 weeks of initial filing of intent.	Court will divide property proceeds to satisfy all lien holders and produce a clear, marketable title. Any unsatisfied lien holders are foreclosed on and the title produced is as good as what was originally given to the defaulted borrower.	Uniformity of State laws to better match the national nature of the mortgage industry. Full redemption and cure opportunities guaranteed up to sale. Clear marketable title at foreclosure.
Major Costs	Less protections against title defects than in judicial sale because of the lack of court involvement. May not be able to impose a deficiency judgment unless the court determines property value.	Time and court costs can be burdensome to the lender. They can also make reinstatement more difficult and less appealing to the borrower who must pay them along with accumulated deficiencies in order to cure the default.	Time from delinquency to foreclose is so short (10 weeks) that it may eliminate potential cures. Does not address problems with the nature of the auction method of sale.

The ULSIA addresses this problem in part by eliminating statutory redemption periods. This would increase the number of bidders and raise foreclosure sale prices in States with these redemption periods. It also allows for automatic recording of deficiency judgments on unrecovered debt, which would give lenders leverage to keep non-hardship cases from exercising simple "put" options in allowing their properties to go to foreclosure.[187] But the ULSIA does not fundamentally change the nature of the foreclosure auction itself. It would still be encumbered by existing statutes that require all but the lender to bid in cash (the primary lender has the "credit" of the debt owed), and by not having industry-standard marketing efforts. It also does not address the underlying concerns about protecting borrower's equity interests in properties, which is perhaps why States have not adopted it.

This issue of whether or not borrower interests are protected at foreclosure sales has been hotly debated since at least the early 19th century. Most commentators would like to see some sort of industry-standard marketing process.[188] At the very least, they call for procedural changes to allow potential owner-occupant buyers to participate in foreclosure sales. This would necessitate better advertising of properties, making them readily available for inspection, and not requiring large amounts of cash at the time of sale. Unfortunately, any approach toward a "normal" marketing effort prior to foreclosure requires the current homeowner/borrower to relinquish possession of the property. The moving costs that would then be obligated upon the defaulted borrower make it more difficult to cure the loan default. In addition, most foreclosed properties have experienced a lack of maintenance which erodes their as-is market value. Lenders typically invest funds into foreclosed properties to rehabilitate them prior to final disposition. Because such investments have high yields and make properties more readily saleable, it is questionable whether or not defaulted borrowers interests would be best served by foreclosure sales to direct owner-occupant buyers. Properties with significant fix-up needs would be most attractive to investors rather than direct homeowners *per se*. Defaulted borrowers who have maintained their properties in good condition would be eligible for preforeclosure sales, which would make them better off than would any type of foreclosure.

One novel suggestion as to how to improve foreclosure-sale prices is to use

[187]The "put" option is, in securities parlance, the right to sell an asset at a set price during a future time period. Here the borrower effectively sells the property to the lender for the mortgage balance. This is advantageous, from a financial standpoint, when the market value of the property is below the value of the debt. The only impediments to this are deficiency judgments, tax liabilities on discharge-of-indebtedness, and decreased availability of credit.

1985, p. 853) for citations on works covering the post-Depression period.

a Dutch rather than English-style auction (Goldstein, 1992). The Dutch auction begins at a high price so that the winner is the first to enter a bid. While this would assure higher net proceeds in cases in which there are third-party bidders, it would not effectively change the outcome in the typical case where only the lender's representative is bidding. A low winning bid by a lender does not mean additional loss to the borrower as State laws have safeguards to prevent abuse of deficiency judgments (see section 6.4).

6.2 The Impact of State-Specific Statutes

Just as wide as the variation in State law is the variation in opinions concerning whether those laws are overly generous to borrowers or to lenders.[189] Certainly, States in which it takes one year or more after foreclosure is initiated to obtain a marketable title tilt in favor of borrower protections, while those in which foreclosure can be accomplished in 6 weeks favor lender interests. Academic researchers have attempted to measure the incentives that different laws give to lenders to either initiate or avoid foreclosure, but have come to no clear conclusions.[190] No one, however, has systematically studied the incentives borrowers have either to cooperate with lender efforts to reinstate the loan or to thwart those efforts. Information received from the industry indicates that it is more difficult to obtain borrower cooperation in States with lengthy foreclosure time frames and in those which make it difficult to obtain deficiency judgments on the debt.[191]

Industry Practice

Mortgage insurers and guarantee agencies go beyond the letter of the law to protect borrower interests. They promote their own national standards for time-before-initiating-foreclosure, attempting alternatives to foreclosure,

[189]For example, Goldstein (1992) argues that foreclosure laws (or at least their applications) favor lenders while Durham (1985) argues that the same laws favor borrowers.

[190]See Aalberts and Clauretie (1988). While they claim to show that States with lower cost foreclosures have higher foreclosure rates, there are weaknesses in both their data and methods. Their data uses foreclosures initiated rather than completed -- the former can be 2-to-4 times the latter -- and their use of ordinary-least-squares regression analysis does not properly control for the effects of different laws or possible truncation bias with their endogenous variables. Clauretie's (1987) work attempting to verify the Mulherin and Muller (1987) theory that lenders will more often foreclose on low-interest-rate loans suffers the same failures.

[191]One study that comes close to this issue of cooperation between lender and borrower is that of Springer and Waller (1993). They review the length of time in delinquency and before final foreclosure on properties foreclosed in Texas in the early 1980s and use this an indication of lender forbearances.

and accepting borrower reinstatements (self cures). Research for this study found none whose foreclosure prevention policies vary according to State foreclosure laws.[192] National exposure and public purposes lead them to be very careful to protect the borrower's interest in the property as much as possible.[193] Because some of these provisions are imbedded in loan documents which -- in the case of Fannie Mae and Freddie Mac -- are now used by even portfolio lenders, such protections are widely dispersed. The Fannie Mae and Freddie Mac deed-of-trust forms require a detailed mailed notice, a 30-day grace period before loan acceleration, and allow complete reinstatement by the borrower up to 5 days before the actual foreclosure.[194] FHA does not allow foreclosure to begin as long as a borrower is making enough partial payments to be less than 90 days delinquent, and permits full reinstatement up to the day of foreclosure sale.[195]

As demonstrated in chapters 2 and 3, protecting borrower interests is cost effective. Any continuing problem with short foreclosure times leading to unnecessary foreclosures stems from an inability of local portfolio lenders to accept the same risks as national firms. Localized concentrations of properties means that there will usually be only small numbers of foreclosures. These firms cannot afford to maintain highly trained workout specialists in-house nor can they take the financial risks involved in rigorous pursuit of alternatives to foreclosures.[196] This does not mean that they should not or do not attempt to avoid foreclosure, but that they cannot do this to the same extent as can firms with national portfolios. A related issue is the inability of small loan servicers to afford full-time workout specialists. Mortgage insurers and guarantee agencies indicate that they are still attempting to find effective ways to get these firms more involved in loan workouts and loss mitigation efforts.

6.3 Statutory Redemption Periods

[192]Foreclosure procedures, on the other hand, are State specific, leading to some differences in loan documents used in various States.

[193]See in particular: Fannie Mae's May 17, 1991 mortgagee letter "Foreclosure Prevention and Loss Mitigation"; Chapters 4 & 5 of the Fannie Mae Servicing Handbook; the Freddie Mac Sellers' & Servicers Guide, vol. 2, Chapters 65, A65, and 66; and FHA's Administration of Insured Home Mortgages (Handbook 4330.1 REV-5), Chapters 7 & 8.

[194] See the Fannie Mae/Freddie Mac Uniform Instrument Deed of Trust form. While the allowance of cure up to 5-days prior to the foreclosure sale is uniform across States (see '18), the actual grace period is a function of State equities of redemption.

[195]See HUD Handbook 4330.1 REV-4, July 1993, 7-22. However, a lender may initiate foreclosure if a deficiency persists for over 6 months without being cured, even if it is less than 90-days in dollar terms.

[196]See the discussion of risk in Chapter 3.

One of the most vexing issues surrounding foreclosure laws is the use of post-foreclosure statutory redemption periods in which defaulted borrowers who lose their properties have the right to "redeem" or repurchase them for the foreclosure-sale price. This practice has its origins in the demands of American mortgagors for greater protections from foreclosure during depressions of the 19th century. When courts refused to extend the equity of redemption, State legislators stepped in with statutory provisions.[197] Today, 15 states have mandatory post-foreclosure redemption periods of 2.5 to 12 months, and five others only allow redemption when the lender seeks a deficiency judgment via a judicial foreclosure. In some cases the original borrower can stay in the property during this period while in others the lender, who will have little competition at the foreclosure sale, must rent and manage the property until a clear title can be obtained.

Table 6.2 gives the impact of statutory redemption periods on effective foreclosure times.[198] In the four States with 10-to-12 month redemption periods, it takes an average of 18 months to obtain clear title to properties once foreclosure is initiated, which means 22 months or more from the original delinquency.[199] At the other extreme, there are six States with quick foreclosure and no redemptions where title can be obtained in around 3 months once foreclosure is started.[200]

Use of Statutory Redemptions

Bauer (1985) traced the use of redemption periods in Iowa over the course of a century (1881-1980). He notes that redemption laws were in favor between 1820 and 1920, then legal scholars began to discredit their usefulness during the 1930s and subsequent periods.[201] While his overall

[197]See Skilton (1944, p. 326f), Tefft (1937, p. 590), and Bauer (1985). This is different from the "equity of redemption" which provides a time period prior to the foreclosure auction in which the borrower can cure the default.

1992, v. 1, 15A) for an outline of state codes and Committee (1968) for a State-by-State discussion of the cost of statutory

[199]Alabama, Alaska, Montana, and New Mexico.

[200]These are Georgia, Mississippi, Missouri, New Hampshire, Rhode Island, Texas, and Virginia. While 3 months is average, uncontested cases can often be closed in 6 weeks or less.

[201]While our current system of property mortgages is rooted in English common law, with ties back to Roman law (see Durham, 1985), the idea of a redemption period extends back at least to second millenium B.C. middle-eastern culture. The early Hebrew people codified post-sale redemptions for all properties, with 1-year limitations on owner-occupied housing (Leviticus 25:25-31). These laws are direct antecedents to current law because the interest was in a person who was forced to sell property due to poverty. As is still the case in most States today, the redemption right could be assigned to another (the Israeli "kinsman-redeemer").

redemption rates are for commercial as well as owner-occupied residential properties, some relevant insights can be gleaned. His findings, and his inferences from other studies of lesser duration, suggest that redemption rights are exercised more during normal times than in periods of depression (i.e., not generally exercised in times of sustained declines in property values), and that they are primarily used with agricultural land. The Bauer work does not clearly distinguish residential from farm properties, indeed he combined data from one primarily residential and one primarily agricultural county and provided no statistical tests to discern

Table 6.2

State Foreclosure Times, Statutory Redemption Periods, and Availability of Deficiency Judgments

State	Months in Foreclosure[a] (1)	Mandatory Redemption Period (2)	Time to Obtain Clear Title (1)+(2)	Other Redemption Period Statutes	Rules on Deficiency Judgments (blank space indicates none)
AL	6	12	18		
AK	5	12	17		
AZ	5.3	6	11.3		
AR	6	0	6		
CA	6	0	6		complicated process to obtain
CO	5	2.5	7.5		
CN	11	0	11		
DE	8	0	8		
DC	4	0	4		
FL	9.5	0	9.5		
GA	3	0	3		
HA	6.7	0	6.7		
ID	6	6	12		
IL	10.5	6	16.5		
IN	7.5	0	7.5		
IO	6.7	6	12.7	12 months if establish deficiency	only if accept an extra 6 months redemption period
KS	6.7	6	12.7		
KY	5.5	0	5.5		
LA	7.3	0	7.3		

State	Months in Foreclosure	Mandatory Redemption Period	Time to Obtain Clear Title	Other Redemption Periods	Rules on Deficiency Judgments
ME	14	0	14		
MD	5	0	5		
MA	9.3	0	9.3		
MI	3	6	9		easier to obtain with a judicial foreclosure
MN	5	6	11	12 months if equity in property greater than 33%	only with judicial foreclosure
MS	3	0	3		
MO	3	0	3	redemption period only if use power-of-sale foreclosure	
MT	5.5	12	17.5		only in judicial foreclosure
NE	7	0	7		
NV	5.5	0	5.5		
NH	3.3	0	3.3		
NJ	17	0	17	6 months if obtain deficiency judgement	must accept 6 months redemption period
NM	8.5	10	18.5		
NY	13.4	0	13.4		
NC	4.3	0	4.3		
ND	5.5	2	7.5	12 months if equity greater than 33% or seek deficiency judgement	must accept 12 month redemption period
OH	10	0	10		

State	Months in Fore-closure	Manda-tory Re-demp-tion period	Time to Obtain Clear Title	Other Redemption Periods	Rules on Deficiency Judgments
OK	7.5	0	7.5		requires judicial foreclosure
OR	6	0	6		must use judicial foreclosure and accept 12 month redemption period
PA	10	0	10		difficult to obtain
RI	4.9	0	4.9	36 mn. redemption in judicial foreclosure	not allowed on residential properties
SC	6	0	6		
SD	4	6	10		
TN	2.7	0	2.7		
TX	2.5	0	2.5	12 months if use judicial foreclosure	
UT	5.5	0	5.5	6 months if use judicial foreclosure	
VT	6.5	0	6.5		
VA	3.3`	0	3.3	allowed in judicial foreclosure	
WA	6	0	6		must use judicial foreclosure and have a redemption period
WV	4	0	4		
WI	10	0	10		
WY	8.2	3	11.3		

[a]Months in foreclosure are typical times from initiation to foreclosure sale.

Source: Months in foreclosure, Freddie Mac Sellers' & Servicers' Guide, vol 2 (McLean, VA: Federal Home Loan Mortgage Corporation, 1993); other information taken from Dunaway, *The Law of Distressed Real Estate*, vol. 1(New York: Clark Boardman, 1992).

differences between the two.[202]

Bauer's point about redemptions being used less during times of depression is relevant to today's situation. The increase in foreclosures since 1980 (see chapter 2) has been due to rolling, overlapping regional recessions. We have witnessed house price declines of magnitudes not seen since the Great Depression; up to 30 percent in affected regions. Thus redemption prices would generally far exceed the market value of foreclosed properties. The second factor which makes redemption less palatable today is that mortgage loans are typically for a much higher percent of the property value than they were in the 1940-1960 period. Even though FHA allowed loan-to-values as high as 95 percent as early as 1948, banking regulators did not relax conventional loan standards to allow for above 80 percent loan-to-value ratios until the 1960s (90 percent with private mortgage insurance) and 1970s (95 percent with private mortgage insurance). Today, like in the pre-Depression era, effective loan-to-value ratios can be over 100 percent. In the pre-Depression era, first mortgages were under 60-percent loan-to-value, non-amortizing balloon loans, but with second mortgages that often made total indebtedness over 90 percent or even

100 percent of property value.[203] Today first mortgages may be for over 100 percent of the property value with government insurance. That means that the percentage of mortgage foreclosures with negative property values will be much greater today than was the case in the 1940-1960 period, making redemption statutes less meaningful.[204,205]

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[202]Bauer found that the redemption rate was actually higher for the post-Depression period than it was during the pre-Depression era (see Table B on p. 369), which may reflect easier access to farm credit through the Federal government. Continued access to mortgage credit during the first years after foreclosure is almost nonexistent for single-family property owner-occupiers, unless they have significant wealth.

[203]Second mortgages were "discounted" in order to circumvent State usury laws. Borrowers would effectively pay back principal that was over 100 percent of appraised value (though there were no standard appraisal techniques), making interest rates as high as 30 percent on second mortgages (President's Conference, 1931).

[204]The VA, by allowing no down payments and requiring sellers to pay some of the buyer's closing costs, effectively pushes the loan-to-value ratio above 100 percent. This is because in a competitive market, the seller will only sell to the VA buyer if the extra cost imposed on them is in some way capitalized into the house price. That means selling to the VA buyer at a higher price than other buyers. With FHA insurance, loan-to-value ratios can be above 95 percent, closing costs can then be added to the loan, and sellers can also provide other incentives of up to 6 percent of the house price. It does not take a house price decline for these loans to be "underwater." Given that selling costs can be up to 10 percent of the house price, and there is little loan amortization in the early years of 30-year mortgages, a government-insured buyer of a $80,000 house with an effective loan-to-value ratio of 100 percent would have to put money "on the table" to sell the house any time in the first few years unless there is significant house price inflation. If house prices decline even 5 percent, this homeowner faces the need to have around $10,000 cash to be able to sell the property. In a typical 1980s-style regional recession scenario, this escalates to nearly $30,000.

Benefits to Borrowers

The benefits of post-sale redemption periods to borrowers are difficult to find. Ostensibly, such laws are designed to protect equity by forcing the lender to bid a reasonable price. These statutes have been interpreted as protecting the property owner's equity from an inadequate foreclosure price by encouraging price-bidding high enough that the original debtor will not have an incentive to redeem (Washburn, 1980).[206] Yet defaulting borrowers do not generally let properties go to foreclosure unless there is an antecedent cause for moving and negative equity in the property. The exception to this rule is in fast foreclosure States with cases in which there is no cooperation between lender and borrower over potential repayment or workout plans. If there is positive equity to begin with, it will usually be gone once all of the delinquent interest payments, penalties, and foreclosure expenses are added to the outstanding debt (see chapter 3.6). National insurers and guarantee agencies authorize any surplus remaining after final sale of foreclosed properties to be returned to borrowers. Yet with rehabilitation, management, and sales costs, any positive equity at foreclosure will almost always be eliminated by the time of lender disposition. That means borrowers will generally not want to redeem foreclosed properties.[207] At the same time, mandatory redemption periods lower third-party bids at foreclosure sales, making potential deficiency judgments larger, and increasing mortgage insurance premiums and interest rates for all borrowers.[208] As a borrower-protection device, mandatory statutory redemption periods are not cost effective.[209]

A compromise occurs in those States which require redemption periods only

[205]As seen in Table 6.2, there are two States that impose longer redemption periods for borrowers with at least 33 percent equity in their homes (Minnesota and North Dakota).

[206]The issue of price inadequacy voiding a foreclosure sale has not been fully resolved by the courts. See discussions in Washburn (1980) and Richards, Jr. (1990).

[207]For example, United Guaranty Insurance Corporation reports that its workout specialists recall having seen only 5 post-foreclosure redemptions on a total of 19,500 foreclosures in the 1988-1993 period. Fannie Mae reports that 1.3 percent of foreclosed properties in its foreclosure inventory were redeemed in 1992. One would expect Fannie Mae to experience a higher redemption rate than an insurer because its foreclosures include properties with higher initial equity. These properties would have a greater chance of redemption being both beneficial (fewer with deep negative equity) and possible (greater wealth and sources of funds) for households.

[208]See Meador (1982), Clauretie (1989) and Schill (1991, p. 496).

[209]The American Bar Association's Committee on Mortgage Law and Practice (1968) presents a scathing critique of statutory redemptions and costly foreclosure procedures. They provide a State-by-State analysis of their effects. This was the impetus behind the foreclosure provisions of the Uniform Land Transfer Act written by that Committee in 1977.

if the lender seeks a deficiency judgment on the debt.[210] This type of arrangement has the effect of eliminating deficiency judgements and thus removes an important element of leverage to induce non-hardship cases to cure their loan defaults. Other States have dealt with this directly by either having statutory pre-sale redemption periods where the borrower can directly reinstate their loans before foreclosure, or by using "upset prices," i.e., minimum acceptable foreclosure sale prices.

The one case in which there could be value to debtors in having redemption periods is during times of rapid house-price inflation. Bauer (1985, Table F) reports that for non-farm land in his two-county sample between 1966 and 1980, 10 percent of all foreclosures with 6-month redemptions redeemed (3 out of 30) and 16.2 percent of those with 1 year redemptions repurchased their properties (6-out-of-37). This covers the period of 1970s stagflation where relatively high unemployment was combined with strong inflationary forces; however, Bauer defines non-farm land as properties of less than 15 acres. This implies there may be significant numbers of commercial properties included in his sample. Bauer cites other studies that confirm that single-family owner-occupied-housing redemptions are a fraction of 1 percent of all foreclosures, even in "normal" times (see p. 348, note 5). Their numbers should be less than commercial properties because it will be more difficult for recently defaulted and foreclosed-on home buyers to obtain new financing, and their properties were likely to be more heavily leveraged to begin with.

As emphasized in chapters 2 and 3, no one wins in a foreclosure: it is a negative-sum game. If the borrower is truly facing a temporary hardship (e.g., loss of job in a good economy, one-time medical expenses, etc.), then a plan to retain the property is the least-cost alternative for all involved. If the hardship is permanent and the borrower needs to relinquish rights to the property, the redemption period simply adds costs with little potential benefits. The alternatives to foreclosure outlined in chapter 3 are all better for both borrower and lender.

Tax Liens

A Federally mandated redemption period of 180 days is in force whenever foreclosure is initiated because of a tax lien on the property (26 USC 6337(b)). It can be due to Federal, State, or local taxes. When this happens, and the mortgage lender is the winning bidder at the foreclosure sale, the 180-day period must pass before it can sell the property with a clear title.

[210]New Jersey, North Dakota (still allows 2 months if no deficiency), Oregon, Rhode Island (3 years if judicial foreclosure used), Utah, and Washington.

6.4 Deficiency Judgments

The question of whether or not a lender can sue a defaulted mortgage borrower for any uncollateralized debt was generally answered in the affirmative until the Great Depression. Abuses of that time led many States to adopt anti-deficiency legislations and moratoriums on foreclosures. Not that recovery of deficiencies was outlawed, but that strict parameters were put on their use. In particular, the "fair value" of the property was to be determined by some method other than the foreclosure-sale price, especially if the lender was the winning bidder. This would prevent the lender from bidding below the outstanding debt, obtaining a deficiency judgment against the borrower, and then selling the property for a profit. Fourteen states have some form of controls over deficiency judgments, most of which are designed to avoid abusive use of power-of-sale foreclosures where there is no court supervision. Only Rhode Island bars them outright. Others, however, tie their availability to provision of statutory redemption periods, effectively removing a lender's incentive to pursue them. Details can be found in Table 6.2 and its source documents.

Allocation of Risk

The root issue with deficiency judgments is where to place responsibility for the risk of house-price deflation. In all business arrangements the first risk is born by the equity holders. They hold both the upside (profits) and primary downside (losses) risk of the business. The courts have also generally held this relationship to be true for homebuyers and mortgage lenders.[211] That is, deficiency judgments are valid remedies for lenders seeking to be made whole on their loans. At the same time, State legislatures have traditionally been sympathetic to the mortgaged homeowner in times of economic distress because of the importance attached to a homestead.

The issue of risk allocation and deficiency judgments came to a head in the 1980s as the courts were dealing with large numbers of filings under a new Bankruptcy Code. Several U.S. district courts ruled that in personal bankruptcies the mortgage debt can be bifurcated into secured and unsecured parcels, the former being an amount equivalent to the appraised value of the property. This alarmed lenders because borrowers could then escape potential deficiency judgments through nonpayment of the unsecured debt. These "cram downs," as they have been called, are discussed more completely in section 6.6.

Today deficiency judgments with single-family foreclosures are generally

[211]See citations in Washburn (1980, p. 873).

used against investors, repeat defaulters, and non-hardship cases. Even though all insurers and guarantee agencies expect servicers to protect their rights to seek deficiencies in all cases, they are rarely used in practice. To obtain a deficiency judgment means incurring court costs and then collection costs. When a borrower has experienced a financial hardship to begin with, the probabilities of recovering these costs are slim. The amount of the deficiency and the assets of the borrower must be substantial before it is worthwhile to pursue collections. However, under the rubric of loss mitigation, the mortgage industry is taking a new look at deficiency judgments, or the threat thereof, as a viable collection tool.[212]

During the initial screening process for workout assistance (see chapter 2), borrowers must complete a financial worksheet of family assets, liabilities, and income sources. This is then used to determine how much the family can afford to contribute towards the costs incurred by the insurer and/or guarantee agency. As a condition of workout assistance, they will then be asked to contribute that amount. This helps alleviate the (moral hazard) problem of defaulted borrower's spreading the news that obtaining assistance is costless. Generally, families will have some resources they can draw upon to help cure their delinquencies, and private insurers and guarantee agencies encourage them to do so as much as possible in order to retain responsibility for their debts.

Discharge of Indebtedness Taxation

As noted earlier, deficiency judgments after foreclosure are typically sought only in cases where there is fraud or abuse (including abandonment of the mortgage obligation as a convenience to the borrower). If the lender does not seek a full deficiency against the borrower, it must report the discharge-of-indebtedness to the Internal Revenue Service, which then counts it as current income to the borrower under Section 61(a)(12) of the Tax Code. The foreclosure sale is treated just like an ordinary sale of property (Tax Code Sec. 1001(b)). In States that do not allow deficiency judgments, the borrower must report the debt discharge as if the property were sold to any other buyer. The tax basis of the property is reduced by the amount of the debt discharge, and the net sale price is the total outstanding indebtedness at the time of foreclosure. So in anti-deficiency States, the debt discharge is treated like a capital gain. Borrowers in deficiency States must also report a property sale for tax purposes. They have sold their properties for an amount equal to the foreclosure price (less sale expenses), and can experience either a capital gain or loss on the property in addition to any discharge-of-indebtedness (regular) income if a deficiency is not pursued.[213]

[212]See Melchiorre (1995).

[213]For example, let us say that taxpayer A experienced a foreclosure on a property worth $70,000 for which there

These provisions of the tax code also apply to deeds-in-lieu of foreclosure (Sec. 9108). The provisions of Section 61(a)(12) are general enough that they too apply to preforeclosure sales where the lender (or insurer) pays a claim on the property, though the IRS has just recently issued interim regulations for lender reporting of this shadow income.[214]

Most homeowners in this situation will be at or near bankruptcy, and Section 108(a)(1)(B) of the Code does limit the debt discharge income to that amount that makes the borrower insolvent. But the remainder must be used to reduce the basis of the property, thus increasing any effective "gain" on sale. That does not help matters because a household just going through a deed-in-lieu or a foreclosure will not have ready access to the mortgage funds necessary to rollover such capital gains into another home. A borrower without the funds to reinstate their mortgage will not have the funds to pay what could then be a substantial tax bill.

These sections of the Tax Code are primarily designed for commercial transactions with for-profit enterprises. They are complicated and create a very cumbersome situation for defaulted borrowers who negotiate for pre-foreclosure property transfers and yet still must attempt to prove insolvency to the IRS in order to avoid further penalties for their financial hardship.

6.5 Moratoriums

Another way States have sought to ameliorate the effects of widespread mortgage default is through enactment of foreclosure moratoriums.[215] These were widespread during the Depression, and came back again in the

was an outstanding mortgage of $80,000. Suppose the property was originally bought for $90,000, net of transaction costs. In a State that allows deficiency judgments, the taxpayer must report a house sale at $70,000 less the lender's foreclosure costs, say of $3,000. So the taxpayers reports a capital loss on sale of property of $90,000 - ($70,000 - $3,000) = $23,000. If the lender chooses not to pursue a deficiency judgment for the full $13,000 ($80,000 - $67,000) plus accrued interest and penalties, taxpayer A will also have to report a discharge of indebtedness as regular income. So if there is no deficiency judgment, and accrued interest and penalties are $3,500, then taxpayer A must report regular income of $16,500 in addition to the $23,000 capital loss on sale of home. If, however, taxpayer A lives in an antideficiency State, then the home has effectively been sold to the lender for $83,500 (the mortgage balance + accrued interest), and has a basis-for-sale of $77,000 ($90,000 - ($80,000 - $70,000 + $3,000)). Taxpayer A therefore reports a capital gain of $6,500.

[214]Interim regulations were published in 58 Federal Register 246 at 68301 (December 27, 1993). Indebtedness discharges from preforeclosure sales have always been covered by the Tax Code, but lenders have varied in their reporting of these. The VA contends that it would not be covered by any new IRS regulations because its mortgage guaranty program is classified as a veteran's benefit. Thus it will continue to offer preforeclosure sales (compromises) without reporting any discharge of indebtedness income.

[215]There is a Federal statute, the Federal Soldiers and Sailors Civil Relief Act of 1940, that requires lenders to provide moratoria for military personnel called into combat.

1980s. The Supreme Court upheld their constitutionality only for emergency situations.[216] They cannot be instituted on any permanent basis because that would jeopardize the freedom of contract imbedded in article I, section 10, of the U.S. Constitution. In response to the 1981-82 recession, Minnesota and Connecticut enacted moratoriums for unemployed workers, the Farmers Home Administration enacted regulations that provided moratoriums and forbearances for its loans, and Pennsylvania introduced a State-sponsored forbearance program to stay foreclosures for up to 3 years.[217] The U.S. Congress had made an earlier attempt at borrower relief by enacting the Emergency Homeowners Relief Act of 1975 (89 Stat. 249). This was to perform the same function for all federally-insured borrowers as did the later Pennsylvania statute for Pennsylvania residents. It has not received appropriations and so has not been implemented.[218]

6.6 Bankruptcy

Bankruptcy is a legal remedy for individuals and business entities in financial distress. It is designed to provide time for a debtor who is unable to maintain such obligations to reorder financial affairs in a way that is equitable to the debtor and to the creditors. The current Federal Bankruptcy Code (hereinafter, the "Code") was adopted in 1978, and has three tracks: a plan to liquidate assets to satisfy creditors (Chapter 7), and two plans to reorganize debts in order to retain assets and still, eventually, satisfy creditors (Chapters 11 and 13).[219] The bankruptcy courts are part of the U.S. District Court system. The act of filing a bankruptcy petition invokes an automatic stay on creditor attempts to collect on debt (11 USC '362(a)), and provides the final safety net for mortgaged homeowners facing imminent foreclosure.

The number of homeowners facing foreclosure who file for court protection is not known. The Administrative Office of the U.S. Courts collects data

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[216]The case of *Home Building & Loan Association v. Blaisdell* started in Minnesota and worked its way first to the State Supreme Court (198 Minn. 422, 249 N.W. 334) and then to the U.S. Supreme Court (290 U.S. 398). The five-part test issued by the Court was designed to provide the State with room to exercise its "protective power," while guarding the contracts clause of the Constitution. See Amundson and Rotman (1984) for a complete discussion.

[217]Connecticut Public Act No. 83-547; Minnesota State Ann. ' 583.07; 35 Pennsylvania Statute ' 1680.401(c). The Pennsylvania experiment is discussed in chapter 5.1.

[218]Other forbearance bills were introduced into the House of Representatives in 1983 and 1992 but were not voted on.

[219]This is the Bankruptcy Reform Act of 1978, 11 U.S.C. ''101-1330, as amended. Complete discussions can be found in Dunaway (1985, vol. 2) and National Consumer Law Center (1992).

only on the number of filings and not any information on the actual cases.[220] It reports that consumer bankruptcies more than tripled from 1980 to 1990, and continue to grow. The National Foundation for Consumer Credit Inc., a trade organization for local Consumer Credit Counseling Services, does indicate that its typical clients are homeowners and owe close to $20,000 to creditors other than the holder of their principal home mortgage. Nearly half of them come for help due to poor money management.[221] Only a minority of Consumer Credit Counseling Services specialize in mortgage defaults, so they cannot paint a picture of those that file for Bankruptcy Court protection.

Mortgage industry sources suggest that the typical bankruptcy path for defaulted homeowners is through Chapter 13.[222] This provides for up to 5 years to return to current status on debts. Some households prolong the process by as much as 10 years by repeat filings under Chapter 13 or successive filings under Chapter 13 and then Chapter 11 and/or Chapter 7.

While a debtor's bankruptcy filing can stop foreclosure proceedings from continuing, the creditor can file a petition for release from the stay (11 USC '362(d)). This is generally honored when the value of the secured property is less than the outstanding loan balance, and allows the lender/creditor to avoid lengthy delays in foreclosure and property disposition.[223] Lenders, servicers, insurers, and guarantee agencies are all impacted by the delays in foreclosure that result from bankruptcy filings. Even if they can obtain a relief from the automatic collections stay and continue processing the foreclosure, they have incurred new legal, loan, and property costs. The borrower would have to repay these in order to cure the loan default.

While not focusing on borrowers in default on their mortgages, a study by Sullivan, et al (1989) highlights the situation of homeowners in bankruptcy. These researchers sampled from all personal bankruptcy filings in 1981

[220] HUD contacted many other organizations involved in monitoring bankruptcies but found none that collect data on personal bankruptcy filings.

[221] See information cited in Stahl (1993).

[222] Chapter 13 is restricted to individuals with modest debts and assets and a regular source of income. The income requirement is broadly construed to go beyond wages and salaries (See National Consumer Law Center (1992, 225). Chapter 11 reorganization may be pursued by either individuals or businesses, but the expense of reorganization plans makes it of limited use to individuals.

[223] There can also be other considerations, such as whether or not the property value is declining, whether such a decline is affecting any positive equity in the property, and, in Chapter 13 cases, whether the debtor is making regular payments on the debt. See Dunaway (1992, vol. 2, '24.02[2]) for a complete discussion of court precedents on the meaning of Code provisions.

and tracked their progress through 1985. They found that while homeowners were more apt to choose Chapter 13 than were non-homeowners, homeowners were still evenly split in their choice of Chapter 13 and Chapter 7 filings. Even more revealing is the fact that 10 percent of homeowner filers in the sample kept their mortgage debt out of the bankruptcy case -- with the approval of judges and attorneys. The incentive appears to be to protect the home and the mortgage by reorganizing or dispensing with all other debts.[224] So this group of filers was typically current on their mortgage obligations even though they were intractably behind on other debts. The authors of the study conclude that Chapter 7 is safer for homeowners than is Chapter 13 because it completely frees household income to support the mortgage.

Homeowners who take on too much other debt have little chance of gaining assistance in keeping their homes outside of the bankruptcy court. Mortgage insurers do not reorganize non-mortgage debt into a refinanced loan except in exceptional circumstances.[225] Allowing for a debt-consolidation refinancing (where there is sufficient equity) may lower the interest rate on the other debts, but it causes the lender to take on the credit risk of those debts as well. Lenders would then increase their risk exposure by such indulgences. Bankruptcy reorganization or liquidation is often the only alternative to immediate foreclosure for these homeowners.

In the event that inability to continue making mortgage payments is the sole or primary reason for filing a bankruptcy petition, the homeowner debtor's financial position would only be improved by taking such action if the lender is refusing to allow a manageable repayment plan. This is, first of all, because primary mortgages for owner-occupied property receive special protection in the Code and thus the debtor cannot escape repaying the debt. A second consideration is that the household's access to credit will be severely curtailed by the combination of a bankruptcy filing and eventual foreclosure. The household is better off negotiating a solution with the loan servicer outside of court. All insurers and guarantee agencies prefer this as well, but once a borrower files a petition with the Court the servicer can no longer negotiate with the borrower.

Cram downs

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[224]Homeowner filers typically had as much non-mortgage debt (as a percent of household income) as non-homeowners. The indication is that they tap into their home equity via second mortgages and equity lines of credit in order to weather financial downturns. When the financial strains continue beyond their capacities to manage, then they turn to the Bankruptcy Courts.

[225]FHA cannot help such borrowers because of the statutory requirement that the borrower's difficulties be due to circumstances beyond their control. See chapter 5 for discussions of what FHA can and cannot do to assist troubled borrowers.

One major issue surrounding mortgages in bankruptcy filings was thought to have been resolved by a recent Court ruling. It involves the ability to bifurcate undersecured debt into secured and unsecured portions.[226] For mortgage loans, this means that the loan is separated into a first mortgage equal to the current property appraisal, and a second mortgage -- with no property lien -- for the remaining indebtedness. The secured portion retains supremacy with regard to payment, while the unsecured portion is grouped with all other unsecured debts and given no special status. The Code for Chapter 13 filings had been confusing with regard to whether this applied to primary purchase mortgages of owner-occupied properties.[227] The issue was resolved in favor of the lender by the U.S. Supreme Court in *Nobelman v. American Savings Bank*, 113 S.Ct. 2106 (1993). In the *Nobelman* case, the U.S. Supreme Court upheld the supremacy of primary residential mortgages under section 1322(b), effectively ending cram downs of first mortgages on residential properties. This ruling was based upon an interpretation of the Code which says that a mortgage lender's "rights" cannot be diminished in a bankruptcy plan.[228] It ruled the same for Chapter 7 liquidations in *Dewsnup v. Timm*, 112 S.Ct. 773, 22 BCD 750 (1992), but has not yet heard a case involving Chapter 11 reorganizations. However, The Bankruptcy Reform Act of 1994 has now codified anti-cram down provisions for both Chapter 13 and Chapter 11 bankruptcy filings.

The mortgage industry expected that *Nobelman* by itself would have stopped nearly all cram-down activity by the bankruptcy courts. However, in late 1995, the Third Circuit Court ruled in *Michael and Jeanette Hammond v. Commonwealth Mortgage Corporation of America* that *Nobelman* did not rule out all cramdowns. In particular, Commonwealth had secured the Hammond's mortgage with the property plus additional

[226]Provisions of the Code are much broader than this, allowing for the debtor to suggest any modification of the loan terms or provisions. However, the splitting of a property lien into secured and unsecured debt has been the most contentious. It is referred to in the Code as "lienstripping."

[227]Such mortgages are protected under section 1322(b)(2), but some courts have ruled that the wording of 1322(b)(2) suggests this is limited by the underlying value of the property at the time of filing. This would follow with the general language of section 506(a) which permits modification of all debts. An early ruling allowing residential cram-downs in Chapter 13 bankruptcies was in Ohio (*In re Neal*, 10 B.R. 535, 540 (Bankr. S.D. Ohio 1981). This line of reasoning led to appeals court precedents in four districts between 1989 and 1992. See Polk (1991) for details of the history of court rulings in this area.

[228]The core issue, as spelled out by Justice Thomas in his opinion for the Court, was that not withstanding the provisions of section 1322(a) which allow for bifurcation of liens into secured and unsecured components, section 1322(b) deals with the "rights" of the holder of a homestead mortgage. Those rights are a product of State law, and are spelled out in the deed-of-trust (or mortgage) documents. While a Chapter 13 petition can stay collections and foreclosure, and give additional time for the debtor to become current on the mortgage note, it cannot be used to reduce the principal amount owed to the lender.

security interests. The bankruptcy Code language dealt with by the Supreme Court in *Nobelman* only refers to mortgages secured by the principal residence. That section of the Code (1322(b))2)) is silent on cases in which there are additional collateral requirements, and thus the Third Circuit ruled that *Nobelman* is also silent on such cases.

Fraudulent Transfer in Foreclosure

The United States Supreme Court has also just recently addressed the issue of fraudulent transfer by foreclosure sale. Section 548(a)(2) of the Code allows the bankruptcy court to nullify a previous foreclosure if it is the cause of or precedes debtor insolvency, if it is not for a "reasonably equivalent value," and if the debtor files for bankruptcy protection within 1 year's time. Previous court decisions did not provide a consistent measure of reasonably equivalent value, although for the most part they adopted the precedent of the *Durrett* decision that a minimum 70 percent of fair-market value is reasonable at a foreclosure sale.[229] Many States then overruled *Durrett* by passing the Uniform Fraudulent Transfer Act, which insulates lenders from future accusations of fraudulent transfer if the property was acquired at a "regularly conducted, noncollusive foreclosure sale."[230] The discrepancy among courts brought the issue to the U.S. Supreme Court in the case of *BFP v. Resolution Trust Corporation as Receiver of Imperial Federal Savings Association*. On May 29, 1994, the Court overturned the *Durrett* precedent and held that a "reasonably equivalent value" for foreclosed real property is the price in fact received at the foreclosure sale, as long as all of the requirements of the State's foreclosure laws have been complied with.

As with cramdowns, questions still remain on fraudulent transfer. In particular, in July, 1995, the Ninth Circuit Bankruptcy Appellate Court overturned a foreclosure because the mortgagee had relied upon an initiation of foreclosure which preceded a court confirmed Chapter 13 reorganization plan. That is to say, once the court has accepted a borrower's reorganization plan, any subsequent default--on that plan--must be treated as a new default for purposes of initiating foreclosure. The lender cannot rely upon any prior foreclosure actions begun on the original default. Typically, lenders simply postpone scheduled foreclosure sales in power-of-sale States to accommodate a borrower's attempt at a Chapter 13 bankruptcy reorganization plan. If the plan fails, the lender can then quickly

[229]*Durrett v. Washington National Insurance Co.*, 621 F.2d 201 (5th Cir. 1980).

[230]See Cook and Mendales (1988) for a complete discussion of this point. Roberts and Moriarty (1985) provide discussion of *Durrett* and the history of case law leading up to that ruling. Richards (1990) gives a synopsis of the case law which has developed out of *Durrett*.

complete the originally anticipated foreclosure. Now, however, that standard practice is being considered grounds for fraudulent transfer in foreclosure. The rationale is that the role of the Bankruptcy Court is to give the debtor a new start, a clean slate, so to speak. Creditors cannot unduly jeopardize the ability of the debtor to regain solvency with actions based upon pre-bankruptcy events.

Appendix 6.1

Uniform Land Security Interest Act[231]
Part 5
DEFAULT

Section 501. Rights and Remedies.

(a) If a debtor is in default under a security agreement, the secured creditor has the rights and remedies provided in this Part and, except as limited by subsection (d), those provided in the security agreement, including the right to reduce the personal obligation of the secured creditor's claim to judgment.

(b) If a secured creditor reduces its claim to judgment before foreclosing under this Part, the judgment lien takes its normal priority as a judgment lien on the real estate, unless the judgment specifies that the obligation was secured by real estate under a recorded security agreement identified therein and an appropriate notation to that effect is made on each docket entry of the judgment, the lien of the judgment relates back to and takes the priority of the security interest in the real estate.

(c) A secured creditor who has foreclosed under this Part may not bring a judicial proceeding to recover the debt except as provided in this Part.

(d) Rights granted to the debtor and obligations imposed on the secured creditor under this Part may not be waived or modified as between creditor and debtor, except as specifically permitted. However, the parties by agreement may determine the standards by which the fulfillment of those rights and obligations is to be measured if the standards are not manifestly unreasonable.

(e) If the security agreement covers both real estate and personal property, the secured creditor may proceed under this Part as to both the real estate and personal property.

(f) In this Part, "foreclosure" and "right to foreclosure" mean foreclosure by a sale conducted by the secured creditor or third party under Section 509 or foreclosure by judicial sale under Section 510.

(g) In this Part, "default" cannot occur until after the expiration of any applicable grace

[231] Copies of the full text with drafting committee comments can be obtained from the National Conference of Commissioners on Uniform State Laws, 676 North St. Clair Street, Suite 1700, Chicago, IL 60611.

period or notice to comply, or both, to which the debtor is entitled.

Section 502. Acceleration.

([(a)] To exercise a right to accelerate against a debtor, a creditor must give written notice after the debtor's failure to perform that if the failure is not cured before a date stated, which may not be earlier than 15 days after the date the notice is given, or in any event earlier than the expiration of the grace period in the security agreement, the entire debt will be due. This provision may be waived or modified by a debtor other than a protected party.

[(b)] If the debt is accelerated, no prepayment penalty may be imposed by the creditor.]

Section 503. Creditor's Right to Possession.

(a) Except as provided in subsection (c), if the security agreement provides that the secured creditor may take possession without judicial proceeding, the secured creditor, on debtor's default, may take possession if the secured creditor can do so without breaching the peace.

(b) Except as provided in subsection (c), a secured creditor, on the debtor's default, may take possession of the real estate by judicial proceeding.

(c) A provision in a security agreement giving a secured creditor the right to take possession without judicial proceeding is not effective against a protected party as to any dwelling unit occupied as a residence by the protected party or an individual related to the protected party. As against a protected party, the court shall stay execution of any order by the protected party or an individual related to the protected party until after the termination of the debtor's possession at an earlier time is necessary to protect the value of the real estate against deterioration or destruction.

(d) In a judicial proceeding to remove the debtor from possession before termination of the debtor's interest, the debtor may assert claims and defenses against the secured creditor, including a claim that there has been no default.

(e) Except as against a protected party, if more than one secured creditor is entitled to take possession, the secured creditor whose security interest has priority also has priority of right to take possession. As against a protected party, the right to take possession before termination of the debtor's interest may be exercised only by a secured creditor whose claim is prior to all other secured creditors.

(f) Any possession of the secured creditor under this section is subject to the terms of any lease executed by the debtor before the creditor takes possession, even though the lessee's right under the lease terminates on termination of debtor's interest in the property, unless the court finds that termination of possession of a lessee whose interest is subordinate to that of the creditor is necessary to protect the real estate against deterioration or destruction.

(g) The right to possession under a default ceases upon cure or redemption of that default under Section 513.

Section 504. Right to Appointment of a Receiver.

Nothing in this [Act] expands the power of a court to appoint a receiver before or after default. A court may appoint a receiver after default only upon a showing that a secured creditor cannot take possession or that possession by a secured creditor will not adequately take into account the interests of persons having a claim to the real estate involved, unless the court in its discretion otherwise finds the appointment of a receiver appropriate.

Section 505. Rents and Duties of Creditor in Possession.

(a) After a debtor's default, a secured creditor in possession of the real estate and any creditor who has an assignment of rents, even though not in possession, may notify a lessee to make payment of the rents to that creditor and, subject to the priority among creditors specified in this subsection, is entitled to the rents accruing after the receipt of the notice, except to the extent that the rents have been paid in good faith either to the debtor or to a secured creditor entitled thereto under a previous notice. If more than one secured creditor entitled to rents has notified the lessee to make payment, the secured creditor in possession has priority or, if no creditor is in possession, the secured creditor having priority of security interest has priority as to rents. If requested in writing by the lessee, the secured creditor, within 10 days after the request is received, shall furnish reasonable proof as to the secured creditor's right to rents. The lessee need not perform to the debtor or any secured creditor who had previously given notice until the time for furnishing the proof has expired. In any case provided for in this subsection the lessee is discharged by performance in good faith to the secured creditor.

(b) A creditor in possession may execute leases (other than oil, gas, or other mineral leases) extending beyond the time of the creditor's possession which have the same priority as of any by the owner of the real estate. The terms of the lease including its duration must be reasonable and customary for the type of use involved.

(c) A creditor in possession shall manage the property as would a prudent person, taking into account the effect of that person's management on the interest of the debtor. If the creditor by contract delegates the managerial functions to a person in the business of managing real estate of the kind involved who is financially responsible, not related to the creditor, and prudently selected, the creditor satisfied the creditor's obligation to act prudently, and is not responsible to the debtor or other persons for the omissions and commissions of the management agent.

(d) In managing the real estate the creditor's delegate:

(1) shall carry casualty and liability insurance reasonably available and reasonable as to amount and risks covered;

(2) shall maintain the property in at least as good condition as existed at the time the creditor took possession, excepting reasonable wear and tear and damage by any casualty not required to be insured against under paragraph (1);

(3) may make other repairs and improvements necessary to comply with building, housing, and other similar codes or with existing contractual obligations of the debtor, and;

(4) shall apply receipts to payment of ordinary operating expenses including royalties, rents, and other expenses of management.

(e) A creditor in possession may abandon or vacate the property after first giving notice to the persons specified in Section 507(f) and in the manner specified in Section 508, stating the date on which abandonment is intended, which shall not be less than 4 weeks after the notice is given.

(f) A creditor in possession may deduct from any money received in managing the real estate all costs and expenses incurred by the creditor or the creditor's delegate, including the costs of hazard and liability insurance premiums against the creditor's delegate, including the costs of hazard and liability insurance premiums against the creditor's or the agent's act or omissions. The creditor also may deduct from the receipts any commission or management fee reasonably paid for managing property of the type involved.

(g) As between the creditor in possession and the debtor the risk of accidental loss or damage and the risk of liability to third parties arising during the course of management is on the debtor if the creditor:

(1) has procured insurance as required by subsection (d)(1), to the extent of any deficiency in the insurance coverage, or

(2) has not procured insurance as required by subsection (d)(1), to the extent that insurance coverage as required thereby would not have covered the risk.

(h) The creditor shall apply moneys received by the creditor after deducting the ordinary expenses of management and operation, in the following order:

(1) to payment of claims having priority over the interests the creditor represents under the laws of the United States and of this State;

(2) to payment of interest and principal of the security interest under which the creditor is acting; and

(3) to payment of any residue to the persons who but for the creditor's taking possession would have been entitled to the moneys.

Section 506. Methods of Foreclosure and Notice.

(a) Before foreclosure, a notice of intention to foreclose (Section 508) must be given. The content of the notice is specified by Section 508(b), the method of sending by Section 508(a), and the persons to whom it must be sent by Section 507(f). If, at the time of default, the real estate is occupied by a protected party or an individual related to the protected party, the notice of intention to foreclose may not be given until the time specified in Section 507(d). Except as specified as to a protected party in Section 507(d), the notice of intention to foreclose may be sent at any time of default.

(b) Before foreclosure under a power of sale, notice of the intended sale must be given. The content of the notice of sale, the persons to whom it must be given, and the method of sending is specified in Section 509(a). Sale may not occur until after the time specified in Section 509(a). The notice of the intended sale may be included in the notice of intention to foreclose or may be by a separate writing and may be given simultaneously with the notice of intention to foreclose or at a later date.

(c) As against a protected party, a judicial proceeding to foreclose cannot be commenced until after the time specified by Section 507(b). As against any other debtor, the judicial proceeding may be commenced at any time after notice of intention of foreclose has been given (Section 507(b)).

(d) The effect of failure to comply with the notice and time provisions relating to foreclosure is specified by Sections 512(a) and 514.

Section 507. Methods of Foreclosure and Notice.

(a) After a debtor's default, the secured creditor and debtor may agree on an acquisition of the debtor's interest in the real estate in lieu of foreclosure.

(b) Absent agreement, but after giving the debtor notice of an intention to foreclose (Section 508), the secured creditor may terminate the debtor's interest in the real estate by a judicial sale (Section 510), but as against a protected party the judicial proceeding may not be commenced until 5 weeks after notice of intention to commence the proceeding has been given.

(c) If the security agreement or other agreement between the debtor and secured creditor authorizes it, the creditor, after debtors default and after giving the debtor notice of intention to foreclose (Section 508), may terminate the debtor's interest by exercising a power of sale (Section 509).

(d) If at the time of default a dwelling unit in the real estate is occupied as a residence by a protected party or an individual related to the protected party, the notice of intention to foreclose (Section 508) may not be given until a payment of money has not been made when due and remains unpaid for 5 or more weeks or until the protected party, having been notified by the secured creditor to cure any other default under the security agreement, has failed to commence and proceed diligently with performance within 5 weeks.

(e) If the secured creditor gives the notice required for exercising a power of sale (Section 509), or commencing a judicial proceeding (Section 510), as part of the creditor's notice of intention to foreclose under Section 508, the minimum time required by Section 508 (power of sale) or subsection (b) of this section (judicial sale) commences when the notice of intention to foreclose is given.

(f) A notice of intention to foreclose required by this section must be sent to the person specified by the debtor in the security agreement or, if none is specified, to the debtor or any one of two or more debtors, but notice must be given to all debtors having an interest in the property who are protected parties, to any person obligated on the debt whom the creditor may wish to hold liable for any deficiency, and to any person in possession of the real estate from whom the creditor has received a written demand to receive notice of intention to foreclose. Failure to comply fully with this subsection does not invalidate the notice as to persons to whom it is given.

Section 508. Notice of Intention to Foreclose.

(a) Notice of intention to foreclose in writing complying with subsection (b) must be sent to the person entitled thereto both by registered or certified mail and by ordinary first class mail. The notice must be sent to a debtor at the debtor's address specified in the security agreement as the place to which notices are to be sent. If the creditor knows of a different address of the debtor at which notices are more likely to come to the debtor's attention, the notice also must be sent to that address. The notice must be sent to a person other than a debtor at any address at which the secured party in good faith believes the notice is likely to come to the person's attention.

(b) The writing must state, in a manner calculated to make the debtor aware of the situation:

(1) the particular security interest to be foreclosed;

(2) the nature of the default claimed;

(3) that the secured creditor has accelerated maturity of the debt, if that is the case; necessary to cure, and the time within which the cure must take place;

(4) any right the debtor has to cure the default, the amount to be paid or other action necessary to cure, and the time within which the cure must take place;

(5) the methods by which the debtor's ownership of the real estate may be terminated;

(6) any right the debtor has to transfer the real estate to another person subject to the security interest or to refinance the obligation and of the transferee's right, if any, to succeed to the rights of the debtor in curing the default;

(7) the circumstances under which the debtor's right to possession will be

terminated and that on termination the debtor may be evicted by judicial process;

(8) the right of the debtor to any surplus from a sale and, if the debtor is or may be liable for any deficiency, a statement of the circumstances under which the deficiency will be asserted;

(9) that no deficiency may or will be claimed if that is the case;

(10) if the secured creditor intends to include in the notice of intention to foreclose a notice of sale under a power of sale (Section 509(a)), or of intention to institute judicial proceedings (Section 507(b)), the creditor shall so state and comply with the provisions of Section 509(a) or 509(b) as the case may be; and

(11) the right of the debtor under Section 514 to apply for a court order controlling the foreclosure.

Section 509. Creditor's Power of Sale After Default.

(a) If the secured creditor is authorized to foreclose by power of sale (Section 507(c)), the secured creditor, after the debtor's default and upon compliance with this section, may sell any or all of the real estate that is subject to the security interest in its then condition or after any reasonable rehabilitation or preparation for sale. Sale may be at a public sale or by private negotiation, by one or more contracts, as a unit or in parcels, at any time and place, and on any terms including sale on credit, but every aspect of the sale, including the method, advertising, time, place, and terms, must be reasonable. The creditor shall give to the persons entitled to notice under Section 507(f) reasonable written notice of intention to enter into a contract to sell and of the time after which a private disposition may be made. The same notice must also be sent to any other person who has a recorded interest in the real estate which would be cut off by the sale, but only if the interest was on record at least 7 weeks before the date specified in the notice as the date of any public sale or 7 weeks before the date specified in the notice as the date after which a private sale may be made. As to persons entitled to notice under Section 507(f), the notice must be sent to the address specified in Section 508(a). As to others entitled to notice, the notice may be sent to any address reasonable in the circumstances. Sale may not be held until 5 weeks after the sending of the notice. The creditor may buy at any public sale and, if the sale is conducted by a fiduciary or other person not related to the creditor, at a private sale.

(b) On acceptance of a bid at a public sale, the bidder, other than the foreclosing creditor, shall deposit at least 10 percent of the bid price in cash or bank obligation. If the successful bidder fails to make the deposit on acceptance, or to complete the transaction within 5 weeks after acceptance, the secured creditor may specifically enforce the contract or resell the real estate under subsection (a). If the contract is not specifically enforced, the bidder's deposit may b retained or recovered as liquidated damages. Any sums retained or recovered by the creditor must be applied in the same manner as the proceeds of a completed sale.

Section 510. Foreclosure By Judicial Proceeding.

(a) A security interest may be foreclosed in a judicial proceeding directing a judicial sale of the real estate that is subject to the security interest.

(b) The secured creditor's initial pleading must state facts showing that:

(1) the notice of intention to foreclose (Sections 507(b) and 508) was properly given; and

(2) if the defendant is a protected party, the notice of intention to institute judicial proceedings (Section 507(b)) was properly given. In addition, if a deficiency judgment is claimed, the secured creditor shall state that the prohibition against a deficiency judgment (Section 511(b)) is not applicable.

(c) Process must be served upon all persons entitled to notice under Section 507(f) and any other person having a recorded interest in the real estate which would be cut off by the judicial sale. If the court finds that the debtor is in default and that the creditor has properly given notice of intention to foreclose, it shall enter judgment for the amount due with costs and order the sale of the real estate. The judgment also must specify the official, secured creditor, debtor, or other person authorized or directed to conduct the sale. Unless the judgment specifies that the sale is to be conducted in accordance with the law relating to the sale of real estate or execution, the sale is to be conducted under Section 509.

(d) A person conducting the sale must seek potential buyers and bidders through means of communication reasonable for the type of real estate involved, even though there has been or will be notice by publication for the purposes of service of process or informing persons having a claim to the property.

(e) The judgment must direct the person conducting the sale to make a report to the court. Upon confirmation by the court of the report of sale, the clerk shall enter satisfaction of judgment to the extent of the sale price less expenses and costs. Unless the judgment states there is to be no deficiency judgment, the clerk shall enter the balance on the judgment docket to become a lien effective as of the date docketed and be enforced in the manner of any other judgment for the payment of money.

(f) If the sale is confirmed, the person conducting it shall execute an instrument of conveyance under Section 512.

(g) If possession of the property is wrongfully withheld after confirmation of the sale and delivery of the instrument of conveyance, the court may compel delivery of possession to the person entitled thereto by order directing the appropriate official to effect delivery of possession.

(h) This section does not affect any existing procedure for strict foreclosure.

Section 511. Application of Proceeds of Sale, Surplus, and Deficiency.

(a) The proceeds resulting from a sale of real estate under this Part must be applied in the following order:

(1) the reasonable expenses of sale;

(2) the reasonable expenses of securing possession before sale; holding, maintaining, and preparing the real estate for sale, including payment of taxes and other governmental charges, premiums on hazard and liability insurance, management fees, and, to the extent provided for in the agreement and not prohibited by law, reasonable attorney's fees and other legal expenses incurred by the creditor;

(3) satisfaction of the indebtedness secured;

(4) satisfaction in the order of priority of any subordinate security interest of record; and

(5) remittance of any excess to the debtor.

(b) Unless otherwise agreed and except as provided in this subsection as to protected parties, a person who owes payment of an obligation secured is liable for any deficiency. If that person is a protected party and the obligation secured is a purchase money security interest, there is no liability for a deficiency, notwithstanding any agreement of the protected party. For purposes of calculating the amount of any deficiency a transfer of the real estate to a person who is liable to the creditor under a guaranty, endorsement, repurchase agreement, or the like, is not a sale.

Section 512. Effect of Disposition.

(a) If real estate is sold by a creditor under a power of sale (Section 509) or at a judicial sale (Section 510), a purchaser for value in good faith acquires the debtor's and creditor's rights in the real estate, free of the security interest under which the sale occurred and any subordinate interest, even though the creditor or person conducting the sale fails to comply with the requirements of this Part on default or of any judicial sale proceeding.

(b) The person conducting a sale under a power of sale (Section 509) or at a judicial sale (Section 510), shall execute a deed to the purchaser sufficient to convey title, which identifies the security interest and the parties to the security agreement, indicates where recorded and recites that the deed is executed by the person conducting the sale after a default and sale under this Part and that person's authority to make the sale. Signature and title or authority of the person signing the deed as grantor and a recital of the fact of default and the giving of notices required by this [Act] is sufficient proof of the facts recited and of the signer's authority to sign. Further proof of the signer's authority is not required even though the signer is also named as grantee in the deed.

(c) A regularly conducted, noncollusive transfer under a power of sale (Section 509) or by a judicial sale (Section 510) to a transferee who takes for value and in good faith is not a fraudulent transfer even though the value given is less than the value of the debtor's interest in the real estate.

Section 513. Debtor's Right to Cure Default and Redeem.

(a) At any time before the earlier of the sale or a contract of sale under a power of sale (Section 509), or before the time specified in a decree of judicial foreclosure, the debtor or the holder of any subordinate security interest may cure the debtor's default and prevent sale or other disposition by tendering the performance due under the security agreement, including any amounts due because of exercise of a right to accelerate, plus the reasonable expenses of proceeding to foreclosure incurred to the time of tender, including reasonable attorney's fees of the creditor.

(b) In determining what is necessary to cure a default, a protected party, except as provided in subsection (c), may cure the default and avoid operation of any acceleration clause (Section 502) in the security agreement by:

(1) paying or tendering all sums that would have been due at the time of tender in the absence of any acceleration clause;

(2) performing any other obligation the protected party would have been bound to perform in the absence of any acceleration clause; and

(3) paying or tendering the casts of proceeding to foreclose reasonably incurred after notice of intention to foreclose (Section 508) was given but not exceeding [ ], including reasonable attorney's fees of the creditor.

(c) A protected party may not exercise the right to cure under subsection (b) if, within the preceding 12 months, the protected party has exercised the right after having received a notice of acceleration.

(d) After default, a debtor entitled to cure or redeem under this section may release that right in writing or assign that right subject to Section 208. If a protected party other than a protected party who defaulted proposes to cure as permitted by subsection (b), the creditor may demand from that person the entire sum due on acceleration unless the creditor receives adequate assurance of due performance, if the creditor in good faith believes that the prospect of further payment or performance would be impaired.

(e) If a debtor is entitled to cure or redeem under this section, the debtor or the holder of any subordinate security interest, subject to the terms entitling the debtor or the holder of any subordinate security interest to cure or redeem, may require the secured creditor, upon full payment of the obligation, to assign the debt and the security interest without recourse or warranty to any person designated by the payer and the secured creditor is obligated to do so. The rights under this subsection may be enforced by the holder of any subordinate security interest even though it is an intermediate security interest. A tender of redemption by any holder of a security interest prevails over a tender or redemption by the debtor. As between or among holders of security interests the tender of redemption by the holder entitled to priority prevails over the tender of redemption by the holder of a subordinate interest. Nothing in this section requires giving an assignment where the secured creditor owns a subordinate security interest that is not to be assigned.

Section 514. Creditor's Liability for Failure to Comply with Part 5.

(a) A sale or disposition of proceeds may be ordered or restrained on terms and conditions determined by the court if it is established by the debtor or any other person entitled to notice under Section 509(a) that:

(1) the obligation is invalid;

(2) the debtor is not in default;

(3) the creditor or other person exercising a power of sale under Section 509 is not complying or is not likely to comply with this Part; or

(4) the proceeds of any sale are not being applied or are not likely to be applied as required by Section 511.

(b) If disposition of the real estate has occurred, the debtor or any person entitled to notice under Section 509(a) hereof may recover from the creditor any loss caused by a failure to comply with this Part.

(c) If a creditor violates this Part, a protected party may recover, without reduction by reason of any unpaid portion of the debt or deficiency judgment owed the lender and without proof of actual damages, an amount equal to one percent of the initial unpaid obligation but not exceeding $500.

(d) In a judicial proceeding under this section, a protected party, in addition to any other remedy granted, may recover the reasonable expenses of litigation, including reasonable attorney's fees.

Chapter 7

Regulatory and Legislative Issues and Recommendations

Legislation authorizing this report invites the Secretary to offer recommendations "for administrative or legislative action to assist homeowners to avoid foreclosure and any loss of equity in their mortgaged homes that may result from foreclosure." In response, this chapter provides a concluding outline of the principal issues the Department believes should be addressed by itself, the mortgage industry, and the Congress. Recommendations found here are aimed at remedying current deficiencies in protections afforded troubled homeowners, while being mindful of the valid interests of mortgage market organizations.

7.1 Loan Modifications

During the 1992-1994 refinance boom, loan servicers indicated their number one desire for change was for loan modifications to be performed more easily and more frequently for defaulted borrowers. Many borrowers who could maintain a mortgage with lower monthly payments were, rather, forced to give up their homes. Temporary job losses which led to mortgage delinquencies and cash shortages disqualified them from refinancing opportunities. Some of these cases showed up as preforeclosure sales and others as foreclosures or deeds in-lieu-of foreclosure.

For portfolio lenders, loan modification is easy. They can lower interest rates, extend terms to make up for missed payments, or reamortize loans up to a 30-year schedule (see chapter 3.4).[232] With the predominance of loan securitization in the 1980s, however, modification became more difficult for financially troubled homeowners. All insurers and guarantee agencies permit servicers to buy defaulted loans out of security pools and modify

[232] One innovative idea that has been put forth is to allow negative amortization on loans with significant equity (more than 30 percent) in order to finance a forbearance period. In this scheme, as long as the equity remains above 20 percent, the lender knows that it can cover its costs if it must foreclose. The lender/servicer would charge monthly forbearance amounts against the loan principal without the cash-flow problem of making security pass-through payments. It is a type of negative amortization of the loan balance to which interest can be charged. Granted, this would only benefit a small percent of borrowers in default, but it could allow them a potentially less expensive route than selling the property and moving.

them, but the servicers do not then want to carry them as portfolio loans.[233] Many are mortgage bankers without portfolio operations. Others do not want to assume new risks by taking these loans into their portfolios and face the scrutiny of their Federal regulators.

Fannie Mae started as a portfolio operation and has always maintained a willingness and ability to repurchase modified loans from servicers and hold them in its retained portfolio. Freddie Mac, however, was created solely to securitize mortgages. It thus maintained a smaller retained portfolio and was less willing to accept lender-modified defaulted loans. This changed in 1994. Freddie Mac issued new guidelines allowing servicers to initiate modification agreements with qualifying borrowers and have Freddie Mac repurchase the loans from their security pools and place them in its now-expanded retained portfolio.[234]

Unlike Fannie Mae and Freddie Mac, Ginnie Mae does not purchase any loans, but only guarantees payments on securities underwritten by others. Ginnie Mae has no portfolio *per se* so loan modifications to remedy default are primarily up to FHA, the VA, and their loan servicers.[235] The VA will accept loans bought out of Ginnie Mae pools and modified as a last resort for helping conscientious veterans retain their homes. Once the servicer buys the loan out of the Ginnie Mae pool, the VA pays a claim and takes the loan into its own portfolio. FHA, however, does not have the statutory or budgetary authority to pay claims to purchase loans for portfolio except in the case of loan assignment where it must provide up to 36 months of forbearances.[236]

As mentioned in chapter 3.4, FHA faces resource constraints which make holding a portfolio, even of performing loans, very difficult. One option to be explored, should HUD receive authority to pay claims for loan modifications, would be contracting out all of the servicing functions. That would include repooling and selling loans once they

[233]In general, however, once loans are bought out of MBS pools they can be modified in any form.

[234]Freddie Mac, Seller/Servicer Guide Bulletin 94-13, September 15, 1994.

[235]Ginnie Mae holds servicing portfolios when it takes receivership of failed mortgagees. These do not involve investment interest in the loans, but rather protection of security holders interests.

[236]Even in those cases, FHA's ability to modify loans was restricted to those within the portfolio that were still in danger of foreclosure. The Multifamily Housing Property Disposition Reform Act of 1994 has now provided discretionary modification for single family loans under 42 USC 3535(i)(5) (See Sec. 104 of 108 Stat. 363). FHA has not yet issued regulations defining when or how it will use this new authority.

gain enough initial seasoning to prove that borrowers have regained financial stability.

An option to be explored for all securitized mortgages is the potential for a new class of mortgage-backed securities where investors accept the possibility that loans in the pool may be subject to modification of terms to cure a default and prevent foreclosure. Discussion of this can also be found in chapter 3.4. However, even if this option were to prove viable, it would only affect future loan originations. Therefore, insurers and guarantee agencies would still require portfolio mechanisms to provide loan modification opportunities for outstanding insured loans.

Recommendations

" That FHA be given statutory authority to pay insurance claims for the purpose of allowing loan modifications to cure a default and prevent a possible foreclosure. This requires both statutory and budgetary authorities. Such authorities could be given under FHA's general authority to pay claims on loan defaults.

" That pursuant to such authorities to maintain a retained portfolio of modified loans, HUD study the feasibility and cost effectiveness of engaging a contractor or joint venture partner to handle the management of the portfolio. This would include the initial purchase from mortgagees, servicing, and resale after seasoning.

" That HUD enter into discussions with industry representatives to examine the potential for new MBS products which would permit limited modification of loans in their security pools in cases where such modification could avoid foreclosure.

7.2 Foreclosure Law

Foreclosure laws address the balance of bargaining power between lender and borrower in the event of a default. As outlined in chapter 6, there are several issues that need to be addressed concerning refining and standardizing this balance across States. One method for attaining balance would be to implement a Federal foreclosure law on all Federally related mortgages. While this could quite possibly withstand judicial scrutiny (see chapter 6.1), it would, because of the pervasiveness of the Federal Government in regulating and chartering mortgage institutions, be a major first step toward overriding the property rights jurisdiction of the States. The Department prefers and recommends a second approach, that the

Congress encourage the individual States to enact more uniform foreclosure codes.

Uniformity can be brought to bargaining power over property rights after mortgage default through an initiative to update and enact Section 5 of the Uniform Land Security Interest Act (ULSIA) (see chapter 6.1, Table 6.1, and Appendix 6.1). The ULSIA has a good outline for borrower notification of default and possible foreclosure (section 508), provides for full redemption and cure opportunities up to the time of sale (section 513), and provides clear title at foreclosure (section 512). It also guarantees that any excess proceeds left after foreclosure expenses and payments to junior lienholders be remitted to the borrower (section 511). Weaknesses of the ULSIA include a very short time-to-foreclosure, no mandated changes in the auction method of foreclosure, and no incentives for lenders and borrowers to negotiate a settlement on their own. The following discussion gives ways in which each of these flaws could be remedied.

Extending the Equity of Redemption

The ULSIA allows foreclosure of residential properties to be initiated after the standard 15-day grace period for late payments and completed on day 85 of a delinquency. It has been previously noted (chapter 3.4) that at least 80 percent of homeowners who find themselves this far delinquent can still find a way to cure the loan. While few lenders would attempt to initiate foreclosure at 15-days delinquency, it would be better for both lenders and borrowers to extend the equity of redemption so that foreclosures cannot occur until day 150 (initiation on or after day 80). By day 150 there will either be a workout agreement in place, the borrower will have cured, or it will be obvious that terminating the borrower's property rights must occur to satisfy the outstanding liens. At the present time, mortgage insurers and guarantee agencies do not allow foreclosure before this point unless the property is abandoned, or investor-held, or the borrower has a repeated history of lengthy delinquencies.[237] Waiting until the industry standard day 90 of a delinquency to send the borrower a notice of intent to foreclose would create a 160 day minimum time from delinquency to foreclosure under a revised ULSIA.[238]

Foreclosure Auctions

The second potential weakness of State law and the ULSIA is that they do not

[237]One exception here is that past delinquency patterns cannot be considered by HUD when first deciding on loan assignment to prevent a foreclosure of an FHA insured loan.

[238]Provisions could be made to speed up this time table for abandonments, repeat foreclosures, and properties other than homesteads.

provide an alternative to the auction method of foreclosure by sale (see chapter 6.1). On the positive side, the ULSIA does not mandate any one form of sale, and it requires that "reasonable" advertising methods would be used (section 509). This latter provision assures a wider audience than can currently follow the typical tombstone advertisements. Most commentators suggest that foreclosure sales be via normal real estate marketing efforts, which includes more than just advertising. It requires active involvement of realty agents who would market the property, and that lenders be given the right to extend their "credit" at the foreclosure sale to buyers who would then obtain long-term financing through the lender.[239]
This alternative suffers from two main problems. First, because the properties involved have generally depreciated in value because of borrower inability or unwillingness to provide maintenance, a normal marketing effort will yield greater losses to lenders than if they can obtain and rehabilitate properties first. In the majority of instances, as-is property values are low at foreclosure, and so lenders obtain title through foreclosure sale auctions by bidding up to the amount of the debt. While the ULSIA permits creditors to rehabilitate properties before sale, such actions are not entirely possible unless there is an eviction. If a more normal marketing effort is to be undertaken, then the lender must also be able to control the final selling effort which requires property possession. An eviction, however, is tantamount to stripping the borrower of their property rights before the actual foreclosure, so normal marketing efforts are not possible without some combination of foreclosure-by-entry, to provide eviction, and foreclosure by sale, to release property claims.

The second problem with making foreclosure sales more closely resemble normal property marketing efforts is that when properties are in good condition, lenders have incentive to initiate preforeclosure sales in which standard sales techniques are used. In those cases, borrowers have an incentive to cooperate because foreclosure avoidance means a better credit rating and release from a deficiency judgment, or reduced tax liability from the smaller effective debt discharge that occurs in foreclosure alternatives. Use of preforeclosure sales even reduces opportunities for speculators to find profitable opportunities at foreclosure sales (obtain good properties at a large enough discount to allow for resale).

Given that properties must be sold in order to have proceeds to relinquish all claims, and that normal marketing efforts may not work here, there is still one possible improvement: the Dutch auction. In a typical English style auction used at foreclosure sales, bids start low and progress until there is only one bidder left. But the sale never finds out how much that final bidder is willing to offer. In contrast, the Dutch auction, now used by the U.S.

[239]The financing aspect could be restricted to arms-length transactions involving owner-occupants.

Treasury for bond and note sales, starts at a high price. The price is lowered until a bid is entered. This could be helpful in foreclosure auctions when there are third party bidders who value the property more highly than the lender. Because winning bids by third parties occur in a minority of cases, borrower protections in a Dutch auction would be strengthened by requiring a property appraisal if the lender is the winning bidder and desires a deficiency judgment.

Because third-party purchases at foreclosure sales are relatively rare events, we currently have in this country a *de facto* method of strict foreclosure where the court transfers property title from borrower to lender without holding a sale. Unless the foreclosure-by-sale process can be substantially improved in order to truly settle creditor claims, reinstituting strict foreclosure is a viable option. But even this, in order to be more cost efficient than the present system, would have to provide ways of minimizing court involvement and still provide a marketable title to property.[240]

Preforeclosure Settlements

State foreclosure laws do not encourage borrowers and lenders to negotiate workout solutions short of foreclosure. A modified ULSIA would have the most impact if it could overcome this dilemma. States that give overly generous redemption periods (pre and post foreclosure) and deny deficiency judgments provide foreclosure avoidance incentives to lenders but not to borrowers, while the incentives in states with short redemption periods and full deficiency judgments are reversed (see Table 6.2). The ULSIA has two good provisions: the elimination of statutory redemption periods and the allowance for no-strings-attached deficiency judgments. Redemption periods have proved ineffective, whereas a significantly long equity of redemption (like the 150 day period mentioned above) can help a large proportion of troubled borrowers. Allowing full deficiency judgments in foreclosure gives borrowers more incentive to negotiate with lenders.

Timing of Foreclosure Initiation

Finding financial incentives for lenders to provide alternatives to foreclosure involves varying the cost of foreclosure. One option is to allow accelerated times for foreclosure processing if lenders wait until after day 150 of the delinquency to initiate it, perhaps a 45-day time period before foreclosure sale, rather than the 70-day ULSIA standard for other cases. That would lower the cost of failed attempts at workout solutions while taking away lenders' present incentives to process workouts and foreclosures on parallel

[240]One commentator who advocates this position is Durham (1985). An historical perspective on strict foreclosure is provided by Tefft (1937).

tracks. Current practices of some lenders to initiate foreclosure while attempting workouts limits the time for negotiations, raises questions about their good-faith in workout programs, and lowers the chance of borrower reinstatement by adding foreclosure expenses to the loan deficiency. Providing for an accelerated foreclosure time after day 150 would lower the cost of borrower cures because no attorney or title fees associated with foreclosure could be charged to them if they can cure by day 150. Foreclosures, when necessary, could still be completed within 7 months of the first missed payment, which is within 4 months of the 90-day delinquency mark. Today it is rare, except in cases of abandonment or fraud, that insurers and guarantee agencies ever complete foreclosures before that date.

Another idea for improving the bargaining power between lender and borrower is allowing the date-of-default to be moved up by 1 month whenever the borrower makes a payment equal to at least 1 month's contractual payment during the delinquency. Limitations on this can hold that the lender may initiate an expedited foreclosure at 150 days after the initial missed payment if the loan is still more than 60 days in arrears, at 180 days if the loan remains more than 30 days in arrears, and at 210 days if the loan is not fully cured. FHA currently uses a similar system of forbearance for partial cures.

Homes with High Equity

If an as-is appraisal at day 90 shows substantial equity in the property, for example, 30 percent or more, the lender could be required not to initiate foreclosure until day 180, with an accelerated timeframe available at that point. Some States currently use more costly statutory (post-foreclosure) redemption periods to protect such borrowers. The method suggested here, however, gives borrowers 6 months to either sell the home on their own or find new sources of income before foreclosure can be initiated. A revised ULSIA could further stipulate that if the default was due to a loss of household income, and the borrower has now obtained new sources of income sufficient for maintaining the mortgage and starting regular monthly payments by day 180, that they be given 6 to 12 months to repay the delinquency on their account before foreclosure can be initiated. Such provisions would contain the usual *caveat* that lenders could pursue immediate foreclosure during this time if any payments are missed.

Recommendations

" That the National Partners in Homeownership task force established by President Clinton to promote ways to increase homeownership in our country continue where this research leaves off by crafting a uniform State foreclosure procedure. It would emphasize balancing creditor and debtor bargaining positions and creating incentives for the parties to negotiate a settlement short of foreclosure using the ideas put forth in this Report. Such work could also address ways in which foreclosure-by-sale could meet its original objectives of separating both lender and borrower from the property without unduly penalizing either party, or else how a system of strict foreclosure could be utilized instead.

" That the U.S. Congress, upon completion of such a foreclosure procedure for owner-occupied homes, encourage the various States to enact foreclosure laws based on a power-of-sale procedure that balances the interests of lenders and borrowers, while giving both parties incentives to negotiate pre-foreclosure settlements when immediate cures are not possible.

7.3 Programs of the Federal Housing Administration

HUD is currently in a position where it needs new, general statutory authority for providing mortgagor relief. A new basis would allow HUD to provide a quality program of foreclosure avoidance which is tailored to individual family needs and which can easily adopt industry innovations. It must not measure the quality of such programs by the depth and duration of financial assistance given to each borrower, as under the current *Ferrell* standard, but rather by success in reinstating borrowers who have the willingness and ability to continue homeownership, while assisting others to transition to less costly housing. Such a new standard would provide the Department with flexibility to modify, add, and delete programs as necessary to further National Housing Act objectives. Flexibility is required in order to keep pace with current, not to mention unforeseen developments in mortgage and housing markets.

Servicer Initiative

A new approach to foreclosure relief should place primary emphasis on servicer-initiated efforts to reinstate loans either through short term repayment plans or longer term modifications and forbearances. HUD could establish financial incentives for servicers to initiate these on their own, recognizing that servicers, as agents of HUD, need to have incentives to do what is in the Department's best interest (see Chapter 4). HUD also needs the freedom to repurchase from servicers defaulted loans that are bought out of Ginnie Mae MBS pools and modified. This will assist borrowers with reductions in income who want to retain their homes.

Workout Departments

A Secretary-held portfolio can be serviced by private firms and monitored by an FHA workout department that also oversees servicer efforts to cure delinquencies and avoid foreclosures. Responsibility for loan servicing and program screening can then be taken out of the field offices, relieving them of burdens which they are not staffed to handle. While servicers can be held responsible for due-diligence in assisting borrowers, the right to bypass servicers and apply directly to HUD for any one form of foreclosure relief cannot be an entitlement. The experience of the existing assignment program shows that it is all too often an expensive way for the majority of loans facing foreclosure to extend the time of living rent free in their homes. The efficiencies gained by having servicers (and counseling agencies) provide relief recommendations to HUD can assure that every deserving defaulted borrower will receive assistance.

Payment Assistance

The final element in a new paradigm for assisting FHA-insured borrowers should be a program of Departmentally sponsored payment assistance for borrowers with long-term but correctable difficulties. It should not necessarily be limited to circumstances beyond the borrower's control, but must be based on borrower hardship and a willingness and ability to correct the existing problems over a reasonable period of time.[241] At the same time, the high rate of delinquencies and default in the current assignment program show that HUD must have tight control over eligibility, arrearage accumulation, and the level of servicing personnel available. Private insurers accomplish this through advance claims: curing delinquencies on behalf of borrowers and then giving them extended repayment periods to pay back these loans while maintaining their regular mortgage payments.

Such assistance would not require buying loans out of Ginnie Mae pools; that is, HUD should not have to take assignment of loans to provide assistance. As shown by the ongoing Homeowners' Emergency Mortgage Assistance Program run by the Pennsylvania Housing Finance Agency (see chapter 5.1), such loans can continue to be serviced by the private sector and remain in their security pools. This had been the intent of the ill-fated TMAP program. It can be accomplished at the national level by HUD for FHA loans, but only with a new statutory framework for borrower assistance.

[241] Borrowers with recurring defaults and/or those with foreclosures initiated within the past 2 years could be excluded, as they are in the Pennsylvania HEMAP program (see section 5.1). In Pennsylvania this is accomplished through Agency regulations under a circumstances-beyond-borrower's-control regime that have been successfully upheld in the State courts.

Because of the problems involved in attempting to manage long-term relief, a preferred option would be to offer a new insurance product, namely, mortgage credit insurance for higher risk mortgagors.[242] Payment assistance would then be an actuarially sound purchased product rather than a draw against the current mortgagee insurance funds. As such, there would no longer be any tension between HUD's fiduciary responsibility to operate the FHA Mutual Mortgage Insurance Fund in an actuarially sound manner and its social responsibility to assist troubled homeowners. Homeowners could be helped without mounting additional indebtedness. Research would need to be undertaken to examine to what extent this could be offered at a cost saving to FHA borrowers and insurance funds.

Default Counseling

The legislation authorizing HUD to pay for credit counseling services for homeowners in default on their mortgages (12 USC 1701x) needs to be expanded to include screening for, and negotiating with, lender/servicers over foreclosure relief.

Training of Servicer Workout Specialists

HUD should require, as a matter of eligibility to participate in FHA programs, that loan servicers have staff trained in loss mitigation and foreclosure avoidance or that such services be adequately performed by outsource contractors (see chapter 5.1).

Recommendations

- That FHA be given the latitude to establish loss mitigation policies and procedures that rely first on servicer efforts either to cure defaults or to provide direct repayment assistance, but also to utilize servicer workout counseling to provide applications and recommendations for HUD-sponsored relief programs when appropriate. HUD requires more flexibility than is now available for paying partial and full insurance claims in order to remedy loan defaults. Such claims payment authority would include the authorization to also pay loss mitigation incentives to loan servicers. These incentives have proved effective in the conventional market.

- That HUD work with appropriate Congressional Committees to write a new statutory basis for borrower relief that charges the Department to further National Housing Act objectives, but to do so in such a way that combines accountability with flexibility in program

[242] See the end of chapter 5.1 for a more complete discussion of this option.

design.

- That FHA continue its present work in exploring ways to use centralized service centers to perform monitoring of servicer loss mitigation/borrower relief activities, and to design cost effective ways of providing loan servicers with incentives to mitigate losses on behalf of the Department and its insurance funds.

- That HUD undertake the analysis of the feasibility of offering a mortgage credit insurance product for FHA borrowers. This would include actuarial analysis of premium rates, potential savings to the Mutual Mortgage Insurance Fund, reductions in premium rates on primary default insurance for lenders, and the attractiveness of such a product to mortgagors and especially those in high-risk categories for whom it could be a mandatory product. It would gauge the feasibility of government versus private provision of the insurance product.

7.4 Other Recommendations

- That Fannie Mae and Freddie Mac follow FHA's lead and evaluate ways to give loan servicers incentives to provide "special" forbearances of up to 12 or 18 months. Forbearances should be made easier to obtain for borrowers with significant equity in their homes, and criteria for forbearances should, in light of the low break-even success probabilities required, look beyond immediate household income to potential for sufficient income to support contractual mortgage payments within a 6-month time frame.

- That mortgage insurers and guarantee agencies evaluate the potential for loan modifications that allow for a period of negative amortization to finance forbearances for defaulted homeowners with significant equity who desire to maintain their homes, especially when the homeowner has no current income but good prospects.

- That all mortgage insurers and guarantee agencies reevaluate their reasonable-chance-of-success criteria for providing foreclosure relief in light of mounting evidence that the break-even success probabilities for these measures may be very low.

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