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Report to the Chairman, Subcommittee on Housing and Community Opportunity, Committee on Banking and Financial Services, House of Representatives

October 1995

HOMEOWNERSHIP

Mixed Results and High Costs Raise Concerns About HUD's Mortgage Assignment Program

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Resources, Community, and
Economic Development Division

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October 18, 1995

The Honorable Rick A. Lazio
Chairman, Subcommittee on Housing and
Community Opportunity
Committee on Banking and Financial Services
House of Representatives

Dear Mr. Chairman:

During the 19-year period ending September 30, 1993, the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) incurred losses totaling about $12.8 billion in 1994 dollars following foreclosure and the subsequent sale of about 525,000 defaulted single-family housing loans that FHA had insured. However, these losses were offset by insurance premiums paid to FHA by borrowers, not by the U.S. Treasury.

As an alternative to allowing lenders to foreclose on FHA borrowers in default, HUD operates a mortgage assignment program. By taking assignment of mortgages (purchasing mortgages) rather than having lenders foreclose on them, HUD can at times avoid foreclosure losses for FHA, help borrowers retain their homes, and provide borrowers with an opportunity to avoid foreclosure. For borrowers accepted into the program, FHA pays the mortgage debt, takes assignment of the mortgage from the lender, and develops a new repayment plan for the borrower under which monthly mortgage payments can be reduced or suspended for up to 36 months. HUD, acting as mortgagee, collects mortgage payments from the borrowers while allowing them to live in their homes. The number of FHA borrowers participating in this program has tripled in the last 6 years, totaling about 71,500 at the end of fiscal year 1994; their unpaid principal balances total about $3.7 billion. About 1 in 4 defaulted single-family FHA loans are assigned rather than immediately foreclosed.

Concerned about the rising number of loans assigned to HUD and their financial impact, you asked us to determine whether the mortgage assignment program (1) helps borrowers avoid foreclosure, (2) reduces FHA's foreclosure losses, and (3) can be improved to reduce such losses.

Results in Brief

HUD's mortgage assignment program helps borrowers avoid immediate foreclosure, but it is not fully successful in helping borrowers avoid foreclosure and retain their homes on a long-term basis. Using historical data on the disposition of program loans, we forecast that about 52 percent of the approximately 68,700 borrowers who have entered the program since fiscal year 1989[1] will eventually lose their homes through foreclosure. We forecast that the remaining borrowers (48 percent) will pay off their loans following the sale or refinancing of their homes, often after remaining in the program for long periods of time.

The mortgage assignment program has not reduced FHA's foreclosure losses; rather, the program's losses have exceeded those that would have been incurred if loans had gone immediately to foreclosure without assignment. We estimate that for borrowers accepted into the program since fiscal year 1989, FHA will incur losses of about $1.5 billion[2] more than would have been incurred in the absence of the program. These additional losses are primarily attributable to the costs that FHA incurs under the program, which more than offset the financial gain to FHA from saving some loans from foreclosure. While FHA borrowers' premiums pay for these losses, these additional costs make it more difficult for FHA's single-family insurance program to maintain financial self-sufficiency.

Options are available to the Congress that would reduce but not eliminate the additional losses incurred by the program. These options include reducing the 3-year relief period provided to borrowers, setting a time limit on eliminating delinquencies, and/or accepting only those borrowers into the program who can afford to pay half or more of their mortgage payments. A revised assignment program would have to require borrowers to begin full mortgage payments within a few months after entering the program to eliminate nearly all of the additional losses.

Background

The mortgage assignment program was created in 1959 by section 230 of the National Housing Act. However, HUD only began operating the program in 1976 in settlement of a lawsuit. The program, intended to help mortgagors who have defaulted on HUD-insured loans to avoid foreclosure and retain their homes, provides mortgagors with financial relief by

[1]At the time of our review, complete information was not available on loans that entered the assignment program before fiscal year 1989. The 68,700 loans analyzed represent about 71 percent of the loans that have entered the assignment program since its inception. Also, the 68,700 loans analyzed differ from the 71,500 loans at the end of fiscal year 1994 in part because the 71,500 loans represent borrowers active in the program at that time, including borrowers who entered the program before fiscal year 1989.

[2]Unless noted, all dollar figures used in this report are presented in terms of their 1994 present value. Loss projections are estimates based on the best information available and can change under different economic scenarios.

reducing or suspending their mortgage payments for up to 36 months until they can resume making regular payments.[3] To enter the program, a mortgagor must apply and meet certain criteria, including that the default must have been caused by circumstances beyond the mortgagor's control, such as the loss of employment or serious illness. However, after the 36-month period, a mortgagor's delinquencies are not required to be eliminated or reduced by a specified time other than over the remaining term of the loan, which HUD can extend for up to 10 years.[4]

Most of the mortgages assigned under the program are insured by FHA under its Mutual Mortgage Insurance Fund (Fund). For these mortgages, the cost of the assignment program is financed by the Fund, which insures private lenders against losses on mortgages that finance purchases of one to four housing units. To cover losses, FHA deposits borrowers' insurance premiums in the Fund. Historically, the Fund has been financially self-sufficient. However, if it were to become exhausted, the U.S. Treasury would have to directly cover lenders' claims and administrative costs.

We based our analysis of whether the assignment program helps borrowers avoid foreclosure and reduces FHA's foreclosure losses primarily on data from two of HUD's national information systems—the Single-Family Mortgage Notes Servicing System and the Single Family Insurance System—as of September 30, 1994. We used these data to analyze foreclosures and delinquencies and forecast the foreclosure rates of the 68,695 mortgages assigned since fiscal year 1989. We also built a cash flow model and prepared analysis to estimate the financial loss to FHA's Fund from these loans by estimating the revenue and expense flows for these loans over their life. Our data reflect nationwide mortgage assignment statistics on single-family loans that were entered in HUD's two national data systems as the Fund's mortgage defaults that were assigned to avoid foreclosure—71,500 mortgage loans as of September 30, 1994. Loans assigned to HUD for other reasons were not included in our analyses.[5] To determine how to improve the program and reduce its losses, we

[3]In the absence of this program, HUD must take ownership of and subsequently manage and sell the properties.

[4]Before assigning mortgages, FHA also encourages mortgage lenders to make use of special forbearance procedures, such as reduced monthly mortgage payments, when mortgagors are temporarily unable to make full mortgage payments. These procedures have been used infrequently by FHA lenders.

[5]Under certain circumstances, loans that are not in default may be assigned to FHA. These include loans made by lenders under the condition that they could be assigned to FHA after a 20-year period. In addition, the records on other loans were eliminated from our analyses because they were either duplicate records, had incorrect information, or concerned loans not from FHA's Fund. The Fund's 71,500 loans represent about 78 percent of the 91,700 loans in the assignment program as of September 30, 1994.

obtained information from four other mortgage assistance institutions that provide foreclosure relief to borrowers in default on single-family housing loans—the Department of Veterans Affairs (VA), Rural Housing and Community Development Service (RHCDS), Federal National Mortgage Association (Fannie Mae), and Federal Home Loan Mortgage Corporation (Freddie Mac). (See app. I for additional details on the scope and methodology of our work.)

To improve the administration of the program, HUD recently has initiated changes to the program. These include selling its currently assigned loans; implementing Activity Tracking, an automated collection computer subsystem; studying the costs and benefits of alternatives to foreclosure; permitting lenders to provide relief to borrowers, such as suspending or reducing mortgage payments, without prior approval from HUD; implementing a "compromise offer" program under which borrowers' loans are considered to be paid off for less than the amount owed; and implementing for a limited period of time a program for reducing interest rates on certain program loans. HUD has also proposed contracting for loan servicing.

The Office of Management and Budget (OMB) considers FHA's mortgage assignment program to be a high-risk area because controls do not protect the financial interests and resources of the government. In the President's fiscal year 1996 budget, OMB stated that the servicing of assigned loans was expensive, inefficient, and labor-intensive. Also, OMB noted that there is little evidence that the program achieves its goal of giving homeowners a chance to keep their homes during a temporary interruption of income. According to OMB, legislative changes should be considered to reduce or eliminate the assignment of loans in the future by greater reliance on the private sector as well as legislation to reduce the program's forbearance period from 3 years to 1 year. To reduce the number of assigned loans and the required servicing of loans, OMB recommended that HUD continue to sell its assigned loans.

Mixed Results in Avoiding Foreclosures Permanently

We forecast, on the basis of historical data on the disposition of program loans, that about 35,400 (52 percent) of the 68,695 borrowers accepted into the program since fiscal year 1989 will eventually lose their homes through foreclosure.[6] For the remaining loans (48 percent), we forecast that

[6]According to a HUD analyst, the ultimate foreclosure rate may be 6 to 8 percentage points higher than our forecast because FHA had difficulty foreclosing on borrowers in fiscal years 1991 and 1992 because of policy changes in the program. Our estimates are based, in part, on those 2 years of relatively low foreclosure rates and therefore may underestimate the ultimate rate.

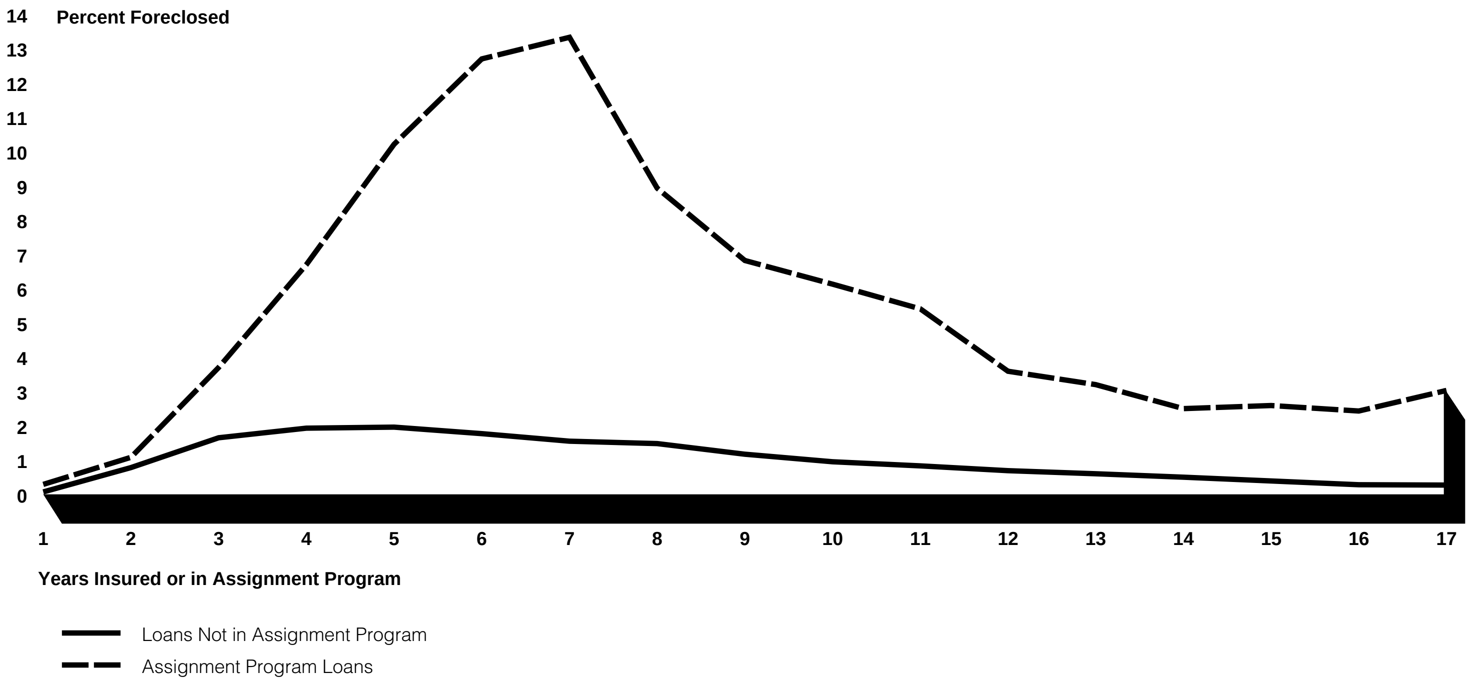
borrowers will pay off the loans and avoid foreclosure by either selling their homes or refinancing their mortgages, often after remaining in the program for a lengthy period of time. Some of these borrowers who eventually pay off their loans may have, under the compromise program, paid HUD an amount less than the total amount owed. (A detailed discussion of our methodology for forecasting the program's foreclosure rates appears in app. II.)

Figure 1 shows our estimates of conditional foreclosure rates[7] based on loans that remained active until a given year and were assigned during a 17-year period (fiscal years 1977 through 1994). We estimate that conditional foreclosure rates will increase sharply over the first 7 years after a loan is accepted into the program, peaking at about 13 percent. The program's conditional foreclosure rates substantially exceed those experienced on FHA's nonassigned single-family loans during the same 17-year period.[8]

[7]The conditional foreclosure rate is the percentage of loans that survive until a given year that then go into foreclosure during that year. This is only one of many ways that foreclosure rates can be calculated.

[8]The percentage of loans on which borrowers made full payments increased with the length of time in the program. The borrowers for more than one-third of the loans over 10 years old are paying over 100 percent of their scheduled payments. Some borrowers who make suspended or zero payments have no forbearance agreement.

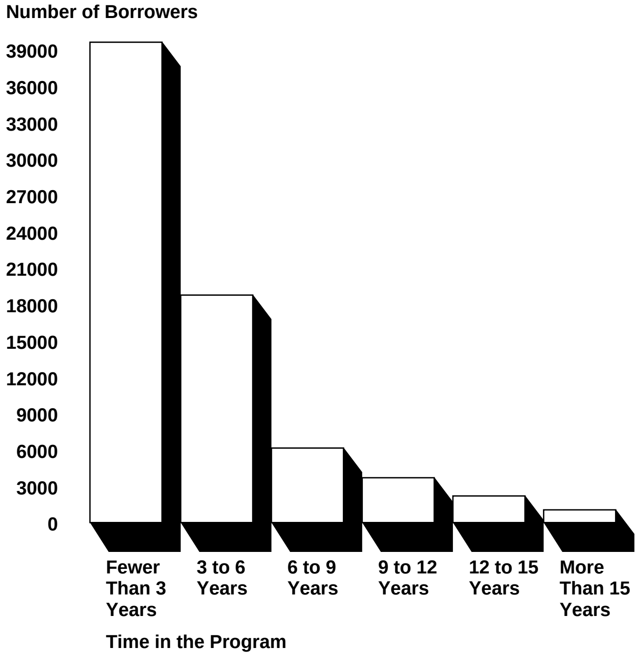
Figure 1: Conditional Foreclosure Rates for FHA's Assigned and Nonassigned Loans



HUD's records show that since fiscal year 1977, at least 96,500 borrowers have been accepted into the assignment program.[9] About 71,500 of these borrowers were still assigned to HUD as of September 30, 1994. A large portion of them—39,603, or 55 percent—have been in the program fewer than 3 years (see fig. 2).

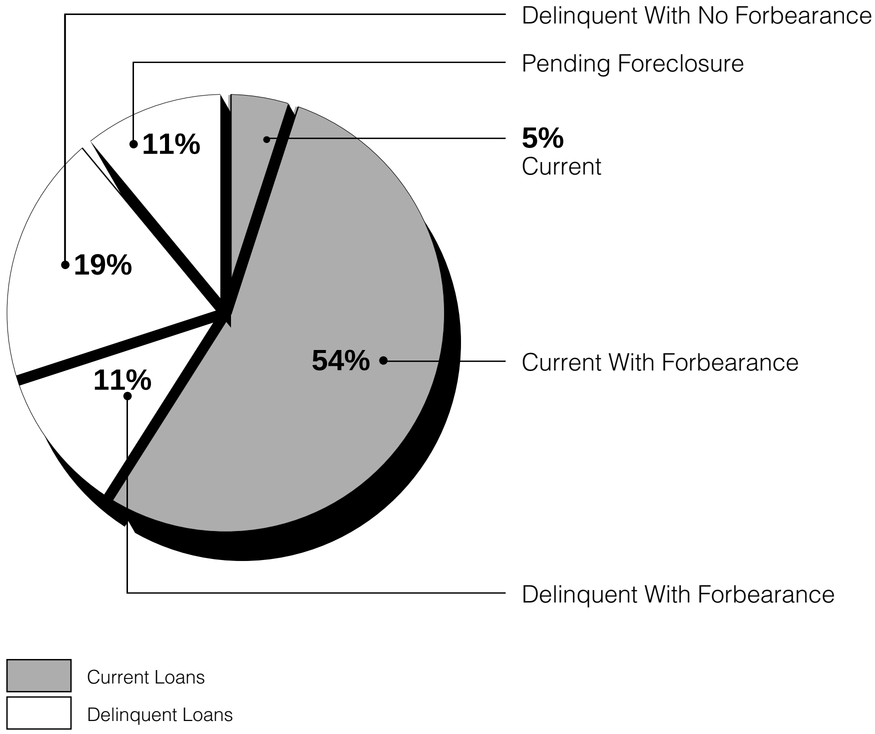
[9] The actual number is greater because an unknown number of loan records were purged after the assigned loans were terminated from the program.

Figure 2: Length of Time Borrowers Had Been in the Program as of September 30, 1994



As shown in figure 3, of the approximately 71,500 borrowers in the program as of September 30, 1994, 59 percent were current with forbearance agreements or current with their original mortgage payments. The remaining 41 percent were delinquent or pending foreclosure. Only 5 percent of the program's borrowers were making full mortgage payments.

Figure 3: Status of the Program's Loans as of September 30, 1994



When borrowers remained in the program beyond the 3-year relief period and therefore were required to make full mortgage payments, the proportion of borrowers current with repayment agreements dropped and the proportion of borrowers in foreclosure increased. Similarly, the average amount of delinquencies owed by borrowers increased. (See app. III for detailed information on borrowers' compliance with repayment agreements.)

Most of the 25,041 borrowers who left the program for whom records are available did so following foreclosure, while other borrowers paid off their loans and at times eliminated delinquencies. Of the 25,041 borrowers, HUD foreclosed on 14,707 borrowers (59 percent), while 10,334 borrowers (41 percent) paid off their loans.[10] An example of a borrower who left the

[10]Because an unknown number of assigned loans were purged after being terminated from the program, we do not know if this distribution between foreclosures and payoffs is similar for all borrowers no longer in the program.

program through foreclosure is a Chicago mortgagor who was accepted into the program in November 1990 and was $9,495 behind in payments at that time. The loan's outstanding principal balance at that time was $34,862. Although HUD determined that the mortgagor's income was sufficient for him to make more than full mortgage payments, the mortgagor made only five payments over the next 3-1/2 years. By September 1994, when HUD began foreclosure, the borrower was over $25,000 behind in payments.

Borrowers who paid their loans generally did so following the sale of their homes at a price that, in most cases, allowed them to repay the outstanding mortgage and the delinquent amount. For example, a Seattle, Washington, mortgagor defaulted on an $89,890 loan 15 months after obtaining it. The mortgagor found a new job after experiencing a salary cut on his previous job. When the mortgage was assigned in November 1990, the mortgagor was already $6,333 behind in payments. Initially, the mortgagor was allowed to make reduced payments of $400 per month, about half the full payment. After 2 years, the mortgagor was unable to pay off the delinquent amount, which had grown to $19,229 when he sold the house in April 1993. However, the sale proceeds enabled the mortgagor to fully satisfy his obligation to HUD. (See app. IV for cases in which some borrowers paid off mortgages and others did not.)

Program's Operating Procedures Contribute to High Foreclosure Rates

Given the lower income of FHA borrowers, which can make them financially vulnerable, the assignment program's operating procedures do not provide assurance that delinquent amounts will be repaid and that borrowers will succeed in avoiding foreclosure. These procedures include (1) accepting borrowers into the program after they have accumulated substantial loan delinquencies and therefore have an uncertain repayment ability and (2) a 36-month relief period when payments can be reduced or suspended, which permits outstanding delinquencies to grow even if borrowers are current with repayment agreements. Most FHA home loans are for moderate-income individuals. These individuals are likely to be more financially vulnerable than other mortgagors who are able to obtain home loans without FHA's assistance.[11]

Under the assignment program, a borrower must miss at least three mortgage payments before submitting an application to enter the program. During the acceptance process, additional payments may be missed, and

[11]See Housing Finance: Characteristics of Borrowers of FHA-Insured Mortgages (GAO/RCED-94-135BR, Apr. 6, 1994).

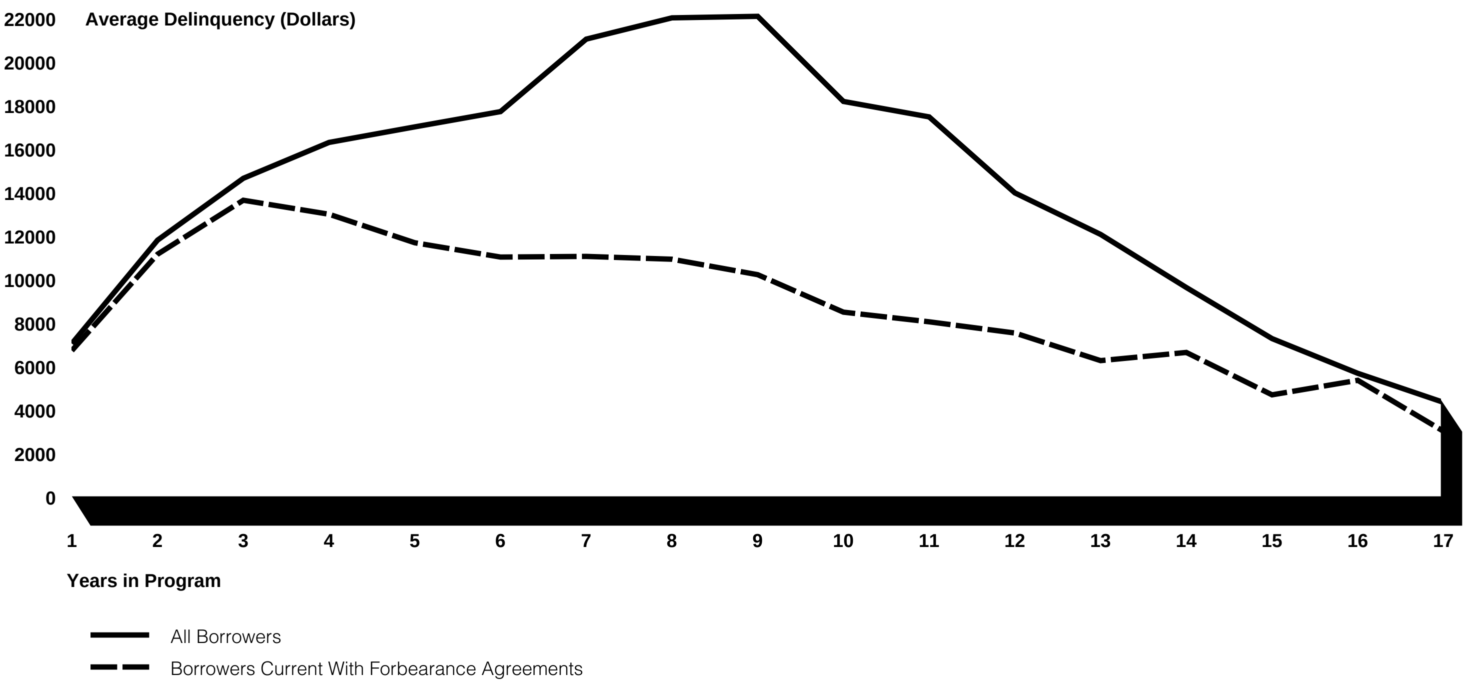
substantial delinquencies may accumulate over a period of 6 months or more.[12] We randomly selected, as case studies, 136 loans from four loan categories—paid-off, current with payments, foreclosed on, and delinquent—from files at four HUD field offices—Boston, Chicago, Ft. Worth, and Spokane—to illustrate, among other things, the amount of delinquencies that borrowers had accumulated when they entered the program. Our review of these loans showed that borrowers were, on average, 8 months behind in mortgage payments of $4,014 on their loans at the time they were accepted into the program. These loans had an average outstanding principal balance of $39,886 at that time. These figures, and others reported later that are based on these case studies, are not projectable to the universe of assigned loans.

The program also allows 3 years of reduced or suspended mortgage payments. For borrowers who qualify for this program feature, delinquencies for unpaid interest and other expenses continue to grow. As shown in figure 4, as of the end of fiscal year 1994, all borrowers in the program for more than 1 year but fewer than 3 years experienced, on average, an increase in delinquent amounts from about $7,000 to $15,000. On average, after 9 years in the program, delinquencies for all borrowers continued to grow, peaking at about $22,000. Similarly, delinquencies for borrowers current with forbearance agreements also grew at about the same rate as those of all borrowers during the first 3 years but began to decline after the borrowers had been in the program for 3 years.[13]

[12]HUD officials believe that their new handbook, which requires lenders to process applications for the assignment program, should expedite the application process.

[13]Although borrowers accumulate delinquencies under the program, they are receiving some benefits, such as the benefit of living in a home for a reduced or no payment rather than paying rent.

Figure 4: Growth in Average Delinquencies for All Borrowers and Borrowers Current With Forbearance Agreements



Once the 36-month relief period is completed, borrowers are expected to resume full mortgage payments and, if possible, increase payments to reduce accumulated delinquent amounts. If borrowers cannot make full payments, HUD may initiate foreclosure action. There is no requirement, however, that borrowers pay off their delinquent amounts or leave the program in a specified time period, other than over the remaining term of the loan, which HUD can extend for up to 10 years. About 31,900 (45 percent) of the borrowers in the program as of September 30, 1994, had been in the program for more than 3 years. About 1,000 borrowers had been in the program for over 15 years.

Assignment Program Increases FHA's Losses

In assessing the cost to FHA of operating the program, we (1) forecasted the foreclosure and payoff rates for loans assigned since fiscal year 1989 and (2) estimated the expenditure and revenue flows for these loans over their expected life. Using historical data on the performance of individual loans in the assignment program, we developed estimates of loan-servicing costs, acquisition costs, and other costs for all surviving loans over their anticipated life. In addition, we estimated revenues received from loan payoffs, mortgage payments, and the sale of properties after foreclosure. In order to estimate the program's net loss to FHA, we compared the resulting cost per assigned loan to the average loss that FHA would have experienced on these loans had they gone directly to foreclosure rather than to the assignment program.

Our analysis showed that losses on the 68,695 loans assigned to HUD since fiscal year 1989 will be an estimated average of about $49,000 each. We subtracted from the estimated average loss of $49,000 the estimated $27,000 loss that FHA would have experienced had the loans not entered the assignment program, leaving an estimated net loss to FHA of about $22,000 per assigned loan.[14]

On the basis of this analysis, we estimate that FHA's Fund will experience additional losses of about $1.5 billion over what it would have incurred if the loans entering the assignment program since fiscal year 1989 had immediately gone to foreclosure instead. Table 1 summarizes our estimates of the expenses and income associated with the program's 68,695 loans over their life. The additional costs incurred by FHA are primarily attributable to the partial payments it received on mortgage loans; delays in receiving funds from the sale of the assignment program's properties that are eventually foreclosed; administrative costs; and advances made by HUD for taxes, insurance, and other expenses.

[14]This net loss is the additional amount above what FHA would have incurred for all loans assigned since fiscal year 1989 if these loans had been immediately foreclosed. The net loss of $22,000 is averaged over all loans that entered the program since fiscal year 1989, whether or not the loans may have been foreclosed.

Table 1: Estimated Expenses and Income Projected Over the Life of Loans Assigned During Fiscal Years 1989-94

Dollars in millions

Costs			
Administrative costs			
Applications received	$150		
Applications accepted	5		
Servicing costs	166		
Defaulted loan costs	131		
Total administrative costs[a]		$451	
Acquisition costs		4,905	
Advances		100	
Total costs			$5,456
Revenues			
Payment receipts		$152	
Payoff revenues		955	
Sale of properties		1,006	
Total revenues			$2,113
Net cost (cost less revenues)			$3,343
Less cost of foreclosed loans if not assigned			$1,868
Total additional cost of assigned loans			$1,478

[a]Figures do not add to total because of rounding.

FHA borrowers' premiums pay for these losses, not the U.S. Treasury. To cover losses, FHA deposits borrowers' insurance premiums in the Fund. According to 12 U.S.C. 1711, the Fund must meet or endeavor to meet statutory capital ratio requirements designed to achieve actuarial soundness; that is, it must contain sufficient reserves and funding to cover estimated future losses resulting from the payment of claims on defaulted mortgages and administrative costs.

To offset substantial losses to the Fund that were incurred in the 1980s, FHA borrowers were required to pay higher insurance premiums beginning in July 1991. In our recent report and testimony[15] on the actuarial soundness of the Fund, we reported that the economic value[16] of FHA's

[15]Mortgage Financing: Financial Health of FHA's Home Mortgage Insurance Program Has Improved (GAO/RCED-95-20, Oct. 18, 1994) and Mortgage Financing: Financial Health of FHA's Home Mortgage Insurance Program Has Improved (GAO/T-RCED-94-255, June 30, 1994).

[16]The economic volume is defined as the current cash available to the Fund, plus the net present value of all future cash inflows and outflows expected to result from outstanding mortgages in the Fund.

Fund clearly has improved significantly in recent years but that the Fund as of the end of fiscal year 1993 had not yet accumulated sufficient capital reserves to cover losses during periods of adverse economic conditions as defined by the law.[17]

Options Available to Reduce the Program's Losses

Options are available to the Congress to change the assignment program that would reduce the losses incurred by the program. These options include directing HUD to shorten the 36-month relief period, set a time limit on eliminating delinquencies, and accept into the program only those borrowers who can afford half or more of their mortgage payments.

Information provided by officials from four[18] mortgage lending or purchasing institutions indicates that these institutions provide borowers in default a shorter time period to begin full mortgage payments under the original loan or a modified loan and to repay delinquent amounts. They also use techniques different from HUD's that could improve the effectiveness and reduce the cost of the program.

VA usually capitalizes the delinquency and reamortizes the new loan balance (i.e. extends the time period for payment of the loan principal) as soon as it acquires the loan. In addition, VA will reduce the interest rate on the reamortized loan to as low as 3 percent below the current market rate if a reduction is necessary to bring the veteran's payments to an affordable level. VA may also acquire loans for borrowers who are not able to resume payments immediately if they show the ability to be able to do so in a reasonable period of time. VA field stations have significant discretion in deciding what constitutes a reasonable period; however, it is usually not extended beyond the point at which the loans reach a full year's delinquency. During this period, VA may provide relief by agreeing to accept payments of less than a full installment or by extending complete forbearance. Fannie Mae and Freddie Mac provide relief for up to 18 months. They may extend this period longer under certain circumstances, but during the relief period, the borrower must eliminate the delinquency. Although RHCDS does not have a specified relief period, an RHCDS official told us that its county supervisors provide short-term relief on a case-by-case basis.

[17]In its May 8, 1995, report on the economic net worth of the Mutual Mortgage Insurance Fund, Price Waterhouse reported that the financial health of the Fund continued to improve during fiscal year 1994 and was nearly actuarially sound as of September 30, 1994.

[18]Officials were contacted at VA; RHCDS, which was formed from the rural housing section of Farmers Home Administration and the Community Facilities Division of the Rural Development Administration; Fannie Mae; and Freddie Mac.

Another option for reducing the program's losses would require borrowers to pay half or more in monthly mortgage payments. We estimate that if all 68,695 borrowers who have entered the program since fiscal year 1989 had paid and continue to pay 50 percent of their original mortgage payments, the program would lose about $433 million more than what would have occurred if the loans had gone immediately to foreclosure, or substantially less than our estimated loss of $1.5 billion. The mortgage payments being made by borrowers as of September 30, 1994, averaged about a third of the original mortgage payments. These borrowers would have to pay 67 percent of their original mortgage payments for the program to break even.

In addition to a shorter period of relief, other mortgage assistance institutions stress resolving the delinquency by the end of the relief period. In contrast, the mortgage assignment program gives borrowers many years beyond the relief period to repay a delinquency, as evidenced by some borrowers who have been in the program for 15 years. If the borrower is unable to pay the delinquency within the 3-year relief period, HUD's regulations require that the borrower must repay the delinquency on or before the mortgage maturity date, but the borrower may be given up to 10 years beyond the maturity date.

Freddie Mac, Fannie Mae, and VA also work closely with borrowers to provide long-term solutions, such as modifying the structure of a loan to resolve delinquencies. Officials from these organizations told us that they believe techniques such as refinancing and reducing interest rates to reduce monthly mortgage payments are successful alternatives to costly foreclosure. However, HUD seldom uses its authority to modify borrowers' mortgage loans. Rather, HUD uses repayment agreements both before and after the 36-month relief period to secure repayment of outstanding delinquencies. These are generally 1-year term agreements based on the borrowers' estimated income and expenses to repay a debt. HUD field office officials told us that the preparation and monitoring of these agreements requires extensive staff resources.

According to HUD's Director, Single-Family Servicing Division, the primary strategy HUD plans to follow to reduce the program's losses is to sell its assigned loans and thereby reduce the number of loans it holds and services. In June 1994, HUD sold at auction about 15,000 performing and nonperforming (loans in compliance with repayment agreements and those not in compliance) single-family loans that were not in default when assigned, including 357 loans that were facing foreclosure. FHA received about $12.6 million from the sale of the 357 loans, which represents about 70 percent of the unpaid principal balance on these loans. FHA officials consider these results encouraging and believe that future sales will provide significant relief to field offices that have a large number of assigned loans. FHA plans to sell an additional 15,000 loans in calendar year 1995 and most of the remaining assigned loans over the next 2 years. By fiscal year 1997, HUD expects its inventory to consist only of newly accepted assigned loans that would be held by HUD for a short time before being sold. The purchasers of these loans would be required to comply with HUD's assignment program's servicing standards, including permitting 3 years of reduced or suspended mortgage payments.

Conclusions

The assignment program operates at a high cost to FHA's Fund and has not been very successful helping borrowers avoid foreclosure in the long run. The program helps about half of the financially troubled homeowners to avoid foreclosure permanently. However, the costs incurred by HUD to achieve this result exceed the costs that would have been incurred if all assigned loans had gone immediately to foreclosure without assignment. While FHA borrowers' premiums pay these costs, not the U.S. Treasury, the program's costs lessen the Fund's ability to build reserves.

Options are available to the Congress to make changes to the program to reduce its losses. The options, such as requiring borrowers to pay more in monthly mortgage payments, would reduce but not eliminate the program's additional losses. The assignment program would have to require borrowers to begin full mortgage payments within a few months after entering the program in order to nearly eliminate the additional losses incurred by the program.

All of these options pose the trade-off of preventing some individuals and families from entering the program who would eventually bring their loans current and/or avoid foreclosure. However, unless changes are made to the present assignment program, its costs will continue to make it more difficult for the Fund to maintain financial self-sufficiency.

Matters for Congressional Consideration

If the Congress believes that the additional losses incurred by the assignment program are excessive in relation to the number of borrowers that avoid foreclosure, it could consider eliminating the program. However, since some borrowers who default on their FHA mortgages can avoid foreclosure with some assistance, the Congress could consider establishing a short-term, temporary relief program of a few months for such borrowers to replace the mortgage assignment program.

If, however, the Congress believes that the borrowers served by FHA's single-family program are at high risk and therefore in need of additional assistance in the form of forbearance, changes to the program should be considered that would reduce but not eliminate additional future losses. The following are options that the Congress could consider:

- Require borrowers to (1) resume full mortgage payments within a shorter time period than the 36 months currently allowed and/or (2) eliminate outstanding delinquency amounts within a specified period. For example, the Congress may wish to require that borrowers resume full mortgage payments within 1 year of entering the program and eliminate outstanding delinquencies within 2 years. If borrowers are unable to bring their loan payments current and/or eliminate delinquencies within the specified time, the Congress may wish to consider requiring that HUD foreclose.
- Require that only borrowers who can pay half their original mortgage amount or more be assigned to the program.

Agency Comments

We provided a draft of this report to HUD, VA, RHCDS, Fannie Mae, and Freddie Mac officials to obtain their comments. We met with HUD and VA officials and obtained their comments.

In a meeting with a HUD Special Assistant to the Assistant Secretary for Housing-Federal Housing Commissioner, HUD's Director of the Single-Family Servicing Division, and officials from HUD's Offices of General Counsel and Policy Development and Research, we obtained HUD's comments. The comments focused on (1) the effects of past litigation efforts on HUD's management of its mortgage assignment program and (2) alternatives available to prevent foreclosure other than the options we suggest for changing forbearance relief (reducing or suspending monthly mortgage payments for a certain period of time) provided through the assignment program.

Specifically, HUD commented that litigation has affected the evolution and operation of the assignment program. According to HUD officials, a consent decree, which the Department entered into in 1979, and litigation preceding and subsequent to entering the consent decree known collectively as the Ferrell v. Pierce litigation have limited HUD's options to modify the assignment program. The Department believes the Congress needs to understand these limitations when it considers changing the program. Under the consent decree, HUD agreed to, among other things, (1) operate the assignment program for 5 years in compliance with its January 1979 handbook without any modification that would curtail the rights of the mortgagors under the program and (2) after the 5-year period, operate either the present assignment program or an equivalent substitute to help mortgagors avoid foreclosure during periods of temporary financial distress. A series of lawsuits concerning HUD's implementation of the consent decree followed.

We agree that the consent decree and the Ferrell v. Pierce litigation have limited HUD's options to change the program. It is because of this limitation that the forbearance relief options we present were addressed to the Congress and not to the Secretary of HUD. So that the Congress has a full understanding of the litigation's effects when considering options to forbearance relief provided through the mortgage assignment program, HUD's description of the current operation of the assignment program and the effect of past litigation on that program is provided in appendix V.

HUD also commented that if the Congress were to consider alternative relief measures for borrowers, there are methods widely used to prevent foreclosure by the private sector that are not discussed in our report. The alternatives to forbearance relief cited by HUD included (1) "modifying defaulted borrowers' mortgage loans by reducing interest rates, (2) extending the remaining period of the loans, and/or (3) paying partial claims to remedy default with a new obligation from the borrower to repay FHA the amount of the claim." HUD noted that while our report discusses some relief options used with other federally related mortgages, the options we present to the Congress for change do not include such options. HUD also commented that pursuant to section 918 of the Housing and Community Development Act of 1992, it is studying the adequacy of existing programs authorized to help FHA borrowers avoid foreclosure and alternatives to foreclosure being used with other federally related mortgages. HUD expects to issue this study shortly.

We agree that there are alternatives to foreclosure other than the forbearance relief measure provided through HUD's assignment program. In fact, our report points out that Freddie Mac, Fannie Mae, and VA provide borrowers long-term solutions, such as modifying the structure of their loans to resolve delinquencies. Officials from these organizations told us that they believe techniques such as refinancing and reducing interest rates to reduce monthly mortgage payments are successful alternatives to costly foreclosure.

However, this report did not seek to analyze all possible alternatives to the mortgage assignment program because of the focus of our work and our desire not to duplicate HUD's efforts in studying such alternatives. However, it should be noted that HUD has seldom made use of modified mortgage loans. Consequently, assessing the merits of modifying financially troubled FHA loans to single-family borrowers in lieu of the forbearance that HUD currently provides is difficult. In addition, no matter how successful other alternatives are in avoiding foreclosure, not all borrowers will be able to resume mortgage payments immediately, which is required under such options as refinancing, reducing interest rates, and extending the period of the loan.

We recognize, however, that to the extent that such alternatives are effective in helping borrowers retain their homes without entering HUD's assignment program, they could be a more effective way to avoid costly foreclosure than the current assignment program. HUD's study on alternatives to foreclosure should be helpful to the Congress in assessing these alternatives. Our report should be helpful to the Congress in assessing changes needed to HUD's mortgage assignment program to reduce losses on those mortgages that enter the program, regardless of other alternatives that may be used to prevent assignment.

While HUD officials agreed that the program's losses have exceeded those that would have been incurred if loans had gone immediately to foreclosure without assignment, they did not agree with the magnitude of our estimate of the additional cost that FHA incurs. We received no official estimate from HUD of the additional cost, although one HUD analyst said that he believes the additional cost is about one-third of our estimate. HUD currently has a contracted study under way that will produce an estimate of the additional cost to FHA of the program.

HUD also provided clarifying information and technical and editorial comments for our consideration in completing our report, which we incorporated where appropriate.

VA's Assistant Director for Loan Management, Loan Guaranty Service, generally agreed with the factual information presented in this report on that agency. We incorporated suggestions by VA to further clarify our report as appropriate.

In telephone conversations with RHCDS, Fannie Mae, and Freddie Mac officials, they told us that they agreed with the factual information presented in this report on their organizations and had no further comments.

We conducted our work between October 1993 and October 1995 in accordance with generally accepted government auditing standards.

Unless you announce its contents earlier, we plan no further distribution of this report until 10 days from the date of this letter. At that time, we will send copies to interested congressional committees; the Secretary of HUD; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others on request.

Please call me at (202) 512-7631 if you or your staff have further questions. Major contributors to this report are listed in appendix VI.

Sincerely yours,

Judy England-Joseph

Judy A. England-Joseph
Director, Housing and
Community Development Issues

Contents

Abbreviations

CBO	Congressional Budget Office
VA	Department of Veterans Affairs
Fannie Mae	Federal National Mortgage Association
FHA	Federal Housing Administration
Freddie Mac	Federal Home Loan Mortgage Corporation
FTE	full-time equivalent
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
OMB	Office of Management and Budget
RHCDS	Rural Housing and Community Development Service
SAMS	Single-Family Accounting and Management System

Objectives, Scope, and Methodology

Concerned about the rising number of loans assigned to the Department of Housing and Urban Development (HUD) and their financial impact, the Chairman, Subcommittee on Housing and Community Opportunity, House Committee on Banking and Financial Services, asked us to determine whether the mortgage assignment program (1) helps borrowers avoid foreclosure, (2) reduces the Federal Housing Administration's (FHA) losses, and (3) can be improved to reduce losses.

To determine whether the program helps borrowers avoid foreclosures, we analyzed information on foreclosures, delinquencies, and borrowers' compliance with repayment agreements contained in two of HUD's national information systems—the Single-Family Mortgage Notes Servicing System and the Single Family Insurance System—as of September 30, 1994. Our data reflect nationwide mortgage assignment statistics on single-family loans that entered these systems as section 203(b) mortgage defaults to avoid foreclosure. Loans assigned to HUD for other reasons were not included in our analyses. We did not perform a reliability assessment of controls over the data in the systems; however, we checked our data results through discussions with HUD personnel, making comparisons to related automated accounting and financial reports and reviewing sampled mortgagors' repayment files. We randomly selected and examined 136 case example assigned loans from four loan categories—paid-off, current with payments, foreclosed on, and delinquent—from files at four HUD field offices—Boston, Chicago, Ft. Worth, and Spokane—to illustrate, among other things, cases in which some borrowers were able to and chose to pay off their mortgages or become current with their payments and others did not. We selected these field offices to obtain geographic diversity to recognize differences in real estate markets.

To determine whether the program reduces losses, we used the data systems mentioned above as well as HUD's Single-Family Accounting and Management System to estimate the foreclosure rates of mortgages assigned since 1989 and revenue and expense flows for these loans over their life. We used this historical mortgage data to estimate loan servicing, acquisition, and other costs of surviving mortgages. We also assessed revenues received from early loan payoffs, mortgage payments, and sales of properties following foreclosure. We further compared the cost per assigned mortgage loan to the average loss experienced by FHA on mortgages that went directly to foreclosure rather than being accepted into the program. A detailed discussion of our methodology for forecasting program foreclosure rates and estimating program costs appears in appendix II.

To determine how to improve the program and reduce program losses, we obtained records, reports, and studies from HUD, the Department of Veterans Affairs (VA), Rural Housing and Community Development Service (RHCDS), Federal National Mortgage Association (Fannie Mae), and Federal Home Loan Mortgage Corporation (Freddie Mac) and analyzed appropriate loan servicing guidelines and foreclosure prevention options. We also interviewed HUD (including HUD's Office of the Inspector General), VA, RHCDS, Fannie Mae, and Freddie Mac officials at their headquarters locations in Washington, D.C., and local HUD officials in Boston, Chicago, Dallas, and Spokane. We also interviewed officials of five organizations concerned with defaulted loans—the Mortgage Bankers' Association in Washington, D.C., Legal Assistance Foundation, Public Action Housing Policy Center, Community and Economic Development Corporation of Cook County, Inc., and the Spanish Coalition for Housing.

GAO's Cash Flow Model Used to Forecast Financial Loss

This appendix describes the cash flow model we built and the analysis we conducted to estimate the financial loss to FHA's Fund for program loans assigned during fiscal years 1989 through 1994. We estimated the loss the Fund will incur on the 68,695 loans that entered the program during this period on the basis of assumptions stated in this appendix. To do so, we (1) estimated the costs that FHA has incurred on and revenues it has received from these loans as of September 30, 1994, and (2) forecasted future costs and revenues during the remaining life of these loans.[19] We converted all cash flow estimates to 1994 present values using an annual discount rate of 7 percent.

The largest element of cost to the Fund is the cost associated with settling the lender's claim on the mortgage, a cost that FHA must pay whether or not the foreclosure occurs immediately or the mortgage enters the assignment program. FHA incurs additional costs while loans are in the program, including the administrative costs to operate the program. Revenues received by FHA, including proceeds from the sale of properties following foreclosure and borrowers' loan payments, partially offset program costs.

The following sections of this appendix contain a detailed description of the data we used and how we estimated the costs and revenues associated with the program.

Data We Used in Our Estimates

In our analysis, we used three of HUD's computerized databases—the F-60 database that provides current and historical information on all mortgage loans that HUD services under the assignment program, the A-43 database that provides historical information on mortgages insured under the Fund before assignment, and the Single-Family Accounting and Management System (SAMS) database that tracks properties held and eventually sold by HUD following foreclosure. From these databases, we obtained information on the initial characteristics of each loan, such as the year the loan was assigned, the initial unpaid principal and delinquency amount, and the loan interest rate and term. We also obtained information on the current status of each loan, such as the current unpaid balance, the last payment date, and the delinquency status. We categorized the loans as either foreclosed, prepaid, or active as of the end of fiscal year 1994.

[19] Although some loans can theoretically remain in the program through the year 2033, we assume that these loans may remain active through the year 2023.

How We Estimated the Program's Costs and Revenues

We estimated the financial losses for program loans by examining all loans by the year assigned. Costs and revenues were computed for each year's group of assigned loans over the life of the loans in the program.

Cash flows out of the Fund when FHA pays (1) lenders' mortgage claims, (2) taxes and insurance on properties, and (3) salaries and other administrative costs. Cash flows into the Fund when FHA collects revenues from (1) the sale of properties following foreclosure, (2) the early payoff of loans, and (3) payments made by mortgagors (borrowers). All cash flows are discounted at 7 percent to a 1994 base year.

We assumed that the net cost to the Fund was partially a function of foreclosure and payoff rates. Other factors that affected costs included the percentages of unpaid principal to original loan amount, receivables due FHA to original loan amount, advances to original loan amount, and the policy year of the loans. In addition, we assumed that FHA would continue to receive partial and delayed payments for some mortgages assigned and that both foreclosure and prepayment behavior will remain the same in future years as it has been in the past. This is a critical assumption because of data limitations. As a result, our analysis does not take into account that the loans assigned from fiscal years 1989 through 1994 may differ from earlier loans in ways that affect their prepayment and foreclosure probabilities beyond 6 years from the date of assignment.

Given these assumptions, we projected future loan activity for foreclosures, prepayments, and surviving loans. Because of inadequate historical data, it was not possible to rigorously estimate foreclosure and prepayment probabilities incorporating economic indicators, such as unemployment rates, payment-to-income ratios, current interest rate, and house price appreciation rates.[20]

Determining Costs

The Fund incurs a number of costs associated with operating the program, including the costs to acquire loans following default, to administer the program, and for property expenses. The largest cost relates to the acquisition of loans before they enter the program. Acquisition costs were compiled for each year's book of business. The total acquisition costs for all 68,695 loans is about $4.9 billion, about 89 percent of the total cost of $5.5 billion incurred by FHA's Fund on these loans.

[20]FHA's database records historical foreclosure and prepayment activity from fiscal year 1989 onward. Data on previous years' terminations were purged from the database.

Administrative costs include staff salaries for those servicing program loans and other costs related to the program's application approval process and the processing of defaulted loans for foreclosure. Administrative costs used in our estimates were those developed by the Congressional Budget Office (CBO).[21] CBO estimated the assignment program's administrative costs and staffing needs—full-time equivalents (FTE)—for each phase of the loan assignment process: assignment requests, endorsements, servicing, and defaulting mortgages.

First we used CBO's estimates for the costs of each administrative function in 1994 to estimate the cost per loan for each function. We then applied this figure to each year's loan activity to estimate the costs incurred in that year for each function. Next, we used a real discount rate of 3.5 percent per year to convert the estimates to 1994 present values. CBO's FTE estimates and GAO's cost per loan and total cost estimates are shown in table II.1, which illustrates that the administrative cost for the 68,695 loans assigned between fiscal year 1989 and the end of fiscal year 1994 totals about $451 million over the life of these loans, about 8 percent of the costs incurred by FHA's Fund.

Table II.1: Administrative Costs of Assigned Loans

Loan assignment phase	Annual 1994 FTEs	Total cost (in millions over the life of the loan)
Assignment requests	414	$150
Endorsements	13	5
Annual servicing	575	166
Defaulted mortgages	78	131
Total FTEs and costs[a]	1,080[b]	$451

[a]Numbers do not add because of rounding.

[b]FHA officials stated that the actual staff totals for administering the program are less than 1,080 FTEs.

Salary costs, which averaged $48,017 per FTE in fiscal year 1994, are used for all FTEs listed. Assignment request costs were allocated to all program loans, although the majority of these costs were for processing loans that were not accepted into the program. Endorsement costs were computed for all 68,695 loans. Servicing costs were applied every year for as long as the loan remained in the program. Default costs were computed for foreclosed loans by year of default.

[21]Congressional Justifications for 1995 Estimates, Department of Housing and Urban Development, March 1994, Part 1, page O-8.

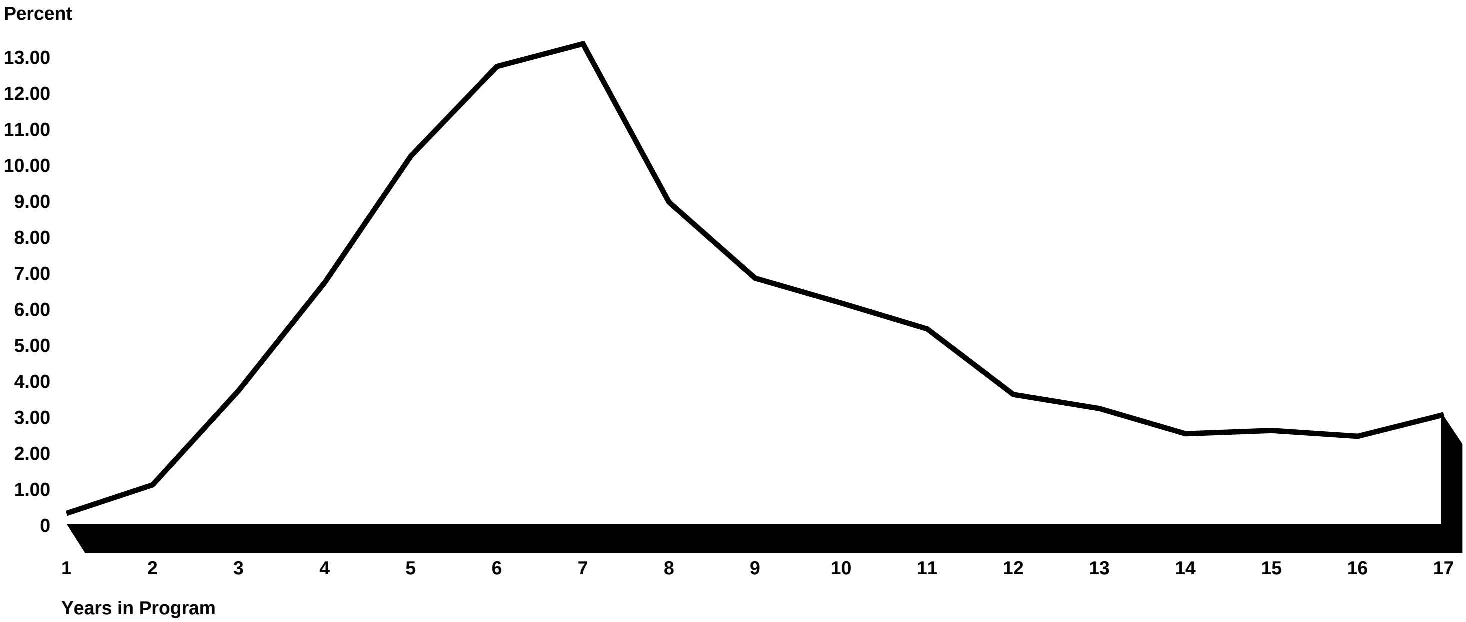
When borrowers are not current on their mortgages, additional costs are often incurred by FHA, including advances for property taxes, insurance, and other costs. HUD makes these payments to ensure clear title to the property and to protect its investment in case of fire. These costs totaled about $100 million, about 2 percent of the costs incurred by the Fund on these loans, and at times are not recovered from the borrower.

Forecasting the Program's Revenues

To estimate the program's revenues, we recorded the characteristics and status of loans for each year's book of business. These data were used to estimate ultimate foreclosure and prepayment probabilities of 52 percent and 48 percent, respectively. The conditional foreclosure and prepayment probabilities for each year were based on the actual number of loans that were foreclosed on and paid off between fiscal year 1989 and the end of fiscal year 1994.[22] We estimated these conditional probabilities using data for the 6-year period ended September 30, 1994. These probabilities were for loans entering the program during a 17-year period (fiscal years 1977 through 1994) and represented loan years 1 through 17. We assumed that the conditional foreclosure and prepayment rates for years beyond 1994 (18-30) were the same as for loan year 17. Figures II.1 and II.2 illustrate the estimated conditional foreclosure and prepayment probability rates by loan year.

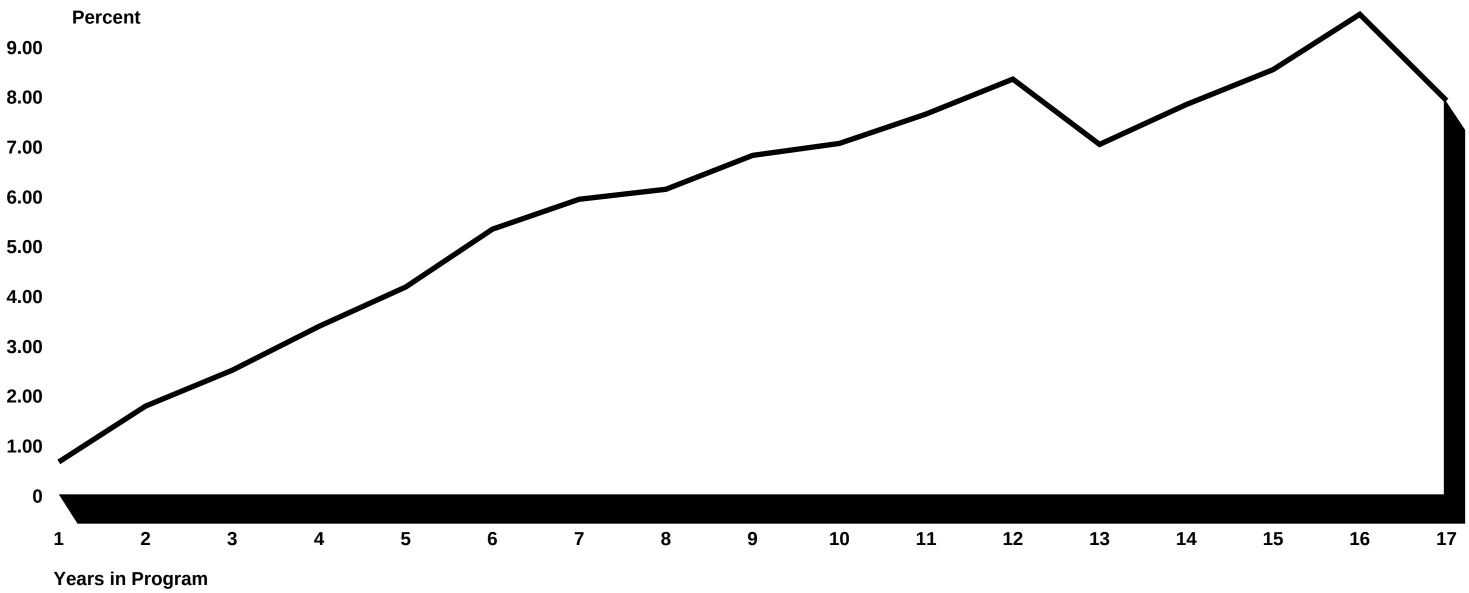
[22]These probabilities are conditional because they are subject to the condition that the loan has remained active until a given year.

Figure II.1: The Program's Conditional Foreclosure Rates, by Year



Source: FHA's F60 database.

Figure II.2: The Program's Conditional Prepayment Rates, by Year



Source: FHA's F60 database.

Revenue estimates were based on the percentage of loans in five loan status categories—current, current with forbearance, delinquent with forbearance, delinquent with no forbearance, and pending foreclosure—and their expected performance in the future. For each year's book of business, we analyzed the unpaid balance to loan amount, the amount of receivables outstanding, the amortized payment amounts, and the actual payments made for each loan category. We also included the amount of advances owed and original loan amounts in the estimates.

Foreclosure Revenues

To estimate foreclosure revenues, an average recovery rate for loans foreclosed and sold was obtained from the SAMS data on 203b loans foreclosed during fiscal years 1983-94. Recovery rates ranged between 43 and 67 percent of acquisition costs each year, averaging 59 percent. The average recovery rate of 59 percent was applied to the acquisition costs of all foreclosed loans. Average acquisition costs were used in estimating foreclosure revenues. Specifically, the average acquisition costs for each year times the recovery rate for each foreclosed loan results in the estimated total foreclosure revenue of about $1 billion, about 48 percent of the $2.1 billion in revenues to be obtained by FHA's Fund on these mortgages.

Prepayment Revenues

Prepayment revenues are based on data for all loans. Using the number of loans that paid off and those forecasted to be paid off, the unpaid principal balance at the time of payoff was estimated and summed for all loans, totaling about $955 million, about 45 percent of the revenues to be obtained by FHA. In estimating the unpaid principal balance, we used the ratio of unpaid balance to original loan amount for each year. Using the average loan amount, year in program, and the number of expected prepayments, we estimated prepayment revenues for each year.

For years 19 through 30, we assumed that the unpaid balance to original loan amount will continue to decrease at an accelerated rate. To determine the unpaid balance for years 19 through 30, a simple regression was applied to the unpaid balance to original loan amount ratio for years 1-18, in which each year's ratio is dependent on the previous year's ratio. The resulting parameters were used to estimate the unpaid balance to loan amount schedule for years 19-30.

Payment Revenues

We forecasted loan payment revenues using the estimated number of loans remaining in the program and the actual and scheduled payments made for each loan category. Actual loan payments averaged about 34 percent of scheduled payments.[23] It was assumed that the assigned loans will have the same distribution over the loan categories that they did in fiscal year 1994 but that the length of time in the program varies. Actual to scheduled payment ratios were also assumed to vary by time in program. As loans age, payment ratios rise, indicating that older loans are paying a higher percentage of scheduled payments.

Mortgagors' total payments for each year through the year 2023 for each year's book of business were summed to obtain the estimated total payment revenue of about $152 million, about 7 percent of the revenues obtained by FHA's Fund for loans assigned since the beginning of fiscal year 1989.

[23]The percentage of loans making full payments increases with time in the program. Some borrowers with less than 3 years in the program make no mortgage payments as part of their suspended payment mortgage forbearance agreement.

Borrowers' Compliance With Program Repayment Agreements

Approximately 39,600 (55 percent) of the 71,500 borrowers in the program as of September 30, 1994, had been in the program 3 years or fewer. HUD's records show that of the 39,600 borrowers, 26,000 (66 percent) are current with repayment agreements while the remaining 34 percent are not current. Of the 26,000 borrowers who are current with repayment agreements, 36 percent are current with original mortgage payments. The remaining borrowers (64 percent) are current with repayment agreements that call for reduced or suspended payments.

When borrowers remain in the program beyond the 3-year relief period and therefore are required to make full mortgage payments, the proportion of borrowers current with repayment agreements drops and the proportion of borrowers in foreclosure increases. Similarly, the average amount of delinquencies owed by borrowers increases (see figs. III.1 and III.2). Of the approximately 31,900 borrowers who have been in the program more than 3 years and are required to make full mortgage payments, 38 percent are current on their repayment agreements.

Figure III.1: Number of Borrowers by Loan Category and Time in the Program as of September 30, 1994

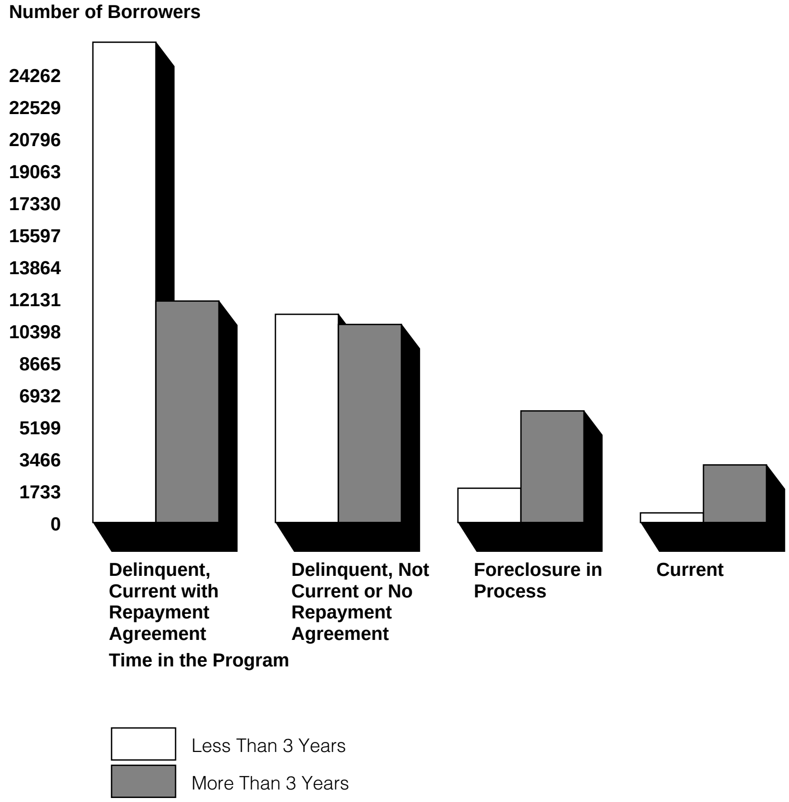
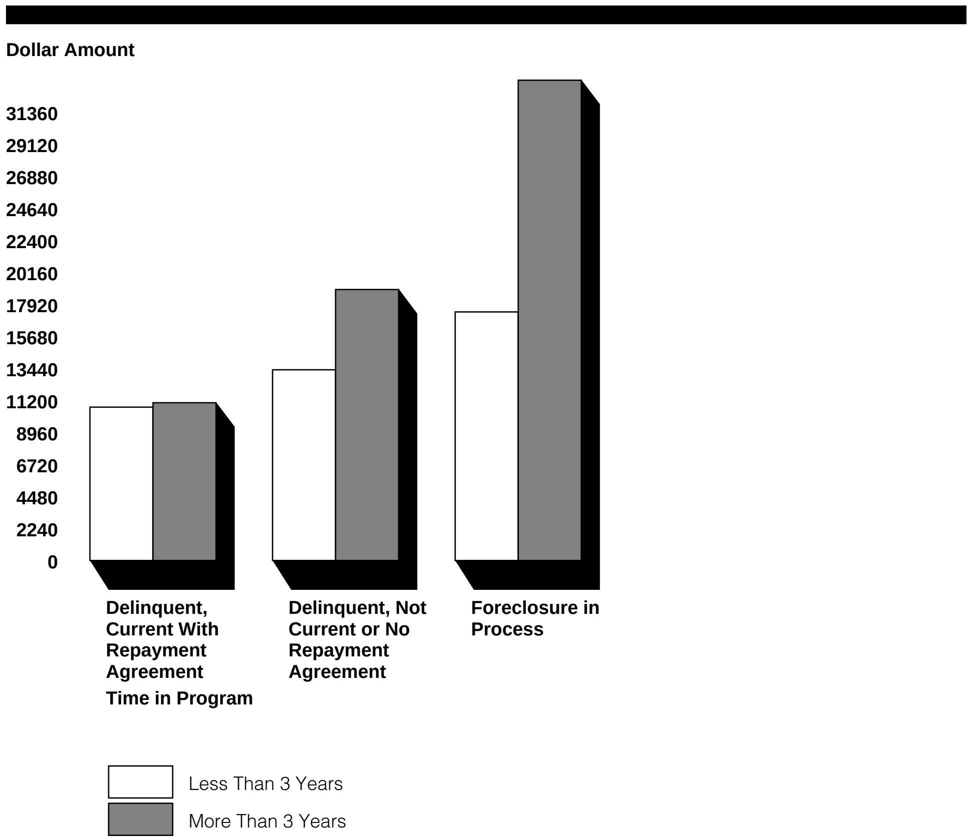


Figure III.2: Average Outstanding Delinquent Amounts by Loan Category and Time in the Program as of September 30, 1994



Cases in Which Some Borrowers Paid Off Mortgages and Others Did Not

People buy homes for shelter and investment purposes. Normally, they do not plan to default on a loan. However, conditions that lead to defaults occur. Defaults may be triggered by a number of events: unemployment, divorce, death, etc. These events are not likely to trigger foreclosure if the home can be sold for more than the mortgage balance and selling expenses. However, if the property is worth less than the mortgage, these events may trigger a foreclosure. Prepayments may be triggered by other events such as declining interest rates or rising house prices, which in turn may result in the refinancing or sale of a residence.

To illustrate that some borrowers were able to and chose to pay their mortgages while others did not, we randomly selected 136 case example loans from four loan categories—paid-off, current with payments, foreclosed on, and delinquent—from files at four HUD field offices—Boston, Chicago, Ft. Worth, and Spokane. Of the 136 borrowers, 78 had paid off their loans, 34 were current with their mortgages, and 24 had either been foreclosed on, provided HUD with a deed in lieu of foreclosure, or were delinquent on their loans.

Borrowers who had been foreclosed on, had given FHA a deed in lieu of foreclosure,[24] or had experienced growing delinquencies were generally unable to resume full payments, and they experienced additional problems after assignment that intensified their financial difficulties. These borrowers generally encountered one or more of the following situations after assignment: (1) intermittent job loss with a reduction in income, (2) reduction in income due to divorce, (3) one or more serious illnesses or injuries, (4) loss of a high paying job and reduced income from a new job, and/or (5) unanticipated housing repairs. Only a few borrowers did not make their mortgage payments because they had high installment debt.

While FHA does not keep track of borrowers after foreclosure, FHA loan servicers familiar with foreclosures told us that after foreclosure, borrowers generally either rent an apartment or are able to stay with relatives. Furthermore, program borrowers who experience foreclosures have experiences that are similar to those of FHA borrowers who experience foreclosures immediately without assignment, according to the servicers. However, officials from two housing counseling agencies told us that some borrowers could become homeless after foreclosure.

[24]The property owner deeds the property to HUD to avoid foreclosure.

In contrast, the 34 borrowers who were able to become current with their loans generally did not experience such a litany of problems. Although their incomes also declined, they either still had jobs, found new jobs by the time HUD accepted their loans for assignment, or were able to obtain second jobs to supplement their incomes. As a result, 25 (about 73 percent) of the borrowers who became current were able to resume full or increased mortgage payments immediately upon entering the program. Of the 34 borrowers who became current on their loans, 13 cured their delinquencies in less than 2 years. However, the remaining 21 borrowers took 92 months on average to cure their delinquencies. Seven borrowers took over 10 years to become current with their original mortgage payments.

Almost all of the 78 borrowers included in our case studies who had already paid their mortgages did so by selling their homes or refinancing their mortgages. Of the 78 borrowers, 71 sold or refinanced their homes, 4 paid mortgages from insurance settlement payments, and 3 paid through regular or increased payments. Borrowers who sold their homes were, on average, 8 months behind in mortgage payments of $4,169 at the time their loans were assigned, which increased to $6,088 when they sold or refinanced their homes. However, the proceeds from the sales were generally sufficient for these borrowers to pay off their original notes and the delinquencies. Generally, these borrowers had either held the properties for more than 10 years or lived in areas where housing had significantly appreciated in value since the homes were purchased. For example, according to a HUD field office official, housing in Spokane has almost doubled in value since 1985. In contrast, the value of homes in the Fort Worth area did not significantly appreciate during this period. Thus, mortgagors in areas where housing had significantly appreciated in value who sold their homes had equity in their homes when they defaulted on their mortgages. Almost half of the 78 borrowers who paid off their mortgages did so within 2 years of assignment, and almost two-thirds did so within 3 years of assignment.

HUD's Description of the Current Operations and Effects of Past Litigation on the Mortgage Assignment Program

MORTGAGE ASSIGNMENT PROGRAM

The following material is an account of the development of the Mortgage Assignment Program within the Department of Housing and Urban Development (HUD), and the effects of various litigations have had on the evolution and operation of the Assignment Program. Attached to the narrative is a litigation summary which provides an abstracted account of various litigation events that affected the Assignment Program. With respect to the former, it was drawn from a draft Report being prepared for submission to Congress.

Borrower Foreclosure Relief

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 1976 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.

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.[1] These are each valid forms of foreclosure prevention. The essential problem facing HUD 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 improve. This and HUD-supported lender forbearances were first permitted in 1959 and made effective through regulations issued in late 1964. The Temporary Mortgage Assistance Program (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 it would then place a lien on the property to secure future repayment. TMAP was enacted by Congress in 1980, but implementation of the program was twarted by continuing litigation over what HUD should be doing to assist borrowers in default.

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[1]There is a fifth which is not under the auspices of HUD's insurance funds and which 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. At present, HUD only insures lenders against failure of good-faith forbearances on FHA loans.

History of FHA Programs

Originally, FHA and HUD relied exclusively on mortgage servicers for handling delinquent accounts and processing foreclosures. While a mortgagee Guidebook was provided to servicers of FHA-insured loans, its provisions were merely suggestions and without the force of law.[2] 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 actively to 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 was aided by fraud and abuse against the insurance funds through HUD's 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 the Congress, and 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) in order to obtain required interest rate yields.[3] If the loan 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.[4]

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 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

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[2]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.

[3]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).

[4]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 to realtors and home builders selling substandard homes. This led to HUD's suspension of subsizided housing programs in January 1973.

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).[5]

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.[6]

In 1976 HUD signed to 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, 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.[7] 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:

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

[6]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.

[7]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*.

- 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 five years.

- After the five 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 to 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 demonstation of a Protective Insurance Payments (PIP) program from May 1976 to October 1979.[8] PIP 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 the Temporary Mortgage Assistance Program (TMAP) in 1980.[9] TMAP was enacted in Section 341 of the Housing and Community Development Act of 1980, amending 12 USC 1715u.[10] 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

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

[9]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 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 section.

[10]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.

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)).[11]

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 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.[12] 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)

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

[12]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."

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.

ATTACHMENT

Mortgage Assignment Program
SUMMARY OF FERRELL COURT ORDERS

The following is a list of significant events, including key court orders that relate to the *Ferrell v. Pierce* litigation, which continue to influence the Department's administration of the Assignment Program.

1973 National class action lawsuit filed alleging HUD failed to provide foreclosure avoidance relief to mortgagors experiencing temporary financial distress as required by the National Housing Act.

10/11/74 District Court issued an opinion in a case captioned Brown v. Lynn denying HUD's motion to dismiss the case. The Court held that the plaintiff class, who were all FHA insured mortgagors who had lost their homes to foreclosure, could bring an action against HUD for its failure to provide the plaintiffs foreclosure avoidance relief.

1976 Settlement agreement entered by District Court providing that the Department operate an assignment program.

1979 Amended stipulation entered amending 1976 agreement - stipulation incorporated the HUD Handbook on operation of assignment program and required HUD to administer the program in compliance with the Handbook. It also orders HUD to reprocess all applications for assignment rejected between 5/17/76 and 1/31/79. It further provides that HUD must sell former mortgagors wrongfully denied assignment a house from the HUD inventory for the amount the mortgagors owed on their former mortgages.

1980 Congress passes amendment to National Housing Act providing for TMAP. HUD files a motion to modify the 1979 stipulation to permit it to implement TMAP legislation as alternate foreclosure avoidance relief. Plaintiffs file motion to have HUD held in contempt.

4/7/83 District Court denies both HUD and Plaintiffs' motions and finds TMAP a violation of 1979 stipulation and enjoins HUD from implementing it.

7/11/83 District Court issues order clarifying that the "advancement rule" is the appropriate method for calculating the date of default. The method HUD used to calculate the date of default had been an issue in the TMAP litigation.

7/11/83 District Court issues order that HUD pay plaintiffs' counsel $45,757.43 for attorneys' fees and costs.

7/11/83 District Court issues order with technical amendments to the 4/7/83 Memorandum Opinion.

4/4/84 District Court orders HUD to reprocess all assignment requests pending or in process on 7/11/83 and to use the appropriate method of calculating the date of default in its new evaluation of the requests. Court stated that HUD already agreed to reprocess all assignment requests in which a preliminary or final decision letter was issued after 7/11/83, and all requests submitted after 7/11/83, that had cited "circumstances beyond the mortgagor's control" as the only reason for denial of mortgage assignment relief.

4/16/84 District Court issues a Preliminary Injunction Order enjoining HUD to reprocess certain categories of cases and to provide certain reports to the Court and plaintiffs' counsel.

9/14/84 Seventh Circuit Court of Appeals issues an opinion upholding the District Court's orders 1) denying HUD's request to implement the TMAP program and 2) granting plaintiffs' counsel attorneys' fees and costs.

3/26/85 District Court issues a Judgment Order that 1) requires HUD to discontinue its use of the two month rule to calculate the date of default; 2) finds the Secretary of HUD in contempt for violation of the 1979 amended Stipulation; 3) orders HUD to reprocess all applications for assignment that were rejected between 1/1/80 and 7/11/83 because of HUD's use of the two month rule; 4) orders HUD to reprocess all applications for assignment processed by the Baltimore Field Office between 1/1/80 and 6/25/84; and 5) provides a process for former mortgagors who are found to have been wrongfully denied assignment to purchase a house from HUD's inventory.

3/28/85 District Court issues a Memorandum Opinion finding HUD in contempt of 1979 decree for using the wrong date of default between 1/1/80 and 7/11/83 - orders HUD to reprocess all mortgage assignment requests filed after 1/1/80 using appropriate date of default.

5/14/85 District Court denies HUD motion to vacate the 3/26/85 order.

6/28/85 District Court issues order specifying how reprocessing ordered on 3/26/85 is to be accomplished by HUD.

8/8/85	District Court issues opinion denying HUD's request to delay implementation of the District Courts 6/28/85 Order pending a decision by the Court of Appeals unless HUD will freeze its existing inventory.
11/4/85	District Court issues an order enjoining HUD to provide certain records to counsel for the plaintiffs' and a professional locator to assist them in locating class members for purposes of providing them with notice of their rights to reprocessing.
1/7/86	District Court enters an order enjoining HUD to reprocess all applications processed by the Fresno and Little Rock Field Offices between 7/11/83 and 12/19/85 and by the Baltimore Field Office between 6/24/84 and 12/19/85.
3/21/86	Seventh Circuit Court of Appeals vacates 3/26/85 contempt order and "all relief ordered by District Court" and remands case for new contempt hearing.
2/24/87	District Court grants plaintiffs' motion to enforce the 4/84 injunction requiring the use of the advancement rule to determine the date of default and to pertinent parts of the 6/28/85 order for reprocessing, i.e., the relief that should be provided to those persons whose cases were reprocessed under the 4/4/84 order.
4/16/93	District Court entered an order enjoining HUD to follow certain procedures to provide relief to mortgagors who were found to have been wrongfully denied assignment and to pay counsel for the plaintiffs $17,500.00 in attorney's fees and costs.

Major Contributors to This Report

Resources, Community, and Economic Development Division, Washington, D.C.

Robert S. Procaccini, Assistant Director
Patrick L. Valentine, Senior Evaluator
DuEwa A. Kamara, Senior Economist
Larry Goldsmith, Senior Evaluator

Chicago/Detroit Field Office

Gwendolyn B. Poole, Senior Evaluator
Frank M. Taliaferro, Senior Evaluator
Francis M. Zbylski, Operations Research Analyst
John A. Wanska, Senior Evaluator

Dallas Field Office

Sally S. Leon-Guerrero, Staff Evaluator

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