

Federal Housing Administration Loan Program

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Mr. Chairman and Members of the Committee, the **National Consumer Law Center**¹ submits the following written testimony today on behalf of our low income clients and the **Consumer Federation of America**² regarding the FHA loan program.

We oppose the Administrations's proposal to raise the Federal Housing Administration's single family loan limit to \$227,150. Our concern is that by raising the loan limits, and thereby expanding the availability of FHA-insured mortgages loans, the high rates of defaults and foreclosures currently experienced by homeowners in this program will continue unabated. We would prefer to see FHA improve its performance on loss mitigation and foreclosure prevention on existing defaults, rather than paper over the problem of high default rates by lending larger amounts to comparatively affluent borrowers. We also have grave concerns with the Administration's proposal to allow sales of defaulted loan to private lenders without FHA protections.

However, it is essential that the committee understand that both the National Consumer Law Center and the Consumer Federation of America fully support the FHA loan program. The FHA loan program is an indispensable provider of homeownership opportunities to low income and minority borrowers. The weaknesses in the FHA program should be addressed, however, before the loan limits are expanded.

FHA must institute a more effective foreclosure avoidance program. In 1997, over 71,000 families lost their government insured FHA homes. Only about 700 households who were in default on their FHA mortgages were able to avoid losing their homes as the result of FHA's loss mitigation program.³ FHA's loss mitigation techniques, as currently implemented, are not, by themselves, sufficient to avoid foreclosure for most FHA homeowners that experience financial problems.

The FHA program was created to facilitate the dream of homeownership for low income, and minority borrowers with comparatively small down payments. By definition, FHA borrowers have fewer resources than others, and thus are considerably more vulnerable to foreclosure when personal disaster strikes. The loss of a job, divorce, illness or disability can all cause a decrease in income -- through no fault of the borrower -- that can lead to default. Since many FHA borrowers have relatively thin margins of income over debt and limited savings, they have more difficulty than non-FHA borrowers to develop a plan to resolve defaults.

For this reason, foreclosure avoidance relief has been an integral part of the FHA program for decades. We recommend that FHA use a greater portion of FHA insurance premiums to save the homes of homeowners facing temporary loss of income, in order to avoid the massive financial loss that FHA would otherwise face from foreclosure. *After all, it does not make sense to create a government program to facilitate homeownership without providing an effective safety net to make sure that homeownership can be sustained during periods of temporary financial difficulty.*

The consequences of foreclosure are devastating for all parties. Families not only lose their shelter but the pressures may result in a break-up of the family. For elders, it can result in an unnecessary transition to a more restricted living arrangement. Some foreclosures lead to homelessness and others result in critical overcrowding when ex homeowners move in with relatives. The education of children often is disrupted due to missing or changing schools. Accumulated equity is lost, credit is impaired, and the family must pay moving expenses.

For the FHA, the fund suffers an estimated \$30,000 loss per foreclosure. In 1997, this totaled approximately \$2.1 billion.⁴ For communities, foreclosures contribute to the overall deterioration of a neighborhood, to property abandonment, to the loss of community cohesiveness, to vandalism and other crime, to the reduction in property value and a resulting loss in the tax base.

The loss mitigation program that FHA has instituted since the mortgage assignment program was terminated in 1996 is not meeting the needs of the vast majority of homeowners who default. According to statistics provided by FHA officials, compared to the 71,000 foreclosures in 1997, only the following homes were saved through loss mitigation techniques:

584 - Special Forbearance

78 - Loan Modifications

111 - Partial Claims

Total - 773 homes saved for FHA homeowners

FHA also points to 4,429 pre-foreclosure sales as evidence that the loss mitigation tools were effective. Although these pre-foreclosure sales save the FHA fund money, they do not enable homeowners to keep their homes. Pre-foreclosure sales are *not* evidence of a successful foreclosure avoidance program for the homeowner since families are forced, often as a last resort, to give up their home without anything to show in return. (By definition, a pre-foreclosure sale is for a price which is less than the amount owed on the loan. There is no return to the homeowner.)

FHA projects that at least 10,000 homeowners will avoid foreclosure in 1998 through the use of the loss mitigation efforts.⁵ This number includes both homeowners who give up the home prior to foreclosure through a pre foreclosure sale as well as those who actually keep their homes.⁶ But even this total is only 14% of the total number of foreclosures in 1997 and likely even a smaller percentage of the total number of homeowners who will default in 1998. *The goal of FHA's foreclosures avoidance mechanism must be to maintain homeownership.*

FHA only requires that the lender "consider" either loss mitigation tools⁷ **or** foreclosure.⁸ Thus, there is no requirement that a lender seriously assess any home saving options. FHA employs an incentive approach to encouraging lenders to try one of the workout options. The carrots include cash payments, but the amount of these payments are small. And payments are significantly higher for sale options than for the homesaving plans.⁹ Moreover, because lenders' losses are almost completely reimbursed after foreclosure, there are no penalties to lenders for failing to employ effective foreclosure avoidance tools.

The National Consumer Law Center has partnered with FHA to endeavor to make the loss mitigation program a success. Through a contract with FHA, in late 1997 and early 1998, we provided training to over 600 housing counselors around the nation on the specifics of FHA's loss mitigation regulations. These counselors work directly with the FHA homeowners facing foreclosure on a daily basis and advocate to the lenders on behalf of homeowners.

However, even after the training, the housing counselors had a host of serious concerns with the current FHA loss mitigation requirements. The counselors, with few exceptions reported that

- Lenders do not understand the loss mitigation program.
- Few lenders have utilized special forbearance, loan modification, and partial claims to avoid foreclosure. Pre-foreclosure sales are being utilized, and in some cases, counselors report that it is the only option the lender is considering; some report homeowners are "pressured" to do this.
- Lenders' behavior are causing many more homeowners than in the past to lose their homes. Some lenders do not

even respond to professionally developed foreclosure avoidance proposals. Others feel that it is simply easier to foreclose and make a claim on the insurance pool.

We stand ready to continue the process of improving and facilitating the loss mitigation program. However, FHA's incentive approach alone is not adequate to stem the enormous tide of foreclosures. This system needs to be improved.

Recommendations To Improve FHA's Loss Mitigation Program

Before the FHA program is expanded with higher loan limits, the problems with the foreclosure avoidance tools should be addressed. The following changes to the Loss Mitigation Program would considerably improve its effectiveness, and remedy a significant and serious problem with the FHA program. FHA should mandate the use of specific loss mitigation tools. This can be accomplished in a variety of ways:

1. Lenders and servicers must be **required** to evaluate first the loss mitigation options designed to save the home. Pre-foreclosure sales and other options which require the homeowner to move should be considered only after all other options have failed.
2. FHA should require that servicers respond to a homeowner's workout plan within ten days of receipt. Any denial of a proposed plan should be made in writing and include the reasons for the decision.
3. Homeowners must be able to raise the claim that the lender improperly foreclosed when a loss mitigation plan was unreasonably rejected by the lender or servicer.
4. FHA should deny claims on the fund from lenders when lenders have refused to consider reasonable loss mitigation alternatives with appropriate documentation.
5. The partial claim program should be expanded. The first step a lender should consider is eligibility for a partial claim payment from FHA which would help the homeowners get caught up on missed payments when there is temporary financial hardship. As in the current program, the FHA can protect itself for any sum advanced by taking a junior mortgage.
6. The criteria for eligibility should include loss of income due to circumstances beyond the homeowner's control, and a reasonable likelihood that the homeowner can begin making the full monthly mortgage payment within a foreseeable period of time not to exceed 24 months. FHA should pay the lender the mortgage payments for the allotted time period. Then, in considerable contrast to the assignment program, the amount paid by FHA should become a second, interest free mortgage on the home payable only when the FHA mortgage is paid off or the house is sold. The lender should be required to provide homeowners with notice of the opportunity to apply for the partial claim within 3 months of default. Written reasons should be required before the lender rejects partial claims, and the homeowner should have the opportunity to appeal to FHA. If rejected, the homeowner should still be able to propose one of the other home-saving options which the lender must review.
7. The current loss mitigation tool of special forbearance is rarely utilized, due to the GNMA requirement that the servicer forward a full payment to GNMA regardless of what the servicer collects. Understandably a complex issue, but we recommend two possible solutions:
 - a. GNMA or FHA should set up a reserve fund to avoid this requirement.
 - b. FHA should provide a larger incentive for special forbearance in recognition of the lender's obligation to GNMA.
8. GNMA's requirement that a servicer provide five loans of similar interest rate and term in a package of re-pooled modified mortgages is an impediment to servicers utilizing this tool. Loan modifications are a good remedy for many defaulted borrowers and many miss this opportunity. FHA staff or an outside contractor might serve as "re-packager" for loans from servicers which do not have sufficient volume.
9. Funding for housing counselors should be increased. The entire system benefits when well trained counselors work with unsophisticated homeowners to develop a realistic budget and communicate viable proposals to lenders. Yet, these non-profit organizations are woefully underfunded.
10. Create and publicize a hotline for consumers and counselors to report lenders whose conduct contributes to unnecessary foreclosures. The hotline could provide an ombudsperson function to assist homeowners in default. Additional monitoring of servicers implementing loss mitigation plans should also be pursued.

Concerns with FHA Sales of Defaulted Notes. The Administration has proposed as an income-producing measure that prior to foreclosure FHA be allowed to sell defaulted notes at discounted rates to private lenders. The lenders

would take the notes, for which they paid less than the face value, and still have first place security in the home worth more than the value of the new note. **The homeowner would have no FHA protections applicable. No loss mitigation requirements would apply whatsoever.**

We know from experience with the FHA sale of other loan notes that the first thing the new lender does is pressure the homeowner into signing a new, high interest rate loan. These new loans will often be at high rates with high points and fees. Homeowners facing the foreclosure of their homes will often grab at any straws offered them, no matter how costly and unlikely to provide real relief these straws turn out to be. The purchasing lenders have a ripe opportunity to take advantage of desperate homeowners who have little or no equity due to loan arrearages.

Learn From Experience. In 1995 HUD sold over 68,000 mortgage loans acquired through the FHA assignment and other programs. The majority of the homeowners whose notes were sold were low-income. The aggressive collection activities of those lenders who purchased the loans from HUD created substantial confusion, anxiety, and cost to these homeowners. According to the allegations of a class action recently certified in the Federal Court in Maryland, immediately following the HUD sale of the notes, one lender sent homeowners notices of intent to foreclose despite the fact that they were current under forbearance agreements with HUD.¹⁰ Additionally, this lender allegedly sent the homeowners additional notices to foreclose and refused to accept payments from homeowners. The homeowners became anxious and believing that foreclosure was imminent, they refinanced with the lender, paying high closing costs and fees.¹¹

The proposal to sell loans in default is especially flawed. It proposes to allow a massive transfer of assets from the poorest homeowners facing financial disaster FHA homeowners in default to private industry. FHA homeowners have paid their FHA premiums. They deserve some special protections in return for these premiums. The sale of their notes after default to a lender who is not required to abide by any protections would represent a serious departure from the promise of some protections after default. The proposal should be rejected.

Conclusion

The FHA program is an invaluable means of increasing homeownership in the United States for families with otherwise limited opportunities. However, until the flaws in the existing foreclosure prevention process are rectified, the program should not be enlarged by increasing the loan limits.

¹ The National Consumer Law Center, Inc. (NCLC) is a nonprofit Massachusetts corporation founded in 1969 at Boston College School of Law and dedicated to the interests of low income consumers. NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government and private attorneys across the country. *Cost of Credit* (NCLC 1995), *Truth in Lending* (NCLC 1996) and *Repossessions and Foreclosures* (NCLC 1996) are three of twelve practice treatises published and annually supplemented by NCLC which describe the law currently applicable to all types of consumer loan transactions. As a result of our daily contact with practicing attorneys, we have seen examples of foreclosure problems for low income families in almost every state in the union. It is from this vantage point many years of dealing with the abusive transactions thrust upon the less sophisticated and less powerful in our communities that we supply this testimony today.

² The Consumer Federation of America is a nonprofit association of some 250 consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

³ This information was obtained from a declaration of Emelda Johnson, Deputy Assistant Secretary for Single Family Housing, U.S. Department of Housing and Urban Development, in the case of *Ferrell v. U.S. Dept. Of FHA*, U.S. District Court, Case No. 73 C 334, E.D.III.

⁴ This number is the result of multiplying \$30,000 by 71,000 foreclosures.

⁵ *Id.*

[6](#) The FHA will not know until the end of this year, how many of these homeowners will actually maintain their home, or which will only avoid foreclosure through pre foreclosure sales.

[7](#) The workout options available to lenders that are designed to save the home include: special forbearance, partial claim, and loan modification/refinancing. The options that result in a loss of the home but save the FHA a loss as high as that which results from foreclosure are: deed transfer in lieu of foreclosure, pre foreclosure sales, assumptions.

[8](#) See 24 C.F.R. § 203.355.

[9](#) For example, the FHA will pay lenders \$100 for each special forbearance, up to \$250 for costs for each partial claim, \$500 for each loan modification. On the other hand, lenders receive \$1,000 for each pre foreclosure sale and up to \$500 for costs for each "deed in lieu" (which is when a homeowner voluntarily provides a deed to the house in return for release of all liability). The amount paid for each special forbearance increases to \$200 if the lender scores in the top 25% on a lender performance scoring system devised by the FHA.

[10](#) *Peoples v. Wendover Funding, Inc.* No. k 97 158 (D.Md. filed 1/17/97).

[11](#) HUD sold these loans for 74 to 91 percent of the outstanding principal balance. This means that the profit margin for investors is very high if homeowners refinance and pay the entire amount due, that is the unpaid principal plus the assignment arrears.