



Selling HUD's Nonperforming Loans

A Win-Win for Borrowers, Investors, and HUD

Laurie Goodman

URBAN INSTITUTE

Dan Magder

CENTER CREEK CAPITAL GROUP

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The Department of Housing and Urban Development (HUD) has been selling nonperforming loans insured by the Federal Housing Administration since 2010, but it has greatly stepped up the pace of these sales since 2013. In selling these loans, HUD aims to improve both the finances of the Mutual Mortgage Insurance fund and the outcomes for borrowers. But this program has increasingly come under fire, with some arguing against the sale of government assets to profit-seeking investors.

We believe that some criticisms point to areas where HUD's nonperforming loan program can be strengthened, particularly regarding three key points:

1. ensuring investors do not walk away from the most challenging assets, leaving vacant and abandoned homes that burden neighborhoods and municipalities;
2. continuing efforts to encourage partnerships between investors and nonprofits to both extend the reach of investors and build capacity in the nonprofit community; and
3. creating better reporting and disclosure about what investors are doing with the loans in order to improve outcomes for borrowers.¹

At the same time, several criticisms are simplistic and reveal a misunderstanding of the nonperforming loans program's performance to date as well as the basic economics of loan investments. These criticisms revolve around three broad themes:²

1. buyers of nonperforming loans are too quick to push borrowers into foreclosure;

2. investors are making too much money on these pools: HUD is facilitating a “massive wealth transfer” from distressed borrowers to wealthy investors; and
3. borrowers would be better served if significantly more nonperforming loans were sold to nonprofits.

We believe the first two charges are simply untrue; the loan sales programs are actually a win for all parties, including the borrowers. Without question, there have been servicing abuses in the past, and current servicing is imperfect. But the data show that borrower outcomes are far better under the nonperforming loan sales than they would be without these programs. What’s more, investors compete intensely for these loans, and HUD realizes the benefit of that. And, if the loans are not sold, HUD would lose significantly more money in holding costs, and in repairs on the deteriorating properties, than it does by selling the loans to investors.

As to the third charge, we question whether nonprofits have or can quickly build the capacity to service a significantly larger portion of the HUD portfolio—especially if they are not working in partnership with for-profit investors who have the capacity to service loans on a large scale.

To properly evaluate the loan sales, it is critical to appreciate three key points. First, the loans being sold were already very delinquent, were required to have exhausted the HUD loss-mitigation waterfall, and were hence likely to be foreclosed upon. So, the impact of these loan sales is measurably positive for any borrower who is able to obtain a foreclosure alternative as a result of them.³ Second, investors have a significant financial incentive to pursue foreclosure alternatives because they retain the upside financial benefit; thus, their interests are aligned with borrowers and help maximize outcomes. Further, investors who purchase the loans have a wider range of options for pursuing loan modifications and short sales than HUD does, because investors are not constrained by HUD’s servicing guidelines. Third, while nonprofits can no doubt help delinquent borrowers, their limited capital and capacity suggests that their near-term impact on working out delinquent loans will be limited.

In this brief, we first look at HUD’s nonperforming loan (NPL) sales to determine if they are maximizing recoveries to the Mutual Mortgage Insurance (MMI) fund and helping borrowers avoid foreclosure. We then show that the economics of loan workouts align the interests of investors and borrowers—that is, you don’t have to believe that investors are altruistic to understand that they will pursue foreclosure alternatives if possible. Against this backdrop, we address the criticisms of the NPL sales program to help create programs that better harness investors’ capital and expertise in order to advance important housing policy goals.

We start by working through some of the more simplistic critiques of the program, in order to clear up some of the noise surrounding the loan sales so we can focus on the issues that really matter. We then make suggestions for improvement. We argue that the program should be refined to ensure investors cannot walk away from the most distressed properties, leaving burdens on municipalities and neighbors. We also propose that HUD collect and publicly release data to provide more transparency on the number and types of foreclosure alternatives that investors provide. We hope that better disclosure will pressure those servicers who are less borrower friendly than others. Finally, we support

increasing and deepening partnerships between investors and nonprofits to work with delinquent borrowers and resolve the nonperforming loans.

Against all these recommendations we also highlight that additional restrictions on investors would come at a cost that would be directly borne by HUD—and, by extension, taxpayers. Thus, the costs and complexity of implementing any enhancements need to be weighed against the value of the policy objectives achieved. The market gives very quick feedback on costs and trade-offs, allowing HUD as well as market participants to see what works and at what cost.

A Short History of the Federal Housing Administration Single-Family Loan Sale Program

The HUD single-family loan sale program was introduced as a pilot in 2010. Under this program, the Federal Housing Administration (FHA) can accept assignment of distressed mortgages from a servicer before a foreclosure and sell the mortgages as nonperforming loans. The goals of the program were to maximize recoveries to the MMI fund and, when possible, help borrowers avoid foreclosure.

These dual goals are possible to achieve because a) the sales allow HUD to avoid costly and lengthy foreclosures and b) purchasers of the mortgages have more options for dealing with NPLs than servicers operating under HUD guidelines. HUD servicers cannot lower mortgage interest rates below current market rates, and they cannot modify loans by reducing principal. And, in short sales and deeds-in-lieu of foreclosure, HUD is limited in what it can pay the borrower to move. By contrast, once the NPLs are sold, the new investors have a wider range of tools available to them. They can lower the interest rate on the loan to a below-market rate, and they can reduce principal. They can pay borrowers enough in relocation costs to encourage a short sale. This wider range of options means that the borrower is able to avoid foreclosure—the worst option—more often. And hefty competition among NPL investors ensures that HUD is generally paid more on these loans than it would recover through foreclosures.

In June 2012, the program was renamed the Distressed Asset Stabilization Program (DASP). Coincident with this renaming, HUD issued its first pool of Neighborhood Stabilization Outcome (NSO) loans, which were concentrated in designated areas. Investors who purchase NSO pools must ensure that at least 50 percent of the loans achieve one of the approved outcomes, including reperformance through loan modifications, rental to a borrower, sale to a nonprofit, or donation to a land bank.

HUD now sells both large national pools and NSO pools, and it began selling pools much more quickly in 2013. Before DASP, HUD sold approximately 2,000 loans totaling \$387 million in unpaid principal balance (UPB). Since then, national sales have totaled 81,750 loans, with a UPB of \$13,593 million. NSO sales have totaled another 24,932 loans with a UPB of \$4,541 million. Through the end of 2015, national and NSO sales have totaled 108,737 loans with a UPB of \$18.52 billion.

Loans included in the note sales are on average 29 months delinquent when they are delivered to HUD. These loans are so delinquent because FHA servicers are required to evaluate all loss-mitigation

options required by HUD's guidelines before including the loans in a note sale. This means first evaluating the options that would lead to home retention: the Home Affordable Modification Program (HAMP), special forbearance, and mortgage modification. If the borrower is unable to support the mortgage debt even with a modification, FHA servicers must consider other loss mitigation tools, including a pre-foreclosure sale or deed-in-lieu of foreclosure. Only after all these options are exhausted is a loan considered for inclusion in a note sale pool. **Thus, in the absence of the loan sale program, the loans in these pools were very likely to go to foreclosure because all their other options had been exhausted.**

Evaluating Whether Loan Sales Maximize Returns for HUD

The loan sales are good for HUD and for taxpayers by helping reduce losses to FHA's MMI fund. The FHA asserts that DASP recoveries on the program from 2013 through fiscal year 2015 have "netted \$2.2 billion, about \$24,000 per unit, over what would have been collected through the standard real estate owned (REO) execution" (HUD 2015a, 29). On loans with balances between \$150,000 and \$200,000 the savings are substantial: 12 to 16 percent.⁴

While we do not have the data to reproduce FHA's analysis, another simpler analysis using publicly available numbers confirms considerable savings. **According to our estimates, FHA loss severities are about 8 percent lower on a note sale than on a foreclosure sale.** The FHA's loss numbers suggest that from 2013 to June 2015, the net loss rate (calculated quarterly) has ranged from 53 to 67 percent of UPB and has averaged 59 percent.⁵ That rate is likely higher on the more delinquent loans included in the DASP pools, so let's use 62 percent. By contrast, average bids on DASP from 2013 to 2015 have averaged 57 percent of UPB, suggesting a net loss rate of 43 percent. Thus, the loss rate is approximately 19 points lower on loans sold through DASP than if those loans had stayed with the FHA. However, the FHA has incurred some expenses associated with the loan sales. The expenses associated with REO sales are 20 to 24 percent;⁶ it is reasonable to think that expenses associated with loan sales are around half that amount (i.e., 11 percent or so). Subtracting an additional 11 percent for expenses, the loss rate on the loans sold is still almost 8 percent better than FHA's own severities.

In summary, the loan sales help HUD avoid claim, holding, and sales expenses that the FHA would have incurred if the loans had gone to foreclosure and HUD had had to pay out insurance to the lenders. The lower severities on the loan sales also incorporate the fact that investors have a larger toolkit than HUD to draw from, which is reflected in the investors' bids. There are more modifications and short sales and fewer foreclosure sales in these loan sales; as a result, investors are able to pay up for the opportunity.

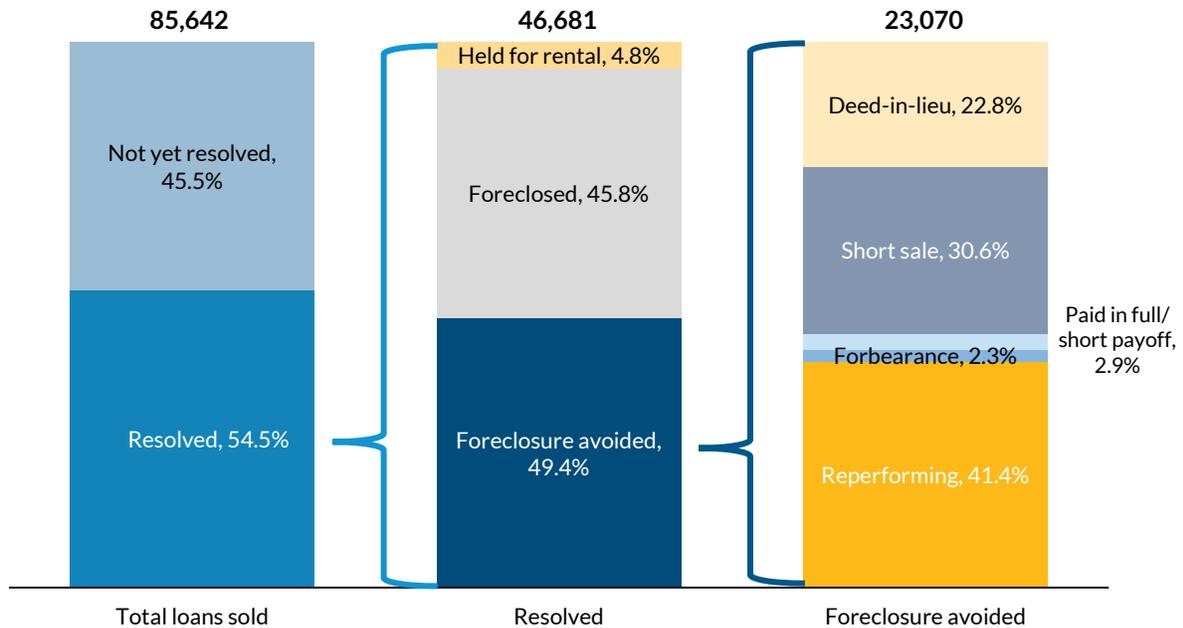
Evaluating Whether Loan Sales Help Borrowers Avoid Foreclosure

We believe the nonperforming loan sales program is giving many borrowers a second chance to avoid foreclosure. In an August 2015 report, HUD reviewed all 14 sales in the Distressed Asset Stabilization

Program and tracked the current status of the NPLs in each pool. Of the 85,642 loans that HUD can track through the program,⁷ 54.5 percent have been resolved; of those resolved, 49.4 percent—that is, approximately 25 percent of the total—have avoided foreclosure (figure 1). And at least some of the 45.5 percent that have not yet been resolved will result in an outcome other than foreclosure.

FIGURE 1

Outcomes for Nonperforming Loans in HUD Loan Sales, 2010–14



Source: HUD (2015d).

While helping at least 25 percent of borrowers avoid foreclosure (including about 10 percent who have been able to remain in their homes) may not be as strong a result as housing advocates want, nearly 100 percent of the loans would have gone to foreclosure without DASP. Distressed borrowers face much better odds of avoiding foreclosure if their loan is sold as part of this process.

Moreover, the average delinquency of the NPLs in the DASP pools is almost two and a half years. The more delinquent a loan, the harder to find a foreclosure alternative. This difficulty is the result of several factors. A longer period of delinquency leads to a higher balance of missed mortgage payments, creating a larger outstanding balance that needs to be addressed. In addition, properties with aged delinquencies are more likely to have been damaged through vandalism or neglect, increasing the cost associated with getting them into livable condition. And, a high share of the loans is tied to vacant properties, where there is virtually no chance of reaching the borrower to even attempt some foreclosure alternative, meaning that the total “addressable market” of loans that could be candidates for loss mitigation is perhaps only half the pool to begin with. This is the proper context to view the

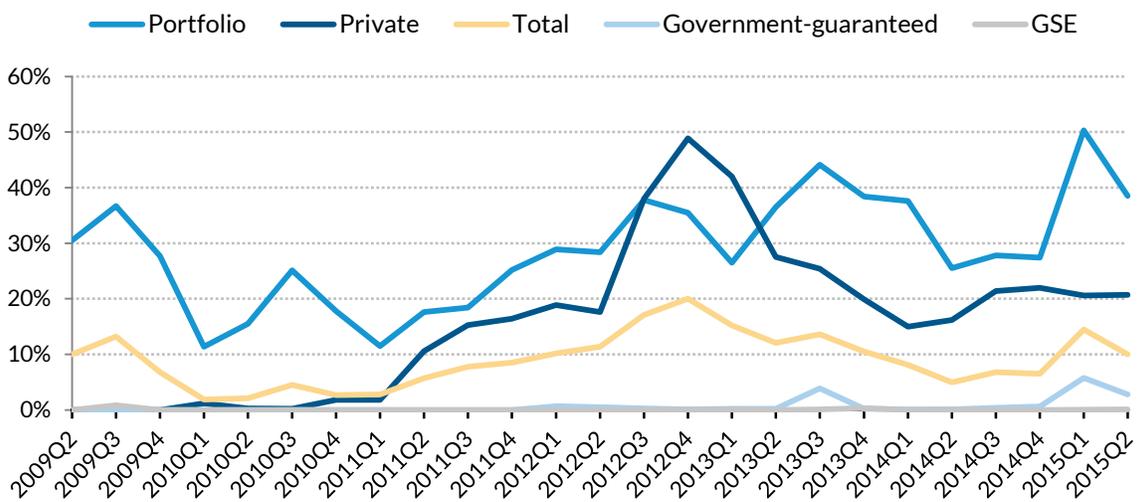
performance of investors who nevertheless have been able to help at least one-quarter of borrowers avoid foreclosure.

Why Investors Can Save Borrowers that Other Servicers Cannot

A bank or other servicer managing a HUD loan will try to follow the HUD loss-mitigation waterfall. Even if a servicer is able to better tailor the modification for the borrower and avoid foreclosure by violating HUD’s rules, the servicer has no incentive to do so. The servicer will reap no benefit if successful and faces substantial penalties if the loan nevertheless goes to foreclosure and the servicer is found to have violated HUD rules.

An investor who both owns and services a mortgage behaves differently, attempting to maximize the return on its investment. The different behavior can be best seen in figure 2, which shows the share of modifications in a given quarter that involve principal reduction by investor type. In most quarters, portfolio lenders provided the largest percentage of principal reduction. Were they altruistic? No; they calculated that principal reduction would give them the highest return on their loans, and they kept the upside. By contrast, the servicers for private-label securities, the government-sponsored enterprises (Fannie Mae and Freddie Mac), and government-guaranteed loans do not keep the upside when they do a better job at loss mitigation.

FIGURE 2
Share of Modifications Receiving Principal Reduction by Investor Type, Q2 2009–Q2 2015



Source: Office of the Comptroller of the Currency, OCC Mortgage Metrics Reports, compiled by Urban Institute.

Note: GSE = government-sponsored enterprises (Fannie Mae and Freddie Mac).

When investors buy nonperforming loans from HUD, their incentive is to maximize the return on their investment. As we work through the math in the next section, it will be clear that foreclosures produce the lowest return on investment, and hence are the last resort for investors. Investors are

much more interested in offering borrowers an alternative like a modification (mod), a short sale, or a deed-in-lieu—not because the investors are necessarily focused on borrowers, but because these outcomes produce better returns to the investor. This is a classic case of aligned incentives producing positive policy outcomes.

Loan Economics 101: Loan Pricing

The key to understanding how investors manage nonperforming loans is to understand the economics involved. To begin with, remember that virtually all investors evaluate their investments the same way: based on measures of internal rate of return (IRR). The internal rate of return measures not only how much money an investor makes, but *when* the money is returned—and the sooner that happens the better. The time value of money means that—except under deflationary conditions—\$100 today is worth more than \$100 next year. In other words, given the choice between, say, \$90 today and \$100 next year, most investors would choose to take \$90 today and reinvest it, because they believe they can make more than \$10 on their new investment over the next year.

As a result, when investors evaluate the return they can expect from a nonperforming loan, they are highly sensitive to timelines. The three main types of resolutions for nonperforming loans—short sales, modification and sale as a reperforming loan (RPL), and foreclosure⁸—have different expected proceeds and very different expected timelines. Foreclosures take the longest, short sales and modifications/sales as RPLs are much quicker. Timelines also vary based on the state’s foreclosure process; some states require that a court be involved, adding a significant amount of time to the process compared with states with nonjudicial processes.

In nonjudicial states, the average timeline from delinquency to REO sales for Freddie Mac loans is 18.7 months. In judicial states, the timeline averages 25.4 months. And FHA timelines are even longer; they average 37.4 months nationwide in August 2015, the latest number available (HUD 2015b). Short sales or other foreclosure alternatives can happen much more quickly: the average timeline for Freddie Mac loans is 12 months in nonjudicial states, 17 months in judicial states. Unfortunately, we don’t have short sale information for FHA loans, but assuming that they take 65 percent of the time a foreclosure takes, FHA short sales would take about 24 months.⁹ Offering borrowers a mod, getting them back to performing status for a few months, and then selling the loan as an RPL generally takes about as long as a short sale; that is, the loan can be sold after it has 12 months of on-time performance.

The time it takes to achieve a certain NPL workout also matters in a different way: longer timelines lead to higher holding costs for investors. Between the time an investor purchases a loan and sells it, the investor has to pay property taxes, homeowners association fees, maintenance costs (including cutting the grass as often as weekly in the summertime), and property preservation costs necessary to ensure the house isn’t vandalized or creating blight in the neighborhood. The longer a house sits vacant and abandoned, as many foreclosures do, the higher the likelihood its condition will deteriorate—resulting in either higher downstream repair costs, or lower proceeds, or both.

Table 1 demonstrates how the economics work for various NPL outcomes. These numbers are illustrative and will vary based on a wide range of factors (different price points, different geographies and timelines). However, the relationship among the three is generally consistent: short sales and modifications/sales as RPLs almost always result in better financial outcomes for investors than foreclosures.

TABLE 1

Illustrative Returns Based on Outcomes

Loan characteristics	
Unpaid principal balance (UPB)	\$175,000
Original property value	\$225,000
Current property value	\$150,000
Original loan	\$180,000
Original LTV	80%
Current LTV	117%
Investor purchase price (% of UPB)	60%
Investor purchase price	\$105,000
Investor price as % of property value	70.0%
Scenario 1: modification and sale as reperforming loan	
Price at sale (% of UPB)	75%
Price at sale	\$131,250
Carrying costs (monthly)	\$400
Time frame (months)	20
Net proceeds	\$123,250
<i>Internal rate of return</i>	9.8%
Scenario 2: short sale	
Price at sale (% of value)	97%
Price at sale	\$145,500
Sales costs	6%
Carrying costs (monthly)	\$400
Relocation incentive	\$3,500
Time frame (months)	20
Net proceeds	\$128,770
<i>Internal rate of return</i>	10.8%
Scenario 3: foreclosure	
Price at sale (% of value)	97%
Price at sale	\$145,500
Sales costs	6%
Carrying costs (monthly)	\$250
Repairs at time of sale	\$6,000
Time frame (months)	36
Net proceeds	\$127,770
<i>Internal rate of return</i>	4.9%

Note: Carrying costs include servicing costs and holding costs, including taxes, insurance, and property preservation. We assume that more effort is expended up front, leading to lower average carrying costs over a longer time frame.

On a blended basis, investors hope to hit an unlevered return in the high single digits or low double digits; if they can achieve more mods and short sales, then their returns increase. Thus, the economics suggest that investors' interests are aligned with the public policy goal of keeping people in their homes if possible. However, the analysis in table 1 is only the first step in understanding how investors look at delinquent loans. To truly understand how investors evaluate the economics of NPLs, we need to go a step deeper.

Loan Economics 102: How Potential Outcomes Drive Investors' Pricing on NPL Pools

When investors buy a pool of NPLs, they consider several factors to determine their bid price. As a first pass, they look at what their proceeds will be if every loan goes through to foreclosure. Given the relative values of the different outcomes shown in table 1, this scenario is the worst-case option, and it provides a floor for the investors' pricing. The next step for investors is to estimate how many loans in the portfolio they expect to be able to short sale or modify; this analysis will adjust their pricing upward. These estimates depend on the characteristics of the pool, including how long the average loan has been delinquent (since loans that have been delinquent longer are less likely to be modified), how many properties are reported to be vacant (which is usually understated, and vacancy almost always precludes a non-foreclosure alternative), who the current or previous servicer is (and whether the servicer is known to be effective at borrower outreach or whether the new investor can expect to find some easy-to-modify loans), and a host of other factors. Based on all these considerations investors can make educated estimates of likely percentages of short sales, mods, and foreclosures in the pool and adjust their pricing accordingly. Essentially, they can pay up for pools with a great number of higher-value loans that are likely to flow through to short sales and mods.

Table 2 uses the same assumptions as table 1, but rather than showing the IRR for each outcome based on a given price, it shows more accurately what investors do: they price each NPL to a target return based on the expected proceeds. Table 2A shows the pricing an investor would be willing to pay: 59.8 percent for a loan that it expects to modify, 60.8 percent for a loan that will go to short sale, and 51.7 percent for a loan headed to foreclosure. Table 2B shows how different expected distributions affect the blended pool level pricing: the more foreclosure alternatives in a pool, the higher the pricing.

TABLE 2A

Pricing Nonperforming Loans Based on Expected Outcomes

Scenario 1: modification and sale as RPL		Scenario 2: short sale		Scenario 3: foreclosure	
Target IRR	10%	Target IRR	10%	Target IRR	10%
Price at sale (% of UPB)	75%	Price at sale (% of value)	97%	Price at sale (% of value)	97%
Price at sale	\$131,250	Price at sale	\$145,500	Price at sale	\$145,500
Time frame (months)	20	Time frame (months)	20	Time frame (months)	36
Price to hit target IRR	104,614	Price to hit target IRR	106,350	Price to hit target IRR	90,496
Price as % of UPB to hit target IRR	59.8%	Price as % of UPB to hit target IRR	60.8%	Price as % of UPB to hit target IRR	51.7%

TABLE 2B

Pricing a Pool Based on Estimated Distribution of Loans

	Pool 1: more foreclosure alternatives	Pool 2: moderate foreclosure alternatives	Pool 3: fewer foreclosure alternatives
Modifications share of total	25%	15%	5%
Short sales share of total	25%	15%	5%
Foreclosures share of total	50%	70%	90%
Weighted average pricing	56.0%	54.3%	52.6%

Source: Center Creek analysis.

Notes: Each pool comprises 1,000 loans. IRR = internal rate of return; RPL = reperforming loan; UPB = unpaid principal balance.

Investors have a strong incentive to estimate correctly both the expected value of each type of outcome and how many loans of each type are in a given pool of NPLs. The auctions attract a lot of different investors (26 bidders have purchased these loans), making for a competitive market. If investors underestimate or lowball the number of higher-value loans, they will lose the auction to investors with rosier outlooks. If they overestimate the value of the portfolio, they will miss their investment targets—and if they do that too often, they will go out of business. Once they've made their bid and won a pool, investors have a very strong incentive to deliver on their projections—that is, they need to make at least as many mods/RPLs and short sales as they predicted. If they can make more than expected, they will beat their projections and have even stronger returns. These economics suggest that investors have a strong financial interest in producing mods and short sales and that they will attempt to avoid foreclosure if possible.

Criticism 1: Investors Foreclose too Often

A front-page article earlier this fall in the *New York Times* stated, "Housing advocates and lawyers for borrowers contend that the private equity firms and hedge funds [buying troubled loans] are too quick to push homes into foreclosure and are even less helpful than the banks had been in negotiating loan modifications with the borrowers."¹⁰

According to HUD data, nearly 25 percent of borrowers whose loans were sold through DASP have been resolved through some foreclosure alternative—and this number will likely rise as some of the 50 percent of loans that are still outstanding are resolved. In addition, the interests of borrowers and investors are aligned in seeking foreclosure alternatives, and investors have an expanded toolbox for pursuing these outcomes. Based on HUD’s claim that all the loans sold through DASP have exhausted the traditional options for foreclosure alternatives, we believe the results of the program are strong. We need to take these factors into account to create realistic expectations of what a second chance looks like for a pool of highly delinquent borrowers.

On a related note, some advocates believe that while the loans sold through this program have theoretically gone through all HUD loss-mitigation options, the reality is much different—and that when HUD sells the loans to investors, the associated borrowers are losing protections they have within the HUD program. It is true that servicers self-report their loss mitigation activities, and it is also true that they are motivated to get loans into DASP as it avoids the very cumbersome HUD conveyance procedures. However, the FHA has taken this complaint to heart and no longer relies on servicer’s self-reporting. For sales beginning in 2015, HUD is auditing the servicer’s coding of the properties as they are tracked in HUD’s national single family default management system, to ensure that loans contributed to the sale program have gone through HUD’s loss mitigation waterfall.

At the same time, in cases with no alternative to foreclosure, the financial as well as public policy goal is to complete the foreclosure process as efficiently as possible. Foreclosing quickly preserves the asset from further deterioration and avoids a situation where the house becomes vacant and abandoned, a situation that has negative spillover effects on neighbors and the surrounding neighborhood. Though foreclosure is a genuinely unfortunate outcome, it is sometimes inevitable. At the same time, investors need to temper their financial analysis with recognition of the real human impact that their investments are having.

Criticism 2: Investors Are Making Too Much Money on Loan Sales

Critics of the loan sale program claim that investors are making too much money on their purchases of troubled loans. The *New York Times* article quoted earlier went on to report that “Federal and state lawmakers are taking up the issue, questioning why federal agencies are selling loans at a discount of as much as 30 percent to such firms.”¹¹ A recent article in *The Atlantic* decried the loan sales as a tremendous “transfer of wealth” and presented some numbers to support its case: “Oaktree paid \$68.6 million for the 803 Baltimore mortgages, about 65 percent of the \$105.7 million HUD says they were worth. That means even if the company doesn’t collect a dime on any of the mortgages, even after legal fees and other expenses, it can more than make its money back by foreclosing and selling the homes.”¹²

This simplistic analysis is either misleading or at least highly misguided. Even if investors could profit from foreclosing on all the homes, as we have shown above, economically rational investors will not foreclose since that is their least economically attractive outcome.

Moreover, the article suggests that Oaktree got too large a discount on the sale. But they could have won the auction on the pool of loans only because no other investor—including any nonprofits that were bidding—thought the loans were worth more. And these auctions generally attract a lot of bidders. The value of auctions like the one HUD runs is that they produce precisely this type of pricing transparency, transparency that HUD should enhance by better disclosure of eventual outcomes.

Looking further at the *Atlantic* article's criticism, \$105.7 million is the broker price opinion (BPO) of the assets underlying the pool of mortgages, not the value of the mortgages. The BPO is a determined by brokers who visit each house and evaluate what it would fetch as is on the open market in a 90-day time frame. However, whoever buys the loans cannot simply sell the underlying collateral within 90 days. To sell the properties tied to the delinquent loans, an investor must first foreclose on the property. During that time the investor incurs all the holding costs associated with that property (property taxes, insurance, property upkeep so they don't get cited by the local authorities for contributing to blight, and so on). Investors must then also pay for legal costs associated with conducting the foreclosure as well as transaction costs—including both fees to agents and transfer taxes—on each property sold. In addition, HUD imposed a 12-month foreclosure moratorium in 2015 that increases holding time along with all the associated holding costs.¹³ So while the gross BPO value of the houses may be \$105.7 million, the net value of the nonperforming loans is far lower, and they will always be sold at a discount.

Further, even if HUD kept the loans, it would not recover the full \$105.7 million on them, since HUD (or its vendors) would incur all the same costs as a private investor in working them out. As we showed earlier, HUD would be apt to recover less as it has a more limited toolbox—and HUD's own analysis suggests the loan sales save the FHA \$24,000 a loan. For all these reasons, the analysis in the *Atlantic* article vastly overstates the “great deal” that the investor got on these loans.

Still, the numbers in tables 1 and 2 suggest that the returns to an investor can be relatively strong, so it is worth taking a step back to look at what is really happening. During the height of the housing crisis, the high volume of NPLs and the lack of players willing to take them on meant that buying NPLs could provide investors with returns in excess of 20 percent.¹⁴ However, the NPL market is now highly competitive, and current NPL pricing generally gets closer to a high single-digit/low double-digit return. While these returns are good compared with investing in Treasury bonds, buying NPLs is certainly much riskier: if investors get their initial pricing wrong, if they stumble on their operations, or if an economic downturn occurs, all their proceeds can evaporate. Plus, the government benefits from the major investments these firms have made in infrastructure, on which they also need to earn a return.

Thus, the returns that investors achieve in the loan sales should be understood as the price policymakers pay to tap into the capital (which bears both the gains and losses) and expertise of the private investors. If investors cannot make an attractive return on these loans, they simply won't buy them. The benefit of the loan sales process is that the auction provides pricing transparency about what

it costs to attract this expertise: the price is competitively set by the market. This process both improves the status of the MMI fund and provides borrowers with a second chance, as these private investors have a more expansive toolkit of options and incentives aligned with borrowers.

Criticism 3: Nonprofits Should Tackle More NPLs

An additional critique raised by program critics is that HUD should be encouraging nonprofits to purchase the NPLs and work them out. One nonprofit, New Jersey Community Capital (NJCC), was highlighted in a recent Center for American Progress report examining the HUD sales (Edelman, Gordon, and Desai 2014). According to an interview with the CEO of the NJCC, the fund was able to modify 35 to 40 percent of the loans it purchased from HUD. This reinforces housing advocates' belief that nonprofits can modify delinquent loans more successfully because they are willing to put more effort into modifications and are more likely to offer principal write-downs and other generous modification terms.

It is indeed possible that NJCC's lower cost of capital—that is, it does not need to make the same profit as private investors—allows the nonprofit to pave the way for more workouts. However, while NJCC may have a low cost of capital, it doesn't have an unlimited amount of this capital; there simply isn't much money willing to take risk on NPLs without earning a reasonable return. Partly for this reason, NJCC has purchased only 261 of 21,400 loans in HUD's NSO pools and 68 loans in one of the most recent nonprofit pools, representing a tiny fraction of the over 100,000 loans sold through DASP.¹⁵ Similarly, Hogar Hispano, another nonprofit that bought the first specially targeted nonprofit pool in the 2015 auction from HUD and bought a second one in the most recent 2016 program, may achieve a higher rate of modifications in its pool, but the first pool it purchased consisted of only 11 loans, and the second had 93 loans (by contrast, national pools can have 700–1,500 loans). A third nonprofit, the Mortgage Resolution Fund (MRF), used funds from the Treasury Department's Hardest Hit Fund program to purchase its HUD pools. These funds are not only limited but also add a whole new layer of regulatory complexity to the nonprofit's efforts. Partly as a result, MRF has not purchased any additional pools since 2013. Finally, in HUD's most recent sale (SFLS 2016-1) on November 18, 2015, one of the three nonprofit pools of loans was not awarded to a buyer. It is unclear why the third pool did not trade, but it is a possible indication of capacity constraints among the nonprofit community.

Thus, it seems that at least for now, the role of nonprofits is limited because of capital constraints and the relatively few nonprofits that have the expertise and infrastructure needed to work out delinquent loans. As a result, pools reserved for nonprofits will tend to trade at lower prices, again emphasizing policy trade-offs.

How Else HUD Could Improve Outcomes

HUD already has quite a few policies in place that require investors to seek foreclosure alternatives for borrowers in the pools of loans that are being sold. On the national pools, investors are not allowed to

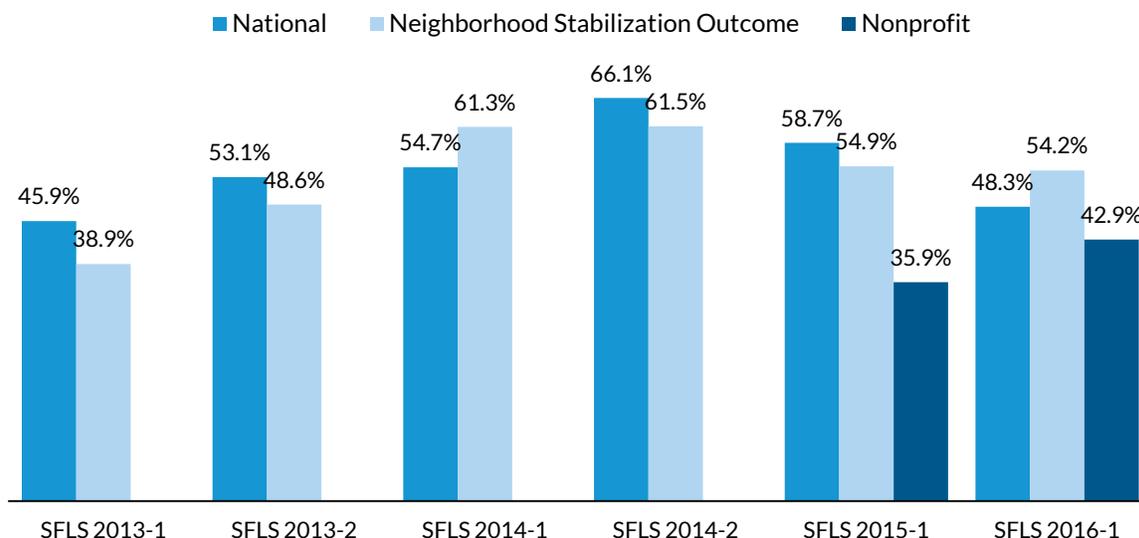
foreclose on borrowers for 12 months after the sale in order to give borrowers a chance to find alternative outcomes.¹⁶ This initial foreclosure moratorium provides significant time for servicers to conduct outreach and attempt to connect with borrowers and find foreclosure alternatives. With the encouragement of housing advocates, HUD also created NSO pools, for which investors have to ensure that at least 50 percent of the loans achieve a more “neighborhood friendly” outcome, defined by HUD to include a loan modification, rental to a borrower, sale to a nonprofit, or donation to a land bank.

As a result of these types of foreclosure moratoria, the timeline for loans to get worked out is pushed back. Thinking back to our loan-level economic analysis, if we push the resolution timeline back by another six months, the IRR to the investor will go down. Since investors still need to hit their investment goals, they will reduce their pricing when they bid on pools that have these restrictions. HUD can certainly layer on more restrictions on future loan sales, but doing so will decrease the price that investors are willing to pay, costing HUD much-needed revenue. Policymakers will therefore need to weigh the policy objectives achieved by the additional restrictions against the cost to the MMI fund of the lower return on their sales.

The data on the loan sale outcomes in figure 3 show that the pricing on the NSO pools has indeed been lower than the national pools on four of the six most recent sales, which is what might be expected since HUD has put additional requirements on investors who purchase these pools.¹⁷ However, the pools have not been totally comparable through time. For example, NSO pools used to include both vacant and occupied properties; they now include only occupied properties, and that should improve their pricing relative to the national pools. The latest two HUD loan sales featured a new type of pool that was only open for bids to nonprofits. In the first sale (SFLS 2015-1), the nonprofit pool traded at 35.9 percent, nearly 20 percent lower than even the NSO pool, showing the magnitude of the additional discount HUD was forced to absorb in order to facilitate the sale of loans to the nonprofit. HUD’s most recent sale (2016-1) included three nonprofit pools; one was not awarded, suggesting that either there were no bids or the bids were below a level deemed acceptable by HUD. The other two traded at 28 percent and 63 percent; the former was by far the lowest priced pool by nearly 20 percentage points, and the latter was the second highest price on any pool.¹⁸

FIGURE 3

Pricing as a Percentage of Unpaid Principal Balance by Pool Type, 2013–15



Source: Center Creek analysis of HUD data.

HUD’s decision to extend the foreclosure moratorium from 6 to 12 months beginning with the 2015-1 sale seems to have brought down pricing on all pools by about 6 percent. This is particularly telling because the supply of NPLs is shrinking, which was driving an increase in pricing over time. That increase seems to be reversing because of the policy change.

While HUD continues to improve the nonperforming loan sales program—enhancing auditing of servicer representations about completion of loss mitigation, experimenting with different types of pools and restrictions—we think HUD can take three additional steps to enhance the goals of NPL sales.

Ensure Investors Do Not Walk Away from Challenging Assets

We agree with critics who are concerned that investors may walk away from the most challenging loans in these NPL pools, leaving vacant and abandoned houses in neighborhoods. This issue arises in part because HUD will not let buyers remove loans from pools. The only circumstance in which a loan can be removed from a pool is if there is a breach of the reps and warrants, such as the buyer being unable to obtain clear title. Therefore we would suggest HUD require that investors in any pools—either national pools or NSO—agree that they will not abandon any loans purchased from HUD. Instead, investors should agree to resolve all loans in the pools they purchase, at the very least by donating them to a nonprofit or land bank along with the funds needed for demolition if necessary. That is, some of these properties may have little residual value and indeed may require demolition, which has associated costs—making their value less than zero. Therefore, if HUD were to impose this requirement, it may see pricing on the pools take a small hit. Yet given the strong financial benefit to HUD of the loan sales as

they are currently structured, we believe this trade-off is worth taking to protect communities, especially those with high concentrations of NPLs. Trying a few pools with these types of restrictions would be a valuable way to see how effective the recommendation is, and at what cost.

Encourage Nonprofit Capacity Building and Partnerships

We support HUD's efforts to continue to carve out smaller, geographically targeted pools for nonprofits, since only by entering the space can nonprofits build capacity over time to undertake larger projects. We also support efforts by HUD to encourage partnerships between for-profit investors and nonprofit organizations on NPL workouts. HUD recently held a "speed dating" workshop to encourage investors and nonprofits to meet, compare notes, and identify potential partners. Hopefully, these will be real partnerships, where the nonprofit has a substantive role and input into the workout process and gains some upside benefit from success. One suggestion is to carve out a role for nonprofits to work with investors on outreach to borrowers, trying to track down borrowers who may be years behind on their payments and skeptical of any outreach to them, even if it might generate a modification or short sale that may be good for these borrowers. In these ways, the nonprofits can develop their skills, extend both their own reach and that of investors, and build capacity in working out NPLs.

Improve Reporting and Disclosure on Investor Performance

Some bidders are better at generating modifications (particularly borrower-friendly modifications) or short sales than others. At the minimum there should be better disclosure of what servicers actually do with the NPLs. It is important to disclose not only the percentage of modifications, but also the types: a principal reduction, an interest rate reduction to a market rate of interest or a below-market rate of interest, and so on. How much of a payment cut did the borrower receive? While some market participants may believe reporting and making public additional information is unnecessary, we disagree. If the data collection were more transparent, it would perhaps exert some peer pressure on less borrower-friendly servicers. It appears the GSEs are requiring investors to track their performance more robustly, although they had not yet publicly released this data.

We are intrigued with the prospect of taking this one step further. FHA could create a report card for each bidder, based on performance at previous auctions, with extra credit for bidders with a good report. Modifications and short sales would both generate more credit than foreclosures. Principal reductions could generate more credit than interest rate reductions, which would in turn generate more credit than simply stretching out the term of the mortgage. HUD could determine that a good report card is worth x percent, and essentially inflate the good servicer's payment by that amount when accepting bids. That is, maybe a good servicer would be able to buy a given pool for, say, 1 percent less than a mediocre servicer.

Here too there is a trade-off: HUD gets paid less for the loans. Moreover, all grading is inherently subjective, and the composition across pools may be very different. There may be wide variations in geography, negative equity, and the percentages of pools that are vacant or already in foreclosure. Thus, it is unclear how HUD would actually implement report card that allows for comparisons across

servicers. And, extra credit for borrower-friendly performance on previous pools would disadvantage first-time entrants.

Conclusion

To accurately assess the HUD loan sale program, it is important to understand the characteristics of the loans being sold, along with the economics of loan workouts, in order to have the proper context and realistic expectations. We must recognize that many of these borrowers simply can no longer afford their homes because of job loss, income reduction, or having taken on an overly ambitious loan. Most important, we need to consider the alternative to loan sales: the loans will stay with their existing servicers, where they have exhausted HUD's loss-mitigation protocols, and nearly 100 percent will go through to foreclosure.

Clearly, servicers are not error free, as highlighted in some well-publicized cases of wrongful foreclosure. However, even when servicers followed every possible guideline, borrowers who cannot qualify for a foreclosure alternative will be unhappy with their outcome.

In order to address some housing advocates' concerns that investors may simply walk away from the worst assets in the portfolios—leaving those houses abandoned and as a blight on their surrounding community—HUD should consider requiring investors to resolve each asset, even if it means donating some to a land bank or demolishing those that cannot be salvaged. And we are intrigued about the possibility of creating a “report card” that rewards investors who produce more borrower-friendly outcomes. At the minimum, better public disclosure is necessary, which could both provide greater clarity about program outcomes and create some peer pressure to improve those outcomes. Finally, we support efforts to encourage partnerships between private investors and nonprofits as a way to encourage capacity building among nonprofits and increase their expertise over time.

We caution that any additional requirements to the loan sale process could lengthen timelines, reduce returns, and drive up costs to investors, which would result in lower bid prices to HUD. Thus, by imposing additional requirements on investors, HUD would effectively be subsidizing these borrower-friendly outcomes. That may be the proper outcome from a public policy perspective, but policymakers and housing advocates must make these decisions with better information about outcomes to date and with eyes wide open about the inherent trade-offs involved.

Notes

1. Many of these points have been made in Edelman, Gordon, and Desai (2014).
2. See, for example, “As Banks Retreat, Private Equity Rushes to Buy Troubled Home Mortgages,” *New York Times*, September 28, 2015; and “The Government Is Selling Thousands of Homes to Hedge Funds without Their Owners’ Knowledge,” *The Atlantic*, September 23, 2015.
3. Advocates had asserted that servicers were falsely certifying that loans had exhausted all loss-mitigation options. In response, HUD has stepped up its enforcement.
4. The average UPB of a loan in the pools sold was \$171,311, so the savings was 14 percent.
5. This analysis is based on exhibit A-7 on page 23 of HUD (2015c).
6. Table 4 (page 6) of the monthly [FHA Single-Family Loan Performance Trends reports](#) (HUD 2015b) breaks down the components of REO losses. The difference between the net loss rate and the loss on collateral is the total expenses.
7. Total loans sold are 101,254, including those done in early 2015. However, outcome data from these most recent loan sales was not available at the time of HUD’s analysis.
8. There are many more potential outcomes for NPLs, including deeds-in-lieu (essentially cash-for-keys) and third-party sales, as well as variations on these outcomes—including HUD’s short refi program, and many different types of modifications including principal reduction, rate reduction, forbearance, changing the amortization term, or a combination of all of four. For simplicity, we look at three basic outcomes, mods, short sales, and foreclosure.
9. The gulf between timelines in judicial and nonjudicial states is likely even wider than these data suggest. The loans that are easiest to liquidate tend to liquidate first—especially in judicial states where the foreclosure process is harder. As a result, the data on completed foreclosures for judicial states incorporate a smaller percentage of the harder loans that are still outstanding. This difference can be measured by the percentage of very troubled loans that have liquidated. Nationally, 53.8 percent of Freddie Mac loans that experienced a credit event (i.e., went more than six months delinquent) were liquidated. But the share was 60.2 percent in nonjudicial states and only 45.5 percent in judicial states. When these tougher loans finally wind their way through the judicial foreclosure system, their timelines will likely be considerably above the current average, thus driving up the total length of time it takes for foreclosures in judicial states.
10. “As Banks Retreat, Private Equity Rushes to Buy Troubled Home Mortgages.”
11. Ibid.
12. “The Government Is Selling Thousands of Homes to Hedge Funds without Their Owners’ Knowledge.”
13. This moratorium does not apply to properties that are not owner occupied.
14. At the onset of the credit crisis, many lenders were not set up to do the extra work needed to identify which borrowers qualified for foreclosure alternatives. Treasury set up HAMP not only to give guidelines to lenders on how to evaluate borrowers for mods and later for short sales (through HAFA), but also to provide lenders with direct financial incentives to encourage them to invest in the people and systems needed to conduct the analysis and then to implement mods.
15. NJCC also purchased 517 underwater mortgages in New Jersey following Hurricane Sandy.
16. HUD’s original requirement for investors was that they could not foreclose for 6 months after a sale; the requirement was extended to 12 months at the beginning of 2015. Vacant properties are excluded from the moratorium.
17. The results for SFLS 2014-1 appear to be skewed by one NSO pool that accounted for 25 percent of NSO loans and priced at 83.3 percent of UPB—based partly on the fact that it was the only NSO pool where the houses had positive equity (i.e., the unpaid balance of their loans was lower than the market value of the properties).

18. The nonprofit pools that traded were both grouped in a single city (Chicago and Tampa, respectively), while the nonprofit pool that did not trade was statewide in Massachusetts and the NSO pools contain loans in multiple states. Geographically targeted pools are easier to work out, so pricing on them should be higher.

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About the Authors

Laurie Goodman is the director of the Housing Finance Policy Center at the Urban Institute. The center is dedicated to providing policymakers with data-driven analysis of housing finance policy issues that they can depend on for relevance, accuracy, and independence.

Before joining Urban in 2013, Goodman spent 30 years as an analyst and research department manager at a number of Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group, LP, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked number one by *Institutional Investor* for 11 straight years. Before that, she was a senior fixed income analyst, a mortgage portfolio manager, and a senior economist at the Federal Reserve Bank of New York. She was inducted into the Fixed Income Analysts Hall of Fame in 2009.

Goodman is on the board of directors of MFA Financial, is an advisor to Amherst Capital Management, and is a member of the Bipartisan Policy Center's Housing Commission, the Federal Reserve Bank of New York's Financial Advisory Roundtable, and the New York State Mortgage Relief Incentive Fund Advisory Committee. She has published more than 200 journal articles and has coauthored and coedited five books.

Goodman has a BA in mathematics from the University of Pennsylvania and a MA and PhD in economics from Stanford University.

Dan Magder is the founder of Center Creek Capital Group, which advises institutional investors and operating companies on policy-driven investment opportunities in the mortgage finance and financial services sectors. He also runs the Center Creek Housing Fund, a social impact investment fund that operates a profitable scattered-site single-family investment portfolio. He was formerly director of investments at Lone Star Funds, which has been an active participant in the HUD loan sales program, although he left nearly three years ago prior to the ramp-up in the DASP program and has not been advising Lone Star Funds since that time. This month he will be joining a national mortgage finance company, working on a wide range of initiatives with a focus on mortgage originations for the underserved market and single-family rental. This company has participated in the HUD loan sales program in the past.

Magder has spoken at the White House National Economic Council, Harvard Business School, George Washington University School of Business, and numerous industry conferences. He has a BA in Ethics, Politics, & Economics from Yale and an MBA in Finance from the Wharton School of Business.

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2100 M Street NW
Washington, DC 20037
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