HUD’s Recent Changes to the Distressed Asset Stabilization Program: A Positive Development

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July 2016

In March 2016, Chairman Jeb Hensarling of the House Financial Services Committee and Chairman Richard Shelby of the Senate Committee on Banking, Housing, and Urban Affairs, sent a letter to Secretary Julián Castro of the US Department of Housing and Urban Development (HUD) and Director Mel Watt of the Federal Housing Finance Agency, concerning the HUD and government-sponsored enterprise nonperforming loan (NPL) sales programs. The letter expressed concern that the Federal Housing Finance Agency and HUD are contemplating changes to their NPL sales programs that would reduce private sector participation. The letter promised “immediate hearings…to investigate any changes made in these programs to undermine their specific purpose or otherwise make unwise use of taxpayer dollars.” The hearing on “HUD Accountability” scheduled for Wednesday, July 13, 2016, concerns the latest round of changes in HUD’s NPL sales program announced on June 30, 2016.

The Hensarling-Shelby letter quoted an Urban Institute research report I coauthored with Dan Magder to propose that the bulk note sales program and private sector participation therein has reduced the potential loss to taxpayers and helped homeowners (Goodman and Magder 2016).

Our analysis relies on the following facts. Loans sold under HUD’s Distressed Asset Stabilization Program (DASP) are on average 29 months delinquent, have been certified to have exhausted every loss-mitigation option that HUD can offer, and would end in foreclosure (except for the note sale program). The wider toolkit that private note buyers can offer borrowers, which the buyers employ to maximize the value of these assets, results in many borrowers receiving modifications and others receiving a short sale, often with moving expenses and some funds to get them started in a new location. Both of these outcomes are preferable to foreclosure. The general alignment of interests between private sector investors and homeowners has been the key to the success of this program.

The paper also suggested several improvements in the program, most of which are included in HUD’s new guidelines. Below, I explain why I believe the HUD changes are largely positive and do not pose a material threat to HUD’s Mutual Mortgage Insurance Fund or to taxpayers.

Program Improvements: No Walkaways, Better Disclosure

The paper's first suggestion included not permitting investors to walk away from the most challenging loans in these NPL pools, a strategy that leaves vacant and abandoned houses in the neighborhood. We argued that investors who purchase these pools should be responsible for resolving all loans in the pools they purchase. Investors can donate the homes to a nonprofit or land bank, but they should also cover the funds needed for demolition, if necessary. Thus, some of the loans actually have a value less than zero. The requirement for no walkaways may have a small effect on the pricing, but it will likely be very small, as there are very few loans that would be affected; using upfront screening, HUD tries to avoid putting loans with low value into these pools. Moreover, there is an offsetting value to the taxpayer because this requirement will protect communities and support the value of neighboring homes, including many that carry Federal Housing Administration–insured mortgages. A recent report by the Center for American Progress confirms that loan sales occur in neighborhoods with a disproportionate reliance on Federal Housing Administration financing (Edelman, Zonta, and Rawal 2016). Government-sponsored enterprise loan sales already have this no-walkaway requirement.

The paper also suggested greater data transparency on the NPL sales. In this new round of changes, HUD has committed to release performance and outcome data for each pool that is sold. Previously, HUD provided data only at the sale level, and each sale had multiple pools bought by different investors, a practice that made it difficult to assess whether some investors were doing a better job than others. HUD has also committed to release demographic data for the first time.

The Additional Restrictions on Modifications Should Have Little Cost

We also pointed in our paper out that putting additional restrictions on loans can result in a worse offer price for these loans. However, the two new restrictions that are being put on the loans should not be costly. The restrictions are as follows:

1. When evaluating a borrower for a modification, principal forgiveness is the first option borrowers must be offered if they qualify
2. Provide payment-shock protection by requiring the initial rate be fixed for five years and increased by no more than 1 percent per year thereafter

Many successful investors have already incorporated these rules in their practices because it is in their economic interest to encourage borrowers to pay their modified mortgage. As we pointed out in the paper, foreclosure is the worst outcome for everyone: it ties up the investor's funds for a long time, and the eventual sale price is not as favorable as if the loan was performing again. If the investor can give a borrower a sustainable modification containing a principal reduction, both the borrower and the investor are better

off. Similarly, it does not serve the investor to get the loan performing for a short time and then have the rate reset to a level the borrower cannot afford and have the borrower default at that time.

Many investors offer principal reduction or payment-shock protection, and it doesn't cost HUD much to require this. In most of these auctions there are many bidders, and the price difference between the winning bid and the runner-up (the *cover bid*) is quite small. We believe most investors with winning bids have incorporated these changes; and in those cases where the winning bidder has not, the cover bid probably has, and the cost to the Federal Housing Administration would be minimal. And even if the winning bid does not currently offer these borrower protections the cost of offering these tweaks to the modifications is very small.

Additionally, FHFA already has both these rules in place for GSE auctions, and most buyers participate in both programs. Moreover, standardizing the rules between the programs will make it easier for NPL buyers to participate in both programs, and could increase the number of bidders and bids.

First Look for Nonprofits

While there is anecdotal evidence that nonprofits are better able to keep borrowers in their homes than for-profit bidders (nonprofits do not need to earn the same return on capital, so they can often afford to do deeper modifications), we note in our paper that nonprofit capacity for purchasing large quantities of these loans is very limited. The paper supported efforts to carve out small, geographically targeted pools for nonprofits, which encourages the nonprofits to build capacity. I am also supportive of the pilot contained in the last round of changes to give nonprofits a first look and the right to buy up to 5 percent of a national pool, as long as they meet the reservation price set by HUD (the methodology for setting the reservation prices was reviewed by the Office of Management of Budget). This should increase the number of nonprofit bidders; the more nonprofit bidders, the stronger the price, as only 5 percent of the pool will be sold in this manner.

The cost of this change to taxpayers would be minimal. Assume that nonprofit investors could bid on the entire 5 percent of the pool, and they could buy these loans at a price 10 percent below a for-profit investor; taxpayer proceeds would decline by up to 0.5 percent. If the price was 20 percent below the for-profit investor, the proceeds would decline by 1 percent. The cost of these changes is much lower than the change HUD made 18 months ago to extend the foreclosure moratorium after auction from six months to a year, increasing the time before investors could move to foreclose properties that were vacant, a help to no one (we estimated in our paper that this change cost HUD and taxpayers about 6 percent).

Ongoing Discussion on Improving the NPL Sales Program

The recent changes are the product of an ongoing discussion about how to improve the NPL sales program that has played out over several years. Our January 2016 paper was not the first to look at the DASP program. There have been a series of papers from the Center for American Progress (Edelman, Gordon, and Desai 2014; Edelman, Zonta, and Rawal 2016) and panels and events on this topic, including one we held on May 18, 2016, at the Urban Institute in conjunction with CoreLogic.[1] This panel included a HUD representative, an FHFA representative, an advocate, and an investor.

HUD has taken to heart suggestions to improve the DASP, including suggestions delivered through research papers, seminars, panels, and informal meetings, and we applaud HUD for their responsiveness.

Note

1. "HUD and GSE Nonperforming Loan Sales: Are Further Improvements Necessary?" Urban Institute, accessed July 11, 2016, http://www.urban.org/events/hud-and-gse-nonperforming-loan-sales-are-further-improvements-necessary; Karan Kaul, "Selling delinquent mortgages to investors is a tough balancing act," *Urban Wire* (blog) Urban Institute, May 27, 2016, http://www.urban.org/urban-wire/selling-delinquent-mortgages-investors-tough-balancing-act.

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