Reforming the FHA's Foreclosure and Conveyance Processes

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This is the third in a series of briefs from the Mortgage Servicing Collaborative (MSC), convened by the Housing Finance Policy Center at the Urban Institute. The briefs examine critical mortgage servicing issues and recommend policy changes that will improve outcomes.

The first brief examined the role of servicing in the mortgage market, explained why servicing matters, and outlined reasons why mortgage servicing needs reform (Goodman, McCargo, et al. 2018). The second brief examined government loan modifications in a rising interest rate environment and offered recommendations to ensure continued availability of effective modifications even when interest rates rise (Goodman, Kaul, et al. 2018).

This third brief focuses on reforming the Federal Housing Administration's (FHA) foreclosure and conveyance processes. It explains the basic functioning of the FHA foreclosure and conveyance process, clarifies key underlying issues, and recommends solutions that create a simpler, more efficient foreclosure process, reduce losses for the FHA's Mutual Mortgage Insurance Fund (MMI Fund), and improve outcomes for borrowers and neighborhoods.

The brief explores the costs of servicing nonperforming FHA loans, including foreclosing and conveying properties to the US Department of Housing and Urban Development (HUD). Using proprietary data provided to the Urban Institute by 10 members of the MSC,[1] we test the following two hypotheses:

- Is the cost of servicing nonperforming FHA loans significantly greater than the cost of servicing government-sponsored enterprise (GSE) nonperforming loans? If so, by how much?
- Do the FHA's current foreclosure and conveyance processes create excess servicing costs?

About the Mortgage Servicing Collaborative

The Housing Finance Policy Center's Mortgage Servicing Collaborative is a research initiative that seeks to identify and build momentum for servicing reforms that make the housing market more equitable and efficient.

One core MSC objective is to improve awareness of the role and importance of mortgage servicing in the housing finance system. Since 2013, HFPC researchers have studied the landscape, followed the work and policies put in place after the crisis, and assessed the impact of the servicing industry on consumers and communities. This includes loss mitigation and foreclosure actions and how servicing practices affect access to credit through tight underwriting standards. The Urban Institute has analyzed and convened forums on emerging issues in mortgage servicing, including calls for reforms, the impact of mortgage regulation, the rise of nonbank servicers, and the implications for consumers and communities. We determined that a focused effort that involves external stakeholders and resources could lead the way in developing policy and structural recommendations and bring visibility to the important issues that lie ahead.

The MSC has convened key industry stakeholders—including lenders, servicers, consumer groups, civil rights organizations, academics, and regulators—to develop an evidence-based understanding of important factors and to develop and analyze solutions and implications with a well-rounded and actionable orientation.

The MSC seeks to

- bring new evidence, data, and recommendations to the forefront;
- foster debate and analysis on issues from regulatory reform, technology innovations, cost containment, and consumer access to mortgages; and
- produce and disseminate our research findings and policy recommendations—including perspectives by MSC members—to offer policy options that can clarify and advance the debate and ensure servicing is addressed in broader housing finance reform.

For more information about the MSC or to see other publications, news, and products, visit the MSC program page, https://www.urban.org/policy-centers/housing-finance-policy-center/projects/mortgage-servicing-collaborative.

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The data provided by MSC members reveal that foreclosing and disposing of an FHA-insured loan is orders of magnitude more expensive than servicing loans backed by the GSEs. Moreover, the data show that the two biggest drivers of FHA servicing costs are

- an inflexible foreclosure timeline and penalty system that does not improve outcomes, and
- a property conveyance process that slows down resolution, which causes properties to remain vacant longer, which can adversely affect neighborhoods and increase maintenance and repair costs.

This brief begins with a short description of the FHA foreclosure process, followed by key findings and take-aways from the data we analyzed and recommendations to improve the current processes.

How the FHA Foreclosure Process Works

The FHA has issued loss mitigation policy guidance to help servicers resolve delinquencies within a reasonable amount of time and, if necessary, seek loan resolution through a foreclosure (FHA 2016, section III). This guidance requires servicers to initiate a foreclosure within 180 days from time of borrower default. This 180-day deadline is the *first legal action date* and is the first critical milestone within the FHA foreclosure process. If a servicer misses this date, it is subject to a financial penalty: the curtailment of debenture interest.[2] The curtailment forfeits the servicer's right to the interest that would otherwise accrue from the date of the missed deadline until the property is conveyed to HUD, regardless of whether the date was missed by a day or a year.[3] The FHA imposes this deadline to encourage servicers to assist borrowers in financial distress quickly and to minimize losses to the FHA and the MMI Fund. During these 180 days, servicers must work with borrowers to understand the reason for delinquency, gather supporting documentation to evaluate the borrower for a modification, identify the most effective loss mitigation option, and get the borrower reperforming as quickly as possible or, if the delinquency cannot be cured, move to a foreclosure alternative such as short sale or deed-in-lieu of foreclosure.[4] If none of these options is successful, the servicer must initiate foreclosure before the 180-day deadline.

The second stage of the process starts with the initiation of foreclosure and ends when the property is sold through a foreclosure auction. During this stage, known as *reasonable diligence*, servicers continue their efforts to get the loan to reperform while pursuing the foreclosure sale, in accordance with the state-specific timelines the FHA has established.[5] Missing the reasonable diligence time frame would result in a financial penalty to the servicer: the curtailment of otherwise reimbursable property preservation expenses and the loss of debenture interest from the date of the missed time frame to the date the property is conveyed to HUD. This penalty is not based on the number of days of delay, so a small delay can result in a large financial penalty. Delays outside servicer control are exempt from the penalty, provided an extension is obtained. Extensions are granted on a loan-by-loan basis.

The third and final stage of the resolution process is property *conveyance*, which begins after a foreclosure sale is completed. Servicers have 30 days after foreclosure or vacancy to repair the property, obtain a clear title, convey the title to the FHA, pay outstanding homeowners association and utility bills, and file an FHA insurance claim. Servicers must inspect the property, get a repair estimate, obtain approval from the FHA where repair costs exceed the FHA allowances, and complete repairs to bring the property to "conveyable condition." This work involves coordination between FHA staff, FHA-contracted property inspectors, servicers, and servicer-contracted repair crews. Restoring the property to the FHA's expectations can often be iterative and time consuming for servicer and FHA staff, which slows down property resolution. The FHA's intention here is to accept only properties that can be immediately resold, without the need for additional title or repair work. For servicers, failure to meet the 30-day conveyance timeline results in a financial penalty: curtailment of debenture interest and property preservation expenses that are otherwise due to the servicer.

What We Learned from the Data

Servicing FHA Nonperforming Loans Costs Three Times More Than GSE Nonperforming Loans

During our data collection exercise, we asked servicers to report average costs for default servicing, average losses and other costs (e.g., property preservation), and penalties for FHA nonperforming loans. Servicers reported that, on average, the cost of servicing an FHA nonperforming mortgage is three times higher than the cost of servicing a GSE nonperforming mortgage.[6] This high-level metric incorporates various aspects of nonperforming loan servicing that drive these costs higher. This includes loss mitigation expenses driven by the high-touch nature of FHA nonperforming loan servicing, which requires frequent borrower contact, face time requirements, and documentation of borrower monthly income and expenses. FHA servicing costs are also driven higher because of a lengthy foreclosure and conveyance process and fines and penalties associated with missing intermediate deadlines. Data collected from servicers (discussed later) show that penalties in particular areas are big drivers of overall costs.

The FHA Foreclosure Process Is Complex and Costly

Data provided by MSC servicer members show that the interim penalties associated with failure to meet the FHA's milestones in the foreclosure timelines is a major driver of increased costs. Two important take-aways emerged from the data:

- ***Strict enforcement of intermediate milestones, which were rendered unrealistic during the crisis because of the high volume of delinquencies, results in frequent penalties.*** As delinquencies rose during the housing crisis, the underlying servicing infrastructure—which functioned well in low-delinquency environments—came under severe stress. Changes to loss mitigation guidelines and updated servicing rules and regulations created new complexity and compliance requirements, which lead to delays, missed deadlines, and penalties across the servicing system. Although the FHA can permit timeline extensions, the process is time consuming, it works on a loan-by-loan basis, and the result is uncertain. Among the data we analyzed for 2015 and 2016 FHA claims, nearly 43 percent of insurance claims received an interest curtailment penalty because of missed first legal action or reasonable diligence milestones (table 1). Of these curtailments, 29 percent were associated with missing the first legal action deadline, while the remaining 14 percent stemmed from penalties associated with overshooting the reasonable diligence time frame.

  - » The FHA approach to penalties related to missing foreclosure timeline milestones is different from the GSE approach. The GSEs have milestones and compensatory fees but with an important distinction. The GSEs use milestones to track progress toward foreclosure, but missing a milestone in and of itself does not trigger a penalty, whereas it does for FHA loans. The GSEs penalize servicers by assessing compensatory fees when a servicer exceeds the total allotted time from default to foreclosure, regardless of whether the intermediate milestones are met.[7] For instance, a GSE servicer that misses the first legal action date but fully makes up for the delay during reasonable diligence—thus completing the foreclosure on time—is not assessed a penalty. This approach grants servicers more flexibility to tailor their work to accommodate operational challenges or borrower circumstances. This flexibility is useful during periods of high delinquencies when servicing operations are already under duress.

- ***Penalties for missing intermediate deadlines are onerous.*** Because the penalties for missing first legal action or reasonable diligence milestones are not based on the number of days of delay, they do not necessarily reflect the financial cost to HUD of the servicer's failure to comply. In our data collection, the average first legal interest curtailment for loans that missed this deadline was $5,360 per loan, roughly 3 percent of an average FHA loan amount of $175,000. Penalties were also high for failure to comply with reasonable diligence milestones, that is penalties for loans that met the first legal action milestone but missed the due diligence milestone, averaging $4,619 per claim filed.

Interest curtailment penalties are high because they accrue from the day of the missed foreclosure deadline to the day the property is conveyed to HUD (as opposed to the number of days of delay). The average number of days from the borrower's last payment through foreclosure auction was 692 (table 1). Of that, the average number of days of interest curtailment for missing the first legal action date was 559, meaning servicers were losing interest for 81 percent (559 of 692) of the days required to complete the foreclosure. To be more precise, we can adjust these numbers to account for the 30 days after the last payment (per the FHA's definition of default) and the 180 days of first legal action, as the servicer does not incur penalties during this 210-day period. With this adjustment, the average number of days from the first legal action deadline to conveyance is 482 (692 minus 210), and the average number of days of interest curtailment is 349 (559 minus 180). Even with these adjusted numbers, servicers were losing interest over 72 percent (349 of 482 days) of the time. The average number of days of interest curtailment for missing the reasonable diligence date was also high, accruing over 302 days, or 44 percent of the 692 days.

None of this is to suggest that servicers should not be penalized for delays. We understand the FHA's intent to ensure servicers work with borrowers' loans expeditiously and reduce losses. But this detail helps underscore that penalties should be based on the cost to the FHA of servicer-driven delays.

TABLE 1

Financial Implications of Missing First Legal Action and Reasonable Diligence Dates among 2015 and 2016 FHA Claims

	Share of claims with interest curtailment	Average interest curtailment on claims	Average days from last paid installment to foreclosure	Average days of interest curtailment accumulated	Share of foreclosure days for which interest curtailment accrued
Missing the first legal action date	29%	$5,360	692	559	81%
Missing the reasonable diligence date	14%	$4,619	692	302	44%

Source: Data from servicer members of the Mortgage Servicing Collaborative.

FHA Conveyance Is Expensive and Time Consuming

The FHA's conveyance process differs from that of the GSEs and the US Department of Veterans Affairs (VA). Servicers of FHA mortgages have 30 days after foreclosure to repair the property and convey it to HUD with a clean title. The GSEs and VA follow a direct conveyance model. They take possession of the property after the auction and hire vendors to perform repair before putting properties back on the market. Data show that the conveyance process significantly slows down property disposition and imposes heavy costs on the FHA, neighborhoods, communities, and servicers.

- ***Conveyance is expensive for the FHA.*** According to the FHA's 2016 annual report to Congress, its loss rate for conveyance (real estate owned, or REO) dispositions was 57.5 percent (HUD 2016). In comparison, the loss rate was 47.3 percent for third-party sales and 42.5 percent for preforeclosure sales. The FHA might benefit from encouraging or providing incentives for more voluntary liquidation options, such as short sales and streamlining those options to make them less cumbersome to execute. Conveyance resulted in a higher loss rate for the FHA than other alternatives. Loss rate trends for fiscal year 2015 were similar, with REO severities being the highest. These losses are compounded by the fact that REO has been the most common FHA disposition strategy and is the most disruptive to neighborhoods, although reliance on REO has declined: 51.7 and 45.3 percent of HUD property dispositions in fiscal years 2016 and 2017, respectively, were REO (HUD 2017). Note sales, third-party sales, and preforeclosure sales accounted for the rest.
- ***Conveyance takes a long time.*** Conveyance is expensive for the servicer and FHA in part because it takes a long time. Per the FHA's Single-Family Loan Performance Trends Report, it takes an average of 12 months to convey a foreclosed property to the FHA instead of the 30 days

contemplated by the rules.[8] This number is roughly consistent with data provided by MSC members, which show that FHA conveyance resolution took longer (928 days from last paid installment to conveyance) than nonconveyance routes (585 days).[9] The conveyance adds 343 days, or nearly a year, to the process. The conveyance process takes so long in part because servicers must perform several tasks, such as making repairs, paying outstanding homeowners association dues and utility bills, and obtaining a clear title. Before they can perform repairs, servicers must inspect the property, get a repair estimate, and obtain FHA approval when repair costs exceed the FHA's allowances. Then, servicers must complete the repairs to bring the property to "conveyable condition." This involves coordination between FHA staff, FHA-contracted property inspectors, servicers, and servicer-contracted repair crews. Restoring the property to the FHA's expectations is often iterative and time consuming, which slows down property resolution and increases cost. Additionally, the longer a property sits vacant and unoccupied, the more likely it is to be damaged, vandalized, or affected by bad weather, thus requiring new repairs. Ultimately, this increases property preservation expenses, which are incurred by servicers, though some expenses are eventually reimbursable by the FHA. Drawn-out timelines also harm the neighborhoods where these properties linger unoccupied for years, resulting in neighborhood blight and neglect.

- ***Conveyance penalties are high.*** According to MSC servicer data, the average per loan property preservation cost for FHA properties that were conveyed was $8,819, compared with $2,113 for nonconveyance routes (table 2). The bulk of these property preservation costs arose from protracted foreclosure and conveyance processes. Servicers are responsible for property preservation either from the point of foreclosure or once a property is vacant. Servicers must repair the properties and maintain them until they are conveyed to HUD. Making the task more difficult, vacant properties are prone to vandalism. Even though repair costs are, in theory, reimbursable by HUD, the dollar amount for certain line items is capped. In addition, data collected from servicers show that a sizable portion of these expenses is not reimbursed, resulting in substantial losses to servicers. For conveyance liquidations, servicers reported an average property preservation loss of $4,179, implying a loss rate of 47 percent on the $8,819 in expenses. In comparison, property preservation losses for nonconveyance resolutions were $706 on average, or 33 percent of the $2,113 in expenses.

TABLE 2

Conveyances versus Nonconveyances among 2015 and 2016 Claims

	Conveyances	Nonconveyances
Share of all liquidations	53%	47%
Days from last paid installment to resolution	928	585
Property preservation costs	$8,819	$2,133
Property preservation losses	$4,179	$706
Other losses (e.g., foreclosure filing, legal fees)	$3,508	$3,450

Source: Data from servicer members of the Mortgage Servicing Collaborative.

Recommendations for FHA Foreclosure and Conveyance Changes

We offer two recommendations to address the issues described above.

Adopt a Foreclosure Timeline with Penalties and Incentives Aligned with Actual Delays

Because of complications and delays that occur during the foreclosure process, many outside of servicer or FHA control, servicers might miss one or more of the FHA's intermediate deadlines but later erase the deficit and complete the foreclosure within the allotted time. Under current FHA policies, this servicer would pay a penalty for missing the first legal action date, even though the foreclosure was completed on time and the FHA experienced no financial harm. If a servicer misses the first legal action date by 60 days, the interest curtailment penalty will start from the day of the missed deadline and end on the day the property is conveyed to HUD—a multiyear process as opposed to the 60-day delay. Moving to a penalty framework that is based on actual days of delay, which can be achieved through an administrative rule change, would address these issues and could improve the process and outcomes for servicers and the FHA.

- Such a framework would allow servicers more flexibility to manage delinquencies and foreclosures more holistically and efficiently. Without penalties based solely on missing the first legal action date, servicers could continue loss mitigation efforts with a borrower if they believe the mortgage can still be cured. This can help prevent an otherwise avoidable foreclosure and related losses. In contrast, under the current 180-day first legal action penalty, servicers must initiate foreclosure even if they believe alternatives to foreclosure could prevail. This is likely not the intention or outcome the FHA would want.
- Assessing penalties only for those cases where the full foreclosure timeline (180-day first legal action plus the reasonable diligence time frames) is missed would align the FHA's foreclosure process and timeline more closely with that of the GSEs and the VA. Alignment would reduce

complexity and costs for the FHA and servicers and would be easier for borrowers and their advocates to understand.

A timeline without intermediate penalties by itself will not result in a longer timeline. The total allotted time for resolution would still be the sum of the 180 days from the date of default, the reasonable diligence period, and the 30-day conveyance period, but without the drawbacks associated with intermediate penalties. Servicers should be penalized when they exceed the allotted time. But if the fines bear no relation to harm, lenders will continue to manage that additional risk by restricting access to credit (see box 1 for a discussion about how servicing costs affect access to credit).

Improve the Property Conveyance Model

The FHA conveyance model is expensive and time consuming. Below are ways to speed up property resolution to maximize recoveries and minimize deadweight losses. There are two ways to achieve this: (1) In the near term, expand the availability of conveyance alternatives or voluntary liquidations to minimize reliance on conveyance, and (2) in the long term, move to a direct conveyance model.

EXPAND AVAILABILITY OF CONVEYANCE ALTERNATIVES

During fiscal years 2015–16 and 2016–17, the FHA completed about half its property dispositions through nonconveyance options (i.e., note sales, third-party sales, and preforeclosure sales), a share that has steadily increased since the housing crisis began (HUD 2017). By eliminating property preservation expenses and other costs associated with conveyance, these alternative disposition options reduce loss severities and speed up resolutions. They are usually more favorable for the borrower as well. In a short sale, the borrower can often receive a lump sum of money that covers moving and related expenses. In a note sale, the buyer of the note often has a larger loss modification toolkit and more flexibility than the FHA.

The FHA should expand these programs to minimize reliance on the more expensive conveyance program without harming homeowners or neighborhoods. For example, the Claims without Conveyance of Title (CWCOT) program, a type of third-party sale, could be improved with a better valuation framework that allows property values to be adjusted to better align with market values, helping speed up the sale.[10] Education and outreach that highlight the benefits of CWCOT could also improve program use. When expanding these programs, the FHA would need the resources to improve its ability to monitor performance on an ongoing basis, ensure consumer safeguards are met, and assess the all-in costs of alternative disposition programs.

The FHA could develop creative ways to use note sales or the CWCOT program to transfer ownership of damaged, vacant, or low-value properties into the hands of buyers who can put them back to productive use without harming homeowners or neighborhoods. To do so responsibly, the FHA could set rehabilitation, demolition, or code-compliant occupancy requirements for buyers of such properties. The FHA could also expand its Good Neighbor Next Door program[11] by adding more revitalization areas to encourage greater involvement and investment at the neighborhood level as a way to repurpose distressed properties in an economically efficient manner.

ADOPT A DIRECT CONVEYANCE FRAMEWORK

Although achieving direct conveyance capability at HUD would take a long time, MSC members nearly unanimously support this approach, which would allow properties to be conveyed to HUD immediately after foreclosure auction. The group also understands that this effort will require significant reforms, including additional resources at the FHA. The MSC discussed two possible pathways toward achieving direct conveyance: (1) build direct conveyance capability within HUD, and (2) leverage alternatives, such as GSE REO disposition infrastructure.

Build direct conveyance capability within HUD. Under this recommendation, properties would be conveyed to HUD immediately after auction, as is. The FHA would pay the insurance claims plus any property preservation expenses incurred until foreclosure. Servicer responsibility, for the most part, would end here. But instead of attempting to repair, market, and sell each property, HUD (or approved vendors) would determine the optimal disposition strategy. The overarching goal would be to seek the fastest resolution for the largest number of properties at the lowest cost to the MMI Fund. Considerations that could drive optimization include property condition and expected repair costs, expected sale proceeds, and neighborhood impact. HUD (or approved vendors) would need to oversee the execution of this strategy, requiring additional resources at the FHA.

The properties easiest to resolve would be those likely to result in minimal losses for the MMI Fund—that is, properties for which sale proceeds would pay for most of the costs associated with insurance claim payment and repairs. If the local housing market is healthy and demand is strong, HUD might even sell these properties without repairs, resulting in savings for the MMI Fund because the FHA will not incur property maintenance costs associated with today's lengthy conveyances. For difficult properties, or those likely to result in losses for the MMI Fund, the decision could come down to the neighborhood impact or other considerations. For instance, if the property is in a neighborhood where it is likely to be occupied after repairs, HUD could have it repaired even if expensive, consistent with its mission. These properties would be less accretive to the MMI Fund, but HUD is likely to realize overall cost savings because of a shorter resolution time frame and lower property maintenance expenditures.

Leverage alternative REO disposition infrastructure. In the wake of the foreclosure crisis, the GSEs established an extensive REO infrastructure, which includes a network of vendors nationwide to restore, repair, and resell foreclosed properties quickly and efficiently. The GSE foreclosure process overall is different, but there is viability in looking at leveraging its property disposition practices for the FHA. Instead of building its own direct conveyance infrastructure and duplicating systems, vendors, and costs for property disposition, HUD could leverage the GSE REO process for repair, maintenance, and resale of foreclosed properties. Under this system, immediately after auction, the servicer would transfer the property title to the FHA, who would transfer control of the property to one of the GSEs. The FHA would pay the servicer the remaining mortgage amount plus any servicing advances and property preservation expenses incurred until foreclosure auction. The servicer would have no further financial responsibility. The GSEs would then use their REO operations to repair, market, and sell the properties. The proceeds from the sale, net of GSE expenses, would be remitted to the FHA. This recommendation will prevent HUD from having to take on the costs and hire resources to build its own direct conveyance infrastructure, but it raises several policy, legal, procurement, and regulatory issues:

- ***Will this arrangement improve financial outcomes for the MMI Fund?*** For this arrangement to work, the loss severity to the FHA would need to be measurably less than the loss severity it experiences for today's conveyance resolutions. More broadly, this arrangement should result in a better financial outcome for the MMI Fund than is presently the case.
- ***Will this arrangement improve outcomes for neighborhoods?*** Will fewer homes sit vacant? Will homes be put back to productive use more quickly?
- ***Will the Federal Housing Finance Agency, or FHFA, allow the GSEs to take on this added responsibility?*** To perform this role, the GSEs will require explicit permission from the FHFA, whose primary responsibility is to ensure the enterprises' safety and soundness.
- ***What risks would this pose to the GSEs?*** The GSEs would not take on credit risk under this recommendation, but they would need an explicit agreement that they be "held harmless" by the FHA for activities related to the repair, resale, and recoveries from the properties. The FHFA and the GSEs will never agree to a contractual framework that leaves room for liability arising from the FHA's expectations for property condition, repair, and sale. The parties would need to be clear about GSEs' role under such an arrangement.
- ***How should the GSEs be compensated?*** The FHA, GSEs, and FHFA would need to establish a balanced arrangement that reimburses the GSEs for their expenses while reducing the loss severity to the FHA and the MMI Fund.
- ***What guidelines should exist for repair and resale?*** The FHA and GSEs would need to agree on guidelines or principles to give the GSEs adequate flexibility to perform the job while maximizing recoveries for the MMI Fund.
- ***How can this arrangement be consistent with federal procurement laws (including competitive bidding requirements)?***

Conclusion

The FHA's foreclosure timeline and property conveyance processes result in avoidable delays, costs, and losses for HUD and servicers. These costs are eventually passed on to neighborhoods and consumers in the form of slow property resolution, depressed property values, and reduced access to credit for future borrowers. The recommendations in this brief are opportunities to reduce complexity and costs and improve property disposition outcomes for the FHA and the MMI Fund. By exploring these reforms, some immediate benefits to the MMI Fund through reduced loss severities and potential benefits to consumers and neighborhoods could be realized. There is broad agreement within the MSC that taking these steps can be an economic win-win for the FHA, servicers, consumers, and communities. We welcome to the opportunity to discuss these recommendations and work toward potential next steps.

BOX 1

How FHA Servicing Costs Affect Access to Credit

Urban Institute research and data collected by the Mortgage Bankers Association on behalf of servicers has shown an extraordinary rise in servicing costs, especially for nonperforming loans.[a] The data collected from MSC servicers confirms this. A simple example illustrates how these costs reduce access to credit.

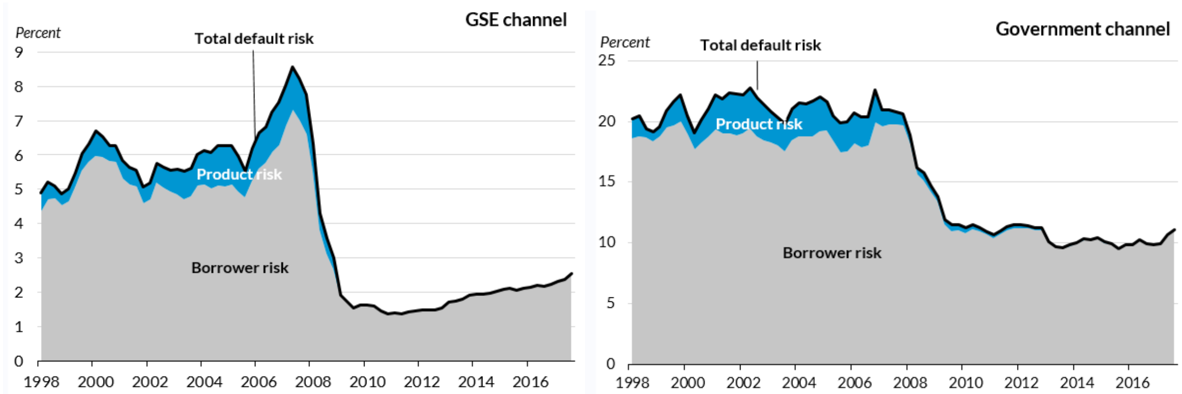
Assume a $175,000 typical FHA mortgage. The annual servicing fee for this loan, at 44 basis points, is $770. The three largest penalty cost components of servicing are as follows:

- For missing the first legal action date, the average interest curtailment penalty is $5,360, roughly seven times the annual $770 revenue
- For missing the reasonable diligence date, the average interest curtailment penalty is $4,619, roughly six times the annual revenue
- The average property preservation loss (conveyance liquidations) is $4,179, roughly five times the annual revenue

In other words, a typical FHA nonperforming mortgage hit with an interest curtailment penalty for missing the first legal action date would wipe out the annual revenues earned from seven performing FHA mortgages.[b] Similarly, a nonperforming loan with either a reasonable diligence penalty or a property preservation loss would wipe out the annual revenue earned from five or six performing FHA mortgages. And servicers can incur multiple penalties on the same loan. For such loans, the combined first legal action penalty and property preservation loss of $9,539 ($5,360 + $4,179), would be more than 12 times the annual per loan servicing revenue. Thus, the cost of 1 nonperforming loan would counteract revenues from as many as 12 performing FHA loans.

This cost-revenue equation motivates servicers to take aggressive steps to reduce the incidence of nonperforming loans. Servicers do this by imposing credit overlays to ensure loans are made only to high-quality borrowers who are unlikely to default. As a result, borrowers find it difficult to get a mortgage, especially through the government channel.[c] The figure below shows the default risk taken by the mortgage market within the government and GSE channels by vintage year.

Default Risk Taken by the GSE and Government Channels, 1998–2017



Sources: eMBS, CoreLogic, Home Mortgage Disclosure Act, Inside Mortgage Finance, and the Urban Institute.
Note: Data are through the third quarter of 2017.

The Urban Institute's Housing Credit Availability Index shows that overall credit remains tight relative to historical standards, but credit availability for government (FHA and VA) loans has continued to deteriorate since the housing crisis, even as conventional credit availability has improved slightly. Servicing is not the only reason credit availability is tight, but it is a contributor. Many underserved borrowers and first-time homebuyers who would otherwise be served by the FHA's mission cannot do so under the present circumstances.

[a] Laurie Goodman, "Servicing Costs and the Rise of the Squeaky-Clean Loan," *Mortgage Banking*, February 2016, https://www.urban.org/sites/default/files/publication/77626/2000607-Servicing-Costs-and-the-Rise-of-the-Squeaky-Clean-Loan.pdf.

[b] This analysis is conservative because it is based solely on penalties. It does not factor in the total cost to service a delinquent FHA loan, which would include other items, such as operational, personnel, and overhead costs. This analysis also does not account for reduced servicing fees (less than 44 basis points) when originators sell excess servicing. Lastly, this analysis is based on revenues, not profits. If all these factors were taken into consideration, a single nonperforming loan would offset revenues (or profits) from even more performing loans.

[c] Servicing is one of several reasons credit availability remains tight. For a detailed discussion on the causes of tight credit, see Laurie Goodman, *Quantifying the Tightness of Mortgage Credit and Assessing Policy Actions* (Washington, DC: Urban Institute, 2017).

Notes

1. Data on the costs of servicing mortgages are not public. The data contributed by the 10 MSC members (large and small, bank and nonbank) enabled us to analyze why the FHA foreclosure process costs so much. The data collected covered FHA claims filed by servicers in 2015 and 2016. To preserve confidentiality, only aggregated data are presented.
2. Debenture interest is interest on the outstanding mortgage balance that accrues to the servicer from the date of default to the day the FHA pays out the insurance proceeds.
3. Certain delays that are outside of servicer control (e.g., bankruptcy or mediation) are permitted but sometimes require the servicer to request and receive an extension from HUD (some extensions are automatic).

4. Members of the MSC indicated that full documentation of household income and expenses at the time of loan modification adds significant time and cost to the FHA loss mitigation process.
5. Each state has a unique timeline because foreclosure laws vary by state. For current reasonable diligence timelines, see Federal Housing Commissioner, "Single-Family Foreclosure Policy and Procedural Changes for HUD Title II Forward Mortgages and Reverse Mortgages," mortgagee letter 2016-03 to all approved mortgagees, February 5, 2016, https://www.hud.gov/sites/documents/16-03ML.PDF.
6. The servicing fee for FHA loans (44 basis points) is not three times higher than the servicing fee for GSE loans (25 basis points).
7. See "Compensatory Fees for Delays in the Liquidation Process," Fannie Mae, December 13, 2017, https://www.fanniemae.com/content/guide/servicing/a1/4.2/02.html.
8. "FHA Single-Family Loan Performance Trends Report," US Department of Housing and Urban Development, accessed January 9, 2018, https://www.hud.gov/program_offices/housing/hsgrroom/loanperformance.
9. Nonconveyance routes are third-party sales, note sales, and preforeclosure sales.
10. Under CWCOT, servicers can sell a property to a third-party buyer as an alternative to conveyance and still receive payment on their insurance claim. This disposition usually reduces costs and quickens property resolution. For program details, see Federal Housing Commissioner, "Increasing Use of FHA's Claims without Conveyance of Title (CWCOT) Procedures," mortgagee letter 2014-24 to FHA-approved mortgagees, November 26, 2014, https://www.hud.gov/sites/documents/16-03ML.PDF.
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