Background Information on HUD Loss Mitigation for FHA Loans

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Foreclosures and Servicing

The Foreclosure Crisis for FHA Loans

The Federal Housing Administration (FHA), a division of HUD, supervises the largest government-insured single family home loan program in the country. Created under the National Housing Act[1] in the 1930s, the FHA program has traditionally played a major role in the U. S. housing market. During the boom years of subprime lending, the percentage of home purchase loans financed through FHA hovered between 3% and 5%. However, by 2010 FHA was backing nearly 20% of all home purchase loans.[2] This recent level of activity is more consistent with FHA's traditional market share.

FHA loans have often served as the vehicles for moderate-income and minority borrowers to achieve homeownership. Unfortunately, the foreclosure crisis has had a particularly harsh impact on the financial health of the FHA. Today, as unemployment rates remain chronically high, foreclosures of FHA-insured loans have reached record levels. As of spring 2012, 9.5% of FHA insured loans were in seriously delinquent status.[3] Twenty-five percent of FHA loans originated in 2007 and 2008 were seriously delinquent.[4] One means to ensure the long-term stability of the FHA program is to minimize unnecessary foreclosures that result in government payouts of insurance claims to private banks.

FHA's Traditional Loss Mitigation Requirements

While the government insures FHA loans, private banks own and service them. The banks, through their servicer, decide when to foreclose or when to work with a homeowner to attempt to avoid foreclosure. A few large banks service most FHA loans. Today, five banks are servicing 557,295 FHA-insured loans that are in seriously delinquent status.[5]

A core feature of the FHA-insured loan program has always been its requirement that the owners and servicers of insured loans consider specific alternatives to foreclosure whenever a homeowner has fallen behind in payments.[6] These alternatives to foreclosure, such as

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[1] 12 U.S.C. §§ 1707-1715z.
[2] http://portal.hud.gov/hudportal/documents/huddoc?id=fhamkt0612.pdf.
[3] "Seriously delinquent" means three or more full monthly payments in arrears. HUD Quarterly Report to Congress on FHA Single Family Mutual Mortgage Insurance Fund Program, Quarterly Report to Congress FY 2012 Q2 (May 21, 2012) p. 15, *available at* http://portal.hud.gov/hudportal/documents/huddoc?id=MMIQtrlyQ2_2012Final.pdf.
[4] *Id* at p. 16.
[5] Bank of America NA, , Wells Fargo Bank NA, , JPMorgan Chase Bank NA, ; CitiMortgage Inc., and US Bank NA,, U.S. Dept. of HUD Neighborhood Watch database as of July 31, 2012. Loss Mitigation Total Delinquent Loans Reported. *Available at* https://entp.hud.gov/sfnw/public/.
[6] 12 U.S.C. § 1715u(a); 24 C.F.R. Part 203.500 and 24 C.F.R. Part 203.600.

forbearance agreements, partial claims, loan modifications, pre-foreclosure sales, and other changes to repayment terms, are set out in the published loss mitigation rules for FHA-insured loans.[7] FHA developed most of its loss mitigation guidelines during the late 1990s, and many pre-date the current foreclosure crisis.[8] The most detailed descriptions of FHA's loss mitigation options are published in HUD "Mortgagee Letters." All current and past Mortgagee Letters are available on HUD's website.[9]

FHA's traditional loss mitigation options did not authorize the permanent restructuring of a loan with the goal of reducing the homeowner's payment to a specific affordable level. For example, FHA's prescribed forbearance agreement reduced or suspended payments for an extended period of time, but required a future repayment agreement or modification in order to reinstate the loan.[10] FHA's "partial claim" option allowed an arrearage of less than twelve months to be transformed to a non-interest bearing lien. The loan would then be reinstated with its original terms.[11] The contours of FHA's traditional loan modification option evolved over time. Most recently, the traditional FHA loan modification imposed a uniform set of changes to loan terms. The arrearage was capitalized, the interest rate fixed at a half-point above the current Freddie Mac Weekly Survey Rate, and the loan term set at thirty years.[12] This was a "one size fits all" modification model. It could potentially reduce the homeowner's payments, but did not set a specific affordability target.

The FHA-HAMP Program

In early 2009, the Treasury Department and the GSEs issued rules for their respective Home Affordable Modification ("HAMP") programs. These programs employed a waterfall of modification steps to reach an affordable target payment for the homeowner. The affordable payment under HAMP was defined as a monthly payment for principal, interest, taxes, and insurance that did not exceed 31% of the household's gross monthly income. In announcing rules for its own HAMP program in July 2009, FHA for the first time incorporated an affordability goal into one of its loss mitigation options.[13] Like modifications under the Treasury and GSE HAMP programs, modifications under FHA-HAMP were structured to reduce the homeowner's total monthly mortgage payment to an amount that did not exceed 31% of gross household monthly income.

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[7] 24 C.F.R. §§ 203.500, *et seq.* and 203.600, *et seq.*

[8] The basic set of FHA loss mitigation guidelines were produced as a result of a regulatory overhaul during the late 1990s and appeared in a HUD "Mortgagee Letter," published in 2000, HUD Mortgagee Letter 2000-05. With some periodic revisions, including the implementation of the FHA-HAMP program in 2009, Mortgagee Letter 2000-05 represented the basic framework for HUD/FHA loss mitigation servicing over the next decade.

[9] http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee.

[10] HUD Mortgagee Letter 2000-05 at pp. 14-18.

[11] HUD Mortgagee Letter 2000-05 at pp. 24-29, Mortgagee Letter 2003-19.

[12] HUD Mortgagee Letter 2000-05 at pp. 18-23, Mortgagee Letter 2005-30.

[13] HUD Mortgagee Letter 2009-23.

FHA created its HAMP program by adding a principal forbearance step to its traditional loan modification option. Under FHA-HAMP, after the servicer capitalized arrears, reduced the interest rate, and extended the loan term, the servicer could go a step further and forbear accrual of interest on a portion of the loan principal until the homeowner's payment reached the 31% of household income level. FHA incorporated its existing partial claim device as the means to implement the new principal forbearance element of an FHA-HAMP loan modification.

Problems with FHA-HAMP

FHA-HAMP has been a major disappointment. Few homeowners qualified for the program. For example, as of November 2012, Wells Fargo N.A. was servicing 141,503 FHA-insured loans that were seriously delinquent (at least three months in arrears).[14] However, Wells Fargo had implemented only 1,974 FHA-HAMP modifications since the inception of the program in 2009. Bank of America, with 270,804 seriously delinquent FHA loans, had implemented only 11,657 FHA-HAMP modifications.[15]

As originally implemented, FHA-HAMP incorporated several overly restrictive eligibility limitations. First, the principal forbearance step of the FHA-HAMP waterfall relied on FHA's partial claim device to create a non-interest bearing junior lien for the amount of forborne principal. The FHA-HAMP rules incorporated a pre-existing twelve-month limitation applicable to FHA partial claims.[16] Under the partial claim rule, the amount of the claim could not exceed twelve months' payments of principal, interest, taxes, and insurance due on the loan. Servicers often failed to process applications for FHA-HAMP before a homeowner reached this twelve month limit. Many homeowners who made timely applications for FHA-HAMP ended up with denials because the servicer allowed the time limit to pass before making a decision on the application.

Another roadblock to eligibility for FHA-HAMP was its requirement that the homeowner's "back-end" debt-to-income ratio not exceed 55%. This ratio looked at the relationship between the homeowner's monthly income and monthly expenses *after* a FHA-HAMP modification. If, after a FHA-HAMP modification, the homeowner's total monthly expenses (all expenses for housing plus all recurring debt payments) exceeded 55% of monthly gross income, the homeowner was ineligible for FHA-HAMP.[17] By contrast, the Treasury-HAMP application process also considers the homeowners' back-end ratio. However, under Treasury's program homeowners with a back-end ratio exceeding 55% must agree to receive credit counseling. They are not denied a HAMP loan modification simply because the ratio is over the threshold.[18]

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[14] HUD Neighborhood Watch data system for servicers of single family home loans. https://entp.hud.gov/sfnw/public/

[15] *Id.*

[16] HUD Mortgagee Letter 2009-23, p. 2; HUD Mortgagee Letter 2003-19.

[17] HUD Mortgagee Letter 2009-23, p. 2

[18] Data indicates that modifications under the Treasury-HAMP program are leaving borrowers with a median back-end debt-to-income ratio of 53.5 %. *U.S. Dept. of Treasury, Making Home*

Not only did few homeowners receive FHA-HAMP modifications, but many of those who did fared poorly. Numerous studies have confirmed the correlation between the percentage payment reduction achieved through a loan modification and the likelihood of redefault.[19] A GAO study released in June 2012 reported that modifications of FHA loans produced the smallest average percentage payment reduction of all categories of loan modifications.[20] According to the GAO, servicers consistently modified conventional, non-insured loans and GSE-related loans at more favorable terms for homeowners. Not surprisingly, modified FHA loans were redefaulting at higher rates than modified loans in all other categories.[21]

HUD has now revised its guidelines for FHA-HAMP, as set out in its Mortgagee Letter 2012-22, issued November 16, 2012. These new guidelines are found in a companion *NCLC eReports* article, "HUD Revises FHA Loss Mitigation Rules—Revamps FHA-HAMP Guidelines."

Affordable Program Performance Report Through September 2012, p. 8. For several reasons, including its lower base interest rate of 2%, Treasury's HAMP program produces deeper payment reductions than FHA modifications. Therefore, the median back-end debt-to-income ratio for FHA-HAMP modifications is likely to be even higher than the median for Treasury-HAMP modifications.

[19] *See e.g.* Office of the Comptroller of the Currency, *OCC Mortgage Metrics Report Second Quarter 2012* (September 2012) at pp. 36-42.

[20] GAO Report to Congressional Addressees, *Foreclosure Mitigation: Agencies Could Improve Effectiveness of Federal Efforts with Additional Data Collection and Analysis* (GAO Report 12-296 June 2012). http://www.gao.gov/products/GAO-12-296.

[21] *Id.* at pp. 54-61.

HUD Revises FHA Loss Mitigation Rules—Revamps FHA-HAMP Guidelines

NCLC eReports December 2012 #15
Foreclosures and Servicing

Background on FHA's loss mitigation requirements and FHA-HAMP can be found at NCLC eReports, at www.nclc.org/webaccess. This article presupposes a general familiarity with that information. This article also is available at NCLC eReports, with live links to all cited HUD Mortgagee Letters.

HUD Mortgagee Letter 2012-22—Overview

HUD Mortgagee Letter 2012-22, issued November 16, 2012, announces changes to the loss mitigation protocol that servicers must follow before they may foreclose upon an FHA-insured loan.[1] Some changes are minor, while those affecting FHA-HAMP are more significant, removing some major barriers to FHA-HAMP eligibility. They also allow for alternative formulas for calculating the target payment for a FHA-HAMP modification. These changes should increase participation rates for FHA-HAMP and allow for more sustainable modifications for homeowners who receive them. The letter states that servicers must begin to assess homeowners in default under these new guidelines no later than 90 days after the letter's issuance date.[2]

FHA has always relied upon a sequential evaluation protocol for loss mitigation. Servicers must evaluate homeowners in default for a series of loss mitigation options in a specific order.[3] Mortgagee Letter 2012-22 distills the current evaluation steps into a one-page chart, "FHA Loss Mitigation Home Retention Option Priority Order Waterfall," included as Attachment A to the letter. Understanding FHA's current loss mitigation guidelines will require a working familiarity with the steps outlined in this chart. Unfortunately, within the confines of Mortgagee Letter 2012-22 FHA did not provide a detailed explanation of all aspects of the protocol reflected in the chart. In addition, in order to follow the steps outlined by the grid, it may necessary to cross reference prior HUD Mortgagee Letters on key servicing issues.[4]

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[1] http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee. A direct link to the letter is found in this article at NCLC eReports, www.nclc.org/webaccess.

[2] The letter also contains a "Re-assessment Requirement" under which a homeowners must be reassessed under these new guidelines prior to scheduling a foreclosure sale "[i]f a foreclosure sale date is not within 30 days from the Issuance Date of this Mortgagee Letter." ML 2012-22, at 6.

[3] 24 C.F.R. §§ 203.605(a), 203.501.

[4] In particular, advocates may need to cross-reference the following: Mortgagee Letter 2000-05 (FHA's general loss mitigation guidelines and protocols); Mortgagee Letter 2009-23 (original design for FHA-HAMP); Mortgagee Letters 2002-17 and 2011-23 ("special forbearance" for unemployed homeowners); Mortgagee Letter 2009-35 (amendments to standard FHA loan modification terms); Mortgagee Letter 2011-28 (trial modification plans); Mortgagee Letter 2008-21 (foreclosure fees and costs); and Mortgagee Letter 2010-04 (FHA's "imminent default" standard).

Reliance on a grid or chart with set formulas to define the flow of loss mitigation review has its advantages and disadvantages. Formulas can be rigid and inflexible, excluding large groups of individuals from a benefit based on a numerical formula. On the other hand, the steps outlined in the protocol are objective. Availability of this protocol can facilitate oversight of servicers, both by FHA and by homeowners and their advocates.

The terms of FHA mortgages and HUD regulations require that owners of the insured loans follow FHA guidelines as a condition to a valid foreclosure.[5] Courts in judicial and non-judicial foreclosure states have barred foreclosures on the basis of failure to comply with the contractual terms of FHA loan documents and violations of FHA regulations.[6] FHA-HAMP has been formally adopted into FHA's loss mitigation standards. Servicers cannot lawfully foreclose unless they have reviewed the homeowner for FHA-HAMP and made an appropriate modification if the homeowner is eligible.[7] Advocates should become familiar with FHA's current loss mitigation protocol and use the specificity of these new guidelines in fashioning discovery requests and in defending against foreclosures of FHA-insured loans.[8]

Changes to FHA-HAMP Eligibility

Mortgagee Letter 2012-22 removes the requirement that arrears for no more than twelve months' principal, interest, taxes, and insurance can be included in the partial claim component of an FHA-HAMP modification. Homeowners more than twelve months in arrears no longer can

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[5] HUD/FHA Standard Mortgage ¶ 9(D), Standard Note ¶ 6(B).

[6] *See, e.g.,* Lacy-McKinney v. Taylor, Bean, & Whitaker, 937 N.E.2d 853 (Ind. Ct. App. 2010); Wells Fargo Home Mortgage, Inc. v. Neal, 922 A.2d 538 (Md. 2007) (rejecting breach of contract claim, but holding violation of FHA loss mitigation rules may be equitable defense to non-judicial foreclosure); Wells Fargo v. Phillabaum, 950 N.E.2d 245 (Ohio Ct. App. 2011); Matthews v. PHH Mortgage Corp., 724 S.E.2d 196 (Va. 2012) (upholding breach of contact claim asserted as ground to preclude valid trustee's sale). *See generally* NCLC's Foreclosures § 3.2.2 (4th ed. 2012).

[7] 23 C.F.R. §§ 203.605(a), 203.606(a). Mortgagee Letter 2012-22 does not supersede Mortgagee Letter 2009-23, which set out the essential requirements that servicers review for FHA-HAMP. The earlier Mortgagee Letter unambiguously recognized a requirement to review for FHA-HAMP during the pendency of foreclosure: "to ensure that a mortgagor currently in the process of foreclosure has the opportunity to apply, Mortgagees shall not proceed with the foreclosure sale until the mortgagor has been evaluated for the program and, if eligible, an offer to participate in the FHA-HAMP has been made. Mortgagee Letter 2009-23 Attachment, at 4.

[8] FHA regulations set out a clear requirement that servicers document their reviews of borrowers for all loss mitigation options. 24 C.F.R. § 203.605(a) (servicer must have completed loss mitigation review before loan is four months delinquent). The servicer must be able to document monthly reviews throughout the foreclosure process: "As long as the account remains delinquent, the lender must reevaluate the status of each loan monthly following the 90 day review, and is required to maintain documentation of the evaluation." HUD Mortgagee Letter 2000-05, at 10. Documented reviews must take place at regular intervals.

be denied FHA-HAMP eligibility solely on that basis.[9] Nor need the homeowner's back-end debt-to-income ratio be less than 55%.[10]

Changes to FHA-HAMP Affordable Payments

The waterfall calculation under the original 2009 FHA-HAMP guidelines[11] targeted an affordable payment level of 31% of the homeowner's gross household income. The calculation began with capitalization of arrears, reduced the interest rate, and set the loan repayment term at thirty years. Departing from the standard FHA loan modification steps, the original FHA-HAMP waterfall then allowed for further payment reduction through principal forbearance to achieve the target payment of 31% of income. The FHA partial claim served as the vehicle to create the principal forbearance. Under both the old and the revised versions of FHA-HAMP, the amount of the partial claim cannot exceed 30% of the outstanding principal balance as of the date of default.

New Mortgagee Letter 2012-22 retains the option to achieve a 31% of income monthly payment through this same waterfall calculation. However, in a new development, Mortgagee Letter 2012-22 creates an alternative payment calculation that may provide for lower payments than those available under the original FHA-HAMP model.

Mortgagee Letter 2012-22 requires that servicers reviewing a homeowner for FHA-HAMP consider a new alternative formula for determining the modified payment. If the alternative formula produces a payment that is lower than the one reached under the original FHA-HAMP waterfall, the modified loan must incorporate the lower payment. Under the new guidelines, the servicer must modify the loan so that the homeowner pays the *lower* of either (a) 31% of gross household income *or* (b) the greater of 80% of current payment or 25% of gross income.[12] For certain homeowners, this will allow a greater percentage reduction in payments than solely targeting a payment of 31% of gross income.

Mortgagee Letter 2012-22 gives an example of application of the alternative payment calculation.[13] Here, the homeowner has a gross monthly income of $3,000 and a current total monthly mortgage payment of $1,000. The modified monthly payment set at 31% of gross monthly income would be $930 ($3,000 gross monthly income x .31). However, applying the alternative calculation, a payment that reduces the same homeowner's current payment by 20% would create a new monthly payment of $800 (current payment of $1,000 x .80) and a monthly payment at 25% of gross household income would be $750. The greater of these latter two figures is $800. Because this $800 figure is less than the 31% of income result ($930), the modified payment will be $800. The original FHA-HAMP formula would have required that the

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[9] The twelve-month limitation never applied to FHA's standard (non-FHA-HAMP) loan modification.

[10] The 55% back-end debt-to-income ratio threshold never applied to FHA's standard (non-FHA-HAMP) loan modification.

[11] HUD Mortgagee Letter 2009-23.

[12] HUD Mortgagee Letter 2012-22 Attachment A (Step 6).

[13] HUD Mortgagee Letter 2012-22, Example 3(b).

modified payment be set at $930, a monthly payment reduction of 7%. Under the new alternative calculation the payment is reduced by 20%.[14]

Other Loss Mitigation Changes

Modification Eligibility After Prior Trial Plan Failure. Homeowners who failed to complete a prior trial modification plan, either under FHA's standard modification or under FHA-HAMP, may re-apply for either form of modification if their financial situation changed since the earlier application.[15] Under either program, a homeowner is limited to one permanent loan modification every two years.

Unemployed Homeowners. Over the past three years the Treasury Department and the GSEs moved to exclude unemployed homeowners from certain loss mitigation options, particularly loan modifications. FHA has moved in the same direction. Under Mortgagee Letter 2012-22, only homeowners with employment income may qualify for certain forbearance plans and for any type of loan modification.[16] FHA now directs unemployed homeowners into a special forbearance option.[17] The special forbearance for unemployed borrowers does not aim directly at reinstatement of the loan. Instead, after a minimum of twelve months of reduced or suspended payments, the homeowner must be evaluated for further options. These options include a loan modification or repayment plan, depending on the homeowner's financial circumstances at the future time.

"Surplus Income." Certain FHA loss mitigation options, such as formal forbearance plans and the standard (non-FHA-HAMP) loan modification, require that homeowners have "surplus income." FHA defines surplus income as the monthly amount left over after the homeowner pays "normal monthly living expenses (food, utilities, etc.) including debt service on the mortgage and other scheduled obligations."[18] Prior to Mortgagee Letter 2012-22, FHA allowed servicers some discretion in determining the requisite amount of surplus income needed for eligibility for a particular loss mitigation option. The new guidelines formalize surplus income determinations. For example, for the standard FHA loan modification the homeowner must have surplus income that is at least the greater of $300 or 15% of net income. Many homeowners facing foreclosure will simply not have surplus income of this kind. For this reason, the standard FHA loan modification will not be an option for many delinquent homeowners. However, homeowners without surplus income are eligible to be considered for the FHA-HAMP options.[19]

"Stand-Alone" Modification or Partial Claim Under FHA-HAMP. In a departure from prior guidelines, a homeowner who has no need for a partial claim to cure a default may now

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[14] The FHA partial claim limit to no more than 30% of the unpaid principal balance would apply under either calculation.
[15] HUD Mortgagee Letter 2012-22, at 5-6.
[16] *Id.* at 2-4.
[17] HUD Mortgagee Letter 2011-23 and Mortgagee Letter 2012-22, at 3.
[18] Mortgagee Letter 00-05, at 11.
[19] HUD Mortgagee Letter 2012-22 Attachment A (Step 3).

qualify for a stand-alone FHA-HAMP loan modification.[20] This option potentially assists homeowners without surplus income and facing imminent default to obtain an affordable modified payment. Similarly, a homeowner may now qualify for a stand-alone FHA-HAMP partial claim—without a contemporaneous loan modification.[21] To be eligible, the homeowner must already have loan terms equivalent to those available through an FHA-HAMP modification, but require only a partial claim to reinstate a loan in default. These stand-alone options fit unique situations, but may assist those homeowners who find themselves in them.

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[20] *Id.* at 4.
[21] *Ibid.*