CONSOLIDATION AFTER CRISIS: HOW A FEW PRIVATE INVESTORS BOUGHT DISTRESSED, FEDERALLY-INSURED MORTGAGES AFTER THE FORECLOSURE CRISIS

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Introduction

In George Packer's seminal 2013 book about the Great Recession, *The Unwinding*, he provides one over-arching thesis. In his view, the "structures that had been in place . . . the norms that made the old institutions useful, began to unwind, and the leaders abandoned their posts [so that] the Roosevelt Republic that had reigned for almost half a century came undone. The void was filled by the default force in American life—organized money."[1]

This Note analyzes the "unwinding" of one of President Roosevelt's most lasting institutions—the federally-insured, thirty-year fixed-rate mortgage serving middle-income homeowners—and explains how organized money filled the void. Indeed, quietly, hundreds of thousands of predominantly low- and moderate-income communities were impacted by this shift. This Note explores three subjects that are generally not addressed by existing legal academic scholarship

1. George Packer, The Unwinding: An Inner History of the New America 3 (2013).

related to the foreclosure crisis and its continuing effects. First, most scholarship evaluating the foreclosure crisis has focused on other areas of the mortgage market, including subprime and other predatory loans.[2] This Note supplements that work by examining the federal government's own efforts to compete with subprime products, including the Federal Housing Administration's (FHA) policy changes leading up to the crisis. Second, most scholarship examining the federal government's subsequent interventions to stem the crisis have focused on the bank bailouts and other efforts in the private market, including the Troubled Asset Relief Program (TARP) or litigation against entities that securitized loans. To supplement that work, this Note analyzes the FHA's unique role in the immediate aftermath of the crisis as a countercyclical backstop that absorbed portions of the failing private mortgage market by providing federal insurance to faltering lenders and mortgages held by highly risky borrowers at risk of foreclosure.

Third, the note analyzes ongoing efforts by the FHA to sell those same loans through a special process, the Distressed Asset Stabilization Program (DASP), to serve a set of policy goals and to avoid initiating foreclosure against highly delinquent borrowers. DASP is reflective of a broader model for other federal government efforts to manage high volumes of delinquent debt in a cost-effective manner. Indeed, Fannie Mae and Freddie Mac also sold thousands of pooled non-performing notes to private investors.[3] Moreover, some members of the U.S. Senate have proposed authorizing the Department of Education to sell federally-insured student loan debt to private investors who offer to refinance loan terms.[4] Therefore, the findings and recommendations in this Note are widely applicable to a wide range of policy domains.

After providing some background on the FHA and the federally insured mortgage, Part I describes how market forces and government actions leading up to the foreclosure crisis undermined long-standing FHA lending practices to compete with subprime products and then, in the immediate aftermath of the crisis, used federal insurance as a countercyclical backstop when the housing market collapsed. Then, as Part II illustrates, when the FHA's mortgage portfolio incurred un-

2. *See generally* Vicki Been et al., *The High Costs of Segregation: Exploring Disparities in High-Cost Lending*, 36 FORDHAM URB. L.J. 361 (2009); Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257 (2009); Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177 (2012).

3. *See, e.g.*, FED. HOUS. FIN. AGENCY, ENTERPRISE NON-PERFORMING LOAN SALES REPORT (2016).

4. Student Loan Relief Act of 2015, S. 2099, 114th Cong. § 102 (2015).

precedented losses and federally-insured borrowers defaulted in record numbers, the government turned to private equity investors and hedge funds to sell pools of loans through DASP.

Part III analyzes the impact of the decision to sell federally-insured loans to a limited number of dominant private firms. For example, Part III evaluates how, for DASP loans, the government undermined traditional borrower protections associated with federally-insured loans and judicial foreclosure, imposed costs disproportionately on lower-income African American and Hispanic neighborhoods, and put private equity investors, rather than the government or homeowners, in the driver's seat when it came time to rebuild housing markets in communities decimated by the Great Recession. Finally, Part IV provides a set of lessons and recommendations for the FHA to consider before the next housing downturn. It also includes ideas for further research and recommends design changes so that DASP can better maximize bids and protect borrowers and distressed communities.

I.
FHA and the Foreclosure Crisis

Part I of this Note provides the historical foundation for the rest of the paper's analysis and explains how the federal government, and the U.S. Department of Housing and Urban Development (HUD) in particular, emerged as a holder of so many delinquent residential home loans during the foreclosure crisis. First, it will broadly describe the FHA's history and its policies regarding single-family residential loan insurance. Next, it will discuss the FHA's evolving business model in the 1990s and 2000s in response to the rise of subprime mortgage products. Finally, Part I will conclude by examining the legal mechanisms used by HUD to respond to mass borrower defaults on mortgages insured by the FHA during the foreclosure crisis.

A. FHA: Background and History

The National Housing Act of 1934[5] established the FHA to address a "crisis in mortgage delinquencies and foreclosures"[6] during the Great Depression that led to mass evictions and bank failures after lenders' entire residential mortgage portfolios were wiped out.[7]

5. Pub. L. No. 73-479, 48 Stat. 1246 (1934).
6. Peter M. Carrozzo, *A New Deal for the American Mortgage: The Home Owners' Loan Corporation, the National Housing Act and the Birth of the National Mortgage Market*, 17. U. Miami Bus. L. Rev. 1, 5 (2008).
7. *Id*. at 10.

Among other functions, the FHA, which was later made an agency of HUD, insures loans on single-family homes that meet certain statutory terms[8] and that are financed by private, approved lenders[9] to borrowers who meet specific underwriting criteria.[10] Almost immediately, the standard FHA-insured mortgage was considered a "win-win" for both borrowers and lenders. Borrowers received the benefit of more favorable loan terms that they could pay off with a consistent monthly mortgage payment over decades.[11] Lenders, meanwhile, had "security in making loans" because they knew the FHA was "acting as a backstop against mass foreclosures" and that they would "not have to carry thousands of foreclosed properties in case of a new crash."[12] In setting statutory loan terms, FHA-insured mortgages became the nation's standard model for single-family residential loans.[13] To secure the promise of federal insurance, lenders were systematically incentivized, and thus decided, to provide standardized loans with FHA-mandated terms including lower down payments, full amortization over long periods of time, and lower interest rates.[14]

Today, FHA insurance remains a popular option for both borrowers and lenders. To receive FHA insurance, borrowers pay two separate premiums. First, borrowers pay a premium at the loan's closing.[15] Second, borrowers pay annual mortgage insurance premiums that are spread out evenly across each month and are included in their monthly mortgage payments.[16] Premiums help finance the Mutual Mortgage Insurance Fund (MMI Fund), which functions as the insurance pro-

8. 12 U.S.C.A. § 1709(b)(3)–(9) (West 2016) (requiring thirty- or thirty-five-year amortization periods, negotiated interest rates, and a 3.5% down payment that can be paid by borrower or family members, and other required terms).

9. *Id.* § 1708(c)–(d) (lenders or "mortgagees" are approved by the Mortgagee Review Board based on certain statutory eligibility criteria).

10. *Id.* § 1709(b)(1)(2) (2016) (describing property appraisal requirements); *see also* U.S. DEP'T OF HOUS. & URBAN DEV., HUD 4155.1, MORTGAGE CREDIT ANALYSIS FOR MORTGAGE INSURANCE § 1.A.1.b (2016) (listing factors for an underwriter to consider when "determin[ing] a borrower's creditworthiness").

11. Carrozzo, *supra* note 6, at 39–40.

12. *Id.* at 39.

13. KATIE JONES, CONG. RESEARCH SERV., RS 20530, FHA-INSURED HOME LOANS: AN OVERVIEW 4 (2013).

14. KENNETH T. JACKSON, CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES 204–05 (1985) (concluding that FHA insurance was responsible for lowering down payments from thirty percent to ten percent of appraised value, extending loans to a 25 or 30-year amortization period, and causing interest rates to fall by two to three percent).

15. 12 U.S.C.A. § 1709(c)(2)(A) (West 2016).

16. *Id.* §§ 1708(a)(6) & 1709(c)(2)(B) (permitting premium adjustments but also limiting increases); *see also* JONES, *supra* note 13, at 4.

gram's cash reserves.[17] Insurance benefits are then paid out of the MMI Fund to indemnify lenders by providing the full amount of the unpaid principal balance remaining on the mortgage to mitigate the lender's losses and satisfy other lender claims.[18]

B. FHA's History of Foreclosure Alternatives

Traditionally, to deal with serious borrower defaults where reinstatement of a loan was no longer an option, the FHA would pay out insurance benefits only after a servicer foreclosed on an FHA-insured mortgage and after the servicer had conveyed title to the property to HUD.[19] Initial changes to this model, including allowing direct assignment of the property to HUD prior to foreclosure, were authorized in 1959.[20] However, HUD only started to operate an alternative "Mortgage Assignment Program" in 1976 through a consent decree with low-income homeowners from Chicago.[21]

Under that model, after borrowers applied to HUD directly, the government would accept assignment of the mortgage from lenders and negotiate directly with distressed homeowners to provide relief.[22] For example, the government would agree to a temporary forbearance by promising not to foreclose on the borrower for up to thirty-six months or would provide other financial assistance to borrowers so they could meet their obligations under the loan.[23] According to government audits, the Mortgage Assignment Program was "not fully successful in helping borrowers avoid foreclosure and retain their homes on a long-term basis" and imposed significant additional costs and program losses that made it more difficult for the "single-family insurance program to maintain financial self-sufficiency."[24] In general,

17. 12 U.S.C.A. § 1709(k)(5) (West 2016).

18. *Id.* § 1710(a)(5).

19. *See* National Housing Act of 1934, Pub. L. No. 73-479, § 204(a), 48 Stat. 1246 ("In any case in which the mortgagee under an insured mortgage shall have foreclosed and taken possession of the mortgaged property . . . the mortgagee shall be entitled upon the prompt conveyance to the Administrator of title . . . to receive the benefits of the insurance.").

20. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/RCED-96-2, HOMEOWNERSHIP: MIXED RESULTS AND HIGH COSTS RAISE CONCERNS ABOUT HUD'S MORTGAGE ASSIGNMENT PROGRAM 2 (1995) [hereinafter GAO HOMEOWNERSHIP] (discussing history of the National Housing Act).

21. *See* Ferrell v. Pierce, 743 F.2d 454, 456 (7th Cir. 1984) (discussing this history); Jeremy A. Rabkin & Neal E. Devins, *Averting Government by Consent Decree: Constitutional Limits on the Enforcement of Settlements with the Federal Government*, 40 STAN. L. REV. 203, 252–53 (1987).

22. GAO HOMEOWNERSHIP, *supra* note 20, at 1.

23. *Id.*

24. *Id.* at 1–2.

government audits blamed two aspects of the program's design for these issues. First, the HUD process for accepting struggling borrowers' loans into the program was cumbersome and borrowers often amassed substantial further delinquencies while their application was under review.[25] Second, the program provided a long thirty-six-month relief period for borrowers, whereas more successful programs run by other agencies had shorter relief periods or immediately re-amortized the loan and required re-performance.[26]

As a result, Congress terminated the program in April 1996 in favor of a loss mitigation program that would compensate lenders who provided delinquent borrowers alternatives to foreclosure—including "special forbearance, loan modification, and deeds in lieu of foreclosure."[27] Under this loss mitigation program, assignment of a mortgage to HUD could take place only after the lender had "modified the mortgage to cure the default" using the available loss mitigation alternatives for which the lender was also compensated.[28] In essence, during the mitigation process, HUD no longer directly negotiated with distressed FHA borrowers but instead deferred to servicers to perform that function.

In 1998, Congress amended Section 204 of the National Housing Act to once again provide HUD the authority to accept the direct assignment of mortgages.[29] Now, if a mortgage was in "monetary default" for at least three months, HUD could pay out partial insurance benefits to lenders after the loan was assigned directly to HUD.[30] Still, Congress explicitly limited the scope of HUD's authority to subsequently negotiate with borrowers after the loan was assigned to the government. The statute reaffirmed that "no mortgage assigned" could take part in a program that was "the same or substantially equivalent" to the old Mortgage Assignment Program.[31] Thus, HUD had two op-

25. *Id.* at 9–10.

26. *Id.* at 14.

27. Omnibus Consolidated Rescissions and Appropriations Act of 1996, Pub. L. No. 104-134, § 221(a), 110 Stat. 1321, 1321–290, *amending* Balanced Budget Downpayment Act, Pub. L. No. 104-99, § 407(a), 110 Stat. 26, 45 (1966).

28. *Id.* § 230(b)(1)(B).

29. Pub. L. No. 105-276, § 601, 112 Stat. 2461, 2670 (1998). The conference committee's report helps explain that this shift reflected a belief that the FHA still needed some "additional flexibility to choose the most cost-effective methods of paying insurance claims and disposing of acquired notes." H.R. REP. NO. 105-769, at 302 (1998) (Conf. Rep.). Still, Congress reiterated that it preferred that the FHA focus on establishing "an aggressive and effective loss mitigation program" rather than an assignment program. *Id.* at 302–03.

30. 12 U.S.C.A. § 1710(a)(1)(A) & (D) (West 2009).

31. § 601, 112 Stat. at 2673.

tions to deal with delinquent loans prior to foreclosure. First, the government could partially pay out insurance benefits to compensate lenders who took direct loss mitigation actions with borrowers before foreclosing on the property. Second, HUD could accept assignment of the mortgage themselves. However, the extent to which HUD could manage those mortgages after assignment and negotiate with borrowers to avoid foreclosure remained uncertain.

As a result, when a borrower was delinquent on an FHA-insured loan, bargaining to avoid foreclosure would typically take place only between the lender and the borrower. HUD was involved only in the modification process indirectly. First, HUD could compensate the lender for agreeing to terms that would avoid foreclosure.[32] Second, HUD also regulated the alternative mitigation efforts that lenders could offer and borrowers could accept.[33] Finally, HUD could still hold the mortgage pursuant to an assignment so long as the government did not directly intervene to provide loss-mitigating benefits on its own to borrowers. Importantly, HUD could also still use the traditional model—paying out insurance benefits upon foreclosure and conveyance of title to HUD.[34]

These changes over time reflected a growing concern that HUD had operated too rigidly and lacked the capacity, flexibility, or expertise to work directly with delinquent borrowers. Instead, after 1998, the government sought to provide parties with greater flexibility.[35] In this view, a flexible process providing borrowers and lenders the opportunity to negotiate would ensure borrowers, lenders, and the government all avoided a range of costs associated with the lengthy foreclosure process.[36] In addition, the government, as an insurer, could avoid transaction and program costs that had proven expensive and unsustainable under the Mortgage Assignment Program. Meanwhile, borrowers could still benefit from programs that would enable them to stay in their homes. For almost a decade, this system worked reasonably well. Eventually, however, the foreclosure crisis exposed its flaws.

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32. § 1710(a)(2).

33. *See, e.g.*, 24 C.F.R. § 203.501 (2016) (outlining potential "appropriate actions" that would mitigate losses to HUD); U.S. DEP'T OF HOUS. & URBAN DEV., MORTGAGEE LETTER 2010-04 (2010), https://www.hud.gov/sites/documents/10-04ML.PDF (outlining new options during foreclosure crisis for loss mitigation).

34. § 1710(a)(1)(B)–(C).

35. *See* H.R. REP. NO. 105-769, at 302–03 (1998) (Conf. Rep.) (citing the need to provide HUD with "additional flexibility").

36. *Id.* at 302 ("[A]n aggressive and effective loss mitigation program. . . . could keep families in their homes longer and would, most certainly, decrease losses to the FHA insurance fund.").

C. FHA and the Rise of Subprime Products in the 1990s and Early 2000s

The next two sections of this Note focus on answering a critical question: How did the FHA, an agency designed to be self-sustaining, end up requiring its first-ever infusion of billions of dollars to cover its losses? Section I.C analyzes how the FHA, in the 1990s and especially in the mid-2000s, began insuring deeply risky loans to compete with subprime products in predominantly African American and Hispanic markets by lowering its loan standards and failing to police fraud. Section I.D then evaluates the federal government's immediate response to the foreclosure crisis, when the Obama administration purposefully used the FHA to help manage the effects of the crisis by allowing lenders to migrate to the FHA from the collapsing portions of the market and by not readjusting its riskier lending standards. Indeed, the FHA intentionally acted as a countercyclical backstop for the broader housing market. In the process, the agency insured its worst performing book of mortgages in its history.

Officials at the FHA essentially were being asked to accomplish three conflicting policy goals. They were asked to stabilize the broader housing market, provide low- and moderate-income borrowers continuous access to homeownership, and act as an insurer that limited its exposure to risk. Often, when these goals were in direct conflict, the FHA decided to take on more long-term risk to serve its more immediate goals related to market stability and homeownership promotion.

First, this Note explores the FHA's decision-making leading up to the foreclosure crisis. Scholarship related to the FHA has frequently focused on its historical role as "the most important factor encouraging white suburbanization and reinforcing the segregation of blacks."[37] Indeed, from the 1930s to the late 1960s, the FHA used subjective criteria like "economic stability" and "protection from adverse influences" in its *Underwriting Manual*, along with neighborhood appraisal maps that redlined largely urban and majority-minority neighborhoods, in order to discriminate against prospective African-American homeowners by designating those neighborhoods "ineligible for loan guarantees."[38] Through these tactics, for decades the FHA

37. Douglas S. Massey & Nancy A. Denton, American Apartheid: Segregation and the Making of the Underclass 53–55 (1993); *see also* Dan Immergluck, Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America's Mortgage Market 48–49 (2009).

38. Jackson, *supra* note 14, at 207, 209 (describing underwriting criteria and Residential Security Maps).

intentionally and overtly denied the benefits of the standard FHA-insured mortgage to minority homeowners.[39]

By the 1990s, however, the opposite was true. In fact, analysts noted a "relatively heavy reliance of black and Hispanic customers on FHA loans" compared to their white counterparts.[40] Though the terms of FHA loans are favorable and may provide real benefits to borrowers, the shift to FHA-insured loans is not without negative consequences. Most importantly, depending on the circumstances, FHA loans can be more expensive than conventional loans for certain borrowers because of the high cost of FHA premiums and other associated fees.[41]

While some scholars cite innocent explanations for this shift, others argue this too reflected a form of discrimination.[42] Some plaintiffs have argued that steering black homeowners to the FHA option is a form of "reverse redlining"—defined as a practice where "lenders or mortgage brokers, presuming a lack of financial sophistication, aggressively market loans to blacks or Hispanics or to particular neighborhoods."[43] Studies showed that mortgage brokers were 6.7% more likely to steer black homeowners to FHA loans compared to white homeowners.[44] In part, this "steering" might reflect mortgage brokers' and lenders' "paternalistic policies" and discriminatory assumptions that black homeowners should be provided FHA-insured loans because lenders perceived minority homeowners as higher-risk borrowers.[45] Recently, the City of Los Angeles unsuccessfully argued that Wells Fargo's steering of black and Hispanic homeowners to FHA rather than conventional loans constituted a Fair Housing Act violation, in part because the high cost of insurance premiums meant these

39. *See* Sarah L. Rosenbluth, *Fair Housing Act Challenges to the Use of Consumer Credit Information in Homeowners Insurance Underwriting: Is the McCarran-Ferguson Act a Bar?*, 46 COLUM. J.L. & SOC. PROBS. 49, 49 (2012) ("Federal Housing Administration promulgated the overtly race-conscious underwriting guidelines . . . .").

40. STEPHEN L. ROSS & JOHN YINGER, THE COLOR OF CREDIT: MORTGAGE DISCRIMINATION, RESEARCH METHODOLOGY, AND FAIR-LENDING ENFORCEMENT 24 (2002).

41. *See supra* notes 15–16 and accompanying text.

42. *Compare* ROSS & YINGER, *supra* note 40, at 65 (providing the case for FHA steering as a form of housing discrimination), *with* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1277 (2002) (providing more innocent explanations).

43. Been et al., *supra* note 2, at 370.

44. ROSS & YINGER, *supra* note 40, at 59.

45. *Id.* at 65.

loans were more expensive in the aggregate and in terms of monthly payments.[46]

On the other hand, more innocent explanations posit that minority homeowners might choose FHA-insured loans rather than conventional loans based on imperfect information and a history of those loans having "long been the primary source of credit for minority households."[47] Of course, most often, borrowers may choose an FHA loan because it is the best or only loan appropriate for their financial situation. In addition, to the extent race correlates with incomes and credit scores, other academics conclude a heavy reliance on FHA loans by low- and moderate-income borrowers may legitimately reflect credit-worthiness because lower income borrowers have "elevated risks of default . . . [and] FHA insurance decreases the downside risk to lenders."[48]

By the late 1990s and early 2000s, however, black and Hispanic borrowers who had previously relied on FHA-insured loans were turning to alternative mortgage products. Government sponsored enterprise (GSE) backed mortgages were long cited as "stiff competition to FHA mortgages because borrowers could get them more quickly and with lower fees."[49] Later, the market expanded when unconventional subprime mortgage products proliferated to attract the population that had come to rely on FHA-insured loans. Subprime loans, at least initially, compared favorably to both FHA-insured and GSE-backed loans for these borrowers. First, subprime loans typically, at least initially, had more affordable terms. Adjustable interest rates with incredibly low initial teaser rates ensured lower monthly payments relative to their fixed-rate FHA counterparts at the front-end.[50] In addition, high loan-to-value ratios and "piggyback loans" to cover portions of a down-payment fully eliminated or reduced the need for borrowers to provide a down-payment.[51] Of course, these products

46. City of Los Angeles v. Wells Fargo & Co., No. 2:13-cv-09007-ODW(RZx), 2015 U.S. Dist. LEXIS 93451, at *29 (C.D. Cal. July 17, 2015).

47. Ross & Yinger, *supra* note 40, at 251.

48. Engel & McCoy, *supra* note 42, at 1277.

49. Fin. Crisis Inquiry Comm'n, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States 39 (2011).

50. Levitin & Wachter, *supra* note 2, at 1196 (citing adjustable rate mortgages with initial monthly payments between $150 and $903.50 compared to fixed rate mortgages with initial monthly payments of $1,079.19 for a hypothetical borrower).

51. Kathleen C. Engel & Patricia A. McCoy, The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps 35–36 (2011).

also often had limited amortization over time, leading to large balloon payments at the back end.[52]

Second, lenders were competing for loans to securitize and needed to support high origination volume goals. Therefore, both GSE-backed lenders and private lenders lowered their underwriting standards for subprime products. When they engaged in any underwriting process, lenders would approve borrowers based on "their ability to pay the initial below market teaser rate."[53] Even worse, subprime lenders often simply abandoned any underwriting process at all—providing so-called "low-doc" or "no-doc" stated income loans where lenders did not even verify borrower incomes.[54] The FHA largely maintained tougher underwriting standards and "required detailed documentation and down payments."[55] Third, in part due to non-existent documentation requirements, borrowers secured subprime mortgages very quickly. On the other hand, securing an FHA-insured product was a more laborious, lengthier, and therefore costlier process for borrowers.[56] Moreover, underwriting and other fees remained relatively high for FHA loans compared to their subprime competitors. Finally, and perhaps most importantly, in the 2000s, lenders purposefully targeted minority homeowners when marketing these products, engaging in "predatory practices [that] are most frequently found in connection with subprime lending."[57]

In combination, these factors ensured subprime loans crowded out FHA loans in serving parts of the mortgage market that the FHA had previously grown to dominate—namely, serving low- and moderate-income African American and Hispanic borrowers and neighborhoods. Between 1999 and 2006 for example, "FHA's market share by dollar volume fell from 7.96 percent to 1.75 percent."[58] At the same time, subprime loans gained a large portion of the market share in predominantly African American and Hispanic neighborhoods.[59]

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52. Levitin & Wachter, *supra* note 2, at 1196.

53. *Id.* at 1200.

54. ENGEL & MCCOY, *supra* note 51 at 36–37.

55. *Id.* at 39.

56. *Id.*

57. U.S. DEP'T OF HOUS. & URBAN DEV. & U.S. DEP'T OF TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING: A JOINT REPORT 47 (2000).

58. ENGEL & MCCOY, *supra* note 51, at 39.

59. The data here are startling and show the emergence of subprime products among minority borrowers across income levels. In 1993, only eight percent of refinance loans in predominantly black neighborhoods and one percent of refinance loans in white neighborhoods were subprime products. By 1998, HUD found that "subprime lending accounted for 51 percent of refinance loans" in black neighborhoods but accounted for only "9 percent in predominantly white neighborhoods." U.S. DEP'T OF

Meanwhile, during the George W. Bush administration, the FHA eventually responded to this new competition for its "market share" by altering its standards.[60] First, the FHA lowered its underwriting standards, accepting borrowers with lower credit scores like its GSE and private subprime counterparts, though it did so more gradually. In fact, by "November 2007, 62.8 percent of FHA borrowers were either deep subprime (scores less than 600) or subprime (scores between 601 and 660)."[61] The percentage of borrowers with lower quality credit ("deep subprime" or "subprime") receiving FHA-insured loans steadily and gradually increased from 2000 to 2007, as seen in Figure 1.[62]

HOUS. & URB. DEV. & U.S. DEP'T OF TREASURY, *supra* note 57, at 22, 47–48. Data from 2006 showed a similar trend among home purchase loans. In fact, according to the Federal Reserve, 53.7% of African American homeowners used subprime products while 17.7% of non-Hispanic whites used these products. Robert B. Avery et al., *The 2006 HMDA Data*, 93 FED. RES. BULL. A73, A95 (2007).

60. For a comprehensive account of these changes, see Marsha Courchane et al., *Industry Changes in the Market for Mortgage Loans*, 41 CONN. L. REV. 1143, 1171 (2009). *See also* Jo Becker et al., *White House Philosophy Stoked Mortgage Bonfire*, N.Y. TIMES, Dec. 20, 2008, at A1 (in response to a fear of subprime predatory lending, FHA Commissioner Brian Montgomery advocated for a robust plan to "address the risky subprime lending practices" but eventually settled for a "narrower plan . . . so it could lure back subprime borrowers" at the urging of more senior officials). Indeed, Commissioner Montgomery frequently focused on promoting reforms to expand FHA's market share relative to subprime products. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, DECLINE IN THE AGENCY'S MARKET SHARE WAS ASSOCIATED WITH PRODUCT AND PROCESS DEVELOPMENTS OF OTHER MORTGAGE MARKET PARTICIPANTS 46 (2007) (responding to the fact that "some of FHA's traditional borrowers are being enticed . . . into signing up for subprime mortgage products," Commissioner Montgomery reiterated the need for the FHA to gain "additional flexibility, new mortgage insurance products, and risk-based pricing [so] it can continue to reach down the risk ladder").

61. Yuliya Demyanyk & Daniel Kolliner, *FHA Lending Rebounds in Wake of Subprime Crisis*, FED. RESERVE BANK OF CLEVELAND (Apr. 14, 2015), https://www.clevelandfed.org/newsroom-and-events/publications/economic-trends/2015-economic-trends/et-20150414-fha-lending-rebounds-in-wake-of-subprime-crisis.aspx.

62. *Id.*

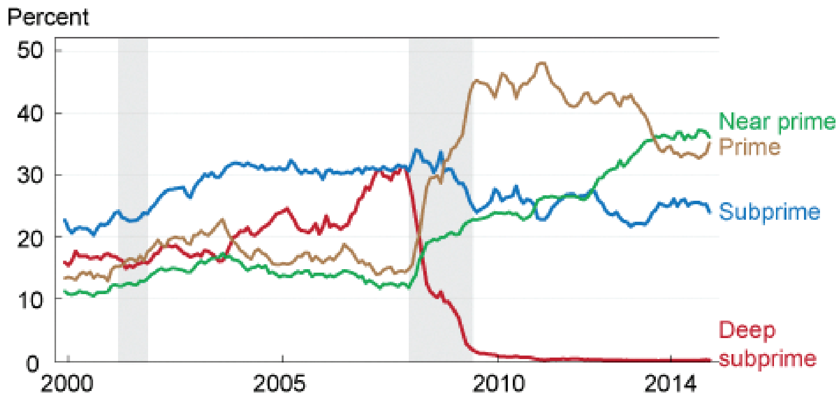


FIGURE 1

The FHA also focused on securing market share by reducing down-payment requirements for prospective borrowers. For example, the government increased loan-to-value ratios and began authorizing the provision of "down-payment assistance" beginning in 1997.[63] From 2000 to 2004, the percentage of FHA-insured loans receiving down-payment assistance increased from six to thirty percent.[64] The FHA permitted the provision of down-payment assistance only where the grants came from family members or a non-profit third party without an interest in the sale of the property.[65] Still, the FHA accepted schemes in which the seller used a non-profit intermediary to funnel down-payment assistance to the buyer and the seller then increased the price of the home above its fair market value to account for that donation while securing insurance for that full, inflated value.[66] Eventually, during the foreclosure crisis, "claim rates for seller-funded down-payment assistance loans [were] almost three times greater than those of other loans."[67]

FHA-insured loans were also not immune to the widespread fraud endemic to the subprime market. During the rise of subprime, the Government Accountability Office (GAO) found in 2000 that HUD's initial review of lenders prior to their qualification as approved

63. IMMERGLUCK, *supra* note 37 at 91.
64. *Id.*
65. *Id.*
66. *Id.*
67. U.S. DEP'T OF HOUS. & URBAN DEV., FHA SINGLE-FAMILY MUTUAL MORTGAGE INSURANCE FUND PROGRAMS: QUARTERLY REPORT TO CONGRESS FY 2010, at 15 (2010).

FHA lenders was haphazard and that, even when lenders exhibited "poor performance" and engaged in "program violations," HUD failed to hold them accountable.[68] The GAO also cited HUD's "2020 Management Reform Plan," announced in 1997, which had cut the staff at field offices responsible for approving and recertifying lenders by fifty percent, as a major obstacle to enforcement of FHA lender standards.[69] As a result, even when evidence of high default rates, outright violations of lending standards, or convictions for criminal mortgage fraud mounted, the FHA failed to prevent troubled lenders from continuing to originate FHA-insured loans.[70]

After the subprime market collapsed, many former subprime lenders migrated to FHA lending. HUD, which still lacked sufficient screeners, was "inundated with requests" from demonstrably poor performing lenders.[71] According to findings from HUD's Inspector General, by 2008 the number of lender applications approved by the FHA tripled compared to the number in 2007.[72] Oftentimes the "FHA did not obtain or consider negative information" about lenders prior to approving them for the program.[73] Some legal scholars have also shown that around the same time "predatory lenders" could make "predatory, FHA-insured loans and insulate themselves somewhat from the cost of defaults."[74]

In summary, though less exposed relative to other segments of the mortgage market, FHA-insured loans were still infected by the so-called subprime virus. Lender fraud, reduced underwriting standards, and unsustainable down-payment assistance programs emerged as real threats to the consistent performance of the FHA's portfolio. Two other factors made the FHA uniquely exposed to the subprime virus. First, the "spillover effects" from mass subprime foreclosures in low-to moderate income, predominantly minority neighborhoods reduced

68. U.S. Gov't Accountability Office, GAO/RCED-00-112, Single-Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk 5 (2000).

69. *Id.* at 8.

70. Frank Thomas, *FHA Scrutiny Shows Cracks*, USA Today, Mar. 28, 2011, at B1.

71. Engel & McCoy, *supra* note 51, at 136.

72. Joan S. Hobbs, U.S. Dep't of Hous. & Urban Dev. Office of Inspector Gen., Audit Report 2009-SE-0004: Controls over FHA's Single-Family Lender Approval Process Need Improvement 2 (2009).

73. *Id*. at 1. HUD's Deputy Assistant Secretary "generally agreed with most of the content of the report and the recommendations." *Id.* at 2.

74. Engel & McCoy, *supra* note 42, at 1278.

home values in neighborhoods jointly served by the FHA.[75] In addition, as the next section explains, the Obama administration's response to the foreclosure crisis relied heavily on FHA insurance as a means of rescuing the nation's housing market. This strategy exposed the FHA to further losses and pushed it to the breaking point.

D. The Subprime Bubble Bursts and FHA Doubles Down

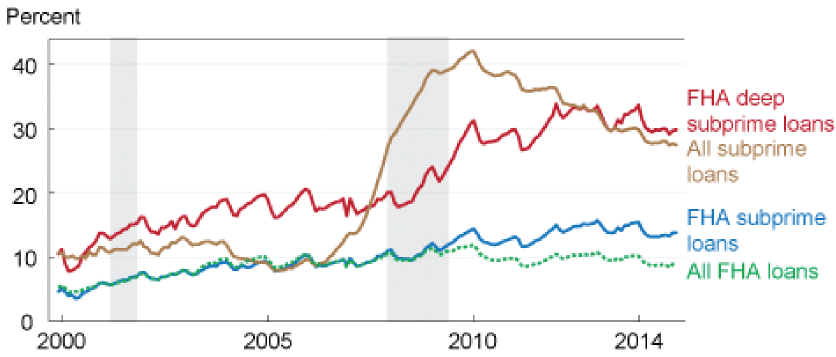
In 2007, as subprime competitors filed for bankruptcy due to mass defaults,[76] FHA-insured loans were still performing better than their subprime counterparts. Some FHA-insured loans, especially those provided to less credit-worthy, "deep subprime" borrowers, suffered higher rates of default.[77] However, as Figure 2 demonstrates, the FHA's default rates did not spike until 2010, and deep subprime FHA borrowers did not mirror the default rates suffered by other subprime borrowers until 2012.[78]

75. *See, e.g.*, Justin Steil, *Innovative Responses to Foreclosures: Paths to Neighborhood Stability and Housing Opportunity*, 1 COLUM. J. RACE & L. 63, 84–85 (2011) (discussing the consequences of foreclosures on neighborhoods including "reduced property tax revenues" and impacts on property values).

76. In April 2007, the second-largest subprime lender, New Century Financial, filed for bankruptcy, followed by American Home Mortgage Investment and Aegis Mortgage Corporation less than six months later. *See American Home Mortgage Seeks Chapter 11 Bankruptcy Protection*, N.Y. TIMES, Aug. 7, 2007, at C3; Julie Creswell & Vikas Bajaj, *Home Lender Is Seeking Bankruptcy*, N.Y. TIMES, Apr. 3, 2007, at C1 (reporting the bankruptcy of New Century Financial Corporation); *Subprime Lender Seeks Protection from Creditors*, N.Y. TIMES, Aug. 14, 2007, at C10 (reporting the bankruptcy of Aegis Mortgage Corporation).

77. Though they did not default on the same scale as other subprime products, many FHA loans were still very troubled. In fact, "seller financed down payment loans . . . [had] nearly three times the default rate of other FHA loans." FED. HOUS. ADMIN., U.S. DEP'T. OF HOUS. & URBAN DEV., FHA ANNUAL MANAGEMENT REPORT FISCAL YEAR 2008, at i (2008) [hereinafter FHA FY 2008 REPORT].

78. Demyanyk & Kolliner, *supra* note 61.



Note: Shaded bars indicate recessions.
Sources: Black Knight Financial Services; CoreLogic ABS; authors' calculations.

FIGURE 2

These timing difference suggest that strategic choices made after the onset of the crisis by both Bush and Obama administration officials, in addition to competitive choices made by the Bush administration to lower standards and permit seller-provided down-payment assistance prior to the crisis, led to some of the FHA's losses. In fact, the FHA's portfolio continues to deal with consequences which derive from the government's immediate response to the foreclosure crisis. Beginning in 2007 and 2008, as the subprime market faltered, the FHA began insuring "about 6,000 loans a day, four times the amount in 2006."[79] The loans insured by the FHA in 2007 and 2008 were more likely than other loans to be rapidly delinquent—"24 percent of 2007 vintage FHA loans and 20 percent from 2008 were in default by 2009."[80]

The dramatic increase in volume was partially driven by market forces. Once borrowers and suspect lenders no longer had access to the subprime market, they undoubtedly turned to the FHA. High rates of delinquency also likely reflected the impact of the subprime virus—as property values in predominantly low- and moderate-income neighborhoods suffered and unemployment rose, FHA-insured loans also suffered. On the other hand, the FHA's growing market share, and the subsequent poor performance of these loans reflected a series of purposeful policy choices.

First, HUD established programs to refinance delinquent borrowers out of subprime products and into FHA-endorsed products. For

79. David Streitfeld & Louise Story, *FHA Problems Raising Concern of Policy Makers*, N.Y. TIMES, Oct. 8, 2009, at A1; *see also* ENGEL & MCCOY, *supra* note 51, at 136.
80. ENGEL & MCCOY, *supra* note 51, at 136.

example, the FHA Secure Program allowed subprime borrowers who defaulted on a mortgage immediately after their adjustable rate "reset" to a higher unsustainable rate to refinance into an FHA-insured mortgage.[81] HUD's Fiscal Year 2008 report to Congress indicated that 368,718 homeowners utilized the program by September 2008.[82] However, HUD terminated the program, established in September 2007, after only fifteen months, because "maintaining the program . . . would have a negative financial impact on the MMI Fund" threatening "the suspension of FHA's single family insurance programs altogether."[83]

Soon after, Congress authorized a similar program, Hope for Homeowners, to provide up to $300 billion in insurance obligations to delinquent subprime borrowers refinancing into FHA-insured loans.[84] Very few borrowers participated in the program,[85] even after Congress later permitted the FHA to increase the loan-to-value ratio requirements from 90% to 96.5%.[86] Government officials continued efforts to refinance subprime borrowers into FHA-insured loans over the next five years.[87] Like any insurance risk pool, a lack of participation actually meant the FHA was taking on more risk by endorsing only a subset of highly distressed loans. Lenders who did refinance using these programs needed to also write down significant portions of the remaining principal, a step lenders were unwilling to take if they could still recoup a portion of their losses.[88] As a result, the economics ensured an "adverse selection problem"—lenders would "retain loans with a higher expected recovery rate" and refinance loans into the

81. Courchane et al., *supra* note 60, at 1172.

82. FHA FY 2008 REPORT, *supra* note 77, at 8–9.

83. Paul Jackson, *HUD Kills FHA Secure*, HOUSING WIRE (Dec. 29, 2008) (quoting HUD MORTGAGEE LETTER 2008-41 announcing the termination of the FHA Secure program).

84. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1402.

85. Adam J. Levitin, *Resolving the Foreclosure Crisis: Modifications of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 634–35 (2009) (finding that Hope for Homeowners received only 312 applications by mid-December 2008 despite predictions it would help 400,000 homeowners).

86. Dina ElBoghdady, *HUD Chief Calls Aid on Mortgages a Failure; Congress Blamed for Shortcomings*, WASH. POST, Dec. 17, 2008, at A1.

87. Binyamin Appelbaum, *President to Offer Way for Easing Home Debt*, N.Y. TIMES, Jan. 25, 2012, at A20 (discussing legislation to expand FHA refinancing eligibility for many borrowers with privately held loans); Lynnley Browning, *Options for the 'Underwater'*, N.Y. TIMES, Mar. 13, 2011, at RE9 (discussing FHA's Short Refi program).

88. Levitin, *supra* note 85, at 635 (reporting that Hope for Homeowners "requires lenders to write down loans to a 85.5 percent LTV ratio based on a new, independent appraisal").

FHA portfolio only where the FHA would "be overpaying for bum loans."[89]

Second, the FHA also increasingly focused on insuring newly originated home purchase loans. In Fiscal Year 2008, the FHA endorsed 1.2 million purchase loans, almost three times the amount it had endorsed in Fiscal Year 2007.[90] The huge increase in FHA-insured originations served two broader purposes. First, federal officials believed the protection of government insurance for newly originated loans, even if the loans were risky, would help prevent the housing market from falling off a cliff in the immediate term.[91] Second, federal officials believed a higher volume of originations would help the FHA shore up its reserves because new borrowers had to pay premiums upon closing.[92]

The makeup of the new home purchase loans also helps explain why the FHA saw its default rates climb almost five years after its subprime competitors. For example, the FHA began insuring loans in more expensive markets after Congress temporarily doubled the maximum FHA loan limit in 2008 to $729,750,[93] permitting the FHA to move into higher cost, less distressed neighborhoods in New York City, Washington, D.C., and parts of California.[94] This change also helped provide an even larger cash infusion to the MMI Fund because premiums are calculated as a percentage of the loan's total value.

Congress and HUD also did not immediately scale back the relaxed underwriting standards and down-payment assistance programs that had been a source of many troubled FHA loans leading up to the foreclosure crisis. Congress only began to alter down payment requirements in mid-2008 when it increased the required payment from 3% to 3.5% of the value of the property and prohibited seller-financed down-payment assistance.[95] They also still insured "deep subprime"

89. *Id.*

90. FHA FY 2008 Report, *supra* note 77, at i ("In FY 2007, FHA endorsed about 425,000 single-family loans. In FY 2008, FHA endorsed over 1.2 million loans . . . .")

91. Streitfeld & Story, *supra* note 79 (reporting that Barney Frank, the Chairman of the House Financial Services Committee at the time, said this "was an effort to keep prices from falling too fast").

92. In fact, in terms of total cash, the MMI Fund's reserves increased by $125.5 billion in Fiscal Year 2008. FHA FY 2008 Report, *supra* note 77, at 4.

93. Congress repeatedly increased the FHA loan limit from its pre-crisis level. *See* American Recovery and Reinvestment Act, Pub. L. 111-5, § 1202 (2009); Economic Stimulus Act of 2008, Pub. L. 110-185, § 201; *see also* David Streitfeld, *With FHA Help, Easy Loans in Expensive Areas: Propping Up Prices, But at More Risk to Taxpayers*, N.Y. Times, Nov. 19, 2009, at B6.

94. FHA FY 2008 Report, *supra* note 77, at i.

95. Housing and Economic Recovery Act of 2008, Pub. L. 110-289, § 2112.

borrowers with credit scores as low as 580 and only required higher down payments for these borrowers beginning in 2010.[96] Moreover, the FHA was still struggling to enforce its lender standards despite the flood of bad actors from the subprime market into the FHA market.[97] As a result, the FHA's market share among home purchase loans continued to climb to a peak of "over 30 percent in the third quarter of fiscal year 2010"[98] but the credit-worthiness of borrowers, underwriting standards and lender practices ensured these loans were some of the riskiest in the FHA's portfolio. Meanwhile, even as the FHA doubled down on the housing market, the MMI Fund was continuing to pay out claims to lenders who were either offering loss mitigation tools or foreclosing on borrowers.

Though never on the brink of full insolvency like Fannie Mae and Freddie Mac, by 2012, as its default rate continued to climb, the FHA was in the most precarious financial position in its history. The MMI Fund's capital ratio was -1.44%, a staggering drop far below the statutory requirement that it remain above 2%.[99] The Fund's negative capital ratio did not mean the Fund itself was immediately insolvent. Still, a negative capital ratio of this magnitude gave rise to serious concerns that the Fund's reserves and future earnings would not be adequate to cover insurance claims for increasingly distressed loans. The drop in the capital ratio mostly reflected "projected losses . . . [that were] particularly large for the fiscal year 2006–2009 loans."[100] In terms of projected losses, the loans insured between 2006 and 2009 were the worst performing loans in the history of the FHA and eventually led to huge actual losses within the FHA's portfolio, as seen in Figure 3.[101]

96. Bob Tedeschi, *FHA Lending Standards Tightened*, N.Y. TIMES, Jan. 29, 2010, at RE7.

97. *See* Thomas, *supra* note 70.

98. FED. HOUS. ADMIN., U.S. DEP'T. OF HOUS. & URBAN DEV., FHA ANNUAL MANAGEMENT REPORT FISCAL YEAR 2012, at 12 (2012).

99. *Id.* at 6, 54. The capital ratio is the ratio of the Fund's capital to its risks—here the total obligations. *Id.* at 6–7.

100. *Id.* at 6–7.

101. John Griffith, *The Federal Housing Administration Saved the Housing Market*, CTR. FOR AM. PROGRESS (Oct. 11, 2012), https://www.americanprogress.org/issues/economy/reports/2012/10/11/40824/the-federal-housing-administration-saved-the-housing-market/ ("The 2008 book of business alone accounts for about $11 billion of those losses, making it the worst book in the agency's history by just about any metric.").

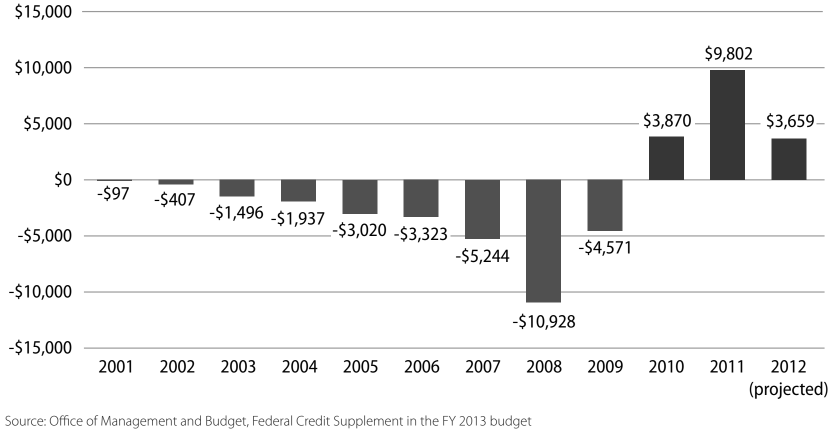


FIGURE 3

The FHA's role in the immediate aftermath of the foreclosure crisis—acting as a backstop for the rapidly deteriorating housing market by refinancing subprime borrowers and dramatically increasing the volume of endorsements of new home purchase loans—is defended by some economists. Jared Bernstein, an economist who worked in the Obama administration, while acknowledging the FHA "exposed itself . . . to greater risk," also concluded it was a critical "countercyclical" force that "helped stave off more foreclosures and even sharper declines in home prices."[102] The Center for American Progress also cited data from Moody's Analytics finding that the FHA's intervention "prevented home prices from dropping an additional 25 percent."[103]

By the end of 2012, federal officials began actively considering bailing out the FHA with taxpayer funding.[104] By 2013, the Obama administration's proposed Fiscal Year 2014 budget estimated that the FHA would need to draw approximately $943 million from the treasury to bolster its reserves in anticipation of additional claims to meet it statutorily required capital ratio.[105] The infusion of additional resources was required despite Congress having authorized various in-

102. Jared Bernstein, *The FHA's Countercyclical Contribution*, N.Y. TIMES: ECONOMIX BLOG (Dec. 16, 2013, 8:15 AM), https://economix.blogs.nytimes.com/2013/12/16/the-f-h-a-s-countercyclical-contribution/?mcubz=0&_r=0.

103. Griffith, *supra* note 101.

104. Annie Lowrey, *FHA Hopes to Avoid a Bailout by Treasury: Agency Will Raise Fees, Sell Some Loans and Try to Stanch Mortgage Losses*, N.Y. TIMES, Nov. 17, 2012, at B3.

105. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 2014 app. at 577 (2013).

creases to the up-front and annual premiums beginning in 2009.[106] Finally, by September 2013, the FHA needed its first ever infusion of taxpayer resources, totaling $1.7 billion.[107]

E. Unwinding the FHA's Portfolio of Delinquent Loans

Faced with rising delinquency rates and dwindling reserves, the government made a series of additional strategic choices as it sought to divest itself of delinquent loans. The FHA had three options when dealing with its increasing portfolio of delinquent loans. First, HUD could provide lenders insurance benefits from the MMI Fund to finance loss mitigation actions that would help borrowers avoid foreclosure.[108] Second, HUD could take assignment of the loan, though upon holding the loan the government could not work with borrowers on its own to mitigate losses.[109] Third, lenders could foreclose on the loan or use a "deed-in-lieu" transaction, triggering conveyance of title to the property to HUD after the government paid out insurance benefits to the lender.[110]

In keeping with its policy goal to serve as a countercyclical force during the initial stages of the crisis and to act as a bulwark for the nation's housing market, the FHA hoped to encourage lenders to avoid the third legal option—foreclosures. Indeed, as Figure 4 demonstrates, foreclosure starts for FHA-insured loans only began to spike in 2012, and were kept relatively stable throughout the crisis even though default rates for FHA-insured loans increased dramatically beginning in 2010.[111]

106. *See, e.g.*, Temporary Payroll Tax Cut Continuation Act of 2011, Pub. L. No. 112-78, § 402, 125 Stat. 1280, 1289 (2011); Pub. L. 111-229, 124 Stat. 2483 (2010); Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 2114, 122 Stat. 2654, 2832.
107. *See* ElBoghdady, *supra* note 86.
108. 12 U.S.C.A. § 1710(a)(2) (2009); 24 C.F.R. § 203.501 (West 2016) (outlining potential "appropriate actions" that would mitigate losses to HUD).
109. § 1710(a)(1)(A) & (D); Pub. L. No. 105-276, § 601(9), 112 Stat. 2461, 2673 (1998).
110. § 1710(a)(1)(B)–(C).
111. For default rates, see *supra* Figure 2 and Bill McBride, *LPS: Foreclosure Sales Declines in April, FHA Foreclosure Starts Increased Sharply*, CalculatedRISK (May 31, 2012, 8:00 PM), http://www.calculatedriskblog.com/2012/05/lps-foreclosures-sales-declined-in.html.

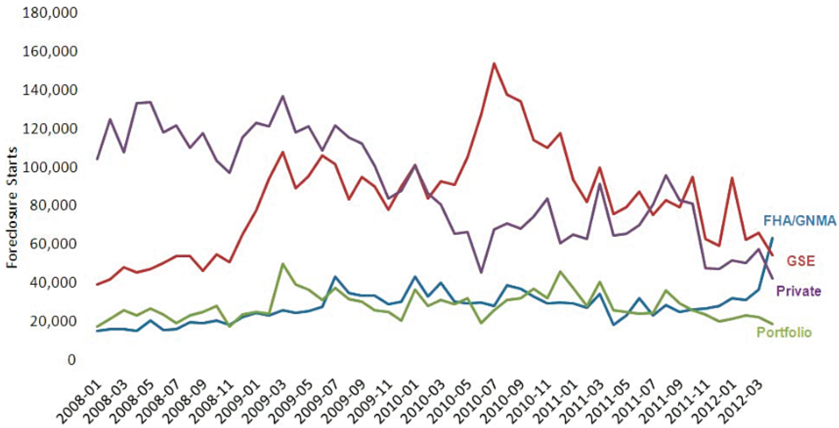


FIGURE 4

Instead, the FHA used a combination of its two other options—lender initiated loss mitigation efforts and HUD accepting direct assignment of the mortgage—to handle the dramatic increase in delinquent loans. Under the government's loss mitigation procedures, lenders were required to "take appropriate actions which can reasonably be expected to generate the smallest financial loss to the Department"[112] and to negotiate with borrowers in default for at least ninety days.[113] HUD regulations outlined several potential loss mitigation actions available to lenders including pre-foreclosure sales,[114] partial claims,[115] assumptions,[116] special forbearance[117] and mortgage modifications.[118] Pre-foreclosure sales[119] and assumptions[120] were largely economically infeasible during the housing downturn. In addition, under its prior authority for paying out partial claims[121] and special

112. 24 C.F.R. § 203.501 (2016).

113. *Loss Mitigation*, U.S. DEP'T OF HOUS. & URBAN DEV., http://portal.hud.gov/hudportal/HUD?src=/Hudprograms/loss_mitigation (last visited Nov. 26, 2017).

114. 24 C.F.R. § 203.370 (2016).

115. *Id.* § 203.414.

116. *Id.* § 203.512.

117. *Id.* § 203.471 & § 203.614.

118. *Id.* § 203.616.

119. Under any pre-foreclosure sale of an FHA-insured property, the lender had to purchase the property "at its current fair market value." *Id.* § 203.370. Because property values suffered during the downturn, lenders were mostly unwilling to purchase loans pre-foreclosure because they would need to write down huge portions of the remaining principal when the amount of remaining debt far exceeded the property's value upon default.

120. Put simply, in a historic downturn, very few potential borrowers were willing to assume delinquent FHA-insured loans with the full remaining principal.

121. Lenders could seek up to twelve months of "arrearage" or unpaid debt. *Id.* § 203.414. Though an attractive option for many lenders, FHA had "a high volume of

forbearance actions,[122] the FHA could provide only temporary relief to severely delinquent borrowers.

Therefore, Congress authorized a separate two-step process incorporating both lender mitigation and HUD assignment when they extended the Home Affordable Modification Program (HAMP) to FHA loans.[123] First, delinquent FHA-insured borrowers and their lenders could privately agree to loan modifications in the short-term. Then, lenders could subsequently assign the loan to HUD. Under HAMP, the FHA could pay out "partial claims" from the MMI Fund that would both satisfy any delinquent debt and compensate lenders who modified the loan's amortization period or the interest rate.[124] In other words, the FHA could pay out insurance benefits through partial claims that would both bring the loan current and modify its terms in an effort to reduce monthly payments.

The legislation also expanded HUD's assignment authority so the government could take assignment of a mortgage in order to "encourage loan modifications."[125] Still, assignment to HUD remained contingent on the borrower, who was previously "facing imminent default," having "modified the mortgage to cure the default" in the short term, while maintaining "the reasonable ability . . . to pay" the remaining obligations in the long-term.[126] FHA-HAMP was conceived as a program where the use of an expanded partial claims authority to modify loan terms ensured conditions for assignment could be satisfied.

Still, FHA-HAMP, like the HAMP program broadly, imposed real risks on the government. First, this subset of previously delinquent borrowers remained highly risky, so accepting assignment of the loans posed a real long-term financial risk for the government. Indeed,

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missing partial claim documents due to mortgagees' failures to comply with HUD's procedures." U.S. DEP'T OF HOUS. & URBAN DEV., MORTGAGEE LETTER 2013-19 (2013).

122. Where default is "beyond the mortgagor's control as defined by HUD," the lender can forbear or refrain from collecting monthly payments. § 203.471 & § 203.614. This option primarily applied to borrowers who were unemployed. The forbearance period was initially four months until it was increased to last up to twelve months in July 2011. Press Release, U.S. Dep't of Hous. & Urban Dev., Obama Administration Offers Additional Mortgage Relief to Unemployed Homeowners (July 7, 2011), https://archives.hud.gov/news/2011/pr11-139.cfm.

123. Helping Families Save Their Homes Act, Pub. L. No. 111–22, § 203, 123 Stat. 1632 (2009) (amending 12 U.S.C. § 1715 (2006)).

124. *Id.* § 203(d).

125. *Id.*

126. 12 U.S.C. § 1715u(c)(B) (2012).

borrowers remained at serious risk for re-default and foreclosure.[127] Second, HUD incurred a series of costs when it needed to pay contractors to service modified loans and manage disposition efforts. Indeed, HUD had already experienced the impact of these costs in other contexts. In Fiscal Year 2012, to service and manage the disposition of foreclosed real-estate-owned (REO) properties, HUD found that "property management and marketing costs associated with the disposition of homes conveyed to typically cost approximately 12 percent of property values and thus increase the severity of loss for FHA."[128]

In summary, the FHA's strategy for protecting delinquent borrowers relied heavily on paying out partial claims to lenders to finance short-term loan modifications, at which point the lenders could assign the loan to HUD. This process had real advantages. All parties could avoid foreclosure, the FHA could reduce the number of claims on the MMI Fund because it paid out only partial claims rather than full claims equivalent to the entire unpaid principal balance, and certain borrowers could temporarily remain in their homes. Between Fiscal Years 2012 and 2014, hundreds of thousands of loans were assigned to HUD through the FHA-HAMP program.[129]

Still, from HUD's perspective, three major issues remained. First, many severely distressed borrowers simply could not qualify for FHA-HAMP.[130] Second, the primary legal option available to unwind these loans—foreclosure—was both disfavored as a matter of government policy,[131] and lenders delayed entering the process.[132] Importantly,

127. Jon Prior, *30% of FHA Mortgage Modifications Redefault Within a Year*, HOUSINGWIRE (Nov. 18, 2011), https://www.housingwire.com/articles/15055-30-fha-mortgage-modifications-redefault-within-year.

128. U.S. DEP'T OF HOUS. & URBAN DEV., ANNUAL REPORT TO CONGRESS FISCAL YEAR 2012 FINANCIAL STATUS FHA MUTUAL MORTGAGE INSURANCE FUND 29 (2012).

129. FED. HOUS. ADMIN., U.S. DEP'T OF HOUS. & URBAN DEV., FHA ANNUAL MANAGEMENT REPORT FISCAL YEAR 2014, at 24 (2014) [hereinafter FHA FY 2014 REPORT] ("Outstanding Single Family Notes partial claims increased by 91 percent from 168,394 notes at the end of fiscal year 2013, to 321,532 at the end of fiscal year 2014. The increase is primarily due to the FHA Home Affordable Modification Program (HAMP), which combines a partial claim with a loan modification.").

130. In part, this is because many severely distressed borrowers were unable to meet the requirement that forty percent of their monthly income be sufficient to cover a modified loan. *See, e.g.*, JOSEPH REBELLA, MFY LEGAL SERVS., INC., THE FHA WATERFALL WORKSHEET: A USER'S GUIDE 11 (2014).

131. FHA FY 2014 REPORT, *supra* note 129, at 8 (noting a desire to "avoid foreclosure" as an "Agency Priority Goal" for the FHA).

132. Servicers tend to claim foreclosure delays were due to "new state laws that made foreclosure more time-consuming" or "ramped-up efforts to help borrowers." GEOFF WALSH, NAT'L CONSUMER LAW CENT., OPPORTUNITY DENIED: HOW HUD'S NOTE SALE PROGRAM DEPRIVES HOMEOWNERS OF THE BASIC BENEFITS OF THEIR

these delays were also imposing real costs on the FHA, which was reimbursing servicers for fees arising from those delays when they paid out claims.[133] Finally, government officials needed to both avoid the enormous default risks and shed the holding costs associated with managing the thousands of loans it now held pursuant to assignment agreements. HUD therefore fashioned a "third step" in the process to avoid being the holder of any mortgages for longer periods and to offload severely distressed loans that both could not qualify for FHA-HAMP and needed to avoid the foreclosure process. The FHA's solution was the Distressed Asset Stabilization Program.

II.
THE DISTRESSED ASSET STABILIZATION PROGRAM

Part II of this Note discusses the Distressed Asset Stabilization Program. First, it discusses the program's history, its emergence as HUD's primary tool for liquidating delinquent FHA-insured mortgages, and its basic legal structure. Second, it discusses specific aspects of the program, including the bidding process and "post-sale" restrictions in more detail.

A. DASP: Background and History

The Single-Family Loan Sale (SFLS) Program was first established as a pilot in 2010.[134] Using changes to its statutory authority initiated in 1998 and discussed in Part I of this Note, the program allows HUD to accept assignment of a distressed mortgage prior to foreclosure after payment of a partial claim.[135] HUD then pools the distressed loans into one financial instrument and sells each pool after a sealed bid auction process. Prior to the bidding process, qualified purchasers must gain FHA approval and meet other net worth requirements. During the bidding process, HUD calculates a reserve price evaluating the underlying properties' fair market value, and the government assesses bids against that reserve price.

GOVERNMENT-INSURED LOANS 4 (2016). Others argue delays arose after "attention focused on 'mortgage servicers' systematic mishandling of foreclosure proceedings." *Id.* at 21. Indeed, most delays occurred in judicial foreclosure states where courts tended to heavily scrutinize missing loan documents and title companies threatened to not recognize lenders' title as valid upon foreclosure. *Id.* at 24.

133. OFFICE OF INSPECTOR GEN., U.S. DEP'T OF HOUS. & URBAN DEV., 2017-KC-0001, SINGLE-FAMILY MORTGAGE INSURANCE CLAIMS (2016).

134. FED. HOUS. ADMIN., U.S. DEP'T OF HOUS. & URBAN DEV., REPORT TO THE COMMISSIONER ON FHA SINGLE FAMILY LOAN SALES 2 (2015) [hereinafter SINGLE FAMILY LOAN SALES REPORT].

135. 12 U.S.C.A. § 1710(a)(1)(A) & (D) (West 2016).

Purchasers of the loans are bound by a "Conveyance, Assignment and Assumption Agreement" to a set of "post-sale requirements" that generally require semi-annual purchaser reporting, a brief foreclosure moratorium, and other affirmative obligations.[136] Importantly, once a loan is sold, FHA insurance is removed from the loan because insurance benefits are paid on the claim. In addition, to benefit the MMI Fund, proceeds from the sales are used to "rebuild" the FHA's reserves, and the "clearing of long foreclosure queues" reduces the Fund's exposure to risks associated with paying out more expensive claims that incorporate costs from delayed foreclosures.[137] From 2010 to 2012 "[a]pproximately 2,000 loans totaling $387 million in unpaid principal balance were sold."[138]

By 2012, as the FHA faced escalating defaults, HUD dramatically ramped up and amended its note sales program and renamed it the Distressed Asset Stabilization Program (DASP). DASP bifurcated the program and established two types of "pools" for loans—"national pools" and "Neighborhood Stabilization Outcome" (NSO) pools.[139] National pools tend to include anywhere from 300 to 1,000 delinquent loans from a wide range of states.[140] HUD also imposes fewer post-sale restrictions on investors who purchase national pools.[141] Indeed, aside from servicing and reporting requirements, an agreement to avoid foreclosure for a limited period of time is the only requirement for buyers of national pool loans.[142]

NSO pools include loans in "limited geographic areas" and impose more detailed post-sale servicing requirements and penalties for non-compliance. NSO pools tend to be populated with loans from

136. *See* U.S. Dep't of Hous. & Urban Dev., Single Family Loan Sale 2012-3: Conveyance, Assignment and Assumption Agreement [hereinafter Single Family Loan Sale 2012-3].

137. FHA FY 2014 Report, *supra* note 129, at 25, 98–99.

138. Single Family Loan Sales Report, *supra* note 134, at 4.

139. *Id.* at 5.

140. *See, e.g.*, Fed. Hous. Admin., U.S. Dep't of Hous. & Urban Dev., Single Family Loan Sale 2016-1 Sales Results Summary (2015) [hereinafter Single Family Loan Sale Summary].

141. *Compare* Single Family Loan Sale 2012-3, *supra* note 136 (providing the post-sale reporting requirements for national pool transactions), *with* U.S. Dep't of Hous. & Urban Dev., Agreement Neighborhood Stabilization Outcome Target Pool Mortgage Loan Rider (providing additional requirements for neighborhood stabilization transactions).

142. Single Family Loan Sale 2012-3, *supra* note 136, at 15 ("The Purchaser(s) shall be required to avoid finalizing any foreclosure action for six months from the applicable Settlement Date for each Mortgage Loan that is owner occupied unless there are extenuating circumstances."). Note that the requirement that purchasers suspend foreclosures was expanded from six months initially to a full year requirement in 2015.

states that use judicial foreclosure, in part because ongoing "robo-signing"[143] litigation had caused long delays which increased the risk of larger claims against the MMI Fund.[144] Investors purchasing NSO pools must achieve "neighborhood stabilizing outcomes" including "re-performance, rental to a borrower, sale to an owner occupant, gift to a land bank, a loan payoff" or transfers to non-profits for at least fifty percent of the loans from a given pool.[145] If more than fifty percent of the loan outcomes are not "neighborhood stabilizing," penalties including remittances of foreclosure sale proceeds are triggered.[146]

By the end of 2015, 105,519 loans totaling $17.9 billion in unpaid principal had been sold by the FHA.[147] In Fiscal Year 2014 alone, HUD sold more than 66,000 loans under DASP.[148] As a comparison point, in August 2014, the FHA's inventory of "Single Family Real Estate Owned (REO)" properties that had gone through a traditional foreclosure process and been conveyed to HUD but were awaiting disposition was at a "historic low" of 18,945 properties.[149]

After considerable criticism from Democrats in Congress,[150] HUD tweaked the program in June 2016. Specifically, HUD further regulated which modifications investors were required to offer post-sale, altered procedures for notifying borrowers regarding the potential sale of their loan, and attempted to prioritize sales to local government and non-profit bidders.[151]

In the end, DASP signaled a purposeful shift in how the FHA would handle delinquent loans. In the past, the FHA had regulated mitigation efforts and, once those were exhausted, proceeded through

143. *See infra* note 201 and accompanying text.

144. Walsh, *supra* note 132, at 28. Indeed, Florida, New Jersey, Illinois, New York, and Ohio, all of which utilize judicial foreclosure, are the top five states with loans sold under the Distressed Asset Stabilization Program (DASP). SINGLE FAMILY LOAN SALES REPORT, *supra* note 134, at 7.

145. SINGLE FAMILY LOAN SALES REPORT, *supra* note 134, at 5.

146. Laurie Goodman, Director, Hous. Fin. Pol'y Ctr., Urb. Inst., et al., Joint Presentation by the Urban Institute & Core Logic, HUD & GSE Nonperforming Loan Sales: Are Further Improvements Necessary? (May 18, 2016).

147. FHA FY 2014 REPORT, *supra* note 129, at 67.

148. *Id.*

149. *Id.*

150. *See, e.g.*, Press Release, Senate Banking Comm., Brown, Cummings Press HUD for Information on Protections for Vulnerable Homeowners (Feb. 1, 2016), https://www.brown.senate.gov/newsroom/press/release/brown-cummings-press-hud-for-information-on-protections-for-vulnerable-homeowners.

151. U.S. DEP'T OF HOUS. & URBAN DEV., FACT SHEET: DISTRESSED ASSET STABILIZATION PROGRAM ENHANCEMENTS [hereinafter DASP FACT SHEET] (listing changes to DASP).

the state foreclosure process prior to conveyance to the government and the payment of claims. Instead, DASP deferred to new, private investors who negotiated loan modifications and other foreclosure alternatives while the FHA was purposefully avoiding the lengthy judicial foreclosure process. In HUD's view, DASP served two goals— "to maximize recoveries to the MMI Fund and, when possible, help borrowers avoid foreclosure."[152] The next two sections focus on the extent to which HUD achieved each of these goals.

B. The Bidding Process and Maximizing Taxpayer Recovery

The government claims DASP was designed to "maximize recoveries" to the FHA's reserves by selling delinquent loans prior to foreclosure so that HUD could avoid "claim, holding and sales costs" associated with the REO process.[153] In other words, HUD believed that the traditional foreclosure process led to more expensive insurance claims due to costs associated with holding and disposing of the property after conveyance to the government that were not incurred by HUD under DASP. Using HUD's data and a set of other assumptions, the Urban Institute confirmed HUD's hypothesis by comparing the average "loss rates" of loans under the two disposition programs. The Urban Institute found losses incurred by the MMI Fund for loans sold under DASP were eight percent lower than the traditional foreclosure and REO disposition process.[154] Of course, one of the reasons the foreclosure process remained more expensive than DASP was HUD's own failure to adequately police deadlines and hold lenders purposefully delaying the process accountable.[155]

The goal of the program, however, was to *maximize* recoveries for the reserve fund, not to simply outperform the foreclosure disposition process. Therefore, the amount raised at DASP auctions relative to post-DASP foreclosures may be the key variable, besides costs of holding and sales of the property. This Section reviews the bidding process and focuses on the limited number of investors who tend to purchase pools of delinquent loans under DASP. Because a limited number of firms dominate this consolidated market, the market-clearing price that purchasers pay for DASP loans might be inadequate relative to the fair market value of the underlying properties. Together, these conclusions demonstrate that the program's design ensures HUD

152. LAURIE GOODMAN & DAN MAGDER, URBAN INST., SELLING HUD'S NONPERFORMING LOANS 3 (2016).
153. *Id.* at 4.
154. *Id.* at 4.
155. *See generally* OFFICE OF INSPECTOR GEN., *supra* note 133.

might not be maximizing taxpayer recoveries. Instead, DASP tends to increase the returns of private investors. In the end, the traditional disposition process might have been more advantageous to taxpayers if the government had exercised some patience.

Like any attempt to dispose government property assets to private investors, "attracting too few bidders can cause inefficiently low bids" and the presence of a "dominant firm can dissuade other bidders from entering."[156] In addition, if the costs of entering the auction or winning the property is high, the problem of too few bidders can be especially acute.[157] In this case, the costs of entry are quite high—investors seeking delinquent loans must have the capital not only to bid on the asset itself, but also to hold the asset and pay to service the loan or foreclose on the property on the back-end if they indeed provide the winning bid.

As a result, only a few dominant firms have entered the market for non-performing loans. Indeed, four firms—Lone Star Funds, Bayview Asset Management, The Corona Group, and Oaktree Capital Management—account for approximately fifty-two percent of the total number of loans sold since the program's inception.[158] Some of these firms have further consolidated their dominance as the program has expanded, in part because the number of loans in each pool has grown, making the total cost of an individual bid more expensive. For example, in one sale in November 2015, Bayview alone provided the winning bid for seventeen of the twenty-one pools of loans for which they were qualified to bid.[159]

In addition, many of these funds or their staff have a long history investing in single-family residential mortgages and other forms of housing, including during the lead up to the foreclosure crisis. Bayview is minority-owned by The Blackstone Group, "the nation's largest private landlord of rental houses."[160] Lone Star services assets through a subsidiary, Caliber Home Loans, whose senior leadership, when the fund was most active in DASP, had helped lead Country-

156. Owen M. Kendler, Comment, *Auction Theory Can Complement Competition Law: Preventing Collusion in Europe's 3G Spectrum Allocation*, 23 U. PA. J. INT'L ECON. L. 153, 174–75 (2002).

157. *Id.* at 175–76

158. FED HOUS. ADMIN., U.S. DEP'T OF HOUS. & URBAN DEV., REPORT TO THE COMMISSIONER ON POST-SALE REPORTING: FHA SINGLE FAMILY LOAN SALE PROGRAM 8 (2016) [hereinafter SINGLE FAMILY POST-SALE REPORT].

159. SINGLE FAMILY LOAN SALE SUMMARY, *supra* note 140, at 1–5.

160. Matthew Goldstein, Rachel Abrams & Ben Protess, *How Housing's New Players Spiraled into Banks' Old Mistakes*, N.Y. TIMES, June 26, 2016, at A1.

wide Financial[161]—one of the worst originators of subprime products leading up to the crisis and a company that had been sued by the federal government for violating the Fair Housing Act.[162] Efforts to include not-for-profits and local governments in the bidding process to reduce the dominance of private firms with targeted pools and training have, so far, been largely unsuccessful.[163]

In part because of the limited number of investor participants, winning bids also tend to be dramatically lower than HUD's own assessment of the "reserve price" or the current, fair market value of the properties securing the delinquent loans. For each pool, brokers evaluate the underlying properties to assign a "broker price opinion" (BPO) value that represents the "as is" value of the combined properties if they were sold within ninety days.[164] In November 2015, most winning bids were only approximately fifty-five to sixty-five percent of the BPO values of the loans. The Urban Institute argues the "discount" between the fair market values of the underlying properties and the value of the DASP purchase price represents the value of the risk to investors associated with servicing costs and a potentially lengthy foreclosure process that, by the terms of the sale itself, could not be initiated within the ninety-day window embedded in the BPO value.[165]

Of course, the overall "discount" amount cannot be fully accounted for using valuations of potential foreclosure or servicing expenses. Therefore, the Urban Institute further concludes that the discount, and the subsequent high rate of return received by these in-

161. Lone Star purchased most of its delinquent loans in 2014, when its CEO, CFO, COO, and Executive VP for Operations had all formerly worked for Countrywide. *Compare* SINGLE FAMILY LOAN SALES REPORT, *supra* note 134, at 8 (citing 17,066 national pool loans purchased by Lone Star as of February 2015), *with* Single Family Post-Sale Report, *supra* note 158 (citing that Lone Star had purchased 18,131 national pool loans as of January 2016); *see also* ELLIOT MALLEN, UNITE HERE, IS LONE STAR FUNDS BUILDING A NEW COUNTRYWIDE FINANCIAL? (2015) (drawing parallels between the two companies).

162. United States v. Countrywide Fin. Corp., No. 2:11-cv-10540, 2011 U.S. Dist. LEXIS 150263, at *2 (C.D. Cal. Dec. 23, 2011) (noting that in 2006 the Federal Reserve Board determined it had reason to believe that Countrywide was violating the Fair Housing Act).

163. *See, e.g.*, FED. HOUS. ADMIN., U.S. DEP'T OF HOUS. & URBAN DEV., SINGLE FAMILY LOAN SALE 2016-2 SALES RESULTS SUMMARY 3–21 (2015) (showing that three of the five "non-profit only" pools were not awarded due to a lack of bidders and the two successful non-profit bidders purchased the loan at an even steeper discount than their private counterparts).

164. *Id.* at 1–4.

165. *See* GOODMAN & MAGDER, *supra* note 152, at 12.

vestors, is simply the "price policymakers pay to tap into the capital . . . and expertise of the investors."[166]

HUD and the Urban Institute essentially argue that, despite this heavy discount, the market-clearing bidding prices remain a better option to save taxpayer money and maximize recoveries for the MMI Fund when compared to HUD's traditional REO disposition process. That argument, with more data, might unravel easily and certainly several questions for future economic research remain. First, the suggestion that the discount represents the cost of foreclosure directly contradicts one of the central rationales of the program. Allowing taxpayers to *avoid* the foreclosure and servicing costs associated with a lengthy process was one of the purposes of the program.[167] If, instead, the foreclosure and servicing costs are jointly *priced into* the private investor's bid then taxpayers' never gain this advantage from DASP's alternative disposition process. Moreover, unlike an REO disposition process, the need to provide private investors with a healthy rate of return is also priced into the bid.

Two additional questions also warrant further economic analysis. First, with some patience and capital, taxpayers and HUD might have been able to secure the full fair market value of the property at a foreclosure sale rather than fifty-five to sixty-five percent of that value through a pre-foreclosure bidding process. Second, analysts might compare expenses incurred by the FHA associated with DASP relative to the traditional full foreclosure process. For example, HUD might have also avoided the new costs associated with administering DASP[168] and avoided the extra costs associated with providing private investors a discount sufficient to gain a healthy return. Importantly, under both disposition options, HUD seems to incur at least some foreclosure or servicing costs—under DASP those costs are simply priced into the private bid whereas in the REO disposition process they are paid out directly.

In the end, though some "discount" is likely necessary to attract private capital, the bidding process is unquestionably dominated by only a few investors. Thus, the market clearing price for winning bids might be highly favorable for those investors compared to a hypothetical, more competitive market. Finally, DASP is therefore potentially failing to secure the full value of the assets it's selling during the dis-

166. *Id.*

167. *Id.* at 3.

168. A private contractor, Verdi Asset Sales, administers the bidding process and, one can assume, also makes a profit on the contract. *See About Us*, VERDI ASSET SALES, http://www.verdiassetsales.com/?page_id=27 (last visited Feb. 9, 2017).

position process, ensuring it fails to meet the goal of maximizing recoveries to the MMI Fund over time, and may not even compare favorably to the potential recoveries under a traditional REO disposition process.

C. Impacts on Borrowers and the Adequacy of Post-Sale Requirements

The government claims the program was designed as a borrower-friendly alternative because the program ensures highly delinquent borrowers temporarily avoid foreclosure and instead might take advantage of a more flexible negotiation for loan mitigation alternatives.[169] Still, the sale of a loan under DASP imposes serious consequences on borrowers. FHA-insured borrowers have the right to be considered for various mitigation options prior to foreclosure.[170] Once a borrower exits the FHA program after a DASP sale, HUD guidelines regulating loss mitigation options no longer apply. HUD claims borrowers impacted by DASP are severely delinquent, "headed to foreclosure," and have already exhausted all available "FHA prescribed loss mitigation" options.[171]

News accounts, however, have reported that many borrowers were still negotiating loan modifications with their original servicer when their loan was sold under DASP.[172] In part, this confusion reflects troubling timing issues. After all, FHA defaults began to spike in 2010.[173] However, the FHA revised its loss mitigation guidelines, including FHA-HAMP, in 2012 to make the tools more generous to

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169. *See infra* Section II.B.
170. *See supra* notes 112–122 and accompanying text.
171. SINGLE FAMILY POST-SALE REPORT, *supra* note 158, at 1.
172. *See, e.g.*, Jared Bennett, *The Government Is Selling Thousands of Homes to Hedge Funds Without Their Owners' Knowledge*, ATLANTIC (Sept. 23, 2015), https://www.theatlantic.com/business/archive/2015/09/the-government-is-selling-thousands-of-homes-to-hedge-funds-without-their-owners-knowledge/406771/ (reporting the story of a man whose loan was sold under DASP even though his original servicer, Bank of America, acknowledged receiving a "signed agreement needed to finalize the modification" of his loan); Matthew Goldstein, *As Banks Retreat, Private Equity Rushes to Buy Troubled Home Mortgages*, N.Y. TIMES, Sept. 29, 2015, at A1 (reporting the story of a family in Ohio that was "working with JP Morgan Chase on a loan modification when their mortgage was sold to Lone Star" in a DASP auction); Jessica Silver-Greenberg & Michael Corkery, *Sale of Federal Mortgages to Investors Puts Greater Burden on Blacks, Suit Says*, N.Y. TIMES, Aug. 15, 2016, at A15 (reporting the story of a man who had "been working with a servicing company to get a modification but was caught by surprise when his mortgage was sold to a private investor").
173. *See* Demyanyk & Kolliner, *supra* note 61 (showing default rates over time).

borrowers.[174] The revisions were promulgated at around the same time DASP was expanded.[175] Some original FHA servicers were then assessing delinquent borrowers for modifications under the new guidelines while also initiating sales under DASP arguing they had exhausted tools available under the old guidelines.[176]

Some additional process might have also helped solve this problem. HUD does not require that the original servicer, or the FHA, provide notice to the borrower when they plan to sell their loan using DASP.[177] As a result, borrowers are not told they will be terminated from the FHA program until after the sale has occurred.[178] During the foreclosure crisis, a lack of transparency within the mortgage transfer system and the failure to put borrowers on notice regarding which parties owned their loan was frequently cited as a real problem for homeowners seeking to utilize modification tools.[179] In this case, some of the confusion regarding whether a borrower had actually "exhausted" all of the available FHA mitigation tools might stem from borrowers' not receiving adequate notice that their relationship with the original servicer and the FHA had terminated. Indeed, borrowers were then unable to object to a sale if they were still negotiating with the original servicer.[180]

Still, in HUD's view, selling the loan to a new servicer and "removing the requirements associated with FHA insurance" helped "provide servicers a wider range of loss mitigation options."[181] HUD essentially believed the new lenders, after purchasing the loans for a price significantly lower than the unpaid principal during the bidding process, might be more willing to agree to principal reductions. On the other hand, FHA loss mitigation "requirements" were designed to protect borrowers from accepting unfair terms that diverged from the program's original mission. Indeed, the eventual modification offers made available to borrowers by private investors make clear why the FHA had previously regulated the process.

174. *See* WALSH, *supra* note 132, at 30 (citing new formulas that permitted substantial reductions in monthly payments so that borrowers would only pay twenty-five percent of their monthly income).
175. *See* FHA FY 2014 REPORT, *supra* note 129 and accompanying text.
176. *See* Walsh, *supra* note 132, at 30.
177. *See id.* at 11–12.
178. *See id.*
179. *See, e.g.*, Merscorp, Inc. v. Romaine, 861 N.E.2d 81, 88 (N.Y. 2006) (Kaye, C.J., dissenting) (citing "lack of disclosure" of a transfer in the public record for creating "substantial difficulty when a homeowner wishes to negotiate the terms of his or her mortgage").
180. *See* WALSH, *supra* note 132, at 12.
181. SINGLE FAMILY POST-SALE REPORT, *supra* note 158, at 4.

Lone Star Funds, the largest purchaser of DASP loans, essentially offers via their form agreement a version of an adjustable rate, subprime product as a modification. During a five year "Reduction Period" borrowers can temporarily secure a lower or teaser interest rate and make lower monthly "interest only" payments.[182] Lone Star was not offering a reduction in the overall loan principal so that, after the Reduction Period, the "interest rate will revert[,] . . . your payment may increase," and the lender has the right to adjust payments to collect the remaining principal.[183] Finally, after the Reduction Period, the servicer is no longer bound by the twelve-month foreclosure moratorium required under the terms of the DASP sale. Many servicers utilized this model with even shorter one-year teaser periods. This framework had the advantage of providing lenders' some capital in the form of monthly payments while securing enough time to satisfy the foreclosure moratorium without providing any real relief to borrowers. For one borrower, a DASP servicer offered a temporary reduction in the interest rate but would have required a $30,342 balloon payment at the end of the term.[184] HUD's own data bears out this trend. Indeed, "rate reductions" were by far the most common modification type, while only approximately thirty-eight percent of the modifications forgave any principal.[185]

Moreover, if borrowers falter under the modified terms of the loan, these investors often provide very limited protections. Bayview is the second largest purchaser of DASP loans. Under the terms of their form modification agreement, if the homeowner defaults on a *single* payment, they must give up the property "immediately through a deed-in-lieu of foreclosure or short sale"[186] even though many DASP borrowers live in judicial foreclosure states. Ironically, these same borrowers had paid higher premiums because the guarantee of FHA insurance, for decades, helped lenders provide favorable terms like full amortization, a fixed interest rate and consistent monthly payments. Then, when loans were delinquent, the FHA and private investors were essentially stripping those benefits from borrowers through the operation of DASP.

HUD's recent changes to DASP in June 2016 attempted to police these abuses. Now, post-sale, investors must first "consider offering"

182. WALSH, *supra* note 132, at 35.
183. *Id.*
184. Silver-Greenberg & Corkery, *supra* note 172.
185. FED HOUS. ADMIN., U.S. DEP'T OF HOUS. & URBAN DEV., REPORT TO THE COMMISSIONER ON POST SALE REPORTING: FHA SINGLE FAMILY LOAN SALE PROGRAM OCTOBER 2016 REPORT 13 (2016).
186. WALSH, *supra* note 132, at 35.

principal forgiveness to borrowers.[187] The new servicer is under no actual obligation to reduce principal in line with the investors' purchase price. They are only obligated to "consider" principal reduction. In addition, new servicers cannot increase the interest rate for the first five years.[188] After the five-year period, lenders then can only increase the interest rate by one percent per year.[189] These changes, however, largely fail to adequately prevent the predatory terms offered by Lone Star and others. After all, Lone Star was already offering a *lower* "teaser" interest rate for a five-year period while HUD's changes require only that servicers *not increase* borrowers' rates for that same period of time.[190] In other words, companies like Lone Star were already in compliance with portions of the new modification requirements. Still, the changes provide some relief to borrowers to the extent the interest rate can no longer immediately revert back to the original rate and instead servicers must steadily increase the interest rate by only one percent each year.[191]

Most importantly, the vast majority of DASP borrowers never even secure a loan modification and most still lose their home. If a borrower agrees to a modification, HUD classifies the loan as "re-performing with loan modification" for the purposes of post-sale reporting.[192] As of January 2016, only 9.9% of the total loans sold under DASP fit into this category.[193] On the other hand, more than 34% had gone through the foreclosure process.[194] Similarly, purchasers conducted a short sale for 9% of DASP loans and borrowers provided a "deed-in-lieu of foreclosure" for 6.7% of the loans.[195] Less frequently,

187. DASP FACT SHEET, *supra* note 151.
188. *Id.*
189. *Id.*
190. WALSH, *supra* note 132, at 35.
191. On average, this change probably provides an additional year of relief to borrowers relative to the status quo. Lone Star evidently provided a modified four percent interest rate to DASP borrowers. Letter from Caliber Home Loans, Inc. to Unnamed Borrowers (Dec. 19, 2014), https://www.nclc.org/images/pdf/pr-reports/Report-CaliberDocument.PDF. FHA-insured loans originated in 2007, 2008, and 2009 had average interest rates of 5.95%, 6.01%, and 5.63% respectively. FED. HOUS. ADMIN., U.S. DEP'T OF HOUS. & URBAN DEV., AVERAGE INTEREST RATES FOR FHA-INSURED 30-YR FIXED RATE ONE LIVING UNIT HOME MORTGAGES. Thus, under HUD's changes, after a five-year period at the four percent rate, a borrower's rate could increase to five percent in the sixth year and then to the original rate of around six percent in the seventh year. Previously, in the sixth year, the loan would have immediately reverted back to the original rate of around six percent.
192. SINGLE FAMILY POST-SALE REPORT, *supra* note 158, at 11.
193. *Id.*
194. *Id.*
195. *Id.*

purchasers might rent the property to the borrower (2.2%), agree to a forbearance (0.5%), or the loan is "paid in full" (0.9%).[196]

In the end, for approximately seventy-seven percent of the "resolved" DASP loans, new servicers never modify the loan or provide borrowers the opportunity to stay in their homes. Instead, the new servicers secure title to the property through foreclosure, short sale, or the deed-in-lieu of foreclosure process. Therefore, most lenders are essentially purchasing loans during the bidding process for fifty-five to sixty-five percent of their current total fair market value and then, soon after, selling those same properties or renting them on the open market. HUD is supposed to impose penalties on purchasers of NSO pool purchasers if less than fifty percent of the loans satisfy certain criteria.[197] However, "re-performance" criteria is defined so that lenders can accept payments on modified or unmodified loans for only six months, sell the property to an owner-occupant or rent out the property for three years, and still satisfy the neighborhood stabilizing post-sale requirements.[198] In other words, temporary modifications or merely accepting payments for a six-month period *during the foreclosure moratorium* may be sufficient to meet the watered-down NSO requirements. As a result, penalties rarely apply despite investors' failure to provide borrowers with long-term, stabilizing outcomes.

It's worth probing, then, why HUD sees DASP as a "borrower-friendly" alternative to the traditional process of REO sales after a foreclosure. HUD's explanation might be to rely on the notion that these borrowers were on the precipice of foreclosure so that *any* program where a single borrower secured another outcome was a "friendly alternative." On the other hand, HUD might have better served borrowers by expanding eligibility and financing for modifications using its partial claims authority and FHA-HAMP. This program could have reached a similar percentage of borrowers relative to modifications negotiated under DASP (9.9%). Moreover, the actual terms of the FHA-HAMP modifications would have been more favorable than the predatory terms offered by many new servicers. Finally, this option might have also been more cost-effective for the MMI Fund than DASP if the value of the partial claim needed to finance the FHA-HAMP modification was lower than the value of the DASP "discount" amount for a given loan.

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196. *Id.*
197. *See* Goodman et al., *supra* note 146, at 11; *see also supra* note 146 and accompanying text.
198. WALSH, *supra* note 132, at 10.

In addition, judicial foreclosure or a more centralized HUD-initiated alternative dispute resolution process might have ensured borrowers greater protection from lender and servicer abuses during the disposition process than decentralizing negotiations and permitting lenders to require deed-in-lieu of foreclosure or short sale transactions.[199] In the end, the best case scenario for DASP borrowers tended to lock predominantly moderate income, African-American or Hispanic homeowners into loan terms through an unregulated modification process. Even more often, DASP ensured private investors could eventually conduct deed-in-lieu or other foreclosure transactions so that they secured title to a property with a significantly higher market value than the discounted purchase price they paid for the loan during the bidding process. Meanwhile, while these private investors reaped a healthy return, HUD had still paid full claims out of the MMI Fund to the original servicer upon assignment.

III.
THE CONSEQUENCES OF TWO DECADES OF FHA DECISION-MAKING

A. *Eroding Judicial Foreclosure and FHA Borrower Protections*

As Part II elucidates, the FHA's decision to utilize DASP eroded long-standing doctrine and practices meant to protect struggling, delinquent borrowers. First, HUD's loan sales predominantly sought to address long-standing delays in judicial foreclosure states that had inflated the government's risk of expensive claims on the MMI Fund.[200] Courts in many judicial foreclosure states were certainly struggling to keep up with a backlog of cases at the height of the crisis. In part, however, these delays derived from efforts by the judicial branch to police lender abuses. During a judicial foreclosure proceeding in Maine, an employee at GMAC Mortgage, later re-branded as Ally Financial, admitted during a deposition to engaging in "robo-signing"—signing foreclosure documents for thousands of borrowers without sufficient review.[201] Subsequent to this deposition in 2010, Ally, JP

199. *See* Lydia Nussbaum, *ADR's Place in Foreclosure: Remedying the Flaws of a Securitized Housing Market*, 34 CARDOZO L. REV. 1889, 1952–53 (2013) (discussing why centralized programs during the housing crisis lead to more "structured, balanced and well-informed" outcomes than decentralized negotiations between borrowers and lenders).

200. *See supra* notes 132, 143–144, and accompanying text.

201. *See* Fed. Nat'l Mortg. Ass'n v. Bradbury, 32 A.3d 1014, 1018 (Me. 2011) (Levy, J., dissenting) ("Jeffrey Stephan testified at his deposition that he signed about 8,000 documents each month. He testified that he did not read affidavits before he signed them; he did not have custody or personal knowledge of loan files or docu-

Morgan Chase, and Bank of America—three of the largest mortgage servicers in the country—"announced they were halting foreclosures" in "Florida and 22 other states that require foreclosure to go before a judge."[202] In the end, the procedural check imposed by judicial foreclosure helped expose substantive, abusive lender practices. Eventually, claims arising out of those same practices led to the "largest joint federal state civil settlement ever obtained."[203]

In other words, when DASP short-circuited judicial foreclosure, borrowers were forced to litigate against the new investor that purchased their loan from HUD rather than against their original servicer. In some cases, the change in lender meant a borrower's prior defenses to foreclosure were no longer available.[204] As a result, during the height of the crisis, DASP blocked some borrowers from exercising their right to use the judicial process in order to protect themselves from a wide-range of lender initiated violations.

Second, when loans were sold through DASP, borrowers also exited the FHA insurance program. As a result, despite having paid premiums, many borrowers were stripped of protections embedded in the program. Indeed, FHA-insured lenders were required by statute to "engage in loss mitigation actions" regulated by HUD and borrowers paid for the federal guarantee of insurance in part to secure fairer

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ments, even though his affidavit said he did; and he did not know whether the documents attached to his affidavit were true and correct copies, even though his affidavit said that they were."); *see also* Ariana Eunjun Cha, *Ally Financial Legal Issue with Foreclosures May Affect Other Mortgage Companies*, WASH. POST (Sept. 22, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/09/21/AR2010092105872.html.

202. Gary Blankenship, *Sloppy Paperwork Exacerbates the Foreclosure Crisis*, FLA. B. NEWS (Oct. 15, 2010), https://www.floridabar.org/news/tfb-news/?durl=%2FDIVCOM%2FJN%2Fjnnews01.nsf%2FArticles%2F6C7B03BE77F32EA3852577B2006673A5.

203. Press Release, U.S. Dep't of Justice Office of Pub. Affairs, Federal Government and State Attorneys General Reach $25 Billion Agreement with Five Largest Mortgage Servicers to Address Mortgage Loan Servicing and Foreclosure Abuses (Feb. 9, 2012), https://www.justice.gov/opa/pr/federal-government-and-state-attorneys-general-reach-25-billion-agreement-five-largest.

204. For example, in many states, borrowers with an FHA-insured mortgage can raise a lender's failure to comply with HUD regulations governing the loss mitigation process as a defense to foreclosure. *See, e.g.*, Palma v. J.P. Morgan Chase Bank, 208 So. 3d 771, 775 (Fla. Dist. Ct. App. 2016); J.P. Morgan Chase v. Hodge, No.121004422, 2014 Phila. Ct. Com. Pl. LEXIS 129, at *12 (2014). However, when a new lender purchases the note through DASP, HUD regulations related to the mandatory loss mitigation process are no longer applicable. *See supra* notes 171–172 and accompanying text. Thus, even if the DASP purchaser or the prior lender failed to comply with HUD regulations before initiating foreclosure, the borrower subsequently could not raise this issue as a defense because the regulations were no longer applicable.

mortgage terms.[205] Many borrowers, when their loan was sold under DASP, lost these benefits without notice or the opportunity to contest whether lenders had actually negotiated loan modifications in good faith.[206] As a result, some borrowers have alleged DASP violated their "right to due process under the Fifth Amendment."[207] Moreover, after the sale of their loan, previously FHA-insured borrowers were forced to accept or decline offers for loan modifications with unfair terms like balloon payments and adjustable rates that were antithetical to the FHA's statutory requirements.[208]

Section I.B of this Note described the reliance of African American and Hispanic homeowners on FHA-insured loan products, and the FHA's response to the increasing market share of subprime products in these communities prior to the foreclosure crisis.[209] HUD's own analysis of the FHA insurance program's market share between 1993 and 2009, broken down by race and ethnicity, bears out these trends.[210] Overall, African American and Hispanic homeowners have almost always been responsible for a higher share of FHA originations relative to white borrowers, except between approximately 2003 and 2007, when subprime products dominated these markets.[211] Importantly, as Figure 5 demonstrates, beginning in 2008 and 2009, the

205. 12 U.S.C.A. § 1715u(a) (West 2016) ("[U]pon default or imminent default . . . mortgagees shall engage in loss mitigation actions.").

206. *See supra* notes 173–176 and accompanying text.

207. First Amended Class Action Complaint at 73, Washington v. U.S. Dep't of Hous. & Urban Dev., No. 16-cv-03948 (CBA) (SMG) (E.D.N.Y. Aug. 12, 2016), ECF No. 11. In my view, procedural due process claims are unlikely to be successful. In analogous cases related to the HAMP program, property owners argued that they have a right to the program's fairer terms under a loan modification, but federal courts have repeatedly said homeowners have no "entitlement" because it remains a "discretionary" program. A similar analysis would potentially apply to the FHA's disposition of already-delinquent loans under its insurance program that would otherwise be undergoing a foreclosure. *See, e.g.*, Edwards v. Aurora Loan Servs., 791 F. Supp. 2d 144, 153–155 (D.C. Cir. 2011) (holding that a loan modification does not establish a constitutionally protected property interest); McInroy v. BAC Home Loan Servicing, No. CIV. 10-4342 DSD/SER, 2011 WL 1770947, at *2 (D. Minn. May 9, 2011); Steffens v. Am. Home Mortg. Servicing, Inc., No. 6:10-1788-JMC, 2011 WL 901812, at *3 (D.S.C. Jan. 5, 2011); Orcilla v. Bank of Am., No. C10-03931 HRL, 2010 WL 5211507, at *3 (N.D. Cal. Dec. 16, 2010); Nguyen v. BAC Home Loan Servs., No. C-10-01712 RMW, 2010 WL 3894986, at *4 (N.D. Cal. Oct. 1, 2010).

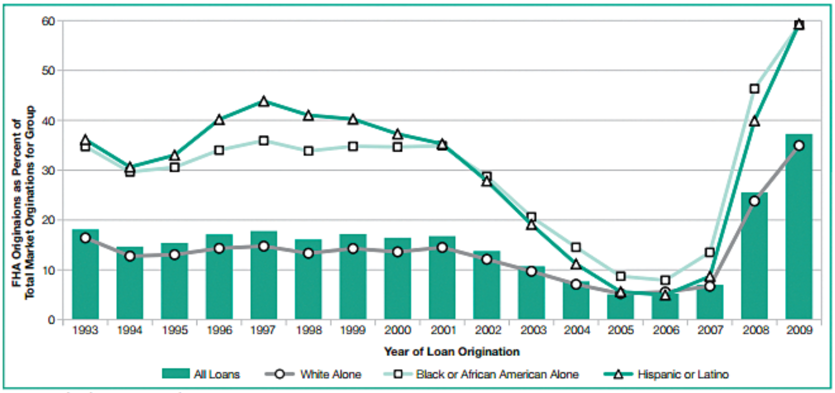
208. *Compare supra* note 8 and accompanying text (discussing FHA statutory terms), *with supra* notes 182–185 and accompanying text (discussing Lone Star's form agreement for loan modifications).

209. *See supra* notes 40–48, 58–59, and accompanying text.

210. *See generally* EDWARD SZYMANOSKI ET AL., U.S. DEP'T OF HOUS. & URBAN DEV., A LOOK AT THE FHA'S EVOLVING MARKET SHARES BY RACE AND ETHNICITY (2011).

211. *Id*. at 8.

FHA's market share within "especially the minority home purchase mortgage market, dramatically" rebounded to pre-crisis levels."[212]



FHA = Federal Housing Authority.

One- to four-unit (single-family) home purchase loan originations: first-lien, owner- and nonowner-occupant borrowers, including manufactured housing.

Source: Home Mortgage Disclosure Act

FIGURE 5

FHA-insured loans that originated after the subprime market collapse, especially in 2008, were significantly more likely to be rapidly delinquent by the time DASP was established.[213] Inevitably, FHA-insured borrowers whose loans were sold under DASP were disproportionately more likely to be African American or Hispanic homeowners because this population had consistently over the previous two decades relied on the FHA more than their white counterparts.[214] Moreover, the pool of delinquent loans sold under DASP included mostly recently originated loans, a pool of loans that disproportionately included African American and Hispanic homeowners who turned to the FHA after the government's subprime competitors collapsed.

Recently, litigants filed a lawsuit in the Eastern District of New York, *Washington v. U.S. Department of Housing & Urban Development*, alleging HUD's administration of DASP violated the Fair Housing Act in two ways.[215] First, they claim DASP had a "disparate

212. *Id*. at 6.

213. *See supra* note 80 and accompanying text.

214. For example, the Center for American Progress, after analyzing the racial and ethnic makeup of communities where some loans had been sold through DASP, found that "84 percent of notes in the sample were sold in ZIP codes with a higher concentration of people of color than the national median." SARAH EDELMAN, MICHELA ZONTA & SHIV RAWAL, CTR. FOR AM. PROGRESS, PROTECTING COMMUNITIES ON THE ROAD TO RECOVERY: WHY STRONG STANDARDS ARE CRITICAL FOR THE DISTRESSED ASSET STABILIZATION PROGRAM 12 (2016).

215. *See* First Amended Class Action Complaint, *supra* note 207, at 75.

impact on African-American homeowners and predominantly African-American neighborhoods in New York City."[216] Second, they argue HUD breached its "affirmative duty" to consider the impact of the program and to "administer [it] . . . in a manner affirmatively to further" fair housing.[217] This Note briefly discusses both claims separately.

1. Disparate Impact and DASP

First, the Fair Housing Act ("the Act") makes it "unlawful" to "refuse to sell or rent . . . or otherwise make unavailable or deny a dwelling" because of an individual's "race, color, national origin" or other protected characteristics.[218] The Supreme Court recently affirmed the availability of disparate impact claims under the Act. To succeed on a disparate impact claim, plaintiffs must show a policy or practice has a "disproportionately adverse effect" on African American renters and that the policy or practice is "otherwise unjustified by a legitimate rationale."[219] The Court established a three-part burden shifting framework similar to the framework used for disparate impact claims in the employment discrimination context.[220] First, a plaintiff must "make a prima facie showing" that a "challenged practice caused or predictably will cause a discriminatory effect."[221] Importantly, statistical discrepancies alone are insufficient to establish a prima facie case if that discrepancy is "caused by factors other than the defendant's policy."[222] This "robust causality requirement" is designed to prevent litigants from attempting to "second-guess . . . reasonable approaches."[223]

The *Washington* plaintiffs will likely have difficulty establishing a prima facie case given the Supreme Court's strict definition of the parameters of this "robust causality requirement." Recently, the Court

216. *Id.*
217. *Id.* at 73 (second alteration in original).
218. 42 U.S.C.A. § 3604(a) (West 1988).
219. Tex. Dep't of Hous. & Cmty. Affairs v. Inclusive Cmtys. Project, Inc., 135 S. Ct. 2507, 2513 (2015).
220. *Compare* Graoch Assocs. #33, L.P. v. Louisville/Jefferson Cty. Metro Human Relations. Comm'n, 508 F.3d 366, 374 (6th Cir. 2007) ("[W]e hold that disparate impact claims against private defendants under the FHA should be analyzed using a form of the *McDonnell-Douglas* burden shifting framework."), *with* McDonnell Douglas Corp. v. Green, 411 U.S. 792, 802–803 (1973) (establishing a burden shifting framework for employment discrimination claims under Title VII of the Civil Rights Act of 1964).
221. *Id.* at 2514.
222. *Id.*
223. *Id.* at 2522.

held in *City of Miami v. Bank of America Corp.* that "foreseeability alone does not ensure the required close connection that proximate cause requires."[224] Instead, plaintiffs must establish some "direct relation between the injury asserted and the injurious conduct alleged."[225] The Court also hinted that plaintiffs in complex cases with large defendants like *City of Miami* or *Washington* may struggle to establish those direct relationships because courts are assessing a "housing market [that] is interconnected with economic and social life" so that misconduct may "be expected to cause ripples of harm far beyond the defendant's misconduct."[226] Indeed, fearing a high degree of complexity in future Fair Housing Act cases, the Court held in *City of Miami* that the statute was never intended to "provide a remedy wherever those ripples travel."[227]

The Court's reference to a complex, interconnected housing market demonstrates how difficult it will be to parse out responsibility for the harms caused by individual troubled loans from larger pools of loans. Indeed, courts will likely be unable to determine in the DASP context whether the lender, the borrower, or HUD, the actor who pooled the loans, are ultimately the "robust" or direct cause of the alleged impacts.

In the *Washington* case, the plaintiffs essentially cite two separate sources for DASP's disparate impact on borrowers. First, they argue the government's sale of the loan ensures borrowers lose the benefits of FHA insurance, including the guarantee of favorable terms and loss mitigation programs regulated by HUD.[228] Second, they argue DASP purchasers, by favoring foreclosure and offering loan modifications with unfair terms, also impose a set of costs on borrowers including a net increase in mortgage payments.[229] Jointly, the plaintiffs argue these actions ensure "African American neighborhoods will become less stable."[230]

Some of the impacts plaintiffs allege are at least directly caused by private investors rather than HUD. Admittedly, plaintiffs could argue those impacts are indirectly caused by HUD's failure to enforce or require sufficient post-sale borrower protections on loan purchasers. However, the alleged impacts from HUD's direct action—selling the

224. Bank of America Corp. v. City of Miami, 197 L. Ed. 2d 678, 690 (2017).
225. *Id.*
226. *Id.*
227. *Id.*
228. First Amended Class Action Complaint, *supra* note 207, at 39.
229. *Id.*
230. *Id.* at 40.

loan—might then be considered separately from the effects that result from other parties' actions, including the private investor renegotiating loan terms in bad faith or foreclosing on the property. The plaintiffs did add one investor, Lone Star (by way of its subsidiary, Caliber), as a defendant in the *Washington* suit.[231]

Similarly, courts might assume a subset of individual, foreclosed loans within a DASP pool are the primary cause of neighborhood destabilization impacts. However, various parties may bear direct responsibility for those impacts, including the individual delinquent borrower, the original servicer, or an investor not included in the claim. Moreover, because other loans in that same pool "re-performed," HUD might argue the government's design of the pool ultimately is not the robust or direct cause of the alleged impacts.

At the second stage, defendants then have "leeway to state and explain the valid interest served by their policies."[232] If a given policy was "necessary to achieve a valid interest," then defendants can maintain the policy in part because the Act is "not an instrument to force housing authorities to reorder their priorities."[233] In this case, HUD might argue their ultimate priority, bolstering the MMI Fund, was a "valid interest" and disposition of loans through DASP was ultimately "necessary" given the financial situation faced by the FHA.[234]

Lastly, at the third stage, plaintiffs succeed if they can demonstrate this valid interest "could be served by 'another practice that has a less discriminatory effect.'"[235] As described in Section II.B above, DASP likely failed to maximize taxpayer recoveries so that a range of other alternatives, including the traditional REO process, might have better served HUD's interest. Still, considering the disproportionate racial and ethnic makeup of the delinquent loans, any alternative disposition process would likely have had some disparate impact on African-American homeowners and neighborhoods. On the other hand, perhaps a traditional REO process, which by definition utilizes borrower foreclosure protections and is governed by HUD's regulations for loan modifications, might have had less discriminatory effect than DASP.

231. *Id.* at 7.
232. Tex. Dep't of Hous. & Cmty. Affairs v. Inclusive Cmtys. Project, Inc., 135 S. Ct. at 2522.
233. *Id.*
234. *See supra* note 99–101 and accompanying text.
235. *Inclusive Cmtys. Project, Inc.*, 135 S. Ct. at 2515.

2. *Affirmatively Furthering Fair Housing and DASP*

The Fair Housing Act also mandates that HUD "administer the programs and activities relating to housing and urban development in a manner affirmatively to further the policies" of the Act.[236] HUD's affirmative duty to further fair housing has been interpreted to require that the Secretary, at a minimum "consider the impact" of a proposed action "on the racial composition of the surrounding neighborhoods."[237]

Still, the standard of review generally disfavors plaintiffs who claim HUD breached this affirmative duty. Indeed, courts must only determine whether HUD's consideration was "arbitrary, capricious, an abuse of discretion or otherwise not in accordance with the law."[238] Still, in cases where "the administrative record contains no information" or HUD fails to provide "any analysis or discussion" of the fair housing impact of a proposed action aside from a "conclusory statement" and "some data on the recent trends," courts have been willing to hold that HUD acted arbitrarily and capriciously.[239]

In the end, at the time of the writing of this Note, HUD had filed a motion arguing for dismissal of the *Washington* claim on standing grounds as well as on the grounds that plaintiffs "have not and cannot establish any plausible let alone 'robust' chain of causation."[240] Meanwhile, the parties also agreed to stipulate as to which information secured through ongoing discovery would be kept confidential and under protective order.[241] Even if the Fair Housing Act claims are not cognizable in the *Washington* litigation, the statistical disparity and the makeup of the FHA and DASP loan portfolio undoubtedly suggests that the borrowers impacted by the program were disproportionately African American and Hispanic.

236. 42 U.S.C.A. § 3608(e)(5) (West 2017).

237. *See, e.g.*, Darst-Webbe Tenant Ass'n Bd. v. St. Louis Hous. Auth., 339 F.3d 702, 713 (8th Cir. 2003); Pleune v. Pierce, 765 F. Supp. 43, 47 (E.D.N.Y. 1991) (citing Otero v. New York City Hous. Auth., 484 F.2d 1122, 1134 (2d Cir. 1973)).

238. *Darst-Webbe Tenant Ass'n Bd.*, 299 F. Supp. 2d at 964–65 (holding that because HUD's actions were not "so egregious, so inconsistent with its duty to affirmatively further fair housing, that a dereliction of the duty can be presumed," a disparate impact claim should be dismissed).

239. *Pleune*, 765 F. Supp. at 47.

240. *See* Memorandum of Law in Support of the Fed. Defendants' Motion to Dismiss Plaintiffs Amended Complaint at 1–3, Washington v. U.S. Dep't of Hous. & Urban Dev., No. 16-cv-03948 (E.D.N.Y. July 7, 2017), ECF No. 56-5.

241. *See* Stipulated Confidentiality and Protective Order, Washington v. U.S. Dep't of Hous. & Urban Dev., No. 16-cv-03948 (E.D.N.Y. July 24, 2017), ECF No. 61.

B. Providing Dominant Investors Concentrated Positions in Distressed Communities' Housing Market

President Theodore Roosevelt, the ultimate enforcer of antitrust and anti-monopoly laws, proposed one over-arching governing principle to deal with the "evils of excessive overcapitalization."[242] In his view, the government should endeavor "not so much to prevent consolidation as such, but to supervise and control it as to see that it results in no harm to the people."[243] Since then, "when it comes to concentrated holdings that threaten competition or that could otherwise dominate markets, the government's responsibility to protect against these evils of amassed holdings of property . . . is generally accepted."[244] Indeed, the nation's homesteading laws, and the decentralized distribution of smaller plots to families rather than the highest bidder, "served as a hedge against property becoming overly concentrated in the hands of industrial employers and land barons."[245]

Paradoxically, DASP's design ensured that only a limited number of dominant, highly capitalized firms[246] could purchase concentrated property holdings. First, HUD aggregated loans previously serviced by several lenders and secured by thousands of individual properties and sold the pooled delinquent loans to a single high bidder. Later, in many cases, these firms then secured title to the properties through foreclosure or other transactions rather than modifying loan terms.[247] Moreover, using NSO pools, a single firm could purchase thousands of loans in even more limited geographies and smaller neighborhood housing markets. In a sense, HUD was assembling a kind of monopoly in single-family homes in smaller housing markets and selling it to hedge funds and private equity investors.

Indeed, for many institutional firms this was a purposeful investment strategy. In the "historically . . . fragmented" rental market, "institutional interest increased meaningfully as the large foreclosure and nonperforming loan inventory resulting from the 2008–2009 financial crisis created the possibility for large-scale investments and attractive economics."[248] While the risk of institutional consolidation in the

242. President Theodore Roosevelt, Sixth Annual Message to the United States Congress (Dec. 3, 1906).

243. *Id.*

244. Ezra Rosser, *Destabilizing Property*, 48 CONN. L. REV. 397, 449 (2016).

245. *Id.* at 450.

246. *See supra* notes 158–159 and accompanying text.

247. *See supra* notes 193–196 and accompanying text.

248. JADE J. RAHAMI ET AL., KEEFE, BRUYETTE & WOODS, SINGLE-FAMILY RENTAL PRIMER 3 (5th ed. 2016).

overall national housing market is limited,[249] DASP permitted some firms to move into smaller, distressed geographies and begin to dominate the housing market.

For example, approximately 3800 loans in Baltimore, Maryland and neighboring counties have been sold under DASP.[250] Two firms—Bayview Asset Management, the Blackstone subsidiary discussed in Section II.B above, and Oaktree Capital Management, a hedge fund based in California—have purchased virtually all of these loans through neighborhood stabilization pools.[251] Blackstone has also financed the purchase of other properties in the Baltimore area.[252] Meanwhile, HUD estimates demand in the Baltimore metropolitan area between April 1, 2016 and April 1, 2019 will require the supply of 11,085 home purchase units and 8650 rental units.[253] In other words, Oaktree and Blackstone are well positioned, assuming they take title to the properties secured by the DASP loans, to potentially dominate the Baltimore area housing market. Importantly, the Baltimore metropolitan area is approximately twenty-six percent African-American, much higher than the nationwide average of twelve percent.[254] Moreover, the City of Baltimore suffered tremendously from

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249. *Id.* at 4 ("Despite increased institutional investment following the 2008–2009 financial crisis and the subsequent increase in foreclosures, the single-family rental market in the U.S. remains fragmented, dominated by smaller investors and so-called 'mom and pop' owners.").

250. Natalie Sherman, *Critics Say HUD Sales of Delinquent Mortgages Are Hurting, Not Helping*, BALT. SUN (Nov. 16, 2016), http://www.baltimoresun.com/business/bs-bz-oaktree-foreclosures-20161116-story.html.

251. *See* Fed. Hous. Admin., U.S. Dep't of Hous. & Urban Dev., Single Family Loan Sale 2015-1 Sales Results Summary 1–4 (2015) (Bayview purchased eighty-nine loans in the Baltimore area and another thirty-seven in Maryland); FED. HOUS. ADMIN., U.S. DEP'T OF HOUS. & URBAN DEV., SINGLE FAMILY LOAN SALE 2014-2, PART 2: NSO PART 2 SALE RESULTS SUMMARY 3 (2014) (Bayview purchased 124 loans in the Baltimore area); FED. HOUS. ADMIN., U.S. DEP'T OF HOUS. & URBAN DEV., SINGLE FAMILY LOAN SALE 2014-1 NEIGHBORHOOD STABILIZATION OUTCOME POOLS (NSO) SALE RESULTS SUMMARY 2 (2013) (Oaktree, via its subsidiary, DC Residential IV Loan Acquisition Venture, purchased 803 loans in the Baltimore area and another 719 in Maryland statewide while Bayview purchased 507 loans in nearby Prince Georges County, Maryland). Note that the loans purchased during these three sales combined constitute 3713 of the approximately 3800 loans sold under DASP in Maryland, and predominantly in Baltimore.

252. Natalie Sherman, *More Private Lenders Looking at Real Estate*, BALT. SUN (Jan. 2, 2015), http://www.baltimoresun.com/business/real-estate/bs-bz-lima-one-lender-20150102-story.html.

253. OFFICE OF POLICY DEV. & RESEARCH, U.S. DEP'T OF HOUS. & URBAN DEV., COMPREHENSIVE HOUSING MARKET ANALYSIS: BALTIMORE-COLUMBIA-TOWSON, MARYLAND 2 (2016).

254. *Baltimore-Columbia-Towson, MD Metro Area*, U.S. CENSUS BUREAU, https://censusreporter.org/profiles/31000US12580-baltimore-towson-md-metro-area/ (last visited Feb. 9, 2017).

the subprime virus. Indeed, the City sued subprime lenders in 2011 alleging they "deliberately steered African-American borrowers . . . into more onerous subprime loans . . . [so borrowers] became unable to make the more demanding payments . . . [which] caused foreclosures and eventual vacancies" in the City in 2011.[255] In some sense, then, we see the foreclosure crisis coming full circle. Homeowners in communities that were previously targeted by subprime lenders are now burdened by housing markets dominated by organized money in a different form—institutional investors with consolidated holdings.

IV. RECOMMENDATIONS

Part IV provides eight recommendations based on the findings explored in this Note. In general, these recommendations detail how the FHA might learn from the foreclosure crisis in anticipation of a future housing downturn. The note also recommends that HUD make more specific changes to the design and operation of DASP.

A. *The FHA Should Define Its Ultimate Policy Objectives During Housing Downturns*

The FHA struggled to balance its three competing policy objectives during the housing downturn and the subsequent recovery.[256] Prior to the foreclosure crisis, FHA-led efforts to promote homeownership generally imposed more risk on the insurance program. Similarly, during the crisis, when the FHA was acting as a countercyclical backstop and a stabilizing force for the national housing market, the agency also insured increasingly riskier mortgages. DASP's dueling goals reflected these competing priorities.[257] On the one hand, DASP sought to maximize taxpayer recoveries to limit risks in the MMI Fund. On the other hand, DASP also sought to avoid foreclosure and stabilize the market generally. In the end, during a historic downturn, these objectives were in stark tension, which led to shifty policymaking.

Before the next downturn, the FHA should more clearly articulate its chief policy objectives. For example, if the government plans to use FHA insurance to stabilize the national housing market, then Congress must also be willing to exercise patience and temporarily

255. Mayor of Baltimore v. Wells Fargo Bank, No. JFM-08-62, 2011 WL 1557759, at *3 (D. Md. Apr. 22, 2011).

256. *See* discussion *supra* Section I.C.

257. *See* discussion *supra* Section II.A.

ease requirements related to taking on riskier loans while financing claims. Otherwise, if the FHA's ultimate objective is to serve as a safe insurer for lenders, then the agency should strictly regulate efforts to promote homeownership that might also impose greater risk on its reserves.

B. The FHA Should Always Maintain Lending Standards and Police Fraud

Before the foreclosure crisis, to compete with subprime products, the FHA insured riskier borrowers after undermining long-standing underwriting standards and establishing an overly generous down-payment assistance program.[258] Moreover, after severe cuts to the agency's staff, the FHA failed to regulate lenders or police a wide range of abuses including outright mortgage fraud, a migration of troubled subprime lenders to the FHA market, and the illegal provision of seller-financed down-payment assistance.[259] In the future, even if alternative products temporarily capture greater market share, the FHA should maintain its lending standards and instead rely on a robust regulatory structure to avoid, once again, taking on the worst-performing book of mortgages in its history.

C. Scholars Should Conduct Further Economic Research Analyzing Whether DASP Maximizes Taxpayer Recoveries Relative to the Traditional Foreclosure Process

HUD and the Urban Institute claim the average "loss rates" for FHA-insured loans sold under DASP were lower than the losses incurred by the MMI Fund under the traditional foreclosure and REO disposition process.[260] In part, they argue DASP compares favorably to the traditional process because HUD avoids long-term foreclosure, servicing, and holding costs associated with the traditional process. On the other hand, the Urban Institute acknowledges the "discount" provided to DASP investors—meaning the difference between the fair market value of properties underlying DASP loans and the price at which those loans are actually sold—evidently includes those same costs after they have been priced into investors' bids.[261] Moreover, the discount also includes a healthy rate of return for private investors, a cost that HUD would avoid if they did not rely on DASP to dispose of

258. *See supra* notes 63–67 and accompanying text.
259. *See supra* notes 68–74 and accompanying text.
260. *See* GOODMAN & MAGDER, *supra* note 152 and accompanying text.
261. *See supra* notes 164–167 and accompanying text.

the loans. In the end, more economic research is necessary to determine whether DASP maximizes taxpayer recoveries relative to the traditional REO disposition process.

D. HUD Should Change DASP's Design to Increase the Number of Bidders

Currently only a few dominant firms, with a long history investing in single-family residential mortgages, bid on DASP loans.[262] HUD's failure to design a competitive market for DASP loans ensures a lower market clearing price for each pool of loans. So far, efforts to increase the number of participants, including by providing local governments and non-profits the opportunity to participate, have been unsuccessful.[263] HUD should instead invest in efforts to lower barriers to entry, including by educating other investors and by reducing costs associated with entering the DASP auction. In addition, HUD should consider reducing the aggregate number of loans in each pool so that smaller firms can be confident they have the capital to both purchase the assets and then subsequently manage the properties after providing the winning bid.

E. HUD Should Provide Notice to Borrowers Before Loans Are Sold Under DASP

Technically, borrowers impacted by DASP must have already exhausted all potential loss mitigation options with their original lender. However, many DASP borrowers have argued their loan was sold under DASP even as they continued to negotiate with a prior servicer. In part, this confusion reflects timing issues, including the implementation of FHA-initiated revisions to their loss mitigation tools that occurred at the same time as the expansion of DASP.[264] Currently, borrowers are not told they will be terminated from the FHA program or that their loan will be sold under DASP until after the sale has occurred. By providing additional process, including notifying borrowers prior to any sale that their loan is about to be sold under DASP, HUD could avoid this problem and instead provide an opportunity for borrowers to object to any sale. Then, borrowers could articulate why they believe all mitigation options have not been exhausted during a proceeding with their lender and HUD prior to any sale.

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262. *See supra* notes 158–162 and accompanying text.

263. *See supra* notes 163 and accompanying text.

264. *See supra* note 173–176 and accompanying text.

F. HUD Should Impose Stricter Post-Sale Requirements on DASP Investors

HUD has only barely regulated the modification terms private investors can offer to borrowers after purchasing a loan under DASP. Thus, investors often offer rigid, predatory terms. For example, many investors will offer a low initial monthly teaser rate for the duration of the required foreclosure moratorium but then impose adjustable rates and balloon payments in the long-term.[265] In addition, investors rarely reduce the loans' principal even though they tend to purchase the loan at a steep discount under DASP. Recent efforts to alter the post-sale negotiating position of lenders and borrowers are largely insufficient to address these issues.[266] HUD should instead consider mandating principal reduction and categorically prohibiting lenders from offering unsustainable adjustable interest rates. HUD might also consider requiring that investors and borrowers enter a dispute resolution process with a neutral mediator so that both parties are able to bargain effectively and have equal leverage during negotiations over post-sale modifications.

G. HUD Should Redefine "Re-Performance" for Neighborhood Stabilization Pools

Technically, fifty percent of the loans sold under NSO pools must "re-perform" for purchasers to avoid penalties like the remittance of foreclosure sale proceeds.[267] Currently, though, HUD's "re-performance" criteria are watered-down so that merely adhering to the foreclosure moratorium may be sufficient.[268] To ensure that outcomes are truly "neighborhood stabilizing" in the long-term, HUD might consider mandating that investors meet stricter benchmarks, including reducing principal and negotiating fair modifications for a certain percentage of loans. Moreover, systematic analysis of each pool by HUD staff could help ensure data on re-performance provided by lenders remains accurate and not misleading.

H. HUD Should Protect Against Investors Securing Consolidated Holdings in Markets

Currently, under DASP, many investors have been able to secure concentrated holdings in single-family residential properties in dis-

265. *See supra* notes 182–185 and accompanying text.
266. *See supra* notes 187–191 and accompanying text.
267. *See supra* notes 145–146 and accompanying text.
268. *See supra* note 198 and accompanying text.

tressed markets. HUD should consider altering its eligibility criteria for certain pools of loans and excluding firms that have already purchased thousands of loans in that metropolitan area. Alternatively, HUD could also sell smaller pools of loans to protect against a single firm placing the winning bid on every loan in each market. Either way, HUD should regularly review the geographic distribution of the loans it sells under DASP and similar note sales programs conducted by Fannie Mae and Freddie Mac to prevent against the very real risk that one or two investors will dominate the housing market in concentrated, distressed geographies like Baltimore.

Conclusion

When it was established in 1934, the Federal Housing Administration was tasked with two purposes—to administer a "system of mutual mortgage insurance" and to "encourage improvement in housing standards and conditions" for middle-income homeowners.[269] Leading up to the foreclosure crisis, the FHA undermined its mission by lowering its lending standards and inadequately policing against predatory lenders. When the bubble burst, the FHA acted as a countercyclical force, taking on additional distressed borrowers in an effort to stem the housing market's collapse. Still, when defaults within the FHA's loan portfolio spiked, these choices imposed an unsustainable risk on the FHA's reserves, placing the agency in the most precarious financial position in its history.

Beginning in 2012, however, the FHA established the Distressed Asset Stabilization Program, an alternative disposition process to deal with the growing number of insured, delinquent loans. DASP pooled these loans and sold them through an auction process mostly to private equity and hedge fund investors. The program was supposed to both maximize recoveries for the FHA's reserves and provide borrowers an alternative to foreclosure. In the end, this Note argues, DASP's bidding process might have failed to maximize recoveries because a few dominant firms set a lower market-clearing price with discounts that reflected both the price of foreclosure and a high rate of return for private investors. Second, DASP undermined borrower protections by short-circuiting the judicial foreclosure process and failing to ensure long-term, stabilizing post-sale modifications or other favorable outcomes.

Finally, though Fair Housing Act claims are unlikely to be successful, because of the racial and ethnic makeup of both the FHA's

269. National Housing Act of 1934, Pub. L. No. 73-479, 48 Stat. 1246 (1934).

broader portfolio and the delinquent loans sold through DASP in particular, there is little question that the costs of DASP were imposed predominantly on African American and Hispanic neighborhoods. For some of these neighborhoods, DASP also exacerbated a larger problem by ensuring the dominance of institutional investors over their housing markets after the foreclosure crisis. Many of these lessons, and the recommendations that flow from them, are useful benchmarks as the DASP model expands into other policy domains. Indeed, Fannie Mae and Freddie Mac's Non-Performing Loan Sales program, and proposals to sell student loan assets to private investors in return for modifications, both borrow elements of DASP. In designing these other efforts to dispose of government-insured, individually held debt and property, the federal government should carefully examine DASP's outcomes.

Policy-makers largely ignored the rising threat to the FHA portfolio posed by the subprime virus and, perhaps justifiably, made the FHA's financial position worse by having the agency act as a countercyclical force. Later, as George Packer warned, "organized money" in the form of dominant institutional investors successfully stepped in to finally "unwind" one of President Roosevelt's most lasting institutions—the federally insured mortgage for lower and middle-income homeowners.[270] In the end, the government successfully shored up its reserves and investors made a healthy return, but distressed borrowers in predominantly African American and Hispanic neighborhoods will likely continue to bear the costs absent policy reform.

270. *See* PACKER, *supra* note 1, at 3.