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Regional & Community Outreach

Issue Brief | 2020-4.4 | June 2020

HUD/FHA-Insured Homeowners and Properties in End-Stage Default and Foreclosure: National Context and Experiences in Massachusetts

HUD Regulations and Policies Concerning End-Stage Default

Rachel G. Bratt

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Abstract

This Issue Brief concerns HUD/FHA's rules regarding mortgage servicing, loss mitigation, and property conveyance, which are derived from federal regulations and carry the force of law: a violation can be grounds for legal action. HUD launched its loss mitigation program in 1996 in an effort to provide lenders/servicers with specific steps they were required to take. As with all HUD initiatives related to homeownership, this program aims to help borrowers retain their homes while also reducing losses to FHA's Mutual Mortgage Insurance Fund. Despite the specificity of HUD's requirements, some servicers are falling short in assisting borrowers through the loss mitigation process.

Three aspects of HUD's regulations and policies pertaining to households facing end-stage default are examined. The first, the requirement that the lender offer a face-to-face interview to the mortgagor prior to foreclosure, offers an example of mortgagee noncompliance with HUD rules and HUD enforcement failure. The second, which provides an option for foreclosed homes to be conveyed with occupants, is an example of a regulation that only has been permitted infrequently. Lastly, this Issue Brief examines restrictions limiting homeowners' ability to buy back their foreclosed home from an entity such as a nonprofit that has purchased the home on their behalf, thereby enabling the household to retain ownership with a renegotiated mortgage. Overall, the Brief highlights how these policies and requirements are infrequently or inconsistently adhered to, attempts to identify why that is the case, considers what the consequences may be, and suggests changes that might lead to greater compliance and utilization.

Series Introduction

By Erin M. Graves* and Chris Herbert**

This series of Issue Briefs was being finalized just as the coronavirus pandemic was beginning. Beyond our current and pressing concerns about health, mortality rates, personal financial distress, and impacts on businesses and the national economy, we will likely soon be facing an increase in loan defaults and foreclosures, as significant numbers of people are unable to make their mortgage payments.

Policy makers and financial institutions have taken several immediate steps to help homeowners who have lost income during this period. The Department of Housing and Urban Development (HUD) took action by placing a 60-day moratorium on foreclosures for loans insured by the Federal Housing Administration (FHA). In addition, the Federal Housing Finance Administration (FHFA) ordered Fannie Mae and Freddie Mac loan servicers to lower or suspend borrowers' mortgage payments for up to 12 months if homeowners have lost income because of the pandemic. Under the Coronavirus Aid, Relief, and Economic Security Act, borrowers can initiate a 180-day forbearance and foreclosure moratorium for any federally-backed mortgage loan. Private non-government-backed lenders and servicers also have volunteered mortgage relief.

These short-term actions may relieve some financial distress and forestall some foreclosures and, in the longer term, the economy hopefully will recover. However, that recovery will likely be uneven and the financial challenges for millions of families could continue as workers struggle to regain a foothold. In addition, those who contracted the virus may experience long-term effects that will impact their ability to work. Should these challenges come to pass, there likely will be a spike in foreclosure rates over the next several years. Other households, unable to afford their mortgage payments, may be able to avoid foreclosure, but they may find themselves forced into a rushed sale and a destabilizing move. And, as always, those who will be hit hardest will be households with less secure employment and fewer assets, a pattern that parallels the disproportionate impact of the disease itself. This situation will therefore likely have a disparate and more serious impact on households of color and on more fragile neighborhoods.

The Federal Reserve Bank of Boston and the Joint Center for Housing Studies of Harvard University are pleased to be presenting this Issue Brief series at a time when the insights drawn from this research may be of great value as policymakers look to craft a response to this latest economic crisis. Since the research and writing for this series of Briefs were done during a period of declining foreclosures for both FHA-insured and conventional loans, the author of the Briefs, Rachel Bratt, points out that this relatively calm stretch provided “a good time to explore the extent to which a number of HUD/FHA default and foreclosure policies and procedures are serving the public interest and to identify opportunities for improvement.”

These Issue Briefs offer a number of insights about HUD’s regulations and procedures concerning mortgages that are close to foreclosure, or end-stage default through the lens of mortgage market upheaval following the Great Recession. Also drawing on the experiences of local and state governments, as well as several nonprofit organizations, a number of thoughtful and innovative suggestions are offered for how homeowners in end-stage default can be assisted to retain their homes, thereby promoting family and neighborhood stability. Now is a good time to consider how to apply the lessons learned in order to safeguard the hardest-hit households and communities facing foreclosures in 2020 and beyond.

*Erin M. Graves is a senior policy analyst and advisor at the Federal Reserve Bank of Boston.
**Chris Herbert is managing director of the Joint Center for Housing Studies of Harvard University.

Introduction

The U.S. Department of Housing and Urban Development (HUD) is the cabinet-level federal agency that is in charge of implementing and overseeing the mortgage insurance programs of the Federal Housing Administration (FHA). Lenders and servicers who deal with FHA-insured single-family homes must follow HUD’s rules governing mortgage lending, servicing, and default/foreclosure procedures. These are long and detailed: the major handbook contains over 1,000 pages, and there are multiple additional handbooks that provide relevant information concerning processes to be followed during default and foreclosure. Yet, regardless of this complexity, it is the responsibility of lenders and servicers to follow the rules and for HUD/FHA to take seriously their job of enforcing the regulations as stated in the handbooks. HUD/FHA’s rules regarding mortgage servicing, loss mitigation, and property conveyance, which are derived from federal regulations, carry the force of law, and a violation can be grounds for legal action.

FHA borrowers who miss mortgage payments are required to be offered loss mitigation, a process in which lenders work with them to arrive at an agreement to resolve past-due mortgage payments. HUD launched its loss mitigation program in 1996 in an effort to provide lenders/servicers with specific steps that they are required to follow. As with all HUD initiatives related to homeownership, this program aims to help borrowers retain their homes while also reducing losses to FHA's Mutual Mortgage Insurance Fund (MMIF). HUD makes clear, in bold and capital letters that **PARTICIPATION IN THE LOSS MITIGATION PROGRAM IS NOT OPTIONAL.** Lenders are directed to take the following required steps:

- Consider all reasonable means to address delinquency at the earliest possible moment.
- Inform borrowers of available loss mitigation options and the availability of housing counseling within the second month of delinquency.
- Evaluate each delinquent loan no later than the 90th day of delinquency to determine which loss mitigation option is appropriate.
- Utilize loss mitigation whenever feasible to avoid foreclosure.
- Reevaluate each loan monthly until reinstatement or foreclosure.
- Initiate foreclosure within six months of default unless a loss mitigation option is being pursued, and ensure that all actions taken are documented.

HUD makes clear that failure to comply with the provisions of the Loss Mitigation Program may result in (among other sanctions) reduced reimbursement of foreclosure and acquisition costs and interest curtailment related to foreclosure delays.[1] HUD explicitly requires lenders/servicers to discuss these measures with the mortgagor and to begin intensive servicing efforts as early as possible in the delinquency since these measures become less viable the longer the delinquency continues. The specific options include the following:

- Special forbearance: lenders may allow borrowers up to nine months of suspended or reduced payments and an additional nine months to repay the arrearage on their delinquent mortgage.
- Mortgage modification: FHA allows lenders to modify FHA-insured mortgages to lower interest rates or to extend mortgage terms in order to finance repayment of arrearage.
- Streamlined refinancing of mortgages: FHA permits streamlined refinancing of mortgages that are no more than two months delinquent at the time of the refinance.

- Refinancing of seriously delinquent mortgages: FHA allows lenders to refinance in a new FHA mortgage arrearages of three months or more if the mortgagor has resolved the temporary financial hardship that caused the default.
- Preforeclosure sale: FHA reimburses lenders' expenses for the sale of a property to a third party in lieu of foreclosure. FHA will approve a preforeclosure sale if the proceeds of the sale equal at least 87 percent of the value of the property.
- Deeds in lieu of foreclosure: through the lender, FHA pays an incentive to borrowers to encourage borrowers facing inevitable foreclosure to transfer the deed to their property to the lender or FHA in lieu of foreclosure.[2]

Despite the specificity of HUD's requirements, in 2011 the FHA commissioner testified before Congress that "the agency found that some servicers are falling short in varying degrees of meeting HUD's expectations in assisting borrowers through the loss mitigation process."[3] The FHA commissioner went on to detail some servicer shortcomings: lack of knowledge of FHA's loss mitigation process, inadequate technology, and insufficient staff with proper experience. He noted that to address these shortcomings, HUD was carrying out customized training and providing ongoing evaluation of servicers' progress in correcting deficiencies.[4]

The weaknesses of the servicing record of mortgagees notwithstanding, based on the record of 10 servicers of FHA-insured loans and loans held by government-sponsored enterprises (GSEs; i.e., Fannie Mae and Freddie Mac), a study found that the cost of servicing nonperforming FHA-insured loans was three times higher than the cost of servicing GSE nonperforming loans. And, in addition, FHA's foreclosure and conveyance procedures were also found to be more expensive and time-consuming than those of loans that were not FHA insured.[5]

Principal debt reduction, one of the most important tools to help homeowners in default, is not allowed by HUD/FHA.[6] Just considering the conventional housing stock, and even during the height of the foreclosure crisis, when a variety of special programs were created to provide relief to mortgagors, principal debt reduction was not common. The Principal Reduction Alternative, which became operational in 2010, "did not require servicers to reduce principal, even when doing so provided greater benefits to investors than other forms of modification."[7] As a result, through 2011, only about 5 percent of the permanent modifications made through the Home Affordable Modification Program included principal reduction.[8] In addition, as noted in Issue Brief No. 2, out of all the FHA-insured loans sold through the Distressed Asset Stabilization Program (DASP) that received loan modifications, only 37 percent received principal debt reduction, or forgiveness. Indeed, creating a mechanism for principal debt reduction for FHA-insured loans in end-stage default was one of the hoped-for benefits of DASP. (See Issue Brief No. 2.)

HUD should assess whether it can and should change its statute to allow lenders/servicers of FHA-insured loans to offer a reduction of debt. A Congressional Budget Office study found that "all three [principal forgiveness] options [assessed in the research] would probably result in small savings to the government, slightly reduce mortgage foreclosure and delinquency rates, and slightly boost overall economic growth."[9] And, certainly, if DASP sales are resumed, HUD needs to ensure that principal forgiveness is, indeed, the first option offered to mortgagors, as prescribed by the June 2016 revised guidelines. (See Issue Brief No. 2.)

While this Issue Brief focuses on the role of HUD/FHA and lenders/servicers of FHA-insured loans, homeowners, too, have a number of obligations and responsibilities if they fall behind in mortgage payments. These include contacting lenders as soon as problems arise in making mortgage payments, remaining in regular contact in an effort to cure the default, and requesting a face-to-face interview with their servicer/mortgagee in an effort to resolve the default. In addition, it may be advisable for the homeowner and other occupants to remain in their homes as long as possible to facilitate ease of communication with the lender/servicer and the likelihood of a loan modification.

This Issue Brief focuses on three related questions concerning HUD's regulations and policies pertaining to households facing end-stage default. First, what is the role of third-party mediators in foreclosure avoidance, and how does this connect with HUD's guidelines requiring face-to-face interviews? Second, how has HUD's regulation permitting the conveyance of occupied foreclosed properties been implemented? And third, what are the implications of HUD's policy that bars foreclosed homeowners from buying back their home with a renegotiated mortgage, whether they try to do this directly or through a nonprofit intermediary?

To pursue these questions, I used a multimethod approach combining document analysis, interviews with stakeholders, and Freedom of Information Act requests to HUD. The document analysis involved a review of HUD statutes, regulations, and program guidelines pertaining to foreclosure as well as a review of recent state and local efforts to provide greater protections to mortgagors at the point of foreclosure. Stakeholders interviewed included legal-services lawyers, staff at nonprofit organizations that work on the issues discussed in this inquiry, and clients of a Massachusetts nonprofit organization that works to keep homeowners in serious default in their homes. I also interviewed HUD personnel. Unfortunately, very little came of my Freedom of Information Act inquires to HUD, despite numerous follow-up contacts.

Before turning to the questions explored in this Issue Brief, the following provides important contextual information: an overview of how state laws vary with regard to the foreclosure process.

The Context of Foreclosure: Variations in State Law

State laws vary concerning foreclosure. In 21 states, the lender must bring a lawsuit against the borrower, a judge's ruling is required for the foreclosure sale to proceed, and the courts oversee the foreclosure process. In 29 other states, including Massachusetts,[10] lenders may evict homeowners and sell the property themselves, and no judicial oversight is involved. In such states, the time from default to foreclosure is much shorter; one study found that foreclosures in nonjudicial states took less than six months from default to sale, while judicial foreclosures took six to 12 months.[11] HUD data suggests that the average time to foreclosure is approximately 10 months longer in judicial-foreclosure states than in those without judicial foreclosure.[12] The shorter the period between default and foreclosure, the less time the homeowner has to modify a loan or find another mechanism for remaining in their home.[13] A desire to cut down the time that judicial foreclosures took has, in fact, been cited as a key reason for the creation of DASP.[14] (Also see Issue Brief No. 2.)

The involvement of a judge represents the best chance of resolving a case, but in the absence of mandated judicial involvement, municipalities in some states have adopted their own ordinances. (Also see Issue Brief No. 5.) For example, in 2011, Springfield, MA, adopted an ordinance requiring banks to involve a third party to mediate direct talks between the bank and the homeowner prior to launching foreclosure proceedings; however, a legal challenge by the Massachusetts Bankers Association ultimately invalidated the ordinance.[15] As one reporter put it, "The real stick between the eyes, for the banking industry, appears to be Springfield's insistence on mediation—requiring banks to meet face-to-face with the homeowners they're trying to foreclose on."[16] Also in 2011, the Massachusetts Secretary of State filed a bill that would have required all foreclosures to be approved by a judge, thereby making Massachusetts a judicial-foreclosure state,[17] but the bill was not enacted, and advocates have not yet been successful in changing the state's foreclosure process.

Communication between the homeowner and the lender is a crucial aspect of any successful foreclosure-prevention effort. A Federal Reserve Bank of Boston report provided this summary:

> Foreclosure mediation solves a basic challenge facing any foreclosure-prevention effort: communication between homeowners and lenders. With a mediator serving as a neutral third party, homeowners and lenders have a clear channel of communication to pursue mutually beneficial alternatives to foreclosure … When both parties communicate and participate in the mediation process, an alternative to foreclosure is likely to be found.[18]

The involvement of a neutral mediator is closely connected to the HUD requirement that lenders/servicers hold face-to-face meetings with FHA-insured borrowers who are in default, discussed below.

HUD's Face-to-Face Interview Regulation

Homeowners who are delinquent in their payments on their FHA-insured home mortgage are entitled to a face-to-face interview prior to foreclosure. The *FHA Single Family Housing Policy Handbook* provides for this mechanism to mediate defaults, stating, "The Mortgagee must have a face-to-face interview with the Borrower or make a reasonable effort to arrange a face-to-face interview no later than the 61st Day of delinquency, unless exempt."[19] A key premise of this guideline is that a conversation between mortgagee/servicer and the defaulting borrower may have a better chance of resolving the problem and devising a suitable plan than communication (and missed communication) through phone calls, email, postal mail, etc. Although HUD has a hotline for mortgagors in default to call, phone conversations, particularly for households for whom English is not the first language, can be difficult, intimidating, and confusing. And, even for native English speakers, communicating over the phone can be challenging, particularly when there is a great deal of detailed information to convey. In short, a face-to-face interview gives the homeowner a chance to fully explain the circumstances of the default and to try to work out a strategy to retain the home. But despite the fact that such a meeting is mandated by the HUD, households in default are not consistently given the opportunity to have one.

A Massachusetts attorney who has litigated a number of cases based on the failure of lenders/servicers to offer a meaningful face-to-face interview stated:

> A servicer might send a letter to the mortgagor offering to hold a face-to-face meeting. In practice, however, these letters appear to be an attempt to create a paper trail showing compliance rather than a willingness to comply with the substance of the regulation. A borrower might call in response to one of these letters, but there does not seem to be a way to actually arrange a real-world face-to-face meeting. In cases where lenders have been specifically ordered to produce evidence that such a meeting could actually be arranged, the lenders have been unable or unwilling to produce documentation—even if it means they will lose their case.[20]

The lack of a face-to-face interview was the central issue in a Massachusetts court case, *Wells Fargo v. Cook.*[21] The lender had gone through a foreclosure process that was overturned by the court because the interview that took place was deemed inadequate: it did not meet the standards for a meaningful interaction. In other words, the failure to provide a meaningful face-to-face interview resulted in the invalidation of the otherwise legitimate foreclosure, which had involved the mortgagor's failure to meet its mortgage payment obligations.

There have been several other court cases, in various parts of the country, with a similar basis. What seems clear is that mortgagees have a duty to abide by the terms of their own contract. Thus, if the contract clearly states that HUD's regulations must be followed in general, or that the face-to-face interview is specifically required, then the courts are likely to render decisions in favor of the mortgagors.[22]

According to a Florida attorney, several court cases have questioned whether the explicit exceptions to the face-to-face interview allowed by HUD's regulation are sufficient to waive the requirement. Specifically, the requirement that lenders/servicers must make "reasonable efforts" to arrange the face-to-face interview is open to interpretation and has been grounds for litigation. Given the subjective nature of this clause, different judges have made different interpretations, resulting in inconsistent rulings.[23]

In an attempt to gather first-hand information from FHA-insured mortgagors in end-stage default on their experiences dealing with their lenders/services, I conducted three interviews with mortgagors in Massachusetts cities in late 2017 and early 2018. All three were clients of a Boston-based nonprofit program, Stabilizing Urban Neighborhoods (SUN), which is affiliated with a community development financial institution, Blue Hub

Capital (formerly known as Boston Community Capital).[24] SUN helps homeowners in end-stage default to try to retain their homes through a renegotiated mortgage. (Also see Issue Brief No. 5.) Working out deals in cases of end-stage default is time-consuming, but if a nonprofit organization serves as an intermediary, the process is likely to proceed more smoothly. None of the homeowners was offered a face-to-face interview by the lender/servicer.

Case 1

A married couple with a child living in a one-family home in Pittsfield suffered reduced income due to job loss; they missed several mortgage payments. The lender/servicer returned the subsequent payments because they did not cover all overdue amounts. Over a five-year period, the owner made numerous applications for loan payment modifications. Each was rejected for various reasons. For each submission, the owner was required to fax the lender/servicer the same financial documents. The servicer never offered a face-to-face interview. When foreclosure was imminent, SUN intervened and the servicer quickly offered the homeowners an acceptable repayment plan. At the time of the interview, the family had been current on their mortgage for two years.

Case 2

Three people bought a two-family home in Lowell in 2007; a husband and wife occupied one unit, with a close friend occupying the other. After several years, the friend encountered financial difficulties, which resulted in her leaving the property and relinquishing all interest in it. The husband-wife owners tried to modify the loan but were unable to do so since the friend was on the mortgage as a co-owner. With the property valued at about $150,000 below the purchase price and in need of major repairs, a short sale seemed like the best option. SUN was contacted and tried to arrange this transaction; however, just before it was finalized, the loan was sold and a new lender/servicer became involved. The owners cited challenges with both lenders, including miscommunications, inaccurate documents being produced, and disrespectful comments. At the time of the interview, with a foreclosure date set, the owners were still hoping for a short sale. Neither of the two lenders had offered the owners a face-to-face interview. All communications with the second lender have been with an office in Coral Gables, Florida, some 1,500 miles from the property.

Case 3

An owner of a four-family home in Fitchburg started to have financial difficulties when his local water bill and property taxes went up significantly. At about the same time, some of his tenants stopped paying rent, which resulted in reduced income. A lawyer advised him to stop making payments while they continued to try to work out a loan modification with the lender. Eventually, the owner attempted to make partial payments, but the lender would not accept them. Efforts by SUN did not result in a positive outcome: the lender was unwilling to sell to the nonprofit, since the latter would have sold the home back to the homeowner. In 2015, about seven years after the owner's financial difficulties started, the lender foreclosed and the tenants were evicted; however, as of the time of the interview, the home had not been sold at a foreclosure auction and the owner was continuing to live there. The situation appears to have fallen through the cracks of the lender's foreclosure process. The owner has never been offered a face-to-face interview with the lender.

Although one might argue that the homeowner in the last case benefited from the lender's seeming negligence, living in a situation of uncertainty about the status of one's home, with a constant worry about a potential eviction, is not an optimal situation for most people. The cases also suggest that in some end-stage default situations, a good resolution could be achieved if HUD insisted on lenders/servicers offering a face-to-face interview. Regardless, HUD appears unable or unwilling to enforce that requirement.

Beyond the considerable involvement of groups like SUN, a key role for nonprofit organizations has been as housing counselors. Housing counseling services have been provided at no charge since the 1970s by HUD-certified agencies, which have become a well-accepted and integral part of the homeownership process. Nonprofit organizations also provide default counseling, which involves connecting borrowers to public services, exploring lender-provided alternatives to foreclosure and providing an outside review of the household's finances to assess mortgage loan repayment options.[25] Homeowners may get into financial difficulty for any number of reasons—poor planning, inappropriate choices, or unanticipated life events that result in financial distress. Regardless of the reasons, it is essential that lenders and homeowners are able to communicate with each other.[26] Sometimes the nonprofit that is offering counseling services may facilitate a face-to-face interview with the servicer/lender, while other times it may serve as a go-between, establishing a direct line of communication between lender and borrower.

Nonprofit organizations providing housing counseling must have both the technical knowledge and sophistication to negotiate with the lender and a social-service orientation, with staff with the skills and commitment to help homeowners understand and navigate the process. As discussed in Issue Brief No. 5, a key element of SUN's model is that it has the financial resources to actually provide a new mortgage based on its own evaluation of a foreclosed property's worth and its own assessment of a household's financial ability to carry a new loan. From a public-policy perspective, although SUN has encountered some recent criticism (see Issue Brief No. 5), the SUN model presents an innovative approach for assisting homeowners facing foreclosure, provided those homeowners have a financially viable profile.

There are a number of unanswered questions about HUD's face-to-face interview requirement. These and a number of policy implications for HUD are presented in Table 1, just prior to the conclusion.

Regulation Allowing Occupied Conveyance of FHA-Insured Foreclosed Homes[27]

When a foreclosure occurs on a FHA-insured home, HUD/FHA, as the insurer of the mortgage, takes possession of the foreclosed property and attempts to sell it to a new owner. Although HUD guidelines generally mandate that foreclosed properties "be vacant at the time of conveyance to HUD," they also allow for occupied conveyance—the transfer to HUD of a property that is not vacant—if the borrower or other occupant meet certain regulatory conditions.[28] For properties with one to four residential units, those conditions include any of the following: the owner or tenants suffer from illness or injury that would be aggravated by the process of moving from the property; state or local law prohibits the mortgagee from evicting a tenant; or it is in HUD's interest to accept conveyance of the property occupied.[29]

The conditions of the last requirement are fulfilled if one or more of the following are true: if occupancy of the property is essential to protect it from vandalism from the time of acquisition to the time of preparation for sale, if the average time in inventory for HUD's unsold properties in the area in which the property is located exceeds six months, if the high cost of eviction or relocation expenses makes eviction impractical, and, with respect to multiunit properties, if the marketability of the property would be improved by retaining occupancy of one or more units.[30]

Beyond the advantages of occupied conveyance to HUD noted above, there are additional reasons why allowing prior owners or tenants to remain in their homes following a foreclosure may be advantageous to other stakeholders. For instance, lack of occupancy can reduce the value of a home, since buyers may assume that the seller is desperate. Also, as noted in Issue Brief No. 3, vacant homes tend to deteriorate, which has an adverse impact on the resale price. Conversely, if a bank chooses to rent the property to the prior owner, rental income can help offset the cost of maintaining the property during what can be a long period between foreclosure and resale.[31]

A model letter that HUD sends to mortgagees for them to send to preforeclosure mortgagors notes, "HUD generally requires that there be no one living in properties conveyed to the Secretary as a result of foreclosure." But that letter also outlines the cases, given above, in which the mortgagor may be "entitled to remain in the property for some period of time," explains why occupied conveyance may be approved, and advises that such a request must be in writing and submitted with 20 days of the date of the letter. The letter also advises that occupancy would be secured by a month-to-month lease, with rent payments at the prevailing fair market rate. It further cautions that occupancy would only be temporary.[32]

But while HUD regulations and guidelines thus explicitly allow for properties to be conveyed occupied, in reality, this happens extremely rarely. During fiscal years 2010–2014, there were a total of 23,746 requests for occupied conveyance in FHA-insured foreclosed properties, but only 87 of those requests—far fewer than 1 percent—were approved.[33]

HUD has provided no information regarding its reasons for approving or denying requests for occupied conveyance or about the more recent number of tenants or homeowners who have been permitted to stay in their homes after foreclosure. With regard to how long households that were approved for occupied conveyance were allowed to stay in their homes, HUD has only said, "Approvals are for a very short period of time."[34] Indeed, a HUD handbook states that the month-to-month lease period is intended to be temporary and can be terminated in order to prepare a property for sale, complete a sale, or assign the property to another use or program.[35] However, even continued occupancy for a short period of time may be advantageous to existing residents and could potentially provide sufficient time for a nonprofit organization to complete a purchase of the home and prevent the home from becoming vacant.

A lawyer in the Massachusetts attorney general's office expressed her frustration with HUD/FHA's rigid conveyance procedures, which are at odds with the latitude stated in the handbook:

> FHA is, in many ways, very difficult to deal with; they purport to be bound by their rules irrespective of the absurdity of the outcome. Specifically, the foreclosed property must be vacant before the servicing bank can convey the house to the FHA and, thus, get reimbursed by the FHA.[36]

As with the face-to-face interview requirement, several questions persist regarding occupied conveyance, and these are summarized in Table 1 along with policy implications for HUD.

Policy Restricting Foreclosed Homeowners' Ability to Buy Back the Home with a Renegotiated Mortgage

A number of legal-services lawyers in Massachusetts, as well as staff of several nonprofit organizations, have noted an additional way in which their dealings with HUD on behalf of low-income clients have been frustrating and problematic: HUD's policy of restricting or making it very difficult for the former owner of a foreclosed home to buy back the home either directly from HUD or from a third-party intermediary, such as a nonprofit organization, that has purchased the home on the former owner's behalf. In short, "the FHA is intransigent, even though a sale [to a nonprofit] is a win-win for all involved and is much less expensive to the FHA than the alternative." [37]

The infrequency with which HUD sells foreclosed homes back to the original owner (or to a nonprofit working on their behalf) appears to be based on a number of related policies and regulations. One such regulation states that neither HUD nor any entity to whom the property has been transferred "will offer former mortgagors in occupancy who have defaulted on the mortgage the right of first refusal to repurchase the same property."[38] Negotiating with the foreclosed owner or with a nonprofit acting on the owner's behalf could be interpreted as offering the owner the right of first refusal and therefore disallowed. This regulation further states that "no nonoccupant mortgagor … of an insured mortgage who has defaulted, thereby causing HUD to pay an insurance claim on the mortgage, is eligible to repurchase the same property."[39]

Another complicating factor is HUD's arm's-length requirement in mortgage transactions. HUD defines an arm's-length transaction as one between unrelated parties that meets the requirements of market value (i.e., the property must be sold for a price comparable to other market-value transactions made between disinterested parties).[40] The requirement was designed to ensure that a property sale is not a sham transaction intended to relieve the homeowner of his or her current mortgage debt while still allowing the person to remain in the property as a homeowner. Specifically, the requirement is intended to protect against a “moral hazard” that would lead to a so-called strategic default, whereby a homeowner defaults on purpose, whether because the property value is “underwater” (the outstanding mortgage is higher than the market price) or for another reason, even though the homeowner can afford the mortgage payments.

Whenever a nonprofit organization is involved in a transaction on behalf of a mortgagor who is in end-stage default or who has gone through a foreclosure, the purchase of that home, by definition, does not qualify as an arm’s-length transaction. Although financial gain for the nonprofit is not the motivation, the arm’s-length requirement works against nonprofits that are trying to negotiate buyback transactions. In effect, the arm’s-length policy, along with HUD’s occupied-conveyance policy and the desire to maximize sales prices to promote the financial solvency of the MMIF, all conspire to create de facto limitations on HUD’s willingness to sell foreclosed homes back to their former owners.

Nevertheless, there have been cases in which, with the help of a lawyer or nonprofit organization, the homeowner has been successful. In one 2014 case, a legal-services lawyer expended significant effort to convince HUD to waive the foreclosed-owner restriction on behalf of her client. She was ultimately successful, but this was a one-time exemption, not a general change in policy. In another case, a homeowner first tried to repurchase their home through a nonprofit organization, Blue Hub Capital (referenced earlier; also see Issue Brief No. 5 for a description of how this organization’s SUN program helps foreclosed homeowners who did not have FHI-insured mortgages re-purchase their homes), but HUD and the lender did not accept the offer. After a number of actions, advocates and the city convinced the mortgagee to reverse its recently completed foreclosure proceeding, in which it had accepted less than the amount required by HUD. The property was then sold to another nonprofit organization, the Coalition for Occupied Homes in Foreclosure, and as of summer 2018, the foreclosed homeowner was scheduled to repurchase the home, with the land being placed in a land trust.[41]

HUD-certified counseling agencies, as well as other independent, reputable nonprofit organizations would be key in ensuring that a more lenient owner buyback policy was used appropriately: a nonprofit in this role would minimize the chance of households that were not in genuine financial distress trying to benefit from this policy.

A Massachusetts law offers some protection to foreclosed homeowners by stipulating that when a 501(c)(3) organization (i.e., a tax-exempt, charitable nonprofit organization) offers to purchase a residential property, creditors may not require as a condition of the sale the limitation of ownership or occupancy of the property by the homeowner or former homeowner.[42] HUD has acknowledged that laws such as this conflict with its policies and advises mortgagees to “seek [FHA] guidance and assistance in complying with both FHA requirements and any applicable state laws.”[43] Since the Massachusetts attorney general has not pursued the issue, it is not known whether the Massachusetts law would prevail over HUD/FHA’s rules. An argument could be made that since the processes of foreclosure and conveyance of real estate are traditionally within the domain of the states, Massachusetts law should prevail.

Although HUD continues to be opposed to selling a home back to the original owner or to a nonprofit organization on the owner's behalf following a foreclosure, the agency is willing, under some circumstances, to allow mortgagees holding FHA-insured loans to sell to SUN (and presumably other nonprofits) in short-sale scenarios. HUD's short-sale guidelines require that the purchase price meet a minimum percentage of the home's value, ranging from 84% to 88% of the fair market value, depending on how long the house has been on the market.[44] Under these circumstances, the homeowner would be able to continue their occupancy of the home while the new mortgage and ownership arrangement is finalized.

However, for homes that have gone through the foreclosure process and are known as bank-owned, or REO (real estate–owned), properties, the situation is different. For a mortgagee holding a FHA-insured loan to be reimbursed by HUD through FHA's MMIF, the mortgagee must convey the REO property back to HUD vacant. As a result, mortgagees simply won't sell SUN any REO property unless it is vacant.[45] Thus, while HUD's guidelines allow for occupied conveyance of foreclosed properties, in order for the lender to receive the money due from the MMIF as a result of the foreclosure, it appears that the property must be vacant. This significantly cuts down on the applicability of HUD's occupied-conveyance guidelines.

Here, too, several questions warrant further study, as summarized in Table 1. Moving forward, a key challenge would be to consider a statute change that would make it possible for HUD to develop a policy that allows principal debt reduction and makes explicit the circumstances under which HUD should write off some amount of the outstanding principal debt. If a statute change is not feasible or desirable, HUD could consider providing principal debt reduction as a loan, to be repaid upon the sale of the home, as with the partial payment option discussed below.

In order to distinguish actual distress situations from sham defaults, as with an expanded owner buyback program discussed above, HUD could require that a certified nonprofit intermediary or HUD-approved counseling agency be involved in approving any request for principal debt reduction. Additionally, it could gather more information on the outcomes when partial payments are accepted as a loss mitigation option and, if warranted, utilize that option more broadly. Utilization involves HUD paying the mortgagee a portion of the principal owed, thereby allowing the homeowner to catch up on overdue payments. The amount of the claim is treated as an interest-free loan that does not have to be repaid until the first mortgage is paid off or until the borrower no longer owns the property.[46] Ideally, this sum would be repayable only if the house appreciates in value, taking into account major home improvement expenditures. Overall, a key goal is for HUD to make protecting homeowners' interests a top priority and to experiment with innovative and bold ways to stabilize their housing situation, which in turn will cut down on the negative impacts that foreclosures have not only on property owners and tenants, but also on the surrounding neighborhood and the municipality.

Conclusion

HUD/FHA's mortgage servicing, loss-mitigation, and property-conveyance rules all have the potential to make it possible for mortgagors in distress to avoid displacement. Yet these mechanisms are infrequently and inconsistently offered to mortgagors. In concluding this discussion, a general overriding question is, What is HUD doing to monitor how well servicers are following its guidelines concerning loans in default, particularly those in the end stages, so that foreclosures are prevented whenever possible? It appears that this task is not receiving adequate attention, and more oversight is needed. HUD itself seems to be aware that there are a number of problems with its servicing operations and that it needs to have "more flexibility to work out loans … [and] eliminate unnecessary paperwork and process steps that will streamline borrower qualification in case of hardship."[47]

Further research is needed to explore what HUD views as best practices for assisting mortgagors facing end-stage default and foreclosure and how it and its mortgagees/servicers can better work with homeowners and nonprofit organizations to enable homeowners and tenants to stay in their homes, using innovative ownership or refinancing mechanisms. A further area of exploration is whether failure to comply with HUD regulations could be used as grounds to deny compensation to lenders/servicers for the many costs incurred as a result of foreclosure.

The disappointing record concerning the implementation of the policies discussed in this Issue Brief are all the more frustrating in view of the costs associated with the servicing of FHA-insured loans—costs that are considerably higher than the costs of servicing conventional loans.[48] Additional questions about the actual costs incurred by HUD due to a foreclosure, including regional differences, should be addressed. Since foreclosure triggers the use of MMIF funds to pay off the outstanding principal balance on FHA-insured loans, as well as other fees, and because the MMIF also "takes a hit" when nonperforming loans are sold to investors through the Distressed Asset Stabilization Program (see Issue Brief No. 2), could HUD be encouraged to see its losses due to foreclosure as providing them leeway to further assist homeowners in default, so as to avoid foreclosure and the expected losses? (See Issue Brief No. 5.)

While answering these questions may be difficult, and while there must be a political will to launch any such inquiry, the efforts of local nonprofit organizations and legal-services lawyers are encouraging. There is good potential for better solutions to be found—solutions that avoid or minimize the negative outcomes of foreclosure for people and neighborhoods while maintaining the integrity of HUD/FHA's programs and the solvency of the MMIF.

Table 1 | Observations, Questions for Further Research, and Policy implications: HUD Regulations and Policies Concerning End-Stage Default

Observations from the study	Questions for further research	Policy implications for HUD
1) HUD/FHA's mortgage servicing, loss-mitigation, and property-conveyance rules all provide mortgagors in distress opportunities to retain their homes and avoid displacement, but these mechanisms are infrequently or inconsistently offered to mortgagors. Many questions are raised about agency operations and oversight. A key question is whether HUD/FHA is doing all it can to prevent foreclosures.	1a) To what extent are the specific steps outlined in HUD's loan mitigation program being followed? 1b) What are best practices for assisting mortgagors facing end-stage default and foreclosure, and how can lenders/servicers better work with homeowners and nonprofit organizations to enable homeowners and tenants to stay in their homes, using innovative ownership or refinancing mechanisms?	1) Utilize and enforce mortgage servicing, loss-mitigation, and property-conveyance rules and policies to reduce the frequency and consequences of foreclosure.
2) Principal debt reduction, one of the most significant ways to help homeowners in default, has been utilized only infrequently by lenders/servicers of conventional loans. This option is not permitted for FHA-insured loans.	2) What are the obstacles to changing HUD/FHA's current statute concerning principal debt reduction? What are the possible debt reduction strategies (e.g., either as a permantent write-down, or as a loan, in exchange for a promise to repay the amount of debt forgiven, upon the sale of the house), and how could these various strategies be evaluated? What are the experiences with the partial-payment option, and how might this inform a new principal debt reduction initiative?	2) Assuming the statute can be changed to allow principal debt reduction for FHA-insured loans, HUD could develop appropriate policies based on an analysis of how various principal debt reduction options could work to better assist homeowners without encouraging "strategic defaults" by mortgagors who are not in financial distress. Even without a change in the statute, it may be possible for HUD to temporarily reduce the debt through a loan, repayable when the home is sold.
3) Servicers of FHA-insured and GSE (Fannie Mae and Freddie Mac)-held loans found that costs of servicing nonperforming FHA-insured loans were three times higher than the cost of servicing GSE nonperforming loans and that FHA's conveyance procedures were	3) What are the best practices for servicing FHA-insured and GSE-held loans?	3) Servicing guidelines for FHA-insured loans should be assessed to bring costs more in line with the cost of servicing GSE-held loans. HUD and the Federal Housing Finance Agency (which oversees Fannie Mae and Freddie Mac) should collect similar data to facilitate comparisons.

Observations from the study	Questions for further research	Policy implications for HUD
more expensive and time-consuming.		
4) HUD requires a face-to-face interview between lenders/servicers and mortgagors prior to foreclosure. However, this rule is not consistently followed.	4a) Does the face-to-face interview actually increase the likelihood of a default being cured, based on results from a controlled study? How does this option compare with other possible ways to communicate with homeowners in default? 4b) Assuming the results of a controlled study are positive, how does HUD enforce its requirement that servicers make a reasonable attempt to hold such a face-to-face meeting (or implement other desirable strategies)? How can this rule be implemented even if the lender/servicer is more than 200 miles from the property (which is one reason for exempting the meeting requirement)? Is a video conference or other type of communication with the lender/servicer a good substitute?	4a) Working with the housing counseling industry, ensure that servicers are communicating with homeowners in default in the most effective ways possible. 4b) Assess the desirability of denying claims for mortgage insurance if the face-to-face interview requirement (or other effective communication strategies or any other requirement of the loan mitigation process) has not been met.
5) Under certain circumstances, HUD allows foreclosed properties to be conveyed with occupants. This can benefit homeowners and tenants. However, this rule has been used very infrequently.	5a) Since HUD has not provided recent information on utilization of the occupied conveyance rule, questions persist about: the number of homeowners who have made such a request: the number of these requests that have been approved/denied by HUD, and the reasons for approval and denial? 5b) What is the record of approved requests for occupied conveyance? To what extent do they result in positive outcomes for homeowners and for preventing homes from becoming vacant? How have	5a) HUD should make such information available. 5b) Based on additional research/evaluations, consider wider use of the occupied-conveyance rule. If the property is conveyed with occupants assess whether lenders should be paid some or all of the

Observations from the study	Questions for further research	Policy implications for HUD
	approvals impacted costs to HUD and to the MMIF?	payments due as a result of the foreclosure.
6) HUD policy has made it very difficult for homeowners who have lost their homes to foreclosure to buy back their homes either directly from HUD or from third-party intermediaries such as nonprofit organzations that have purchased the homes on behalf of the foreclosed homeowners. The key reason for this relates to HUD's "arm's length" rule, which attempts to preclude any self-dealing or fraudulent activities in mortgage-lending transactions.	6a) What additional information would be necessary and what criteria should HUD use to reverse its policy restricting sales of foreclosed properties to the original owners or to permit a third-party intermediary to negotiate such a sale? How could a comparison between the likely positive outcomes of such a policy change and the likely negative outcomes of the property becoming vacant following a foreclosure contribute to better policy outcomes?	6a) Consider adopting alternatives to the "arm's length" requirement that enable prior owners or tenants to stay in their homes after a foreclosure without jeopardizing the seemingly valid intent of the provision: to safeguard against sham or fraudulent transactions.
HUD-certified counseling agencies and other independent, reputable nonprofit organizations would be key in ensuring that a more lenient owner-buyback policy was used appropriately.	6b) What is the optimal way to promote home retention while also avoiding "strategic defaults?" (See point 2 above.) What type of research/controlled experiments would be able to answer this question? How can the role of nonprofit organizations in these transactions be assessed?	6b) Based on research findings, consider adopting safeguards and regulatory controls so that policy change would not result in a wave of "strategic defaults."

About the Author

Rachel G. Bratt

Rachel G. Bratt recently was a visiting scholar at the Federal Reserve Bank of Boston and is professor emerita at the Department of Urban and Environmental Policy and Planning at Tufts University. She is also a senior research fellow at the Joint Center for Housing Studies of Harvard University and the author of numerous works in the field of housing policy.

Rachel.Bratt@tufts.edu

Endnotes

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[24] Staff at SUN provided a list of all of SUN's FHA-insured clients from between 2009 and September 2017, who were facing near-certain foreclosure or eviction (N = 115). Of these, 18 came from households in one of the Federal Reserve Bank of Boston's Working Cities (the Working Cities from which these households came were Chelsea, Fitchburg, Lowell, Pittsfield, Springfield, and Worcester). Since there were not enough households in this database from Lowell alone, I broadened the list of possible interviewees to include anyone from the six Working Cities. Based on SUN's information about the cases, letters were sent to12 of these households, explaining my project and asking them to contact me if they were interested in discussing their experiences with SUN. I heard from three people, whose cases are presented in the text. Sharon R. Shepard, (former) managing director, Boston Community Capital Venture Fund, and chief operating officer, SUN Initiative, was enormously helpful in facilitating the interviews.

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