**Policy Options Memo for Delinquent Loans and Foreclosed Homes**

*How can the disposition of foreclosed homes and delinquent loans by government –related entities increase the supply of homes for purchase and stabilize neighborhoods?*

Currently there is a serious inventory shortage of lower priced, high-quality, single-family homes for potential homebuyers across both urban and suburban areas. This housing shortage is partly attributable to the fact that new housing starts in the single family sector never recovered after the financial crisis. The conversion of single family homes to rental housing owned by investors also plays a role in this shortage.

Government policies with regard property disposition need to be reformed now so that foreclosed properties can benefit families and neighborhoods. With the right disposition policies, these homes can increase the supply of affordable housing while avoiding the costs of blight and vacancy. This approach is a win-win that creates more housing with less subsidy than new construction.

When borrowers whose mortgage loans that are purchased by Fannie Mae or Freddie Mac or are guaranteed by FHA get into financial trouble, it ultimately has an impact on the supply of affordable homes. Troubled loans are sometimes packaged into pools that are sold to investors who either work with the existing homeowner to resume payments or move to foreclosure and sale of the property. In other cases, after a foreclosure, the property is sold by the holder of the mortgage or the guarantor.

Many of the 10 million homes that were foreclosed on during the Great Recession were sold to investors through these channels and many of them eventually became rentals. More than 3.8 additional households rented single family homes between 2006 and 2016. By 2015, one in five single family homes were rented.[1] One of the reasons for this wholesale shift in the ultimate use of these properties is how the properties changed hands after foreclosures. Rather than being made available on conventional real estate listing services where families shop for homes, millions of properties were sold to investors through auction web sites used by investors.

These homes that were sold off to investors after the Great Recession were a tremendous missed opportunity. This inventory could have been used for affordable homeownership or well-managed rental by mission-driven landlords. Instead, the U.S. government sold ultimately hundreds of thousands of properties to private equity funds or other private buyers at a discount. When the eviction and foreclosure moratoria in effect now in

[1] Carolina Reid, *The Rise of Single Family Rentals after the Foreclosure Crisis*, The Terner Center, University of California Berkeley.

response to COVID expires, inevitably there will be more foreclosures and property sales. Thus, it is important now to improve the way troubled government- backed loans and foreclosed properties are handled.

There are three aspects of this issue that require policy solutions. (The best practices suggested below could be models for responsible property dispositions by private financial institutions with troubled loans and REO as well.) Each is described below in order of when in the foreclosure process it occurs.

1. **Note Sales (FHA and GSEs):** These are sales of mortgages that are in the foreclosure pipeline but have not yet gone through foreclosure sale. FHA and the GSEs generally sell these in bulk pools. The way they are currently sold, the vast majority of them are purchased by private equity funds or other private financial entities. FHA sells some special pools with "outcome requirements." Examples of outcome requirements include stipulations that sales be to owner-occupants or nonprofits and that current homeowners be offered options to reperform on their mortgage. Outcome requirements are designed to advance policy priorities like affordable homeownership and neighborhood stabilization. The GSEs sell nonperforming loans with "guidelines" about the treatment of borrowers and preferences about who can purchase the pools.

   The sale of nonperforming loans at FHA and the GSEs need a complete overhaul to better support public purposes such as affordable homeownership, neighborhood stabilization, and racial equity. Outcome requirements are essential to achieving these purposes. This could be done either by legislation or by regulatory change.

2. **Third Party Sales (FHA only):** Because FHA is an insurer rather than a direct investor like the GSEs, their foreclosure process historically consisted of a two-step process: first, the lender would foreclose on the home, and then, in order to receive its insurance claim payment from FHA, would "convey" the property to the HUD REO portfolio. However, in part because the HUD REO conveyance process is known to be slow and difficult to navigate, servicers are always looking for other options. In recent years, a very small program of "third party sales" has grown to become the predominant way that servicers receive their payment of claims - more than 75% of HUD foreclosures are sold this way. In this process, which goes by the cumbersome yet descriptive name of "Claim Without Conveyance of Title" (or CWCOT), servicers can sell their properties directly to third parties but still get their claim paid by FHA. The properties are generally sold at auction largely to investors, who either flip them for a profit or rent them out. It is rare for owner-occupants or nonprofits to be able to buy them. This process needs a complete overhaul for several reasons.

   First, because properties that flow through CWCOT never enter HUD's REO portfolio after foreclosure, these properties are not subject to the special homeownership and nonprofit acquisition opportunities provided through HUD's REO program:

- The 15 day “first look” period of priority for homeowners, nonprofits, and government agencies on insured homes (eligible for FHA loans) and a 5 day period for uninsured homes (ineligible for FHA).
- The “Good Neighbor Next Door” program that gives teachers, firefighters, police officers, and nonprofits access to properties at a significant discount in revitalization areas.
- The “Insured with Escrow” program for homes needing less than $10,000 in repairs which provides that buyers are eligible to receive funds to repair the property upon acquisition through an FHA renovation loan.

Second, the vast majority of properties sold in the CWCOT program are sold through private auction websites rather than on the Multiple Listing Serve (which is how most families shop for homes.) While theoretically those auction websites are open to all members of the public as well as real estate agents, many pose significant obstacles to participation by homeowners such as listings that specify cash-only offers or the need for a deposit in an account to be an active buyer.

By facilitating sales to cash buyers rather than homeowners, HUD is unintentionally speeding the transition of neighborhoods from homeownership to rental and putting upward pressure on home prices. Thus cash sales negatively affect housing affordability and neighborhood stability. HUD should change the CWCOT rules to prioritize selling foreclosed properties to owner occupants whenever possible. To do so, HUD should require that all CWCOT sales be conducted on platforms that are fully accessible by typical homebuyers and nonprofits, including the use of conventional and FHA financing as well as cash or lines of credit, with a 15-30 day “First Look” priority for nonprofits and potential owner-occupants.

3. **REO Sales (FHA only)**: REO stands for “real-estate-owned,” which are properties that are reclaimed by FHA, Fannie Mae, or Freddie Mac after homeowners default on their loans. The GSEs already have special programs to give an exclusive first opportunity to purchase these properties either to nonprofits or to owner-occupants, although these programs are regulatory choices rather than legal requirements. FHA also has several programs for its REO Sales, including a homeownership first look, the Good Neighbor Next Door program, and the Insured with Escrow program that provides buyers with repair funds. However, since most FHA-insured properties are not coming through HUD REO, these programs are virtually irrelevant in today’s environment. These programs need to be recreated and improved through the reforms to the CWCOT program discussed above.

4. **Mission-focused single family rental pilot (GSEs):** The GSEs should create a pilot that provides financing to mission-focused developers to purchase distressed properties to be used as rental housing with an eventual conversion to homeownership. There is a need for capital to finance acquisition of properties in

communities struggling with blight and low demand for homeownership. These properties are at risk of being acquired by investors without rehab and thus continuing the cycle of blight and disinvestment that harms neighborhoods.

With financing from the GSEs, a nonprofit developer could rehab the homes and manage them as affordable rental housing and thus stabilize the neighborhood. When the market improves, these properties would be good candidates to be sold to owner-occupants. This model could also work in markets where mission-driven developers can sell the properties directly to owner-occupants. These activities should be eligible for Duty to Serve credit for the GSEs.