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HUD's Distressed Asset Stabilization Program: Salvation or Sound Bite?

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Earlier this summer, the U.S. Department of Housing and Urban Development (HUD) announced the kickoff of the *Distressed Asset Stabilization Program* (the Program or DASP) and last week HUD issued additional information regarding the upcoming September sale under the DASP. The Program expands an earlier Federal Housing Administration (FHA) single family loan sales pilot program (the Pilot) intended to safeguard the FHA insurance fund while helping seriously delinquent FHA borrowers avoid foreclosure after they have exhausted the loss mitigation options available under existing FHA regulations.

Under the Program, servicers may submit loans meeting certain criteria for claim submission and assignment to HUD before the loans are foreclosed, after which HUD will pool the loans and sell the pools to bidding investors. To participate in the Program, however, servicing mortgagees will have to certify the loans' compliance with applicable FHA rules, including loan origination, servicing and loss mitigation requirements – certifications not required in HUD's existing insurance claim process. In addition, investors that purchase recently announced Neighborhood Stabilization loan pools must be amenable to becoming long-term landlords in many instances.

HUD is moving forward with a September launch of the expanded Program, but questions remain as to how successful the Program will be, given the additional certifications required of the servicing mortgagees assigning loans to HUD and the additional restrictions on investors that purchase the Neighborhood Stabilization loan pools. The additional certifications made by assigning mortgagees could materially increase a servicer's risk of liability under the False Claims Act, which authorizes the government to pursue treble damages, where the lender is liable for *three times* the damages sustained by HUD, and civil penalties of up to $11,000 per transaction, if such certifications are not accurate.

The Distressed Asset Stabilization Program

The DASP expands the FHA's Mortgage Acquisition and Disposition Initiative, a pilot program that HUD initiated in 2010 under Section 601 of the 1999 HUD Appropriations Act, which amended section 204 of the National Housing Act to give HUD greater flexibility in handling FHA insurance claims. Under the Pilot, HUD used this new flexibility to pay claims upon the assignment of mortgage loans, rather than conveyance of the properties securing FHA-insured loans subsequent to foreclosure, in an effort to help borrowers avoid foreclosure, stabilize neighborhoods, and minimize FHA and taxpayer losses. While servicers still had to exhaust all of the standard loss mitigation options and meet certain other requirements to participate, they did not foreclose on or evict the borrowers; rather, they submitted claims for FHA insurance benefits and assigned the defaulted mortgage loans to HUD while the borrowers remained in title to the properties.

HUD then sold the loans to investors at a discount, and the investors were prohibited from foreclosing on the borrowers for an additional six months. While FHA rules are strict in connection with modifying defaulted loans and preclude lenders from simply reducing loan balances, an investor under

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the Pilot was free to modify the now uninsured loan as it saw fit and thereby could utilize additional loss mitigation options outside of FHA requirements to enable borrowers to remain in their homes.

With the DASP, HUD intends to expand the Pilot by increasing the size of pools of available loans by 10 times with an ultimate goal of reaching 5,000 loans per quarter, or 20,000 loans per year. HUD officials have indicated that there will be two pool types: (1) standard national pools, where the Program will increase HUD's standard, unrestricted note sales at the national level in line with HUD's current process; and (2) neighborhood stabilization pools, where FHA will seek to assemble pools in communities hardest hit by the foreclosure crisis and include sale provisions to support neighborhood stabilization. In a press release issued last week, HUD announced that it will accept bids on loan pools consisting of approximately 9,000 loans for the September 2012 sale. HUD's offer includes 3,500 loans in Neighborhood Stabilization pools consisting of loans secured by properties located in four geographic areas that are among the hardest hit by the housing crisis.

HUD has touted the Program's ability not only to lower losses to the FHA, but to help borrowers avoid foreclosure and thus entire neighborhoods avoid the declines in value associated with foreclosures. Based on additional information released by HUD last week, we understand that the same basic requirements imposed on servicers under the Pilot also will apply to the enhanced DASP, with additional requirements for investors that purchase Neighborhood Stabilization loan pools through the Program. Below, we summarize these requirements for both servicing mortgagees and investors.

Program Requirements for Servicing Mortgagees

While the Pilot and DASP champion admirable goals, servicing mortgagees wishing to partner with HUD in its endeavors face steep requirements. For example, unlike under the typical HUD claim process whereby a servicer must certify only that the information contained in the claim form is correct, under the Program, a servicer must enter into a Participating Servicer Agreement (PSA) with HUD and execute a Self Certification Form.

The representations and warranties in the agreement state that all applicable loan origination (if applicable) and collection requirements were met in connection with every loan in the pool. Only certain representations and warranties are qualified by materiality, such as the failure to comply with applicable law in all material respects. The repurchase remedy is not in any way qualified by a breach that has a material adverse effect on the purchaser of the loan. In addition, the Self Certification Form requires the servicer to attest to the fact that every loan in the pool meets HUD's eligibility criteria and that the servicer retains detailed supporting documentation of such eligibility in its files, again without any materiality or knowledge qualifiers. *Under the PSA, like the position taken by the GSEs, a servicer's breach of these requirements could result in its repurchase of the affected loans or a claim reduction by HUD, regardless of whether a breach causes any losses to HUD or has a material adverse effect on the loans or HUD's interest in the loan, as well as any other remedies available to HUD under applicable statutes or regulations*. HUD provides certain loan level representations and warranties that it makes to seller if it reconveys the loan following a repurchase demand. Ironically, HUD qualifies its repurchase obligation in respect of a breach by it "...only if the breach materially and adversely affects the value of the related Mortgage Loan and may demand that HUD repurchase the Mortgage Loan only if the breach is not curable by HUD or Participating Servicer."

Under both the PSA and a Participating Servicer Desk Guide, a loan is eligible for the Program if, among other things: (1) the property is a single-family 1-4 unit dwelling; (2) the unpaid principal loan balance is at least $20,000; (3) the borrower is at least 6 months delinquent; (4) the loan has an LTV of at least 85%; (5) the loan is not subject to a HUD Indemnification Agreement; (6) the property

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is not so damaged that the cost of repair would exceed 10% of the property value; (7) the loan is not subject to pending litigation related to its origination or the underlying property; (8) the first legal action to foreclose was taken in compliance with the applicable timelines for foreclosure initiation; (9) no foreclosure sale is scheduled to occur within 60 days of the claim date; and (10) the servicer complied with all FHA loss mitigation requirements and exhausted the loss mitigation options. The Program contains detailed requirements pertaining to communications with borrowers and the HUD assignment and claims processes.

Under the PSA, HUD, the Office of Inspector General (OIG), and other federal agencies are able to audit servicers for compliance with Program requirements, which include a review of the servicers' books, papers, records, accounts, and other items as necessary. HUD has indicated its intent to conduct annual compliance audits of participating servicers. Under the DASP, servicers should expect to execute the same or a similar PSA and Self Certification Form, with the same loan eligibility criteria and certification requirements. In other words, the servicer will have to certify each loan's compliance with all loan origination (if applicable), servicing, and loss mitigation requirements without regard to materiality or knowledge.

Program Requirements for Investors

To qualify as an investor, among other things, the entity must meet certain net worth requirements (typically $5 million), agree that the loans in the pool will be serviced by an entity approved to service loans by, and in good standing with, the FHA, Fannie Mae, or Freddie Mac (although their respective servicing requirements do not apply), and agree not to foreclose on the borrowers for an additional six months while the investor works with the borrowers to bring them out of default. In addition, neither the investor itself nor any of its affiliates, principals, significant owners, or related entities could have serviced or held any mortgage loan in the pool at any time during the two-year period before the award date. Investors will be able to bid on the pools at public auctions, and HUD will sell the pools to the winning bidder without FHA insurance and servicing-released at market prices that generally are below the outstanding principal balances of the loans, which could result in principal write downs and refinancing at the lower amount.

Investors that successfully bid on Neighborhood Stabilization loan pools will face more rigorous requirements. The same investor eligibility and post-purchase servicer eligibility requirements necessary to participate in the Program will apply, and investors still will be precluded from foreclosing on borrowers for at least six months while they work with the borrowers to bring their loans out of default. For the 3,500 loans in Neighborhood Stabilization pools up for auction in September, however, investors also must be willing to take on the role of landlord for at least 50% of the properties in the purchased pool.

Under the expanded Program, an investor will not be permitted to sell more than half of the loans within a pool as real-estate owned (REO) properties and must achieve one of several "Neighborhood Stabilization Outcomes" (NSO) set forth in riders to the investor agreement made public last week, one of which requires the investor to hold these loans for a minimum of three years, even if they are unable to assist the borrowers out of default. In other words, an investor may not foreclose and sell more than 50% of the properties in the pool, even after the six-month waiting period expires, for at least three years after the award. Once the 50% limit is reached, for any properties where the borrowers' defaults are not cured, the investor will be required to hold the properties in its inventory for at least three years or achieve another NSO, such as selling the underlying property to a qualified owner-occupant or tax exempt organization. This requirement would leave the investor in the role of a landlord in many instances.

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According to one HUD official, the purpose of this new requirement is to change the behavior of investors and ensure they do not purchase loans with the intent to evict the borrowers and sell the properties for a profit. HUD will hold investors to a higher standard than it did under the Pilot for these Neighborhood Stabilization pools, and we have been informed that HUD intends to monitor investor compliance with these new requirements. According to the recently released riders, the penalty for exceeding the 50% limit on REO sales will be liquidated damages in the amount of the net or gross sales proceeds for each loan exceeding the 50% limit, depending on certain factors such as the extent to which the investor exceeded the 50% limit.

Salvation or Sound Bite?

HUD's goals underlying the Program appear laudable on the surface – help borrowers who have exhausted their loss mitigation options avoid foreclosure, reduce property vacancies and increase home prices in communities with high foreclosure rates, incent servicing investors to help borrowers overcome defaults or rent properties to families who need them, and (of course) minimize losses to the FHA insurance fund. HUD officials have flaunted the Program as a potential "lifeline" for homeowners and noted the agency's effort to focus on the increasing back log of delinquent mortgages rather than vacant properties at a time when the percentage of seriously delinquent FHA loans is at an all-time high but HUD's inventory of REO properties available for sale is at its lowest in three years. Moreover, servicers likely will be encouraged by the ability to obtain FHA insurance benefits without having to foreclose under state law. Is the Program, however, truly a delinquent borrower's or servicer's salvation? Or are HUD's servicer and investor participation requirements so onerous as to render the Program little more than a sound bite?

For a servicer to sell a pool of loans, it will have to identify severely delinquent loans that are free of any loan origination or servicing deficiencies so that it can truthfully certify that the loans comply with applicable FHA loan origination, servicing and loss mitigation requirements under threat of being charged with making false statements and/or false claims to HUD. Unlike the traditional conveyance claim process, assignment of loans to HUD under the Program will require a servicer to certify specifically that it has evaluated a borrower for loss mitigation and exhausted loss mitigation options under HUD regulations.

Will servicers be able to certify such compliance given the detailed and strict requirements regarding HUD's loss mitigation options? Will the sale of troubled loans to HUD before foreclosure be worth the risk of a demand for repurchase of the loan or a False Claims Act charge that the servicer, as a result of loss mitigation missteps, made a false certification regarding compliance with HUD's servicing and loss mitigation requirements in connection with a claim to HUD for insurance benefits upon assignment of the loan to HUD, which could result in treble damages and civil penalties of up to $11,000 per transaction? While HUD's press release last week announced that servicers have identified approximately 9,000 loans up for auction for September's sale, it remains to be seen if servicers will continue to accept the risks associated with the Program.

Assuming servicers participate, are investors likely to bid on the pools subject to the expanded investor requirements under DASP? To bid on the expanded Neighborhood Stabilization pools, not only must an investor meet the qualification criteria, go through the bidding process, and refrain from foreclosing on any loans in the pool for at least six months, but the Program will require the investor to retain at least 50% of the properties for at least three years regardless of whether the borrowers come out of default. Will investors be willing to play the role of landlord? Also, HUD has indicated its intent to monitor investor compliance, and penalties will include forfeiting net or gross sales proceeds depending on the level of non-compliance. Investors also will be required to give

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certifications to the federal government regarding their post-sale activities that could subject them to the risk of substantial claims, such as claims under FIRREA for false statements to the government. Will investors accept these risks?

These types of questions abound. HUD officials continue to suggest that the Program is gaining traction, but one cannot help but question the likelihood of significant expansion under HUD's newest proclamation.

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