United States General Accounting Office

GAO

Report to the Honorable
Paul S. Sarbanes
Chairman, Committee on Banking,
Housing, and Urban Affairs, U.S. Senate

April 2002

SINGLE-FAMILY HOUSING

Opportunities to Improve Federal Foreclosure and Property Sale Processes

GAO
Accountability * Integrity * Reliability

GAO-02-305

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Abbreviations

FHA	Federal Housing Administration
HUD	Department of Housing and Urban Development
IG	inspector general
MMI	Mutual Mortgage Insurance Fund
VA	Department of Veterans Affairs
RHS	Rural Housing Service

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Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

April 17, 2002

The Honorable Paul S. Sarbanes
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

This report discusses opportunities to reduce the time necessary to sell foreclosed properties and minimize costs to the federal government. Federal programs in the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA),[1] the Department of Veterans Affairs (VA), and the Department of Agriculture's Rural Housing Service (RHS) promote mortgage financing for, among other groups, low-income, first-time, minority, veteran, and rural home buyers. Congress has also chartered Fannie Mae and Freddie Mac, which are private corporations, to facilitate mortgage lending and to promote homeownership opportunities. Although these programs have expanded homeownership opportunities in the United States, many homeowners fall behind in their mortgage payments each year due to unemployment, health problems, or the death of a provider. When home buyers fall behind on their mortgage obligations, FHA, VA, RHS, Fannie Mae, and Freddie Mac (the organizations) instruct mortgage servicers, typically large financial institutions, to assist the home buyers in bringing their mortgage payments current, because foreclosure proceedings can impose high costs on financial institutions and homeowners.[2] Despite these efforts, in nearly 118,000 cases in 2000, the mortgage servicers engaged in foreclosure proceedings under the direction of the organizations. Once foreclosure proceedings have been completed, it is generally in the best interests of the organizations and communities that foreclosed properties are adequately maintained and resold as quickly as feasible. If foreclosed properties are not properly secured and maintained in a timely fashion, their condition can deteriorate, thereby resulting in lower sales prices,

[1] In this report, when we refer to FHA it should be understood that it is an agency within HUD. It is FHA that is directly responsible for administering HUD's foreclosure and property sale programs.

[2] These efforts are referred to as "loss mitigation" and are discussed more fully in this report.

which could limit the federal government's ability to recover the costs that it incurs.[3] In addition, vacant and poorly maintained foreclosed properties that are on the market for extended periods contribute to neighborhood decay.

To respond to your request that we discuss foreclosure and property sale procedures, identify key differences in the federal programs that can delay or add costs to foreclosures and property sales, and measure the comparative performance of the organizations, we

- provided a general overview of the foreclosure process as established by state laws and organization procedures,
- compared and contrasted the organizations' approaches to managing and selling foreclosed properties,
- compared and contrasted the organizations' approaches to establishing title to foreclosed properties, and
- provided comparative data on the time that it takes the organizations to acquire and sell foreclosed properties and describe potential reasons for any differences in these time frames.

To meet these objectives, we interviewed officials from the organizations, mortgage servicers, and law firms that specialize in foreclosures. We also reviewed state and federal statutes, the organizations' procedures and regulations, and reports on the foreclosure processes. We compared and contrasted the organizations' foreclosure and property sale procedures and identified procedures in federal programs that can add time and costs without clear, corresponding benefits. We also collected data on foreclosed property sale timelines from large servicers and the organizations. Appendix I provides a more detailed description of our scope and methodology.

We conducted our work from June 2001 through January 2002 in accordance with generally accepted government auditing standards.

[3] Generally, FHA, VA, and RHS pay claims to mortgage servicers to cover the outstanding loan balances on foreclosed mortgages and interest and other expenses. If foreclosed properties are resold at relatively low prices, then the organizations' ability to recover their claim payments will be limited.

Results in Brief

State laws establish the general framework for conducting foreclosures, and within this framework, the organizations have established specific foreclosure procedures that in some respects differ. State laws provide certain protections to homeowners who have fallen behind in their mortgages, such as requiring financial institutions to notify borrowers that they face foreclosure proceedings. Several states have also enacted "redemption" laws that provide homeowners a period of time to pay the funds necessary to reclaim their foreclosed properties. Several of the organizations' specific procedures for conducting foreclosures are different. For example, Fannie Mae and Freddie Mac believe it is cost-effective to encourage servicers to use specific law firms in certain states to conduct foreclosures, while FHA, VA, and RHS allow servicers to choose their own law firms. On the other hand, all of the organizations require servicers to complete foreclosure proceedings within time frames that can vary by state.

FHA procedures can delay the initiation of critical steps necessary to preserve the value of foreclosed properties and to sell them quickly. While Fannie Mae, Freddie Mac, VA, and RHS designate one entity as responsible for the custody, maintenance, and sale of foreclosed properties,[4] FHA divides these responsibilities between its mortgage servicers and management and marketing contractors, which operate largely independently of one another.[5] We found that FHA's divided approach to foreclosed property custody can prevent the initiation of critical maintenance necessary to make properties attractive to potential buyers, such as the timely removal of all exterior and interior debris. In addition, FHA's divided approach delays the development of property marketing strategies and generates disputes between servicers and contractors. Because FHA's divided approach delays maintenance and other steps necessary to preserve the value and marketability of foreclosed properties, the properties may be sold at lower prices than would otherwise be the case. In this report, we make recommendations that would help FHA streamline its procedures, ensure prompt property maintenance and marketing strategies, and minimize foreclosure losses.

[4] As measured from the date of the foreclosure sale until the foreclosed properties are sold to home buyers or investors.

[5] FHA's management and marketing contractors have certain maintenance responsibilities and sell foreclosed properties to home buyers or investors.

FHA and VA together spent about $31.5 million in 2000 on new title insurance policies to help establish that they had clear title to foreclosed properties, while Fannie Mae, Freddie Mac, and RHS generally did not purchase new title insurance policies during the foreclosure process.[6] Neither FHA nor VA collects data to determine the need for these expenditures. However, available information suggests that FHA and VA's annual expenditures on title insurance policies are not cost-effective. In 1995, the VA's Office of Inspector General issued a report that questioned whether VA's expenditures on title insurance offer value to the government, and VA has not implemented a policy designed to assess the cost-effectiveness of such expenditures.[7] In addition, Fannie Mae, Freddie Mac, and RHS officials report few title-related problems when they sell foreclosed properties. We make recommendations that FHA and VA collect additional data and reevaluate the cost-effectiveness of their title insurance expenditures.

Determining the organizations' comparative performance in selling foreclosed properties is difficult because FHA and RHS do not collect all of the data necessary to make such comparisons. However, on the basis of available data, we estimate that it takes about 55 days longer to acquire and sell FHA foreclosed properties than VA properties, and about 100 to 110 days longer to acquire and sell FHA properties than RHS, Fannie Mae, and Freddie Mac properties.[8] Several factors, such as FHA's divided approach to foreclosed property custody, likely contribute to FHA's comparatively slow performance. In addition, FHA's requirements for compensating servicers for their expenses may inadvertently provide them with financial incentives to take the maximum time permitted to complete the foreclosure process. We cannot estimate the amount of time each factor contributes to the time involved in selling FHA properties. We make recommendations that FHA and RHS collect the additional data necessary to better establish the time that it takes to sell foreclosed properties.

[6] Title insurance policies are issued by title insurance companies to protect against defects in title to properties. FHA and VA, as described in this report, reimburse servicers for purchasing title insurance policies during foreclosures.

[7] *Audit of Title Insurance for Foreclosed Home Loans*, Department of Veterans Affairs, Office of Inspector General, Report No. 5R5-B10-081, July 25, 1995.

[8] As measured from the foreclosure sales date until the property is sold to home buyers or investors.

We presented a draft of this report to officials from FHA, VA, RHS, Fannie Mae, and Freddie Mac for their review and comment. FHA and VA officials provided written comments while RHS, Fannie Mae, and Freddie Mac provided oral comments. The organizations' comments are described later in this report, and the FHA and VA written comments are reprinted in appendixes II and III, respectively. FHA, VA, and RHS officials agreed to implement the recommendations contained in this report.

Background

Established by the National Housing Act of 1934, the FHA single-family mortgage insurance program helps low- and moderate-income families, minorities, and first-time home buyers become homeowners by providing insurance on single-family mortgage loans. The mortgage insurance allows private lenders to provide qualified borrowers with favorable mortgage terms, such as a 3-percent down payment, and generally compensates lenders for nearly all of the losses incurred on such loans. To support the program, FHA imposes up-front and annual mortgage insurance premiums on home buyers.[9] FHA's single-family mortgage program currently does not require a federal credit subsidy to operate.[10] The Mutual Mortgage Insurance Fund (MMI), which supports this program, is required by law to contain sufficient reserves and funding to cover the estimated future payment of claims on foreclosed mortgages and other costs. FHA's current mortgage limits vary across the country from $261,609 in high-cost areas to $144,336 in low-cost areas. FHA uses management and marketing contractors to perform certain maintenance on foreclosed properties and to sell the properties to home buyers or investors.[11]

VA's mortgage loan program is an entitlement program that provides eligible veterans with housing benefits. The VA guaranty program allows mortgage lenders to extend loans to eligible veterans on favorable terms, such as a no-down-payment loan, and provides lenders with substantial financial protections against the losses associated with extending such

[9] The up-front fee premium, which is charged when borrowers close on the loan and can be included in the mortgage payment, is 1.5 percent. The annual mortgage insurance premium, which is 0.25 to 0.50 percent, depending on the loan term, is automatically cancelled when the loan amount is reduced to the lesser of 78 percent of either (1) the sale price or (2) the appraised value at the time of origination.

[10] Appropriations acts may limit the amount of the credit subsidy.

[11] As discussed in this report, FHA servicers also perform certain maintenance on foreclosed properties.

mortgages. To help support the program, veterans are required to pay a funding fee of 1.25 to 3.0 percent of the loan amount. In addition, the program is financed by credit subsidy appropriations to the Veterans Housing Benefit Program Account.

RHS operates a guaranteed loan program to help rural Americans with low and moderate incomes purchase single-family homes. The RHS guaranteed loan program does not require borrowers to make down payments or pay monthly mortgage insurance fees. To help offset losses to the government associated with providing financial protections to lenders who make RHS mortgages, RHS currently requires lenders to pay a guarantee fee of 2 percent of the mortgage principal loan amount, which they may pass on to borrowers.

Fannie Mae and Freddie Mac are private corporations chartered by Congress to provide a continuous flow of funds to mortgage lenders and borrowers.[12] To fulfill their responsibilities of stabilizing the nation's mortgage markets and expanding homeownership opportunities, Fannie Mae and Freddie Mac purchase mortgages from lenders across the country and package them into mortgage-backed securities. Most mortgages that Fannie Mae and Freddie Mac purchase are conventional mortgages (i.e., mortgages with no government mortgage insurance or guarantees). They purchase single-family mortgages up to the "conforming loan limit," which is now set at $300,700.[13] Fannie Mae and Freddie Mac typically require mortgage insurance from private companies on any mortgage purchases with loan-to-value ratios that exceed 80 percent.[14] Fannie Mae and Freddie Mac finance their mortgage purchases through borrowing or issuing mortgage-backed securities that are sold to investors.

[12] Their Charter Acts provide Fannie Mae and Freddie Mac with benefits such as exemptions from fees charged on securities transactions by the Securities and Exchange Commission. Federal laws also impose certain requirements on Fannie Mae and Freddie Mac. For example, federal law requires Fannie Mae and Freddie Mac to meet certain annual goals in purchasing mortgages that serve low-income home buyers and other groups.

[13] Referred to as the conforming loan limit because the mortgages conform to underwriting standards established by Fannie Mae and Freddie Mac.

[14] The loan-to-value ratio generally refers to the percentage of the purchase price that is financed. For a property costing $100,000, an $80,000 mortgage with a $20,000 down payment would have a loan-to-value ratio of 80 percent.

Mortgage servicers, such as large mortgage finance companies or commercial banks, typically service mortgages insured or guaranteed by FHA, VA, or RHS or purchased by Fannie Mae or Freddie Mac. Mortgage servicers do not necessarily finance the mortgages they service, but rather service mortgages for a fee on behalf of those entities that own mortgages, such as lenders, Fannie Mae, or Freddie Mac. Large servicers typically service FHA, VA, Fannie Mae, and Freddie Mac mortgages, and some service RHS mortgages. Mortgage servicing involves administrative activities such as collecting monthly mortgage payments, maintaining escrow accounts for property taxes and hazard insurance, and forwarding proper payments to purchasers of the loans. Mortgage servicers also are generally responsible for "loss mitigation" (see fig. 1) and for conducting foreclosure proceedings. Table 1 shows the number of FHA, VA, RHS, Fannie Mae, and Freddie Mac foreclosures that were ongoing in 2000.

Figure 1: What Is Loss Mitigation?

Loss mitigation refers to attempts to avoid foreclosures, which can impose high credit and administrative costs on lenders and the organizations. Mortgage foreclosures also impose high costs on borrowers, who may lose their homes. When mortgage defaults rose in the mid-1980s, the mortgage industry aggressively sought to minimize the financial losses and trauma associated with foreclosures. The industry found that "workouts" (resolution short of foreclosure) are in the best interest of both the lender (or insurer/guarantor) and the borrower. Workout options can allow borrowers to remain in their homes. For example, a mortgage servicer with the approval of one of the organizations may suspend mortgage payments for several months for homeowners who are temporarily unemployed. In such situations, the servicer would generally add the missed mortgage payments to the balance of the mortgage loan.

Source: GAO analysis.

Table 1: FHA, VA, RHS, and Fannie Mae and Freddie Mac Foreclosures, 2000

Organization	Number of foreclosed properties
FHA	67,953[a]
VA	23,439[a]
RHS	2,575[b]
Fannie Mae and Freddie Mac	23,883[a]
Total	**117,850**

[a]Represents foreclosed properties transferred from servicers to the organizations in 2000.

[b]Represents loss claims paid by RHS in 2000 for foreclosed properties.

Sources: FHA, VA, RHS, Fannie Mae, and Freddie Mac.

Title insurance companies issue title insurance policies to protect purchasers and lenders against unknown defects of title or against a loss due to any lien or encumbrance that has not been disclosed when a property is purchased or acquired. Title policies typically cover such matters as defective or lost documentation, mistakes, maladministration, or forgery. In addition, title policies typically list exclusions from title coverage for certain defects of title.

The Organizations Conduct Foreclosures within State and Federal Guidelines

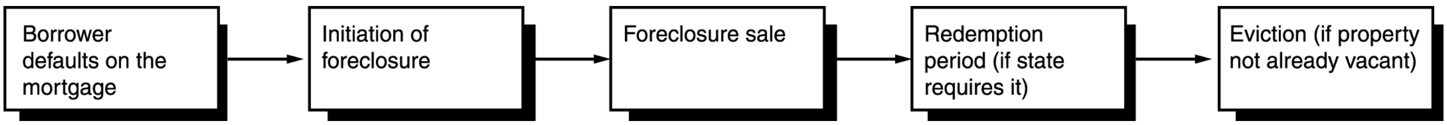
State foreclosure laws establish the general framework and processes that the organizations and mortgage servicers must follow when foreclosing on defaulted mortgages. These state laws and the federal bankruptcy code establish protections for residents and minimum time frames for conducting foreclosures. Within the framework of applicable state and federal laws, the organizations have developed specific procedures for conducting foreclosures.

State and Federal Laws Establish Foreclosure Rules

State foreclosure laws establish certain procedures that servicers must follow in conducting foreclosures and establish minimum time periods for various aspects of the foreclosure process (see fig. 2). Under state laws, servicers are required to provide to borrowers and the public notices associated with the initiation of the foreclosure process. For example, servicers may be directed to mail a notice to the borrower, post a notice of the foreclosure on the affected property, and publish notice of the foreclosure in local newspapers. State laws also generally require servicers or public officials to conduct foreclosure sales. At the foreclosure sale, the servicer purchases the property by bidding the amount of the outstanding debt or the property fair market value.[15] Then servicers, as described in this report, transfer or convey the properties to the organizations for sale or sell the properties themselves.

[15] The purpose of a foreclosure sale is to "foreclose" or eliminate the rights of the borrower and all parties that have an interest junior to the mortgage. A foreclosure sale is designed to give the purchaser at the sale a title equivalent to that held by the borrower before the property was mortgaged. A properly conducted foreclosure sale will extinguish any mortgages or liens junior to the mortgage being foreclosed, but any liens senior to the mortgage are unaffected. In all states, the servicer may foreclose by having a court order the sale of the property. This is known as judicial foreclosure. In about half the states, the primary method of foreclosure is sale at a public auction without court involvement. These sales are usually known as nonjudicial, but are sometimes known as "trustee's sales," or "private sales." In both cases, state laws specify procedures for conducting the sales.

Figure 2: Overview of the Foreclosure Process



Source: GAO analysis.

Several states have enacted "redemption" laws that give borrowers the opportunity to match the winning bids from the foreclosure sale and reclaim their properties. During redemption periods, the organizations or servicers[16] are generally not permitted to pursue additional foreclosure proceedings, such as evicting property residents or securing the properties. According to a Freddie Mac official, state redemption periods range from 10 days to 9 months. If properties are vacant, some state laws may permit the shortening of redemption periods and allow the organizations or servicers to take control of foreclosed properties.

After foreclosure sales and applicable redemption periods, the organizations or servicers typically proceed with eviction proceedings if foreclosed properties are not already vacant. State laws generally govern eviction proceedings and provide certain protections to the residents of foreclosed properties. For example, state laws require servicers or the organizations to notify property residents before the initiation of an eviction lawsuit. For example, some states have notification periods that range from 3 to 7 days.

Homeowners may also file for bankruptcy proceedings under federal law, a procedure that can extend foreclosure proceedings.[17] Filing a bankruptcy petition automatically stays any pending or planned foreclosure proceedings. Generally, a foreclosure conducted in violation of the stay is

[16] Depending upon whether the organization or its servicers are responsible for overseeing properties during redemption periods.

[17] A Chapter 7 or straight bankruptcy is designed to liquidate the assets of the borrower. In a Chapter 7 bankruptcy, if the borrower has equity in the property, the property may be sold by the bankruptcy court, either free and clear or subject to existing mortgages. If the property is sold free and clear, then the sales proceeds will be used to pay off the mortgages on the property. If the borrower has no equity in the property, the trustee will lift the stay, and the lender is free to proceed with foreclosure. A Chapter 13 bankruptcy is designed to rehabilitate the debtor by extension and reduction of debts. Filing under Chapter 13 usually gives the borrower time to bring mortgage payments current.

void, and the lender can be liable for damages. Under certain conditions, courts may lift stays and allow foreclosure proceedings to resume.

Comparison of the Organizations' Foreclosure and Property Sale Procedures

Within the framework of state and federal laws, the organizations have established procedures for initiating foreclosure proceedings, conducting foreclosures, and selling foreclosed properties to home buyers or investors. Some procedures differ, such as the organizations' criteria for initiating foreclosures, while others are similar. This section summarizes the organizations' foreclosure procedures, while two key differences—FHA's approach to foreclosed property custody and FHA and VA title evidence requirements—are discussed more fully later in the report.

Criteria for Initiating Foreclosures Differ

Table 2 shows the criteria that the organizations have established for initiating foreclosure proceedings. Fannie Mae and Freddie Mac direct their servicers to initiate foreclosure proceedings at earlier stages than FHA, VA, and RHS. According to Fannie Mae officials, while the organization directs servicers to proceed with foreclosure at an earlier stage than the government organizations, servicers are also required to continue pursuing loss mitigation efforts. Fannie Mae officials said that the organization directs foreclosures at an earlier stage to help minimize losses and because borrowers are more likely to be receptive to loss mitigation efforts when foreclosure is pending. Fannie Mae officials said that the simultaneous approach of loss mitigation and foreclosure proceedings is advantageous because it enables more borrowers to retain their homes and reduce losses in the event loss mitigation is not successful. Freddie Mac officials also stressed that loss mitigation efforts continue even after the initiation of foreclosure proceedings. A Freddie Mac official told us that in some cases the organization, servicers, and borrowers have worked out loss mitigation agreements on the date of foreclosure sales. FHA, VA, and RHS officials said that they have public missions and obligations to their customers, such as low-income Americans, veterans, and rural residents, and take additional time to initiate foreclosure proceedings. Like Fannie Mae and Freddie Mac, each of these organizations also encourage their servicers to continue pursuing loss mitigation efforts after the initiation of foreclosure proceedings.

Table 2: The Organizations' Criteria for Initiating Foreclosures

Guidelines for initiating foreclosure proceedings	FHA	VA	RHS	Fannie Mae	Freddie Mac
Maximum time to begin foreclosure as measured from the first missed mortgage payment	210 days	210 days	180 days	105 days	120 days

Sources: FHA, VA, RHS, Fannie Mae, and Freddie Mac.

The Organizations' Procedures for Conducting Foreclosures

Table 3 summarizes the procedures that the organizations have established to conduct foreclosures. As shown in the first row of table 3, all of the organizations expect servicers to follow established foreclosure time frames, which can vary by state. [18] Organization officials said that they have analyzed the foreclosure laws and bankruptcy laws in each state and collected data on past foreclosure proceedings to determine how long it should take servicers to complete the foreclosure process in each state. The organizations may reward servicers financially for meeting or beating these deadlines and may impose financial penalties where servicers fail to meet the guidelines. For example, FHA generally does not compensate servicers for their interest expenses if they exceed the established deadlines.[19]

[18] RHS state office personnel determine if liquidations are conducted expeditiously based on their own knowledge and in conjunction with the other organizations' analysis. RHS officials said that they are considering adopting the timelines established in each state by Freddie Mac.

[19] After FHA servicers convey properties, they file claims with FHA for payment. FHA pays claims to reimburse servicers for their interest expenses, the lost principal on outstanding mortgage balances, and maintenance costs.

Table 3: Comparison of the Organizations' Foreclosure Procedures

Procedure	FHA	VA	RHS	Fannie Mae	Freddie Mac
Time frames for completing foreclosures	Guidelines established by state	Guidelines established by state	General guidelines established	Guidelines established by state	Guidelines established by state
Foreclosure attorneys	Servicers select own attorneys	Servicers select own attorneys	Servicers select own attorneys	Retained attorneys in certain states; use of attorneys is optional	Designated attorneys in 14 states; use of attorneys is required for some servicers
Bidding at foreclosure sale	Total outstanding mortgage debt plus foreclosure expenses	Property fair market value less expected foreclosure costs	No formal bidding instructions; may encourage bid of 85 percent of fair market value under certain conditions	Total outstanding mortgage debt plus foreclosure expenses	Lesser of 90-day fair market value[a] or total debt; bid can be as low as 90 percent of 90- day fair market value

[a]The 90-day fair market value assumes that the property will be sold relatively quickly and that no discounts in price will be necessary to facilitate the sale.

Sources: FHA, VA, RHS, Fannie Mae, and Freddie Mac.

As shown in the second row of table 3, the organizations have developed differing approaches regarding the law firms that mortgage servicers use to conduct foreclosures. In certain states, Fannie Mae and Freddie Mac have identified law firms that are available to servicers in conducting foreclosures. Referred to as "retained" or "designated" attorneys, these law firms conduct all of the legal procedures related to foreclosures. Fannie Mae and Freddie Mac officials said that the designated attorneys have significant experience in foreclosure work and can ensure that the process is completed in the most efficient manner possible. VA, FHA, and RHS do not designate attorneys but rather permit servicers to choose the law firms that they will employ to carry out foreclosures. According to FHA, while the use of designated attorneys may be more efficient than allowing servicers to choose their own law firms, as a mortgage insurer FHA lacks the prerogative to designate attorneys for its servicers.[20]

Also, as noted in table 3, the organizations have established different bidding instructions for servicers at foreclosure sales.[21] VA instructs servicers to bid the property fair market value less foreclosure expenses,

[20] FHA stated that Fannie Mae and Freddie Mac own mortgages and therefore have the authority under their servicing contracts to appoint service providers, such as attorneys.

[21] Typically, the servicers borrow funds to bid on properties at foreclosure sales. The bid proceeds are used to pay off the lenders that issued the mortgages.

while Freddie Mac[22] instructs servicers to bid the outstanding debt on foreclosed properties or the fair market value. In some cases, the properties' fair market value may be less than the outstanding debt.[23] While RHS does not require servicers to follow specific bidding instructions, the organization allows servicers to bid at 85 percent of the fair market value when the property value is less than the outstanding loan balance. According to organization officials, these instructions, by allowing bids below the outstanding debt or fair market value, are designed to encourage third parties such as investors to bid at foreclosure sales, thus permitting the organizations to avoid the costs associated with selling such properties. However, organization and servicer officials estimate that only about 3 to 5 percent of foreclosed properties are sold to third parties, because the properties are frequently occupied and investors are not allowed to inspect the properties unless they are vacant.[24] Freddie Mac officials also said that bidding below a property's outstanding debt allows financial institutions to pursue deficiency judgments against defaulted borrowers.[25]

In contrast, Fannie Mae and FHA generally instruct servicers to bid the outstanding debt plus foreclosure expenses, an amount that may be significantly higher than the fair market value.[26] Although Fannie Mae and FHA bidding instructions deter third-party bids and result in the

[22] Freddie Mac instructs servicers to start bidding at the statutory minimum level prescribed in certain states. These states may require bidders to bid two-thirds of a property's value at the foreclosure sale. Freddie Mac instructs its servicers to start bidding upward from the statutory minimums until bids reach the 90-day fair market value or the outstanding debt, whichever is less. The 90-day fair market value assumes that properties will be sold quickly and that discounts will not be necessary to facilitate sale.

[23] In some cases, the fair market value of foreclosed properties may be below the outstanding debt. Thus, requiring servicers to bid the outstanding debt makes the properties less attractive to home buyers or investors, since the bid is set above the properties' fair market value.

[24] Representatives from one large RHS servicer said that in one state, Ohio, third parties purchased approximately 40 percent of properties at foreclosure sales.

[25] According to Freddie Mac, some states allow financial institutions to pursue deficiency judgments for the debts owed by defaulted borrowers. The states may require financial institutions to bid below the outstanding debt to preserve the right to pursue deficiency judgments.

[26] Fannie Mae implemented these bidding instructions as a pilot program in 2000. The organization amended its permanent guidelines to incorporate these bidding instructions in February 2002. Previously, Fannie Mae instructed servicers to bid foreclosed properties' fair market value.

organizations themselves selling the properties, officials said that the instructions were cost-effective. Fannie Mae and FHA officials said that the costs associated with enticing third-party bids at foreclosure sales, such as the costs for conducting appraisals to determine fair market value, were not justified by the relatively low percentage of successful third-party bids. FHA officials said that they rarely pursue deficiency judgments because most defaulted borrowers have minimal, if any, recoverable assets.

FHA Property Custody Procedures Delay Maintenance and Marketing

VA, RHS, Fannie Mae, and Freddie Mac follow a similar approach in that the organizations, or servicers in the case of RHS, have custody of and are responsible for maintaining foreclosed properties from the time of the foreclosure sale until the properties are sold to home buyers or investors. FHA, on the other hand, divides foreclosed property custody between its servicers and its management and marketing contractors from the time of the foreclosure sale until the property is sold to purchasers. FHA procedures (1) prevent the timely initiation of critical property maintenance and marketing, as is practiced by the other organizations; (2) can delay conveyance to FHA management and marketing contractors due to time-consuming procedures necessary to perform maintenance that exceeds established cost ceilings; and (3) result in disputes between FHA servicers and management and marketing contractors after property conveyance. Because of delayed property maintenance and marketing strategies, FHA may receive lower property sales prices than would otherwise be the case. FHA officials have recently considered proposals to streamline FHA's foreclosed property custody procedures.

The Organizations' Approaches to Property Custody Differ

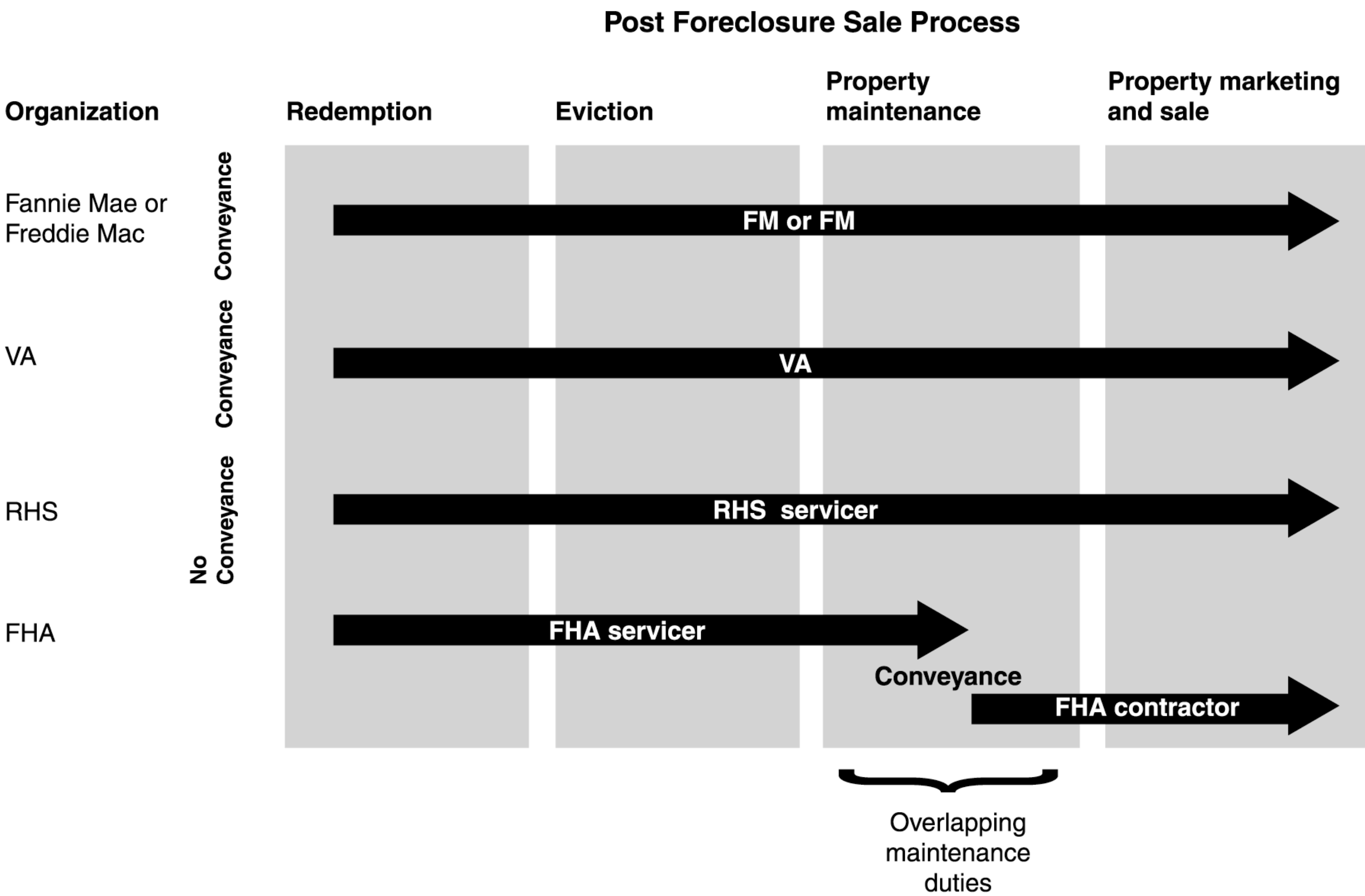
As shown in figure 3, Fannie Mae, Freddie Mac, and VA maintain unified custody of foreclosed properties from the time of the foreclosure sale until the properties are sold to home buyers or investors. Fannie Mae and Freddie Mac require servicers to convey properties to them within 24 hours of foreclosure sales, while VA generally requires servicers to convey within 15 days.[27] The organizations and their vendors or contractors are

[27] VA has the option to leave the foreclosed property with the servicer for sale, if the cost of paying the guaranty is less than the estimated cost to VA for taking possession of the property and reselling it. VA calls such a situation a no bid. VA procedures also allow servicers to write down the outstanding balance on foreclosed mortgages until the cost to VA of guaranteeing the loan is more than VA's estimated costs of taking possession of the property and reselling it. VA's most recent data for fiscal years 1997 through 1999 shows that no bids accounted for about 1.5 percent of all loan terminations.

responsible for overseeing properties during redemption periods, evicting property residents, performing necessary property maintenance, and selling the properties. Although RHS's approach differs in that servicers never convey foreclosed properties, property custody is unified. RHS servicers are responsible for overseeing properties throughout the foreclosure process, maintaining the properties, and selling them. RHS establishes a 6-month deadline for servicers to sell foreclosed properties, measured from the date of the foreclosure sale, and will generally not compensate servicers for any liquidation expenses incurred beyond the deadline.[28]

[28] A 1-month extension of the marketing period may be requested if needed to close a sale.

Figure 3: Comparison of the Organizations' Postforeclosure Sale Property Responsibilities



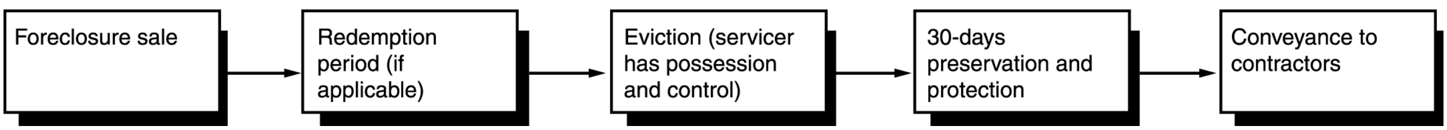
Source: GAO analysis.

In contrast, FHA divides property custody and maintenance responsibilities between its servicers and contractors, which operate largely independently of one another. FHA requires servicers to oversee properties during postforeclosure sale redemption periods, to evict residents if properties are occupied, and to perform critical maintenance on properties (also known as "preservation and protection").[29] Under FHA procedures, servicers are to initiate preservation and protection work on

[29] In this report, the terms "preservation and protection" and foreclosed property "maintenance" are used interchangeably.

the date that they obtain “possession and control” of the properties, typically the date that tenants are evicted or when the servicers determine that the property is vacant (see fig. 4). Servicers have 30 days to complete the preservation and protection work, convey the properties to FHA’s management and marketing contractors, and then file claims with FHA to recover the costs associated with the foreclosures. FHA typically reimburses servicers for the costs associated with performing preservation and protection work.[30]

Figure 4: Time Frame for FHA Servicers’ Preservation and Protection Work



Source: FHA.

The management and marketing contractors also have ongoing preservation and protection responsibilities that can overlap those of the servicers (see table 4). FHA pays the contractors a fee, generally ranging from 6 to 10 percent of the net sales price, as compensation for their work. FHA usually does not reimburse contractors for the costs of performing basic maintenance; they are generally expected to cover such costs from the fees that they earn for selling the properties.[31]

[30] FHA, through its management and marketing contractors, may reconvey properties to servicers when required maintenance is not performed. FHA officials said that reconveyances are rare. As discussed in this report, FHA and its contractors may also require servicers to reimburse FHA for failure to perform required property maintenance.

[31] FHA may reimburse contractors on a case-by-case basis for some of the costs associated with completing preservation and protection work that servicers failed to complete prior to conveyance.

Table 4: FHA Servicer and Contractor Foreclosed Property Maintenance Responsibilities

Servicers' responsibilities	Contractors' responsibilities
• Inspect the property every 30 days if it is occupied. • Maintain lawn. • Remove interior and exterior debris that poses a health and safety hazard. • Protect plumbing and other operating systems against damage from freezing. • Boardup properties. • Convey properties undamaged by fire, flood, earthquake, hurricane, or tornado (exceptions apply). • Perform other needed tasks.	• Inspect the property at conveyance. • Maintain lawn. • Remove interior and exterior debris that does not pose health and safety hazards. • Perform any protection and preservation neglected by servicers. • Perform other needed tasks.

Source: FHA.

FHA's Divided Custody Prevents Timely Property Maintenance and Marketing

With unified property custody, Fannie Mae, Freddie Mac, RHS, and VA are able to develop comprehensive and timely strategies that can help sell foreclosed properties quickly. For example, Fannie Mae and Freddie Mac officials said that with unified custody they can ensure that properties are inspected routinely, vacant properties are immediately secured,[32] all needed maintenance and repairs are initiated promptly, and marketing strategies are developed at an early stage. VA and RHS officials we contacted expressed similar views about the benefits of unified property custody.

In contrast, by dividing responsibility between servicers and contractors, FHA procedures prevent the initiation of all maintenance necessary to protect foreclosed properties and sell them quickly. Rather, FHA procedures can prevent the initiation of critical maintenance until after servicers convey foreclosed properties to management and marketing contractors—up to 30 days or more after the possession and control date.[33] Current FHA guidance does not require servicers to clean up exterior and

[32] Fannie Mae and Freddie Mac officials said that some states with redemption periods allow for the shortening of the redemption periods if the properties are vacant. In such cases, Fannie Mae and Freddie Mac routinely inspect properties to determine whether they are vacant and whether immediate steps to secure the properties can be taken.

[33] As discussed later, servicers do not always convey foreclosed properties within 30 days.

interior debris left on properties unless it poses public health and safety risks. The presence of such nonhazardous debris (such as discarded furniture) for extended periods can reduce buyer interest in the properties and negatively affect neighborhoods. Property maintenance is further complicated by the fact that some local FHA offices require servicers to clean up all exterior debris, regardless of whether it is a hazard or not, while others require only hazardous debris removal. An FHA official we contacted said that FHA is working on regulations that will require servicers to remove all exterior debris. However, the FHA official said that the revised regulations will not require servicers to remove nonhazardous debris from property interiors.

FHA procedures can also require a substantial amount of interpretation by servicers and management and marketing contractors. For example, servicers are required to determine whether debris left on foreclosed properties poses "immediate" health and safety risks and whether to remove such debris. [34] If servicers determine that an object such as an abandoned vehicle does not pose an immediate health risk, they may decide to leave it on the property. An FHA official also said that since servicers are responsible for lawn maintenance but are not responsible for removing nonhazardous exterior debris, servicers would technically be within regulations to cut the grass around debris left on the properties. An FHA official said that FHA's new regulations will require servicers to remove exterior debris and cut the entire lawn.

FHA's divided approach to property custody also prevents the immediate development of marketing strategies. Representatives from management and marketing contractors that we contacted said that they often do not learn about foreclosed properties until servicers convey the properties to the contractors, which could be months after the foreclosure sale. In contrast, VA, Fannie Mae, and Freddie Mac officials and RHS servicers can begin marketing strategies shortly after the foreclosure sale, since these organizations have established unified property custody procedures.

[34] FHA regulations state: "For clarification, examples of health and safety hazards are decaying organic matter, dead animals, animal feces, or anything that poses an immediate threat to health or safety."

FHA Has Time-Consuming Procedures for Reviewing Maintenance That Exceeds Established Cost Limits

FHA's divided approach to property responsibility and custody can also result in delays in conveyance when required preservation and protection work exceeds established cost ceilings. Fannie Mae, Freddie Mac, VA, and FHA have established locality-based cost ceilings for property maintenance.[35] Although establishing controls over maintenance expenditures is important, FHA's procedures for reviewing such proposed expenditures are more formal and time consuming than those of the other organizations.

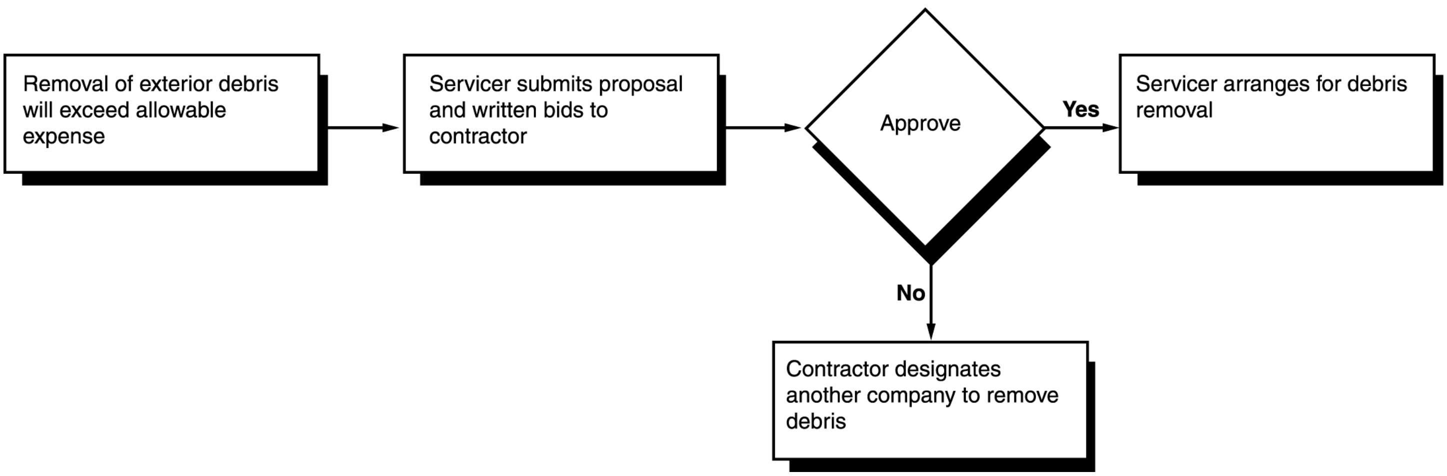
Fannie Mae, Freddie Mac, and VA officials have extensive information about properties within days of foreclosure sales and can act in a coordinated fashion with vendors and contractors to review proposals to exceed established maintenance costs as quickly as is feasible. Fannie Mae and Freddie Mac officials said that in cases in which required maintenance exceeds established limits, vendors call the organizations or submit fax requests. According to Fannie Mae and Freddie Mac officials, their staffs work closely with their vendors and generally review and make final decisions on requests within 1 or 2 days, frequently via E-mail or telephone call. A VA official said that its 46 district offices have maintenance cost guidelines that are set within prevailing local rates. According to the VA official, when contractors determine that maintenance will exceed established rates, they call VA officials or representatives for decisions, which are typically granted within a day or two. The VA official said that contractors are subsequently required to submit photographs or other evidence to support these expenditures and VA performs audits to assess the appropriateness of these costs.

Because FHA servicers and contractors act largely independently of one another, rather than in a coordinated fashion, FHA maintains a comparatively formal and time-consuming system for reviewing property maintenance proposals that exceed established cost ceilings. FHA expects servicers to complete preservation and protection work, including work exceeding established cost limits, within the 30-day period between possession and control and property conveyance. Servicers must submit written proposals to management and marketing contractors for review, and FHA regional officials must approve such requests as well. FHA allows the management and marketing contractors 10 days to review the

[35] RHS has not established specific maintenance cost guidelines. However, if emergency advances exceeding $500 are needed to preserve the property's value, the servicers must first submit them to RHS for approval.

servicers' requests and to respond in writing.[36] If contractors fail to respond in writing within 10 days, FHA regulations require servicers to follow up with the contractors until the servicers receive a written response. FHA, through its contractors, may also require servicers to obtain written bids from outside providers for work exceeding the established limits. For example, a senior FHA official said that servicers are required to obtain written bids when proposed removal of hazardous exterior debris removal exceeds established cost ceilings (see fig. 5).

Figure 5: FHA Procedures for Exterior Debris Removal That Exceeds Cost Limits



Source: FHA.

According to FHA servicer representatives we contacted, obtaining permission from management and marketing contractors to do maintenance that exceeds FHA's cost ceilings can delay conveyance. In some cases, servicer representatives said that the management and marketing contractors did not respond to their requests on a timely basis, potentially preventing them from completing necessary preservation and protection work within the 30-day deadline. We asked three large FHA servicers to provide data on their performance in conveying properties within the 30-day guidelines. Table 5 shows that these servicers conveyed

[36] Management and marketing contractors may not be aware of a foreclosed property until they receive a servicer's request to exceed established costs ceilings on preservation and protection work.

properties within the deadlines less than 80 percent of the time on average in 2000 and 2001.[37]

Table 5: Three Large Servicers' Performance in Conveying FHA Foreclosed Properties to Contractors within 30 Days of Obtaining Property Possession, 2000 and 2001

	Percent of properties conveyed within 30 days	
Servicers	**2000**	**2001**
Servicer A	78.5%	81.6%
Servicer B	80.6	89.4
Servicer C	70.2	67.5
Average	76.4%	79.5%

Source: FHA servicers.

Figure 6 provides an example of the types of delays that servicer representatives said can occur in attempting to obtain approval from management and marketing contractors to perform preservation and protection work that exceeds established cost limits.

[37] FHA generally may not compensate servicers for foregone interest if they fail to meet the 30-day conveyance guidelines.

Figure 6: Example of Delays Associated with FHA's Procedures for Work Exceeding Established Costs

- A large servicer sent the FHA contractor a request on August 8, 2001, to spend $3,750 to remove 375 paint cans on the property.
- Two weeks later, the FHA contractor requested that the servicer send photographs of the paint cans on the property. The servicer sent the photographs 2 weeks after this request.
- Within several days of receiving the photographs, the FHA contractor approved the removal of paint cans but limited the spending to $1,875 not $3,750 as the servicer had orginally requested. The FHA contractor argued that the work should only cost half the original request because two cans of paint could be carried at a time.
- On the same day the servicer responded, pointing out that the cost was not necessarily for the labor of removing the paint cans but for disposal. The servicer also pointed out that the original request followed HUD guidelines, which allow $10 per gallon of paint.
- The FHA contractor approved the original request of $3,750 on September 18, 41 days after the servicer first contacted the contractor.

Source: FHA servicer.

Management and marketing contractor representatives said they did not believe that timeliness was generally a problem, but added that sometimes servicers fail to provide required paperwork and that this can cause delays. FHA officials we contacted cited other factors as responsible for servicers' failure to convey all foreclosed properties within 30 days. The FHA officials said that some servicers lack the staff necessary to ensure that properties are maintained and conveyed in accordance with FHA standards.

FHA Servicer and Contractor Disputes Occur after Property Conveyance

As shown in table 4, FHA's management and marketing contractors are responsible for performing certain preservation and protection work on conveyed properties, including work that servicers fail to complete. Servicer compliance with FHA standards for completing required preservation and protection work has been a source of continuing conflicts among FHA, contractors, and servicers. Senior FHA officials and several management and marketing contractor representatives that we contacted questioned servicer compliance with required preservation and protection work on conveyed properties and said that the failure to perform such work can negatively affect foreclosed property values and marketability.[38] Representatives of several large FHA servicers that we contacted said that they generally perform preservation and protection work within established guidelines.[39] Although FHA has instituted additional layers of review to ensure adequate property maintenance, FHA's divided approach to property custody will likely result in continuing conflicts.

In March 2001, FHA instituted a program to improve servicer preservation and protection work that subsequently encountered significant implementation problems. FHA required its management and marketing contractors to identify neglected maintenance on conveyed properties and demand that servicers reimburse FHA for such work.[40] As a result of this program, management and marketing contractors issued hundreds of "demand letters" to servicers requiring refunds within 10-day deadlines. In many cases, servicer representatives we contacted said that the management and marketing contractors (1) failed to provide the demand letters until the expiration of the 10-day deadline or later, (2) demanded refunds to FHA on properties that had been conveyed as long as 2 years prior to the date of the letter, and (3) required refunds for maintenance that is not the servicers' responsibility. Figure 7 provides an example of a dispute between an FHA servicer and a management and marketing contractor.

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[38] FHA currently requires management and marketing contractors to accept conveyed properties, regardless of their condition.

[39] Previous GAO and HUD Inspector General reports questioned the quality of management and marketing contractors' oversight of FHA foreclosed properties. See U.S. General Accounting Office, *Single Family Housing: Stronger Measures Needed to Encourage Better Performance by Management and Marketing Contractors*, GAO/RCED-00-117 (Washington, D.C.: May 12, 2000) and *Single Family Property Disposition Program*, Department of Housing and Urban Development, Office of Inspector General, Report No. 99-AT-123-0001, Sept. 17, 1999.

[40] Under the program, contractors were responsible for inspecting conveyed properties and determining if servicers had filed claims with FHA and received payment from FHA for preservation and protection work that had not been completed. In such situations, FHA directed the contractors to send "demand letters" to the servicers requiring reimbursement to FHA within 10 days. If the servicers did not provide reimbursement, FHA planned to "offset" or reduce future servicer claim payments by the dollar amount that the servicers had been paid for the neglected preservation and protection work. FHA also provided contractors with a payment of 25 percent of the maintenance costs as a financial incentive for identifying situations where servicers had billed FHA for work that had not been completed. Contractors are generally responsible for completing servicer-neglected work.

Figure 7: Example of FHA Servicer/Contractor Dispute over Required Maintenance

- The FHA contractor sent a letter to a large servicer on October 18, 2001, demanding a refund of $135 to FHA that the servicer had claimed for mowing the lawn. The FHA contractor reasoned that the servicer did not comply with FHA's guidelines for cutting grass, including cutting grass twice a month between April and October and maintaining a maximum length of 2 inches. The FHA contractor enclosed photographs it had taken on the day of inspection as proof that the length of the grass failed to meet FHA guidelines.
- Having received no response from the servicer, the FHA contractor sent another letter 10 days later, again demanding a $135 refund.
- Within 3 days of this second letter, the servicer responded, asserting that the grass was cut on August 15–39 days prior to conveyance. The servicer also enclosed photographs along with its dispute letter.
- Four days later, the FHA contractor sent the servicer a final notification, rejecting the servicer's claim and stating that the servicer's photographs did not prove that grass cutting met FHA guidelines at the time of conveyance.
- Two days later on November 7, the servicer forwarded the case to FHA for review.

Source: FHA.

A senior FHA official acknowledged that the program experienced significant implementation problems and said that revised procedures have been initiated. According to the official, FHA did not provide the contractors with adequate training on the types of maintenance deficiencies for which contractors could demand refunds from servicers. FHA has taken several steps to help clarify procedures and resolve disputes between contractors and servicers:

- FHA servicers can appeal contractor demand letters to the local regional office and subsequently to HUD's National Servicing Center in Oklahoma City for a final decision.
- FHA is in the process of drafting additional guidance to management and marketing contractors that will clarify the circumstances under which the contractors can demand refunds from servicers on neglected preservation and protection work.
- FHA has instituted a pilot program in which independent inspectors examine properties at the time servicers obtain possession and control, which will allow FHA to identify damage caused by occupants and note preservation and protection work that must be completed prior to conveyance. (FHA officials said that in fiscal year 2002 inspectors will review about 250 properties and noted that there are plans to expand the program to 6,000 properties by the latter part of fiscal year 2003.)

Despite FHA's recent initiatives, divided custody will likely continue to generate disputes between servicers and management and marketing contractors. Continued disputes are likely between servicers and management and marketing contractors due to the complexities of FHA's property maintenance procedures. [41] FHA's appeals process and preconveyance inspection program provide opportunities to resolve disputes between servicers and contractors. However, these initiatives add layers of oversight and review to FHA's foreclosure and property sale processes, at FHA's expense, that are not present at the other organizations, which have established unified property custody.[42]

Delayed Maintenance and Marketing Could Increase FHA's Foreclosure Losses

By delaying the initiation of critical maintenance and marketing and generating disputes between servicers and contractors, FHA's divided property custody approach can place financial demands on the MMI. To the extent that property values deteriorate as a result of such factors as debris left on properties for extended periods or lawns left uncut due to disputes between servicers and contractors, the properties may sell for lower prices than would otherwise be the case. As a result of lower property sales prices, FHA would recover less of what it had already paid in claims to servicers. That is, revenues flowing into the MMI would be lower than would otherwise be the case.

FHA Has Considered Proposals to Establish Unified Property Custody

During 2000 and 2001, FHA considered proposals to revise procedures and establish unified property custody and thereby help ensure prompt maintenance and marketing strategies necessary to preserve property values. Two large servicers made proposals to FHA under which the servicers would sell foreclosed properties rather than conveying them to management and marketing contractors. The servicers proposed to clean up all debris on foreclosed properties immediately and develop strategies to market the properties at an earlier stage than was currently the case. One large servicer estimated that its proposal would shorten the sales time on FHA foreclosed properties by about 59 days and save FHA

[41] FHA will continue to require its management and marketing contractors to demand refunds in cases in which servicers bill FHA for preservation and protection work that is not performed according to standards. The potential exists for contractors and servicers to continue to disagree in such situations.

[42] FHA is also responsible for assuming the costs associated with the preconveyance inspection program.

approximately $18 million annually.[43] In addition, a senior FHA official said that FHA has considered implementing a pilot program under which management and marketing contractors would assume responsibility for foreclosed properties earlier in the process, perhaps as early as the foreclosure sale. Although FHA officials said that they were supportive of proposals to establish unified property custody, they have not established firm time frames to test their feasibility. A senior FHA official said that FHA and HUD must first resolve outstanding legal and contractual issues before the proposals can be tested. More recently, FHA has proposed a pilot program in which servicers would assign mortgages to FHA rather than completing the foreclosure process and conveying the properties to management and marketing contractors. FHA would then sell the defaulted notes to the private sector for servicing and/or sale, thereby permitting one entity to control both the foreclosure and property sale processes.[44] FHA officials said that the program will likely reduce but not eliminate the number of properties that the organization acquires through foreclosure proceedings and becomes responsible for selling.

[43] Estimate based on the number of foreclosed properties that the servicer conveys to FHA annually. The servicer estimated a total annual savings of $138 million if the servicer sold all FHA foreclosed properties. The other servicer's proposal estimated that it would save FHA $6 or $7 million on a monthly basis.

[44] Section 601 of the Departments of Veterans Affairs and Housing and Urban Development and Independent Agencies Act, P. L. No. 105-276, authorized FHA to pay claims upon assignment of mortgages that had been in default at least 3 months. On February 5, 2002, HUD published a notice in the *Federal Register* soliciting public comments on a demonstration project under section 601. FHA will assess the demonstration based on factors including reduced loss rates, costs and time associated with claim disposition, and the demonstration's success in enhancing FHA's ability to assess risk and manage the FHA mortgage insurance fund.

FHA and VA Have Not Adequately Supported Title Insurance Policy Expenditures

FHA and VA together spent approximately $31.5 million in 2000 reimbursing servicers for the costs associated with purchasing title insurance policies, which are used to help establish that the organizations have title to foreclosed properties that have been conveyed and can be resold to home buyers or investors.[45] In contrast, Fannie Mae, Freddie Mac, and RHS do not reimburse servicers for the purchase of new title insurance policies and report few title-related problems in selling their foreclosed properties. FHA and VA do not collect adequate data to determine whether their expenditures on title insurance policies are cost effective.

The Organizations' Approaches to Title Insurance Policies Differ

Although title insurance policies can provide protection against certain title defects to borrowers—and their lenders—when new mortgages are originated, Fannie Mae, Freddie Mac, and RHS have determined that new title policies are not necessary during the foreclosure process. [46] Fannie Mae and Freddie Mac officials that we contacted said that servicer foreclosure attorneys are responsible for identifying parties and resolving title issues prior to the foreclosure sales. Organization officials said that the foreclosure sales typically resolve the vast majority of title issues. The officials also said that they do not purchase new title insurance policies at conveyance.[47] Fannie Mae and Freddie Mac officials said that the organizations may reconvey foreclosed properties to servicers if serious title problems arise, but that such cases are very rare. Similarly, RHS does

[45] Neither FHA nor VA could provide data on their annual title insurance expenditures. Our estimate is based on an average cost of $500 per title insurance policy and about 65,000 FHA and 20,000 VA foreclosed property acquisitions in 2000. FHA typically reimburses servicers two-thirds of the cost of a title insurance policy, or $330. Therefore, 65,000 acquisitions multiplied by $330 equals $21,450,000. VA could not tell us how many district offices encourage the use of title insurance. So, we estimated that 85 percent of VA's district offices encourage title insurance, since six of the seven (or 85 percent) we contacted do. We then multiplied 23,500 FHA acquisitions by 85 percent to achieve an estimate of about 20,000 acquisitions. VA also reimburses servicers the full cost of a title insurance policy. Thus, 20,000 acquisitions multiplied by $500 equals $10,000,00. FHA's $21,450,000 in expenditures plus VA's $10,000,00 equals $31,450,000.

[46] Fannie Mae procedures provide for the purchase of title insurance policies in Hawaii, which a Fannie Mae official said has unique and complex foreclosure laws that make establishing title difficult. Thus, the Fannie Mae official said a title policy may be justified in Hawaii.

[47] A Fannie Mae official said that the deeds recorded from foreclosure sales generally represent adequate evidence of title.

not require servicers to purchase title insurance policies at foreclosure sales,[48] and RHS officials said that serious title-related problems are rare.

FHA and VA statutes provide the organizations with discretion in establishing what constitutes acceptable evidence of title. Although FHA and VA have established several potential forms of evidence of title, title insurance policies are the de facto standard. FHA and servicer officials said that it is the standard practice for servicers to purchase title insurance policies, which cost about $500,[49] and that FHA reimburses the servicers for two-thirds of the costs of these policies. According to a VA official, each of VA's 46 field offices has the authority to determine acceptable evidence of clear title, and available evidence suggests that the majority of VA district offices require title insurance. For example, we contacted a judgmental sample of seven VA district offices nationwide and found that six require title insurance policies at conveyance.[50] VA reimburses servicers for the full costs associated with these policies. FHA also typically provides financing for new title insurance policies when its foreclosed properties are sold to home buyers or investors, while some VA offices may provide similar financing.[51]

FHA and VA officials said that title insurance policies provide an extra level of assurance that the organizations have title to foreclosed properties. As discussed below, however, FHA and VA officials are reconsidering the cost-effectiveness of their title insurance policy expenditures.

[48] RHS requires servicers to have loans secured by a first lien on the property and to maintain that lien priority, but RHS does not require new title insurance policies. Servicers ensure that title requirements are met, but they may or may not require title insurance to guarantee that title.

[49] Representatives from a large servicer stated that title insurance policies cost $400 to $700 on average.

[50] The VA 1995 IG report on title insurance (5R5-B10-081) found that 39 of the 46 district offices accepted title insurance.

[51] FHA may pay closing cost of up to 5 percent of the sales price of foreclosed properties. Purchasers can use these funds to purchase title insurance policies. Some VA district offices provide such assistance. Fannie Mae and Freddie Mac may also provide financial assistance when foreclosed properties are sold. RHS does not provide such assistance on the foreclosed properties that its servicers sell.

FHA and VA Do Not Collect Data to Support the Need for Title Insurance Expenditures

Although FHA and VA generally expect servicers to purchase new title insurance policies as evidence of title, they do not collect data necessary to support these expenditures. An FHA official said that FHA does not collect data on the number of times that title policies are invoked during the foreclosure process, although the official said this rarely happens. Several management and marketing contractor representatives that we contacted also said that they do not collect data on how often FHA title insurance policies are invoked after conveyance. However, the contractor representatives also said that title insurance policies were rarely if ever needed during the foreclosed property sale process.

Senior FHA officials said that they were not certain whether the costs associated with purchasing title insurance policies were justified and were considering revising these policies. FHA officials also stated that the state foreclosure laws require servicers' attorneys to conduct title searches[52] to ensure that all parties may be notified and the foreclosure properly conducted.[53] These title searches are conducted prior to the foreclosure sale, and FHA compensates servicers for the costs associated with these title searches. FHA officials stated that the title insurance policies that servicers subsequently purchase are based on the same title searches. Therefore, the FHA officials stated that the title insurance policies offer questionable additional value. We note that two large servicers have made proposals to sell foreclosed properties for FHA, rather than conveying them to management and marketing contractors. The servicers proposed to sell FHA properties without obtaining new title insurance policies.

VA officials have not implemented the recommendations in a 1995 VA inspector general (IG) report[54] that questioned the cost-effectiveness of the department's title insurance policy expenditures. Although VA began to encourage servicers to purchase title insurance policies in 1989 to facilitate title reviews on foreclosed properties, the IG report concluded that the policies did not meet this objective. The VA IG report found that title defects were rare and could generally be easily corrected by VA staff. The report also found that VA paid about $23.9 million in title insurance

[52] A title search is an examination of the real property records in the county where the land is located to discover title defects. The records searched will generally be the county real estate indexes and state district court, probate court, and tax lien records.

[53] See appendix II, the FHA commissioner's written comments on this report dated March 5, 2002.

[54] Report No. 5R5-B10-081, July 25, 1995.

premiums in fiscal years 1992 through 1994, but would have paid only about $121,169 to correct title defects if it had “self-insured” (i.e., paid to resolve these title defects) during the same period. The IG report recommended that VA work with foreclosure attorneys to ensure that foreclosures produce adequate evidence of title and discourage the purchase of title insurance policies. VA agreed in 1995 to direct its district offices to review their title evidence requirements annually and to document that new title insurance policies are cost effective in establishing title.

Despite this 1995 VA policy, five of the six VA offices we contacted that encourage the purchase of title insurance policies at conveyance could not produce the required memorandum on cost-effectiveness. One VA district office produced a memorandum, which merely stated that it would be cost effective to encourage the purchase of title insurance policies to facilitate title reviews. However, an official at the VA district office in Houston, which does not require a new title insurance policy as evidence of title, said that its servicers generally provide a copy of a title search, which costs about $75, as evidence of title. The VA official said that title searches save time and money associated with obtaining new title policies and that the office rarely encounters title problems when selling foreclosed properties to home buyers or investors.

Because they do not collect additional data on the cost-effectiveness of title requirements, VA and its district offices cannot determine whether similar strategies to lower the costs of purchasing title insurance policies could be used successfully. According to VA officials, they are in the process of reviewing their approach to foreclosed property management. As part of this review, VA officials said that they are reviewing the cost-effectiveness of the organization’s title insurance expenditures. VA officials said that they expect to make a decision regarding whether to continue expending funds on title insurance policies by early in calendar year 2003.

Available Data Suggest FHA Takes Longer to Sell Foreclosed Properties

Determining the organizations' comparative performance in selling foreclosed properties is difficult because FHA and RHS do not collect all of the data necessary to do so.[55] On the basis of available data, we estimate that it takes about 55 to 110 days longer to sell foreclosed FHA properties than is the case for the other organizations. We note that it is also difficult to determine the extent to which FHA's divided approach to foreclosed property custody contributes to FHA's comparatively slow performance. Other factors, such as FHA's approach to compensating servicers for their foreclosure expenses, may also play a role. Under certain conditions, FHA may inadvertently provide servicers with financial incentives to use the maximum allotted time to complete the foreclosure process.

FHA and RHS Do Not Collect Data on the Time Used To Sell Foreclosed Properties

Fannie Mae, Freddie Mac, and VA[56] collect data on the time that it takes to sell foreclosed properties from the date of the foreclosure sale until the properties are sold to home buyers or investors. Although FHA does collect data on the time foreclosed properties are in management and marketing contractors' inventory (from the date servicers convey properties to the contractors until the date they are sold to home buyers or investors), this period represents only a portion of the entire postforeclosure sale timeline.[57] The data FHA collects does not measure

[55] Comparative performance is measured from the time of the foreclosure sale until the property is sold to home buyers or investors. We did not include the period prior to the foreclosure sale because organization officials said that loss mitigation efforts may continue up until foreclosure sales. The officials also said that loss mitigation is more cost effective than foreclosure under most circumstances. Therefore, we did not want to imply that the organizations should move any faster than currently is the case to proceed to foreclosure sales. In addition, the period of time from the foreclosure sale until the property is sold is a common measure of performance in the real estate industry.

[56] The VA data consists of the time that VA receives custody of foreclosed properties until properties are sold. VA procedures allow servicers up to 15 days to convey properties. VA could not provide data on the average time that elapses from the date of the foreclosure sale until conveyance. However, VA officials said that servicers have strong incentives to convey within a limited period of time after the foreclosure sale because VA does not reimburse them for interest expenses beyond the date of the foreclosure sale, and because they are responsible for any damages that occur to properties prior to conveyance. Because of these financial incentives, it is likely that servicers convey properties to VA on approximately the foreclosure sales date.

[57] FHA does collect data on specific dates during the time that servicers maintain property custody. For example, FHA collects data on the "possession and control date." However, FHA does not use this data in estimating the entire time necessary to acquire and sell foreclosed properties. Rather, FHA reports the time for which management and marketing contractors are responsible for properties: the date of conveyance until the properties are sold.

the time that servicers have custody of properties, including the redemption, eviction, and preservation and protection periods. An RHS official said that RHS currently does not maintain centralized and automated data on the time that it takes their servicers to sell properties, from the time of the foreclosure sales until properties are sold.[58]

Senior FHA and RHS officials told us that they plan to collect additional data. As discussed earlier, FHA officials said that they plan to conduct preconveyance inspections on about 250 properties in fiscal year 2002 and hope to expand the program in the future to include as many as 6,000 properties by the latter part of fiscal year 2003. As part of these inspections, FHA officials said that they plan to collect information on property foreclosure sales dates. The FHA officials said that they would use the information to help assess servicer performance. Beginning in fiscal year 2002, RHS officials said servicers will report on the time necessary to sell their foreclosed properties. RHS officials said that collecting the data in a centralized and accessible manner would allow them to better monitor servicer performance. RHS officials expect the automated system to be in place by February 2003.

Available Data Suggest FHA Foreclosed Property Sales Performance Is Comparatively Slow

Table 6 provides available data on the time that elapsed in acquiring and selling FHA, VA, RHS, Fannie Mae, and Freddie Mac foreclosed properties in 2000, and the data indicates that FHA properties took the longest to sell, at 292 days. Although the Fannie Mae, Freddie Mac, and VA data are more comprehensive, we had to collect data and estimate comparable time frames for FHA and RHS. We collected state-by-state averages of the number of days from the foreclosure sale until property conveyance from four large servicers. We then added these data to data provided by FHA on the average number of days that it takes management and marketing contractors to sell foreclosed properties.[59]

[58] RHS staff responsible for analyzing loss claims have this information for individual cases.

[59] We present the combined foreclosure-to-sale average of 292 days in table 6. To arrive at this figure, we first determined an average conveyance time of 107 days from foreclosure sale to conveyance across four large FHA servicers by weighting each servicer's state-by-state averages by the number of foreclosures that servicer had in that state. We added to that 107-day average the 185 days, on average, that management and marketing contractors had properties in their inventories (acquisition date to property sale), according to FHA.

Table 6: Average Number of Days Between Foreclosure and Property Sales in 2000

Organization	Days in inventory
FHA	292[a]
VA	237[b]
RHS	196[c]
Fannie Mae and Freddie Mac	180[d]

[a]Based on data provided by four large FHA servicers on the average time from foreclosure sale until properties are conveyed to management and marketing contractors. These servicers initiated about 30 percent of all FHA foreclosures in 2000. The resulting servicer average was combined with data provided by FHA on the average number of days that management and marketing contractors take to sell foreclosed properties.

[b]VA data include the time from the date VA receives custody of the property until the property is sold. VA requires servicers to convey within 15 days of foreclosure sales, although servicers have financial incentives to convey as soon after the foreclosure sale as possible.

[c]Based on data provided by the two largest RHS servicers.

[d]Represents a simple average for the two organizations.

Sources: Four large FHA servicers, FHA, VA, the two largest RHS servicers, Fannie Mae, and Freddie Mac.

We also contacted the two largest RHS servicers,[60] and they provided data on the time their staffs took to sell foreclosed properties, as measured from the foreclosure sale until the properties were sold to home buyers or investors.

Servicer Compensation Requirements May Inadvertently Provide Financial Incentives to Take the Maximum Time Allotted to Complete the Foreclosure Process

While FHA's divided approach to foreclosed property custody likely contributes to the length of time needed to sell FHA properties, other factors may contribute as well. We could not, however, determine the amount of time each factor contributes to FHA's lengthy foreclosure sale to property sale process. These other contributing factors may include the strength of real estate markets and FHA's sale of foreclosed properties to nonprofit organizations.[61] In addition, the compensation that FHA is required to provide to servicers may help explain the comparatively long period that it takes to sell FHA's foreclosed properties.[62] Potentially, FHA's

[60] These two servicers service about 30 percent of the RHS mortgage portfolio.

[61] FHA management and marketing contractors sold about 11 percent of FHA's foreclosed property inventory in 2001 to nonprofit organizations at discounted prices. According to a senior FHA official, these sales take additional time to complete and add a few days to the overall average time taken to sell properties.

[62] FHA is required to pay servicers a debenture interest rate, which is established by statute.

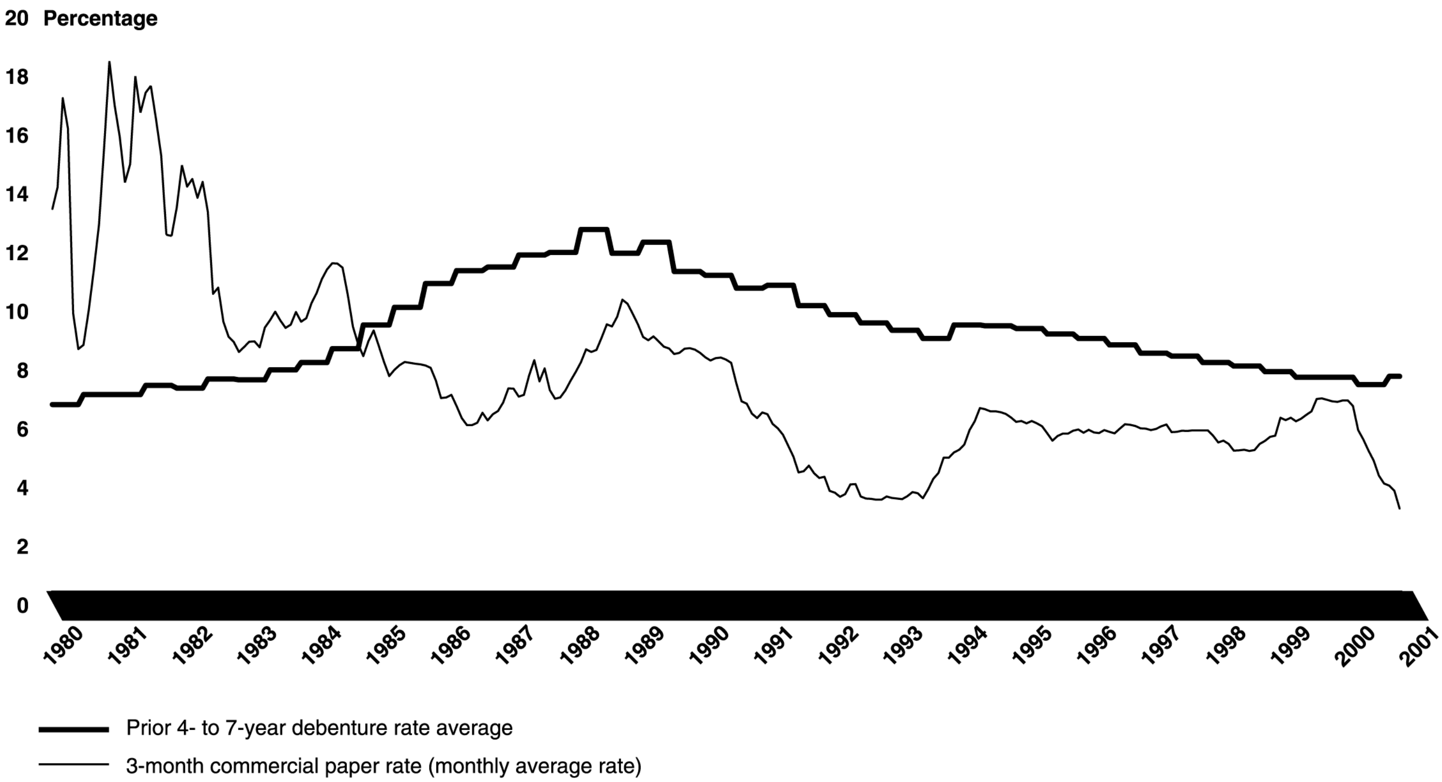
process for compensating servicers for expenses associated with foreclosures inadvertently provides servicers with financial incentives to take the maximum time that FHA allows to complete foreclosure proceedings.

Servicers typically use borrowed funds to finance the payment of outstanding debt on mortgages in the process of foreclosure.[63] When servicers bid on properties at foreclosure sales, they continue to use borrowed funds to finance the recovered properties. Servicers pay interest on these borrowings, which is referred to as the cost of funds, until they file claims with FHA when properties are conveyed. FHA compensates servicers for their interest expenses at what is known as the debenture interest rate, which is set slightly below the rate at which the foreclosed mortgages were originated. We found that the difference between the servicers' cost of funds, and the debenture interest rate that these servicers receive, can be significant.[64] Our analysis shows that, from 1985 through the first half of 2001, the FHA debenture rate average consistently exceeded the cost of funds (see fig. 8). In September 2001, during a period of declining interest rates, the difference between this average rate and the cost of funds was about 4.5 percentage points. Given that FHA's compensation system provides servicers with a potentially significant profit, these servicers appear to have financial incentives to take the maximum time allotted to complete foreclosure proceedings.

[63] Typically, mortgages are recorded in the name of the servicer. The servicer then becomes the owner of the property after successfully bidding at the foreclosure sale. In some instances, however, the servicer acts on the behalf of a mortgagee.

[64] For this analysis, we used the average debenture interest rate that had been in effect during the prior 4- to 7- year period, as mortgage defaults and foreclosures typically occur at the highest rates 4 to 7 years after the mortgages are issued. For estimating the cost of funds for servicers, we used the interest rate on commercial paper, or short-term business loans, because that is a proxy for the interest rate at which large servicers borrow funds.

Figure 8: Differences in FHA Debenture Interest Rate and Servicers' Cost of Funds, January 1980 through September 2001



Source: Federal Reserve Board and FHA.

Conversely, Fannie Mae, Freddie Mac, and VA servicers do not receive any interest after foreclosure sales because they convey properties immediately after the foreclosure sales. Therefore, Fannie Mae, Freddie Mac, and VA bear the interest costs associated with holding properties themselves and have financial incentives to complete proceedings and sell properties as quickly as possible. We note that RHS's compensation system for servicers is similar to that of FHA and may provide its servicers with financial incentives to take the maximum time allotted to complete foreclosure and property sale proceedings.[65] However, RHS has also set strict deadlines for servicers to complete foreclosure proceedings and sell properties. RHS generally requires servicers to sell properties within 6

[65] RHS compensates servicers at the interest rate at which the mortgages were originated. In contrast, the FHA debenture rate is set slightly below the rate at which the mortgages were originated.

months of foreclosure sales and will not pay any interest on loss claims beyond that date. As noted earlier, FHA has established time frames for servicers to complete foreclosure proceedings and will not pay interest expenses if servicers exceed these guidelines. The FHA guidelines are not directly comparable to the RHS guidelines because FHA servicers are not required to sell properties.

Conclusions

FHA's divided approach to foreclosed property custody is inefficient, delays critical maintenance and marketing necessary to preserve property values, results in disputes between servicers and contractors, and likely contributes to the lengthy period of time that available data suggest it takes to sell FHA properties. As a result of the inefficiencies in FHA procedures, the organization maintains or has initiated several complex layers of oversight, such as an appeals process and preconveyance inspections, to ensure that properties are properly maintained. FHA officials have appropriately considered alternative procedures to establish unified property custody, but have not yet implemented pilot programs to test their feasibility. Although unified property custody would streamline FHA's procedures, it need not come at the expense of current FHA policies that encourage servicers to pursue loss mitigation, and it need not result in foreclosure proceedings being initiated faster than is currently the case. Nor would unified custody affect state and federal laws that provide protections to homeowners. If properly designed, unified custody procedures would have built-in financial incentives that preserved foreclosed property values and resulted in faster sales to the benefit of the MMI and to neighboring communities.

FHA and VA cannot provide information on either the costs of purchasing title insurance policies during the foreclosure process or their benefits. We estimate that FHA and VA spent $31.5 million on new title insurance policies in 2000. We also found that the limited evidence that is available suggests purchasing new title policies is not cost-effective and that less expensive options may be available. In particular, the VA IG report[66] questioned the cost- effectiveness of title insurance policies, and management and marketing contractor representatives we contacted reported few if any instances when title policies were necessary. Further, Fannie Mae, Freddie Mac, and RHS do not encourage servicers to purchase new title insurance policies during foreclosures and report few title-related problems.

[66] Report No. 5R5-B10-081, July 25, 1995.

FHA and RHS do not collect data necessary to measure the time that elapsed in acquiring and selling foreclosed properties. Specifically, neither organization collects data on the foreclosure sales date. Without such data, the organizations cannot assess the performance of servicers in fulfilling their obligations in either managing or selling foreclosed properties. FHA officials stated that collecting the foreclosure sale date would be helpful in measuring the performance of servicers in completing foreclosure sales and in obtaining control of properties. Likewise, RHS officials have stated that collecting such data would be useful in measuring servicer performance in selling properties. Both organizations plan to collect data on foreclosure sales dates. Collecting such data should not pose an undue burden on FHA and RHS servicers, given that we were able to collect it from several large servicers.

Recommendations

- To provide for the most effective acquisition and sale of FHA's foreclosed properties, we recommend that the secretary of the Department of Housing and Urban Development (HUD) establish unified property custody as a priority for FHA. The HUD secretary should determine the optimal method of unified property custody. That is, the HUD secretary should determine the method of unified custody that best ensures FHA borrowers continuing benefits from loss mitigation and homeowner protections under state and federal laws, provides appropriate incentives for limiting the time and expense of acquiring and selling properties, and ensures that properties are maintained to the benefit of the FHA insurance fund and communities. The HUD secretary should then implement the optimal method for establishing unified custody. If this optimal method requires additional statutory authority, the HUD secretary should seek it.
- We also recommend that the HUD secretary and the secretary of the Department of Veterans Affairs (VA) immediately assess the cost-effectiveness of their expenditures on title insurance purchases. The HUD secretary and VA secretary should revise these policies if the costs of purchasing these title insurance policies are not clearly justified by their benefits and less expensive alternative means of establishing title are available.
- Finally, to improve the quality of information available to FHA and RHS on the time necessary to sell foreclosed properties, we recommend that the HUD secretary and the secretary of the Department of Agriculture collect additional data from their servicers. Specifically, the HUD secretary should collect data on foreclosure sales dates, and the secretary of agriculture should collect data on foreclosure sales dates and the dates that foreclosed properties are sold to home buyers or investors, and maintain this data in a format that is easily accessible by RHS managers.

Agency Comments and Our Evaluation

We obtained written comments on a draft of this report from FHA and VA officials. The written comments are presented in appendixes II and III, respectively. In addition, we sought and obtained further clarification of FHA's written comments from a senior FHA official. RHS, Fannie Mae, and Freddie Mac officials chose to provide oral comments on a draft of the report. All of the organizations provided technical comments, which have been incorporated into the final report as appropriate.

FHA agreed with our recommendations to establish unified property custody as a priority, assess its title insurance policy expenditures, and collect additional data. First, FHA stated that unified custody could streamline processes and oversight, reduce holding time, and increase the net return on the sale of foreclosed properties. FHA also stated that there were statutory explanations for the current divided approach to foreclosed property custody, and that statutory changes are necessary to implement specific approaches to unified custody. FHA stated that it would continue research to determine the feasibility of unified custody within the framework of existing statutes and to identify regulatory and contractual issues that would be necessary to facilitate such a change. Further, FHA stated that it would explore statutory changes that could increase the efficiency of its property sale program. Second, FHA agreed that its expenditures on title insurance policies during the foreclosure process add questionable value. FHA stated that it is reviewing these expenditures and has begun to investigate alternative approaches. Third, FHA stated that it agreed with our recommendation to collect data from all servicers on foreclosure sales dates, although it may take a year or more to implement the recommendation for several reasons, such as the need to change computer systems. We believe that collecting data on foreclosure sales dates is crucial for FHA to assess servicer performance in managing foreclosed properties and in assessing the various approaches to establishing unified property custody.

VA agreed with the report's conclusions and the recommendation that the organization immediately assess the cost-effectiveness of its expenditures on title insurance policies. VA said that it would review its title insurance expenditures as part of its ongoing analysis of its loan-guaranty related business processes and policies. VA expects to complete this review early in calendar year 2003.

RHS stated that it agreed with our recommendation that the organization collect data on foreclosure sales dates and the dates that foreclosed properties are sold to home buyers or investors, and it also agreed that the data be maintained in a format that is easily accessible by RHS managers.

RHS said that it has plans to collect the additional data and is in the process of developing a comprehensive, fully automated system that will be used to support both payment and monitoring of loss claims. RHS estimates that the automated system will be in place by February 2003.

Fannie Mae and Freddie Mac officials said that the draft report accurately portrayed their foreclosure, property sale, and data collection programs.

As agreed with your offices, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days after its issuance date. At that time, we will send copies of this report to the Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs and other interested members of Congress and congressional committees. We will also send copies to the HUD secretary, the VA secretary, the secretary of agriculture, the chief executive officer of Fannie Mae, and the chief executive officer of Freddie Mac. We will also make copies available to others upon request.

Please contact me or Mathew J. Scire at (202) 512-6794 if you or your staff have any questions concerning this report. Key contributors to this report were Andrew E. Finkel, Diana Gilman, Rachel DeMarcus, Jill M. Johnson, Kyong H. Lee, Wesley M. Phillips, Barbara M. Roesmann, and Richard Vagnoni.

Sincerely yours,

Davi M. D’Agostino
Director
Financial Markets and
Community Investment

Appendix I: Scope and Methodology

To provide information on state foreclosure laws and compare the organizations' procedures, we interviewed officials from the organizations, mortgage servicers, FHA management and marketing contractors, law firms that specialize in foreclosures, the Mortgage Bankers Association, the American Land Title Association, and Mortgage Insurance Companies of America. We also contacted other experts in housing market finance and foreclosures and three banks in the Boston area that hold mortgages in their portfolios and manage foreclosures and property sales. We reviewed relevant rules and regulations provided by the organizations, reports and studies, state and federal statutes pertaining to foreclosures, and statistics on mortgage defaults and foreclosures. We also developed summaries of the organizations' foreclosure and property sale procedures.

To identify the effects of FHA's procedures on property maintenance and marketing, we contrasted FHA's procedures to those of the other organizations and identified procedures that can delay steps necessary to sell properties and that offer no clear and corresponding benefits. We discussed FHA's procedures with organization officials, servicer representatives, management and marketing contractor officials, and experts in real estate management. We also collected data and examples from FHA officials and large mortgage servicers that demonstrate the effects of FHA's procedures. In particular, we asked three large servicers to provide data on their performance in conveying foreclosed properties within deadlines established by FHA, which they agreed to do.

To assess the cost-effectiveness of FHA and VA title insurance expenditures, we reviewed their policies regarding the evidence necessary to establish title to foreclosed properties. We also requested that FHA and VA provide data on the benefits of their title insurance expenditures. In addition, we reviewed a relevant VA IG report[1] on VA's title evidence policies, and we contacted seven VA district offices to assess their compliance with a VA policy that was implemented in response to the report's recommendations.

To estimate the time that it takes to acquire and sell foreclosed properties, we collected data from Fannie Mae, Freddie Mac, and RHS. To estimate the time necessary to acquire and sell FHA properties, we collected data from four large servicers who conducted about 30 percent of all FHA foreclosures in 2000. We judgmentally selected these servicers on the basis

[1] Report No. 5R5-B10-081, July 25, 1995.

of their size and willingness to provide data. Specifically, the servicers agreed to provide data on the average amount of time that they held custody of FHA foreclosed properties (from the time of the foreclosure sale until conveyance to FHA management and marketing contractors). We combined these data with national data provided by FHA on the time that it takes its contractors to sell foreclosed properties. Because RHS does not yet collect data on the time that it takes to sell foreclosed properties, we collected data from the two largest RHS mortgage servicers, which service about 30 percent of all RHS mortgages. We focused our analysis on the time from the foreclosure sale until properties are sold to homeowners or investors, because the organizations encourage servicers to pursue loss mitigation strategies until foreclosure sales. The organizations generally consider loss mitigation as the best means to minimize the cost and disruptions associated with foreclosures, and we did not want to imply that the completion of foreclosure sales should proceed any faster than is currently the case. The period of time from foreclosure sale until properties are sold to investors is also a common measure of performance in the real estate industry. We did not independently verify the data provided by the organizations or servicers.

Due to data limitations, we were not able to estimate the number of days that various factors, such as FHA's approach to foreclosed property custody and the strength of real estate markets, contribute to the total number of days that are taken to acquire and sell FHA foreclosed properties. To discuss another potential contributing factor, we collected historical data that shows the differences between FHA's debenture interest rate and large servicers' cost of funds. To estimate large servicers' cost of funds, we used the interest rate on commercial paper.

We conducted our work in Washington, D.C.; Boston; Dallas; Manchester, N.H.; and Oklahoma City between June 2001 and January 2002 in accordance with generally accepted government auditing standards. We obtained written comments on a draft of this report from FHA and VA, which are reprinted in appendixes II and III, respectively. RHS, Fannie Mae, and Freddie Mac officials decided to provide oral comments on a draft of this report. Each of the organizations provided technical comments, which have been incorporated into this report where appropriate.

Appendix II: Comments from the Department of Housing and Urban Development

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

March 5, 2002

Ms. Davi M. D'Agostino
Director, Financial Markets
and Community Investment
United States General Accounting Office
Washington, DC 20548

Dear Ms. D'Agostino:

Thank you for the opportunity to provide comments on your office's draft report: Single Family Housing: Opportunities to Improve Federal Foreclosure and Property Sale Processes (GAO-02-305). The Department is continually seeking ways to improve the conveyance and resale processes for its real estate-owned inventory. The information contained in your report on the different approaches used by the Department of Veterans Affairs (VA), the Rural Housing Service (RHS), Fannie Mae and Freddie Mac will contribute to this effort.

See comment 1.

Before discussing the recommendations, we would like to comment on the substantive conclusions. The report does not provide a balanced assessment of HUD's overall REO disposition results, in that it makes no mention of the significant process and performance improvements since the Department began outsourcing management and marketing (M&M) responsibilities to the private sector in 1999. The REO inventory, which in 1999 exceeded 47,000 properties, has been reduced to 29,000 and is remaining level even though the economy is in recession. Time in inventory has declined from an average of 219 days to 173 days. Most significantly, FHA's loss per claim has also declined from 38.6 percent in 1999 to 32.7 percent in 2001.

See comment 2.

One reason for the reduction in REO inventory is the exponential growth of FHA's loss mitigation outreach. While loss mitigation is tangential to the subject of property disposition, foreclosure avoidance is certainly one way in which FHA fulfills its mission of preserving homeownership, protecting neighborhoods and preserving the integrity of the insurance fund. Footnote 17 on page 13, does not cite current data on HUD's loss mitigation efforts. The study cited contained 1999 data, the third year of FHA's Loss Mitigation Program. Program activity has doubled since then, going from 26,400 loss mitigation actions in FY 99, to more than 50,000 loss mitigation cases in FY 2001. HUD believes that our loss mitigation efforts are a primary explanation for the diverging trends in delinquencies and claims. Other contributing factors include strong real estate markets and low interest rates. Delinquencies, at the end of FY 2001 were at their highest rate in 10 years; yet at the same time, foreclosure claims were at their lowest level in 10 years, representing only 0.76 percent of the FHA insured portfolio. This is an eight percent reduction from the prior year. Numerically, FHA loss mitigation increased by 19,000 loans, while claims declined by 10,000.

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While FHA's recent property disposition experience is generally successful, we recognize that it is possible to improve and we understand your recommendations as suggestions for improvement. We generally agree with these recommendations; however, as your report notes, we may have to seek changes to our authorizing statutes in order to implement some of them. More detailed responses to the recommendations and comments on specific material presented in the report follow:

See comment 3.

Recommendation 1 - HUD should determine if unified property custody represents the optimal method of property custody and if so, implement it after seeking any required statutory authority.

HUD developed its dual property custody approach primarily in compliance with statutory requirements that a) prevent the Department from expending funds on properties before title has been transferred to HUD, and b) require that lenders deliver marketable title to HUD before a claim can be paid. The combination of these two statutory requirements created a need to have lenders retain responsibility for property preservation up to the point when marketable title can be conveyed.

We agree that a unified custody approach may streamline processes and oversight, reduce holding time and increase net return. We expect to be able to immediately shorten the time to convey properties to HUD; however, adopting either approach described in this study will require statutory changes. We intend to continue research to determine the feasibility of unified custody within the framework of existing statutory requirements and to identify regulatory and contractual issues that would have to be resolved to facilitate such a change. Further, HUD will explore statutory changes that will increase efficiencies in the property disposition program.

Recommendation 2 - HUD should assess the cost effectiveness of its expenditures on title insurance and, where justified, use less expensive alternatives.

We agree with this recommendation and have begun to investigate alternative approaches.

Recommendation 3 - HUD should collect foreclosure sales dates from its servicers.

We agree with this recommendation. It will require changes to computer systems of HUD, servicers and service bureaus, as well as OMB approval of a modified form and revised FHA guidance to servicing mortgagees. We anticipate that these changes, especially the computer changes, will take more than a year and will be subject to the availability of funds for the required system modifications.

Additional Comments:

See comment 4.

- **Foreclosure Moratoria in Calendar Year 2000.** [pp. 5, 38] The increase in the average time to complete foreclosure in CY 2000 was due to special circumstances. HUD spent much of the year investigating predatory lending. As part of this investigation, foreclosure was suspended on approximately 7,800 delinquent FHA-insured mortgages in Atlanta, Baltimore, Chicago, Los Angeles, and New York in CY 2000. During the moratorium, HUD

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staff reviewed the underwriting and servicing of the individual loans. The length of the moratorium varied from a few months to over a year, depending on the circumstances of the case. These moratoria, as well as those imposed for Presidentially declared disaster areas, contributed to increases in the average time to complete foreclosure.

See comment 5.

- **Loss Mitigation** [p. 11] The graphic shows loss mitigation efforts in advance of a borrower default, when generally it is the default of the borrower that triggers loss mitigation.

See comment 6.

- **Initiating Foreclosure on an FHA-insured Mortgage** [p. 14] The "390 days" presented in Table 2 as FHA's guideline is incorrect. The correct time to begin foreclosure is 210 days. The basic rule, as stated in 24 CFR 203.355, is that foreclosure should commence within six months from the date of default which is defined in 24 CFR 203.330 and in the Handbook as "… a mortgagor's failure to perform under any covenant of the mortgage and the failure continues for 30 days." More time is permitted if the borrower files bankruptcy, the lender engages in loss mitigation, or HUD imposes a moratorium on foreclosure. Less time is allowed if the property is vacant.

See comment 7.

- **Use of Designated Counsel** [p. 16] We acknowledge that use of designated counsel may be more efficient than allowing lenders to select their own law firms to conduct foreclosures. However, Freddie Mac and Fannie Mae actually own the loans and therefore have the ability under their servicing contracts to appoint service providers. As an insurer, HUD does not have this prerogative.

See comment 8.

- **Preservation & Protection (P&P) Issues** [pp. 23 - 28] HUD will be issuing additional guidance via Mortgagee Letters and an internal Housing Notice regarding P&P issues and will provide training to HUD and contractual staff. This should correct previous misunderstandings, expedite responses to lenders' inquiries and requests, and reduce the disputes that have been occurring after conveyance. One of the Mortgagee Letters will provide updated P&P cost schedules, which should eliminate some of the requests for approval to exceed the guidelines. Finally, we will review the example presented in Figure 6 to see whether hazardous material disposal fees justified such extraordinary charges if you will identify the case.

See comment 9.

- **FHA's Pre-conveyance Inspections** [p. 31] This pilot is intended to determine the condition of the property when the servicing lender takes possession, which will enable HUD to identify damage caused by the occupant and note P&P work that must be completed prior to conveyance. The draft report's description of this pilot implies that the P&P work should have been completed by the time of the inspection.

See comment 10.

- **601 Demonstration** [p. 33] As mentioned in the draft report, the Department is in the process of implementing a demonstration program using the authority granted by Section 601 of the 1999 HUD/VA Appropriations Act. Under the demonstration program, which is being called the Accelerated Claims Disposition (ACD) Program, the Department will identify eligible loans and request the servicers to assign the loans. Rather than foreclosing and disposing of the property, the Department will sell the notes, thus avoiding the property custody and disposition function altogether. If the demonstration proves successful, the program will be expanded to the majority of defaulted loans. While ACD will certainly not eliminate HUD's acquisition of REO, it is expected to substantially decrease the volume of foreclosed real estate conveyed to the Secretary.

See comment 11.

- **Data Collection relative to Title Insurance** [p. 36] State foreclosure laws require the foreclosure counsel or trustee to obtain a title search to ensure that all parties may be notified and the foreclosure properly conducted. HUD reimburses lenders for the cost of this search. Additionally, HUD currently requires that lenders purchase a title insurance policy with HUD named as the insured. Since the policy is based on the same title search, it is questionable that any additional value is gained by buying the title policy. Contrary to the statement in the report, HUD does retain data on the number of properties that are reconveyed as a result of irresolvable title defects and the number is de minimus.

See comment 12.

- **Debenture Interest Rates** [p. 42] The report implies that lenders may have an incentive to delay conveyance of foreclosed real estate because the debenture interest rate that HUD pays from default to conveyance is several basis points above the current cost of funds. This is certainly true during periods of declining interest rates; however, the debenture interest rate can also prove to be a penalty during periods when lender costs of funds are increasing.

See comment 13.

  The report also notes that RHS manages the incentive provided by debenture interest by capping at 6 months the period for which debenture interest will be paid. It should be noted that FHA also has established a reasonable diligence time frame for completion of foreclosure and conveyance and will not pay debenture interest if servicers exceed published reasonable diligence guidelines.

The Department is committed to improving its programs and processes, assisting homeowners in avoiding foreclosure whenever possible, and maintaining the actuarial soundness of FHA's Mutual Mortgage Insurance Fund. We appreciate both your suggestions for further improvement and the opportunity to comment on the draft report.

Sincerely,

John C. Weicher
Assistant Secretary for Housing-
Federal Housing Commissioner

The following are GAO's comments on the Department of Housing and Urban Development's March 5, 2002, letter.

GAO Comments

1. We agree that FHA data show a significant decline in the average time that management marketing contractors held properties between 1999 and 2001. In fact, FHA data show that nearly all of the improvement in inventory time occurred by 2000. Specifically, data that FHA provided subsequent to the official comment letter show that the average inventory time declined from 270 days in calendar year 1999 to 185 days in calendar year 2000, and 173 days in calendar year 2001. According to a senior FHA official, the 219-day figure cited for 1999 in the comment letter is incorrect. Because we used data for calendar year 2000, the report reflects the significant decline in inventory times that FHA has reported. Therefore, we believe that the report fairly describes the time that it takes to sell FHA properties.

2. This footnote has been deleted.

3. The FHA comment letter paraphrases our recommendation differently than the way the full recommendation was written in the draft report. We recommended that the HUD secretary establish unified property custody as a priority for FHA and determine the optimal method of unified property custody. FHA paraphrased our recommendation as stating that HUD should determine if unified property custody represents the optimal method of property custody and, if so, implement it after seeking any required statutory authority. We contacted a senior FHA official to obtain clarification on FHA's position on our recommendation. The FHA official said that FHA, in paraphrasing the recommendation in the draft report, did not mean to change the recommendation's meaning. FHA agrees with our recommendation that it should establish unified property custody as a priority. FHA is conducting analysis to determine the feasibility of establishing unified custody within the existing statutory framework and to identify regulatory and contractual changes that would have to be resolved to implement unified property custody.

4. We do not agree with FHA that actions taken to suspend foreclosure proceedings in these 7,800 cases contributed to the time taken to sell FHA properties in 2000. The timeline we provided measures from the date of the foreclosure sale until properties are sold to homebuyers or investors. Because suspension of foreclosure proceedings on these

mortgages occurred prior to the completion of the foreclosure sale, the suspension would not add time to the period measured in this report.

5. We revised the figure.

6. We revised the table.

7. We added language to the report body.

8. The final report notes that FHA is developing guidance to clarify the circumstances under which management and marketing contractors can demand refunds from servicers for preservation and protection work that has not been completed according to standards.

9. We have revised the report language.

10. As stated in the report body, the section 601 authority may allow for unified property custody. While FHA's Accelerated Claims Disposition Program could reduce the number of properties that FHA acquires through foreclosure, it is too early to judge its ultimate success. Further, as the FHA commissioner states, even if the demonstration program is successful and expanded to the majority of defaulted mortgage loans, it will not eliminate FHA's responsibility for acquiring and selling foreclosed properties entirely. We believe that FHA should established unified custody as a priority for any such foreclosed properties for which it becomes responsible in the future.

11. We disagree with FHA that the draft report stated that FHA does not retain data on the number of properties that are reconveyed due to irresolvable title defects. The draft report stated that FHA does not collect data on the number of times that title insurance policies are used during the foreclosure process or the types of problems that require title insurance. Therefore, we made no changes in response to this comment.

12. As stated in the report draft, the debenture rate can significantly exceed servicers' cost of funds. In fact, the debenture rate has exceeded servicers' cost of funds since 1985. In a rising interest rate environment, such as last occurred in 1984, servicers' cost of funds may exceed the debenture rate.

13. We added further language to the final report noting that FHA has established time frames in each state for completing foreclosures.

Appendix III: Comments from the Department of Veterans Affairs

THE SECRETARY OF VETERANS AFFAIRS
WASHINGTON

March 4, 2002

Ms. Davi M. D'Agostino
Director, Financial Markets
and Community Investment
U. S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Ms. D'Agostino:

This responds to your draft report, ***SINGLE-FAMILY HOUSING: Opportunities to Improve Federal Foreclosure and Property Sale Processes*** (GAO-02-305). I agree with your conclusions and concur with your recommendation to immediately assess the cost-effectiveness of the Department of Veterans Affairs (VA) expenditure on title insurance purchases. VA is presently conducting a comprehensive review of its loan guaranty-related business processes and policies in an initiative known as Loan Administration Redesign. The issue of whether to change our present policy on title insurance will be considered during this review. We expect to conclude this initiative early in calendar year 2003. This issue has been a matter of discussion between the Veterans Benefits Administration (VBA) and VA's Office of General Counsel. As GAO recommends, VA will make a decision regarding requiring title insurance after the cost-effectiveness is known.

Please note one technical concern with the draft report. Footnote 16 on page 12 of the draft says that in a chapter 7 bankruptcy, if the borrower has equity in the property, "the property will be sold by the bankruptcy court . . . ." (Emphasis added.) Perhaps "may" should be substituted for "will" in the quoted sentence. In some states, such as Texas and Florida, a debtor's homestead interest in the principal residence is generally beyond the reach of the bankruptcy court.

I appreciate the opportunity to comment on your draft report.

Sincerely yours,

Anthony J. Principi

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