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TESTIMONY ON

EVALUATING THE CITY'S PURCHASE OF FHA-FINANCED UNDERWATER MORTGAGES THROUGH THE COMMUNITY RESTORATION PROGRAM

PRESENTED BEFORE:

CITY OF NEW YORK,
COMMITTEE ON HOUSING AND BUILDINGS
&
COMMITTEE ON ECONOMIC DEVELOPMENT

PRESENTED BY:

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My name is Christopher Fasano and I am a Staff Attorney in the Foreclosure Prevention Project at MFY Legal Services, Inc. ("MFY"). MFY envisions a society in which there is equal justice for all. Our mission is to achieve social justice, prioritizing the needs of people who are low-income, disenfranchised or have disabilities. We do this through providing the highest quality direct civil legal assistance, providing community education, entering into partnerships, engaging in policy advocacy, and bringing impact litigation. We assist more than 20,000 New Yorkers each year. In the summer of 2016, MFY filed a federal class action lawsuit on behalf of African-American homeowners in New York City whose loans were sold or may be sold through the Department of Housing and Urban Development's ("HUD") Note Sale Program.[1] That lawsuit exposes the discriminatory impact of these sales, HUD's violation of these homeowners' due process rights, and the harm homeowners experience after the sales, when private equity purchasers impose unsustainable loan modification terms on homeowners.

As an organization dedicated to preserving New York communities, MFY commends the Council for examining the City's efforts to revitalize foreclosure-plagued neighborhoods by purchasing FHA-insured mortgages through the Community Restoration Program.

The Purpose of HUD's FHA Mortgage Program: Increase Homeownership & Build Wealth

The Federal Housing Administration's ("FHA") mortgage program, administered through HUD, is an important source of mortgage lending for those shut out of the conventional mortgage market who too often have been homeowners of color. FHA mortgages have also served as an important pathway to the middle class for many American families, enabling them to build inter-generational wealth through property ownership.

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[1] The lawsuit, *Washington et al. v. HUD et al.*, can be found under number 16-cv-03948 in the Eastern District of New York.

FHA does not make mortgages, but rather insures the loans made by FHA-approved lenders against a homeowner's default. As a result, HUD is able to promote lending to borrowers with lower credit scores and who have less than 20% for a down payment. Recognizing that FHA homeowners often have higher bouts of unemployment and less savings, HUD provides various protections when homeowners fall behind. Under HUD regulations, FHA lenders and mortgage servicers must reach out within a month of a homeowner's default, must arrange for a face-to-face meeting, and must review homeowners for all of FHA's mortgage modification programs. These regulations ensure that FHA homeowners receive counseling after they default, and that their servicers regularly review them for affordable loan modification options that will keep them in their homes.

These benefits do not come free. FHA homeowners are required to pay to HUD a mortgage insurance premium at closing, currently 1.75% of the loan balance.[2] FHA homeowners are also required to pay HUD a monthly mortgage insurance premium, currently .85% of the annual unpaid principal balance spread over the 12 month period.[3] For homeowners in Southeast Queens, where the average home sells for approximately $350,000,[4] the mortgage insurance premium at closing is approximately $6,125 and the monthly mortgage insurance in the first year is approximately $248. These insurance premiums are all paid into FHA's Mutual Mortgage Insurance Fund ("the Insurance Fund"). In cases where the mortgage servicer must foreclosure, HUD accesses the Insurance Fund to pay out the mortgage servicer's insurance claim. Usually the

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[2] HUD, *Mortgagee Letter 2017-07* (Jan. 20, 2017), *available at* https://portal.hud.gov/hudportal/documents/huddoc?id=17-07ml.pdf (last visited Feb. 8, 2017).

[3] *Id.*

[4] *See* Trulia, *Queens Home Prices Page, available at* https://www.trulia.com/home_prices/New_York/Queens-heat_map/ (last visited Feb. 8, 2017),

claim includes the full amount of unpaid principal balance and a certain amount of arrears, making the servicer whole or close to whole where a home cannot be saved.

A Boon for Banks But Harmful for Homeowners

In 2010, because of the drain the foreclosure crisis had on the Insurance Fund, HUD launched its Note Sale Program to sell off delinquent mortgages that it perceived as unsavable and to help shore up the Insurance Fund. Under its Note Sale Program, HUD pools these defaulted mortgages and then auctions these pools to the highest bidder. While it is unclear how precisely HUD chooses which defaulted mortgages to include in the pools, mortgage servicers can only select mortgages where the mortgage is at least six months in default and where all of HUD's pre-foreclosure protections, including reviewing the homeowner's mortgage for FHA's various modification products, have been offered. If HUD selects the mortgage for the pool, HUD will pay out the insurance claim for the full unpaid principal balance to the mortgage servicer.

HUD then conducts an auction of these defaulted mortgages, selling the mortgages for between 40% and 60% of their value. The purchasers of these mortgages are largely hedge funds and private equity firms. Although HUD has touted that the program gives homeowners a second chance at a modification, MFY has found that less than 7% of sold-off mortgages were modified.

In fact, MFY has found that that even the 7% of mortgages modified may not have been modified into sustainable modifications. For instance, one purchaser, Lone Star Funds ("Lone Star"), and its servicer, Caliber Home Loans, Inc. ("Caliber"), have largely provided homeowners with a five-year interest-only modification with a teaser interest rate. That product results in anything but sustainable homeownership and stable neighborhoods because, after the five-year

period lapses, homeowners are responsible for paying back the entire principal over a period even shorter than what is required by their notes. This means that these homeowners will experience a dramatic spike in their mortgage payments after the interest-only period ends. HUD has also carved out certain pools to be "Neighborhood Stabilization Outcome" ("NSO") pools, requiring a certain percentage of the mortgages in the pool to be modified. But many of these specialized pools have been purchased by the same hedge funds and private equity firms as the other pools and, because HUD does not distinguish between sustainable modifications and modifications that will likely result in default in five years, it is unclear if these NSO pools will in fact produce long-term homeownership and stabilization of communities.

Finally, although the FHA mortgage servicers are supposed to have exhausted FHA's modification options before including the mortgages in the sales, MFY has found that this is often not true. Our review shows that many homeowners were actively applying for a modification or were in a trial plan when their mortgage was sold through HUD's Note Sale Program. As far as MFY is aware, HUD never independently verifies the FHA mortgage servicer's self-certification that it had exhausted all modification options and, quite troublingly, homeowners are never informed that their mortgage is about to be sold out of the FHA mortgage program. Thus, these homeowners' right to access the FHA modification program – a program they have paid for through HUD's insurance premiums – is, unbeknownst to them, cut short by the FHA mortgage servicer, who instead of modifying the homeowner's mortgage in accordance with FHA requirements, is made whole by receiving their full insurance claim for the mortgage.

The Disparate Impact of HUD's Note Sale Program

Since 2010, HUD has conducted 17 Note Sale auctions. New York mortgages make up a large proportion of the pools. In the most recent Note Sale, conducted on November 30, 2016,

New York State mortgages encompassed 22% of one of the pools.[5] In the September 14, 2016 Note Sale, New York State mortgages encompassed anywhere from between 7% to 26% of each national pool.[6] In fact, experts have maintained that HUD's Note Sale Program unfairly targets those states that have instituted homeowner protections through their judicial foreclosure process.[7]

But even more alarming is the fact HUD's Note Sale Program has had a disparate and negative impact on New York City's African-American communities. The below map, where each black dot represents a mortgage sold in the Note Sales held between 2012 and 2014,[8] demonstrates the disastrous impact of HUD's Note Sale Program on African-American communities.

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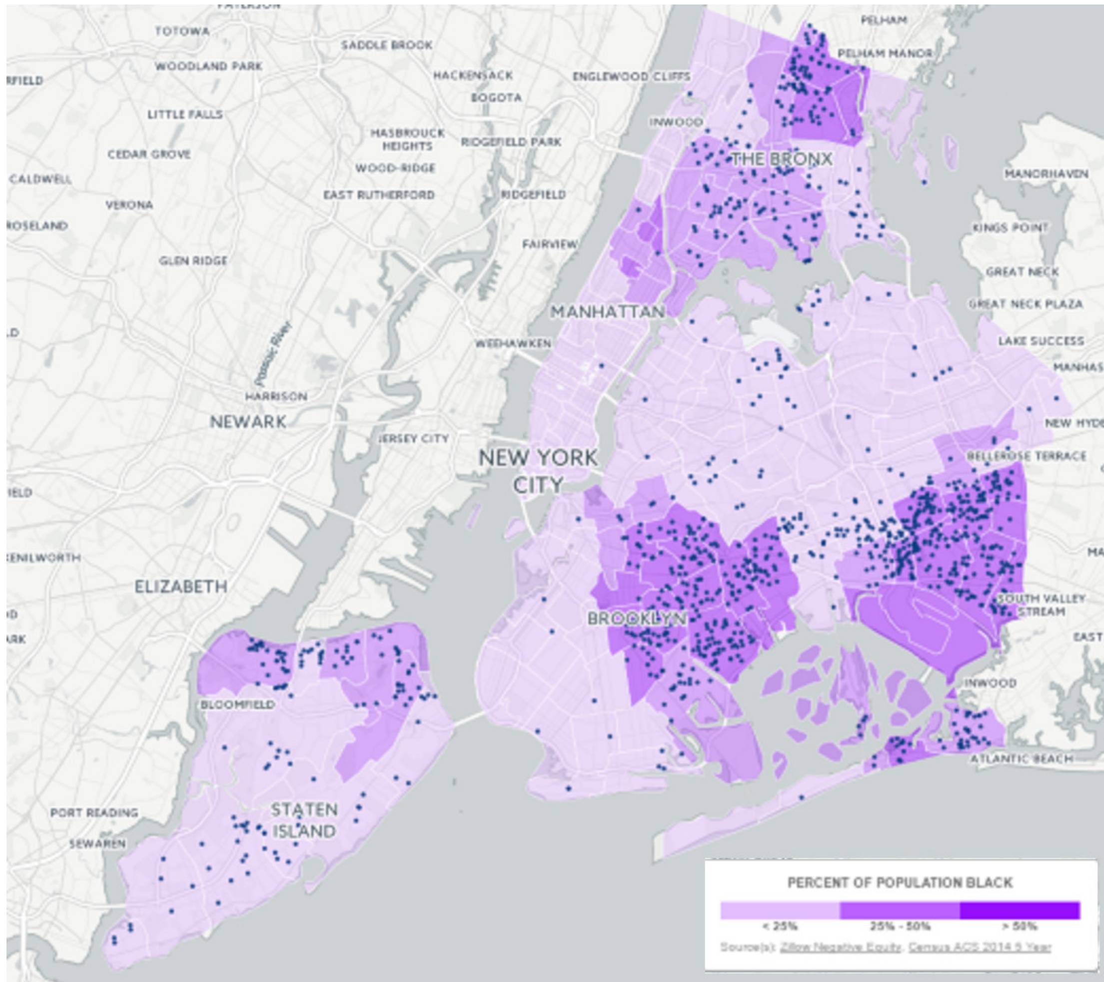
[5] HUD, *HUD-Held Vacant Loan Sale 2017-1 Sales Result Summary* (Bid Date: Nov. 30, 2016), *available at* https://portal.hud.gov/hudportal/documents/huddoc?id=sale1report.pdf (last visited Feb. 9, 2017). In its Sales Result Summary, HUD only identifies mortgages by state, not by municipality.

[6] HUD, *Single Family Loan Sale 2016-2 Sales Result Summary* (Bid Date: Sept. 14, 2016), *available at* https://portal.hud.gov/hudportal/documents/huddoc?id=sale2report.pdf (last visited Feb. 9, 2017).

[7] Geoff Walsh, *Opportunity Denied: How HUD's Note Sale Program Deprives Homeowners of the Basic Benefits of Their Government-Insured Loans*, National Consumer Law Center, pp. 10, 18-21 (May 2016), available at https://www.nclc.org/images/pdf/pr-reports/opportunity-denied-report.pdf (last visited Feb. 9, 2017).

[8] MFY obtained the addresses for every New York City mortgage sold through HUD's Note Sale Program between 2012 and 2014 as a result of a Freedom of Information Act request to HUD.



Although African Americans compromised 36% of New York City homeowners who obtained an FHA mortgage between 2012 and 2014,[9] more than 61% of all New York City mortgages sold in the Note Sale Program for the same time period were for homes located in predominately African-American neighborhoods.

Even though African-American homeowners rely more upon FHA mortgages than their white neighbors, as the chart below demonstrates, they are the only group of homeowners in New

[9] MFY obtained information about the type of mortgages issued in New York City between 2012 and 2014 by reviewing the Home Mortgage Disclosure Act ("HMDA") data mortgage lenders are required to provide to the federal government. This information is searchable on the Consumer Financial Protection Bureau's ("CFPB") website, available at http://www.consumerfinance.gov/data-research/hmda/.

York City for which the percentage of mortgages sold through the Note Sale Program is significantly higher than their market share.

	Non-Hispanic White	**Hispanic**	**Non-Hispanic Black**	**Asian**	**Other**	**Total**
FHA Mortgage Borrowers in NYC - 2012 to 2014 (by borrower)	3,671	2,508	4,746	1,270	1,267	13,462
FHA Mortgage Borrowers in NYC by Percentage – 2012 to 2014	27%	19%	35%	9%	9%	100%
NYC DASP-Sold Mortgages – 2012 to 2014 (by neighborhood)	171	219	675	37	--	1,102
Racial Breakdown of NYC DASP-Sold Mortgages by percentage – 2012 to 2014 (by neighborhood)	15.5%	19.9%	61.3%	3.5%	--	100%

And it is Southeast Queens and eastern Brooklyn that are unfairly bearing the brunt of HUD's Note Sale Program. The eight neighborhoods most affected by HUD's Note Sale Program have been:

(1) Springfield Gardens (black population of 86.9%);
(2) Canarsie (black population of 85.4%);
(3) St. Albans (black population of 88.9%);
(4) Jamaica (black population of 64.9%);
(5) Rosedale (black population of 85.5%);
(6) Laurelton (black population of 92.2%);
(7) East New York (black population of 65.7%);
(8) Flatbush (black population of 89.9%);

HUD's Note Sale Program, with its disproportionate impact on these communities, ensures that the economic recovery will not be shared equally by all neighborhoods across New York City. Further, selling these mortgages to hedge fund and private equity firms that offer only predatory modifications, if they offer anything at all, guarantees that the plague of foreclosures that has long decimated African-American communities, and the resultant neighborhood blight, will persist. The racial wealth gap, a gap that historically is the result of the denial of property ownership to African Americans, will further increase.

The Damage Done: When Private Equity is the Sole Purchaser in HUD's Note Sales

In its design, the Note Sale Program enables purchasers of distressed assets, who purchase the notes at a discount, to pass some of the savings on to borrowers while still making a profit from a modification. Purchasers could forgive principal, or modify loans on terms more favorable than FHA's Home Affordable Modification Program ("HAMP"), and still generate a revenue stream from the modified payments that exceeds the cost of purchasing the notes. In execution, the program has been a give-away to private equity firms. Purchasers like Lone Star have exploited HUD's lax oversight, by not only retaining the discount and steadfastly refusing to forgive any principal, but by modifying loans on terms even *worse* than what is required under HUD guidelines. When municipalities and nonprofits do not purchase the notes, homeowners are almost invariably worse off after a Note Sale. Thus far, the benefits of the Note Sale Program have accrued exclusively to private equity, at the expense of homeowners who finance the Insurance Fund with their monthly premiums.

Joseph Washington's struggle to modify his mortgage highlights the pitfalls of leaving private equity purchasers unmonitored. At age 18, Mr. Washington began working in New York City's meat industry, first as a wholesaler and then as a butcher. Thirty years of diligent saving enabled him to purchase his first home in the St. Albans section of Queens, a community that has long been a bastion of African-American homeownership. His FHA-insured mortgage had a fixed, affordable interest rate of 4.5 percent over the life of the 30-year loan. After a family member moved out of the house in November of 2013, Mr. Washington defaulted on his mortgage. Within months of his default, he applied for a modification through his FHA mortgage servicer, LoanCare. At the time he submitted this application, Mr. Washington was eligible for a FHA-HAMP modification, one that would have produced an affordable monthly payment of $1,205.59 for principal and interest, a loan term of 360 months, and an interest rate of 4.375

percent. LoanCare initially denied that application in April of 2014, claiming, without justification, that a modification of his loan did not "meet Investor requirements" – even though no investor owned his loan, and he otherwise satisfied all of the requirements for a FHA-HAMP modification.

Undaunted, Mr. Washington continued to apply for a modification through LoanCare. In August of 2014, LoanCare offered him a forbearance plan in which he would make reduced monthly payments in lieu of his regular mortgage payment, and promised that at the end of this forbearance plan, it would review him for a loan modification. As with its initial decision, LoanCare's offer did not conform to HUD guidelines and the forbearance plan it offered bore no semblance to the kinds of forbearance plans authorized under HUD guidelines. Mr. Washington accepted this offer. Unbeknownst to him, however, his loan had been sold on July 17, 2014, and servicing rights had already been transferred to Caliber.

Although Caliber eventually approved him for a modification, that modification was a windfall to Caliber and will ultimately cost Mr. Washington his home. Unlike a fully amortizing FHA-HAMP modification, Caliber's loan modification has a five-year interest only period. That interest-only payment is $1,280.09, which exceeds the fully amortizing principal and interest payment he would have made with a FHA-HAMP modification. His interest rate during this interest-only period is now 4.88 percent—higher than the FHA-modification he should have received from LoanCare, and even higher than the original note rate. After the five-year interest-only period lapses, Mr. Washington's loan will revert to the original loan terms. Since the length of the loan term remains unchanged, and since he will not have paid down any principal during the interest-only period, Mr. Washington will have to pay off his principal over an even shorter period of time than what is contemplated in the original note. As a result, his mortgage payment will spike by about $653 when the interest-only period ends in September 2020. Mr. Washington

does not expect any dramatic increase in his income over the next three years. Caliber has therefore positioned him to yet again default on his mortgage. Meanwhile, Caliber will collect five years of interest-only payments, amounting to $76,805.40. And when Mr. Washington defaults, Caliber can then pursue foreclosure on a property that is now worth approximately $406,720. Rather than offer Mr. Washington a modification that keeps him and his family in the home, it has instead secured for itself a fixed income stream at above-market interest rates, and an opportunity to foreclose in five years.

Mr. Washington's circumstances are not unique. Caliber continues to offer borrowers interest-only modifications,[10] even though HUD, on April 24, 2015, required note purchasers to offer a HAMP or HAMP-like modification product. But Caliber's loan modification decisions make no mention of this HAMP or HAMP-like product, and Caliber maintains that it offers no such modification program, in violation of HUD guidelines and federal servicing law. Caliber remains impervious to the near-certain consequences of its unaffordable modification programs. When confronted with the spike in mortgage payments, Caliber dismisses homeowner concerns by claiming that they can refinance their loans before the five-year period comes to end. These predatory terms, and single-minded focus on short-term profits over long-term financial stability, replicates the very worst practices that precipitated the foreclosure crisis.

The Importance of the Community Restoration Program To Community Stabilization

Private equity purchasers not only imperil individual homeownership, but in their relentless pursuit of short-term profit, they jeopardize entire communities. As explained above, the Note Sales are concentrated in New York City neighborhoods with large African-American

[10] In addition to this interest-only modification, Caliber also offers borrowers modifications in which they pay down principal and interest during the five-year period. However, the interest rate still exceeds the market rate, and Caliber does not extend the loan term. This modification program, though better than the interest-only modification, falls far short of a HAMP or HAMP-like modification.

populations. A proliferation of unaffordable modifications in these communities can contribute to a foreclosure death-spiral, as foreclosures drive down property values, and lead to possible blight and abandonment. Yet, the very same concentration of Note Sales offers a unique opportunity to municipalities and nonprofits. Just as Caliber's predatory products do greater damage when targeted to certain neighborhoods, a program that offers affordable modifications within these neighborhoods could trigger the opposite effect. The kinds of modifications that municipalities and nonprofits offer, which would preserve homeownership, would increase neighborhood stability, protect property values and start to reduce the racial wealth gap.

Municipalities and nonprofits, however, are at a disadvantage when competing against private equity in these Note Sale auctions. By including in the auction homeowners with steady income—homeowners who should have received FHA-HAMP modifications, like Mr. Washington—HUD makes the pools more attractive to for-profit purchasers. A note that can generate a stream of above-market interest payments, like Mr. Washington's note, is more valuable than a note that requires some forgiveness for the homeowner to afford a modified payment. HUD's neglect when assembling the pools, by not verifying that homeowners have exhausted FHA's loan modification options, drives up the cost of these pools. And when HUD neglects to enforce its own guidance after the sales, which requires Note Sale purchasers to offer HAMP or HAMP-like products, it similarly disadvantages municipalities and nonprofits. The private equity purchasers can impose ever more onerous terms on homeowners, and generate ever greater profits from these predatory products, which means that they can afford to pay more than the municipalities and nonprofits that abide by HUD's guidance and try to keep homeowners in the their homes with affordable modifications. In fact, recent bank settlements have skewed the playing field even further. In its January 17, 2017 settlement with the Department of Justice, Deutsche Bank will receive credit for lending money to private equity firms so that those firms

can purchase distressed assets.[11] This makes City funding for nonprofit and municipal purchases – such as the Community Restoration Program - even more important to sustainable neighborhoods in New York City.

Recommendations to Ensure New York City Neighborhoods Prosper Equally

In June 1997, Lucille Mason achieved the American dream through the purchase of her very first home in Canarsie, Brooklyn, where she and her children still live. She specifically chose Canarsie because of the stability offered by the neighborhood. In January 2010, she refinanced her home through an FHA-insured mortgage with Chase.

In summer 2012, due to a medical condition, Ms. Mason was forced to take several weeks of unpaid leave. At the same time, her tenants stopped paying rent. As a result of these combined, unexpected hardships, Ms. Mason was unable to keep up with her mortgage payments. Once Ms. Mason returned to work, she tried to make payments, but Chase rejected them. Although the FHA mortgage program requires, when a homeowner falls behind, that mortgage servicers attempt a face-to-face interview, provide written information on how to apply for a modification, and to issue a list of housing counselors and legal services, Chase never did any of these things for Ms. Mason.

Instead, it was only through meeting with her Councilmember that Ms. Mason even found out she could apply for a modification—which she did. While Ms. Mason's modification application was pending in March 2013, Chase sued Ms. Mason in a foreclosure. Ms. Mason continued her quest for a modification by submitting the requested documents over and over again, but Chase never made a decision on her application.

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[11] Matt Scully, *Deutsche Bank Eyes Private Equity Help in U.S. Settlement*, Bloomberg, Jan. 4, 2017 (*available at* https://www.bloomberg.com/news/articles/2017-01-04/deutsche-bank-said-to-eye-private-equity-help-in-u-s-settlement).

Like countless other FHA homeowners, in June 2014, while she was still applying for a modification, Ms. Mason's loan was sold out of the FHA program without her knowledge. Rather than receive a modification, Ms. Mason was forced to accept a new servicer, Caliber, and to re-apply for a modification. In April 2016, Caliber offered Ms. Mason a trial plan for a five-year interest-only modification. However, the reality of an interest-only modification is that it only temporarily lowers the payments without providing a long term solution. After the five-year period, Ms. Mason's principal and interest payments would increase by $1,592.53. At 73 years old and facing retirement, Ms. Mason knew she would ultimately lose her home if she accepted Caliber's offer. She is now in the process of asking Caliber to review her for an affordable HAMP or HAMP-like modification that will preserve her home for her and her children.

Long-time New York City residents like Ms. Mason and Mr. Washington, who continue their struggle to save their homes, are at the mercy of private equity's profits. By continuing to allow hedge funds and private equity firms to purchase FHA-insured mortgages, HUD puts individuals and entire neighborhoods at risk, threatening their stability with unaffordable loans. The only way to keep these mortgages out of investors' hands is for government and nonprofit entities to purchase these loans. As a result, MFY offers the following recommendations:

1. Continue to Fund the Community Restoration Program. Given the inherent inequities in HUD's Note Sale Program, initiatives like the Community Restoration Fund are the only way to give nonprofits and municipalities a leg up in their competition with the private sector and reverse the adverse affects of the Note Sale Program in African-American communities. It is only sales to nonprofit and governmental entities that will promote and preserve homeownership and stability in New York City neighborhoods.

2. Pressure HUD to Increase its Nonprofit Sales. Although HUD decides which loans will be sold in which sales, we ask the Council to continue urging HUD not to sell loans for which

a home-saving solution is available. We thank the Councilmembers who signed on to the September 8, 2016 letter calling on HUD to stop Note Sales to hedge funds and investors, and instead to make more loans available for purchase at a competitive price to government and nonprofit entities.

3. Demand that New York City Public Pension Funds Divest From Lone Star. Several New York City Public Pension Funds are now invested in Lone Star, including the New York City Teachers' Retirement System, New York City Board of Education Retirement System, New York City Employees' Retirement System, New York City Fire Pension Fund, and the New York City Police Pension Fund.[12] These investments mean that some of the very same New York City residents who fall victim to Caliber may indirectly fund their predatory practices. Divestment would not only limit the funds Lone Star has available to purchase notes, but it would also pressure Caliber to follow HUD guidelines and offer affordable modifications.

4. Pressure HUD to Provide Notice to Homeowners Immediately Before Their Mortgages Are Sold. Although homeowners have paid to be a part of the FHA mortgage program, they have no say when their mortgage is about to be sold out of the program. In a September 8, 2016 press conference, Councilmembers called on HUD to provide notice to homeowners, so they can tell their side of the story as to whether their homes can be saved. MFY has found too many homeowners who were actively applying for a modification -- and should have gotten one -- when their mortgage was sold out of the FHA mortgage program after their mortgage servicers self-certified that the homeowners did not qualify for a modification.

5. Demand the Congressional Delegation to Open an Investigation. Lastly, we ask that the Chair of the Committee on Housing and Buildings write a letter to the New York

[12] The current market value of these investments is $462,822,017, with an additional $138,900,000 in capital commitments.

Congressional Delegation urging them to call on HUD's Office of the Inspector General ("OIG") to conduct an investigation into HUD’s Note Sale Program. In particular, the OIG should investigate to what degree FHA-mortgage servicers are submitting false self-certifications and what happens to the loans after they are sold.

Finally, MFY thanks the Council for taking the time to evaluate the City’s purchase of distressed FHA loans and encourages the Council to continue supporting the ongoing efforts of municipalities and nonprofit organizations to purchase FHA-insured mortgages. MFY is committed to working with the City Council to better protect homeowners and preserve long-term homeownership in New York City, particularly in communities of color who rely upon their homes as a source of generational wealth and help limit the ever-increasing economic inequalities of this City. Thank you for holding today’s hearing and for considering this important issue.

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